The Legitimacy of Global Financial Regulation and Post-Crisis Reform

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Declaration

I hereby declare that this thesis represents my own work. Where information has been derived from other sources, I confirm that this has been duly acknowledged in the thesis.

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Abstract

This thesis examines the importance of legitimacy in international financial regulation and post-crisis regulatory reform by analyzing the theories of legitimacy in the disciplines of law, economics, politics, and international relations, and applying the principles of legitimacy to the analysis of the financial regulatory reform after the global financial crisis of 2008. It argues that legitimacy plays an imperative role in achieving the sustainability of the global financial regulatory system as legitimacy promotes the fairness of the rulemaking procedure and the reasonableness of substantive policy actions. Legitimacy of financial rulemaking is particularly important at the international level contrary to the conventional assumptions that legitimacy is a static concept, confined to established legislations. The absence of central governance and enforcement mechanisms at the international level warrants a higher level of legitimacy in the rulemaking procedure and substantive policy actions in international financial rulemaking. In particular, this thesis analyzes the relevance of legitimacy to financial regulation, identifies the principles of legitimacy applicable to financial regulation, assesses the legitimacy of the post-crisis financial regulatory reform with a focus on the reform of the global financial architecture, and demonstrates the nexus between legitimacy and sustainability of financial regulation in the digital era. The findings suggest that legitimacy is imperative in global financial regulation and post-crisis reform as an interactive concept, and emergency responses should be distinguished from post-crisis regulatory reform as their policy priorities and objectives are not identical. For general principles of legitimacy in financial regulation, the responsiveness, efficacy, integrity, and reasonableness of law and regulatory reform should be thoroughly considered. As these principles are based on the interactive and reciprocal relationship between regulators and citizens, an in-depth understanding of the concept of stakeholders in financial regulation is required. An empirical analysis of the legitimacy of international financial architecture reform in the post-financial crisis of 2008 demonstrates that the existing international financial governance systems lack legitimacy in many aspects, including the heavy reliance on soft law networks and the mismatch between participation and influence. It is necessary to improve the procedural fairness of global financial rulemaking by incorporating strengthened administrative rules and giving the stakeholders with legitimate interests access to the international financial rulemaking process. Recently, the rapid digitalization in the financial sector has brought critical implications to the legitimacy of financial regulation in the digital era as the global economy has strived to meet the new challenges posed by digital transformation. The growth of Fintech as a new business model has caused the reconfiguration of the traditional boundaries of financial regulation in several ways. Therefore, a comprehensive understanding of the regulatory ecosystem is essential for the long-term sustainability of the global economy, and the legitimate principles of financial regulation should be taken more seriously as guiding principles. In this regard, the role of international financial governance organizations is key to sharing information and aligning policy responses between regulators to address systemic risks that threaten the resilience and sustainability of global financial systems.

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Table of Contents

PART I Introduction

Chapter 1 Overview

While the global financial crisis of 2008 followed a myriad of past financial crises and demonstrated the typical vicious cycle of boom and bursts in financial markets like many other precedents, it revealed two key features that distinguished it from the past crises.[1] First, the massive spillover effect of the credit crisis that started on Wall Street following the fall of global financial intermediaries to the entire world economy demonstrated that the modern financial market is global, and capital is highly mobile more than had been perceived.[2] Second, it was a crisis of financial regulation as the traditional structure and approach to financial supervision tragically failed to properly perceive the nature and operational risks of modern financial markets including the complexity of financial products.[3] Amid severe public resentment of the apparent regulatory failure and the urgent need to restore confidence in the financial market, leading economies have adopted ambitious reform measures for regulatory overhaul and have put in place institutional changes to strengthen surveillance.[4] At the global level, the Basel III accord set the main ground for the new post-crisis banking regulations, among others. Nevertheless, after a decade of embarking on ambitious reforms, it is unclear whether the regulatory reform efforts, both at the national and international levels, have successfully

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[1] See Ross Buckley and Douglass Arner, *From Crisis to Crisis: The Global Financial System and Regulatory Failure* (Wolters Kluwer 2011). See also, Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press 2008); Markus Brunnermeier et al., *Fundamental Principles of Financial Regulation* (CEPR 2009).

[2] Ethiopis Tafara, 'Foreword: Observations about the Crisis and Reform' in Eilis Ferran and others (eds), *The Regulatory Aftermath of the Global Financial Crisis* (CUP 2012) xi-xxvi.

[3] Ibid.

[4] Eilis Ferran, 'Crisis-Driven Regulatory Reform: Where in the World is the EU Going?' in Eilis Ferran et al. (eds), *The Regulatory Aftermath of the Global Financial Crisis* (CUP 2012) 1-2.

addressed the fundamental causes of the financial crisis and improved the resilience of the global economy.[5] In particular, the global health crisis caused by the COVID-19 pandemic demonstrated how vulnerable the global economy was even after a decade of ambitious financial regulatory reform efforts. The chronic issues of income inequality and unequal access to quality financial services have escalated during the lockdown. The lack of access to digital platforms for most of the global population was certainly worrisome as the digital divide will likely accelerate the inequality of economic and social opportunities. As the COVID-19 pandemic which started as a global health and environmental crisis became a global macroeconomic crisis, it is reasonable to ask whether the post-crisis reforms have made the global economy more resilient to address new challenges or unreasonably allocated the limited public resources for the benefit of the financial incumbents under the aim of financial stability at the cost of social cohesion and economic sustainability.

As to the adequateness of the post-crisis regulatory reform, this research hypothesizes that the post-crisis reforms have exclusively focused on changing technical rules and requirements while paying insufficient attention to fundamental problems of international financial regulation and governance by addressing the legitimacy of rules and regulations that direct financial institutions' overarching business conduct and governance structure. Legitimacy is a crucial concept in financial regulation and reform not only in the sense of limiting the regulatory power within the scope of entrusted competence and enhancing the accountability of regulators but also in achieving the efficacy of reform by improving compliance and avoiding astray of policies which are particularly important for reducing regulatory uncertainty

[5] Kern Alexander, *Principles of Banking Regulation* (CUP 2019) 77.

in the economy. Against this backdrop, this thesis first analyzes the concept of legitimacy in financial regulation from an interdisciplinary perspective of legal philosophy, economic theory, politics, and international relations to examine the importance of legitimacy in the discourse of financial regulation and to identify the legitimate principles of financial regulation (Chapters 2 and 3). This analysis will set the ground for the following discussions in this thesis because understanding the meaning of legitimacy in financial regulation is a prerequisite for identifying the legitimate principles of financial regulation, among various ideas and approaches regarding the principles of financial regulation. Then, it examines whether the legitimate principles of financial regulation were properly applied in the post-crisis global financial rulemaking process, focusing on the post-crisis reform of the international financial architecture (Chapter 4). Furthermore, considering the changing regulatory landscape due to the impact of massive digital transformation on financial markets, it analyzes the legitimate principles of financial regulation in the digital era and the role of global financial governance organizations in achieving sustainability objectives (Chapter 5).

The rest of this chapter discusses the problem of global regulatory failure as revealed by the global financial crisis, the missing agendas in the discourse of post-crisis financial regulatory reform, the hypothesis and originality of the thesis, and the scope of analysis and methodology.

1.1 The Global Financial Crisis and the Failure of Global Financial Regulation

The global financial crisis of 2008 demonstrated that the degree of interconnectedness between financial markets is much higher compared to the lower level of international cooperation for the cross-border financial regulatory systems.[6] As financial distress quickly spread to the entire world economy and deteriorated the economies of developed and developing countries alike, stronger cooperation at the international level became more than essential. The importance of restraining financial instability requires stronger international cooperation as the objective of financial stability cannot be realized by the act of any single country. The systemic risks posed by internationally active financial intermediaries cannot be controlled effectively without internationally agreed standards of supervision and policy coordination between host and home countries. Cross-border regulatory coordination is considered inevitable to reduce the risk of the systemic downfall of financial markets and discourage regulatory arbitrage.[7] In the aftermath of the global financial crisis of 2008, thus, supranational regulations and trans-governmental networks have become increasingly important albeit the legal rules promulgated at the international level have to be implemented and enforced at a national or regional level to be effective.[8] Among others, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) have taken primary roles in adopting international regulatory standards to address macro-prudential risks under the G20 leaders' commitments to strengthen national and international oversight institutions and continuing intergovernmental coordination to restore the stability of financial markets.[9] This realization and progress in international

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[6] It was the intention of the architectures of the post-war financial system who wanted to keep finance essentially national. See Buckley and Arner, *From Crisis to Crisis* (n 1) 3-5; Christian Tietje, 'The Role of Law in Monetary Affairs: Taking Stock' in Thomas Cottier, Rosa M Lastra, and Christian Tietje (eds), *The Rule of Law in Monetary Affairs* (CUP 2014) 15-16.

[7] Jennifer G Hill, 'Why Did Australia Fare So Well in The Global Financial Crisis?' in Eilis Ferran and others (eds), *The Regulatory Aftermath of the Global Financial Crisis* (CUP 2012) 226; Chris Brummer, 'How International Financial Law Works (and How It Doesn't)' (2011) 99 Georgetown Law Journal 257, 290-295.

[8] Hill, 'Why Did Australia Fare So Well' (n 7); Chris Brummer, 'Post-American Securities Regulation' (2010) 98 California Law Review 327; Pierre-Hugues Verdier, 'Mutual Recognition in International Finance' (2011) 52 Harvard International Law Journal 55.

[9] Kern Alexander, 'The European Central Bank and Banking Supervision: The Regulatory Limits of the Single Supervisory Mechanism' (2016) 3 ECFR 467; Colin I Bradford and Johannes F Linn, 'The April 2009 G20 Summit in Retrospect' (The Brookings Institute 2010) <www.brookings.edu/opinions/the-april-2009-london-g-20-summit-in-retrospect/> accessed 15 December 2019.

financial regulatory cooperation are overdue as the global scale and scope of the financial crisis warrant financial regulatory reforms at the international level.

Moreover, the global financial crisis of 2008 revealed that the traditional structure and approach to financial supervision tragically failed to properly perceive the nature and operational risks of modern financial markets as well as the complexity of financial products.[10] As Reinhart and Rogoff (2008) put it, it was hardly imagined in the run-up to the 2008 financial crisis that the U.S. could have a financial crisis resembling that of an emerging market.[11] This confidence of the time in the U.S. financial market was largely based on the prevailing belief in the superiority of the financial system along with a better understanding of monetary policy and the phenomenon of securitized debt.[12]

However, when the U.S. government poured out an enormous amount of money to save the failing banks to resist the collapse of the entire economic system and proposed several new pieces of legislation to overhaul the regulatory system at an unprecedented scale, such policy actions manifested the regulatory failure of the most advanced economy regardless of the result of the policy interventions or the level of commitments to withhold financial turmoil. On this front, Tucker (2014) put it bluntly that the crisis would not have been so deep and long-lasting if the core of the financial system had not been so weak, and that the authorities failed to realize that the state of global imbalances, unusually low risk-free real interest rates and elevated asset values, compressed risk premia in credit markets, and accumulating household debt call for a

[10] Tafara, 'Foreword' (n 2) xi-xii.
[11] Reinhart and Rogoff, *This Time Is Different* (n 1).
[12] Ibid.

much more resilient banking system.[13] At the global level, it would be enough to remind that the leaders of G20 at the 2009 London Summit stated that "major failures in the financial sector and financial regulation and supervision were fundamental causes of the crisis."[14] The immediate criticism was targeted at the irresponsible financiers who devised and sold complicated financial instruments, such as collateralized debt obligations (CDOs), without appropriate disclosure of potential risks, and credit rating agencies who shared the incentives of giving higher ratings to the financial products than they ought to be given.[15] However, the ultimate responsibility for the worldwide financial disaster should be laid down to the regulators entrusted to oversee the soundness of the overall system with an adequate level of understanding of the nature and progress of financial markets. This does not necessarily mean that the financial regulators should have "predicted" the crisis beforehand using econometric tools and other forecasting methodologies. It is quite the opposite. There had been too much reliance on economic modeling to test and prove the resilience of financial institutions which easily have given a skewed picture of the impending risks of both individual institutions and the entire system. Moreover, those efforts could not adequately capture the status of financial markets as interconnected systems.[16]

[13] See Paul Tucker, 'Regulatory Reform, Stability, and Central Banking' (2014) Hutchins Center on Fiscal & Monetary Policy at Brookings.

[14] G20 Research Group, 'London Summit: Leaders' Statement' (G20 2009). <http://www.g20.utoronto.ca/2009/2009communique0402.pdf> accessed 10 October 2019. See also, Zhao Xijun, 'Financial Regulation Reform and Financial Stability' in Daniel Remler and Ye Yu (eds), *Parallel Perspectives on the Global Economic Order* (CSIS and SIIS 2017) 26-28.

[15] Ross Buckley, 'Reconceptualizing the Regulation of Global Finance' (2016) 36 Oxford Journal of Legal Studies 242, 252. See also, Lawrence J White, 'The Credit Ratings Agencies and the Subprime Debacle' (2009) 21 Critical Review 389; *Crash Course: The Origins of the Financial Crisis* (The Economist 2013).

[16] Barry Eichengreen*, Toward A New International Financial Architecture: A Practical Post-Asia Agenda* (Institute for International Economics 1999). In this book, Eichengreen describes the imperfection of predicting crisis by comparing it to the exercise of predicting earthquakes, and argues that the international policy community should not spend too much resources on crisis prediction as the early-warning exercises will produce an unwarranted sense of complacency in the official community by giving false confidence.

Indeed, some of the key criticisms against the regulatory community both at home and abroad include their lack of understanding of the fundamental changes of modern financial markets and adapting to them following the most up-to-date financial innovation and new business models. In line with this, one of the key sources of regulatory failure came from the prevailing approach to prudential financial regulation, which focused on the stability of individual financial institutions and their exposure to risks while overlooking the systemic risks caused by the correlation of individual risks to the structured financial markets.[17] Thus, the importance of macro-prudential regulation was highly emphasized in the aftermath of the global financial crisis. In academic literature, many observers emphasized the importance of systemic risks and called for stronger macro-prudential regulation as the previous regulatory focus on micro-prudential risks undermined the capacity of understanding systemic risks.[18] Still, others are cautious of the paradoxes of using macroprudential tools considering the potential political backlash.[19]

Another cause of regulatory failure can be attributed to the weak accountability mechanism of the regulatory agencies and the reluctance of regulators to raise warning flags in good times when everyone is optimistic and the political support for tightening would be low compared to the post-crisis period.[20] There has been increasing literature on the issue of independence and accountability of regulatory agencies, including the governance structure of regulatory

[17] Kern Alexander, 'Bank Capital Management and Macro-prudential Regulation' [2012] *ZBB/JBB* 331, 331-333; Tafara, (n 2) xi-xii

[18] See generally, Alexander, 'Bank Capital Management' (n 17); Brunnermeier et al., *Fundamental Principles of Financial Regulation* (n 1); Sudipto Karmakar, 'Macroprudential Regulation and Macroeconomic Activity' (2016) 25 Journal of Financial Stability 166.

[19] Andrew Baker, 'The Bankers' Paradox: The Political Economy of Macroprudential Regulation' (2015) Systemic Risk Centre Discussion Paper No. 37.

[20] Brunnermeier et al., *Fundamental Principles of Financial Regulation* (n 1) 36.

institutions.[21] However, such discussions in the existing literature are generally limited to the issue of providing checks and balances on regulatory agencies by applying corporate governance components to public institutions while the more fundamental aspect of regulatory competency and legitimacy of regulatory approaches and policy measures are not critically analyzed in the context of post-crisis regulatory reforms. Without a profound analysis and understanding of these fundamental aspects of the systemic structure of regulation in a market economy, it is hard to fully grasp the appropriateness of the present regulatory system including the ongoing reforms. For the same reason, it would be hard to avoid the recurrence of similar causes and effects of financial crises one after another.[22] The lost appetite for reform from policymakers, businesses, and investors in relatively good times often leads to the recurrence of financial crises. In this term, the former Bank of England governor Mervyn King, who was in office during the devastating financial crisis of 2008 and the deep economic recession in its aftermath, stated at the 2019 annual meeting of the International Monetary Fund that "there had been no fundamental questioning of the ideas that led to the crisis of a decade ago."[23] As to the significance of the recurrence of financial crises, Lord King rightly pointed out that the recurrence of economic and financial crises would devastate the legitimacy of a "democratic market system" and that the basic ideas underpinning economic policy should be challenged to

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[21] See generally, Michael Barr, 'Comment: Accountability and Independence in Financial Regulation: Checks and Balances, Public Engagement and Other Innovations' (2015) 78 Law and Contemp. Probs.119; Hadar Jabotinsky and Mathias Siems, 'How to Regulate the Regulators: Applying Principles of Good Corporate Governance to Financial Regulatory Institutions' (2017) Law Working Paper No. 354, ECGI Working Paper Series in Law.

[22] Indeed, the periodical occurrence of financial crises over the past decades, including the Latin American sovereign debt crisis in 1982, the savings and loans crisis in the U.S. in the 1980s and the early 1990s, the stock market crash in 1987, the Asian financial crisis in 1997, and the dotcom bubble from 1999 to 2000, and the global financial crisis in 2007-2008, has convinced many observers that the root causes of financial crises have not been fully redressed despite lessons learned from the past crises.

[23] Mervyn King, 'The World Turned Upside Down: Economic Policy in Turbulent Times' [2019] The Per Jacobsson Lecture at the IMF Annual Meeting 2. See also, Larry Elliott, 'World Economy is Sleepwalking into a New Financial Crisis, Warns Mervyn King' *The Guardian* (London, 20 October 2019) <www.theguardian.com/business/2019/oct/20/world-sleepwalking-to-another-financial-crisis-says-mervyn-king> accessed 20 March 2020.

solve the structural weakness of the global economy.[24] After a decade of the global financial crisis that was not well anticipated and prepared to meet, it is more than timely to reconsider the appropriateness of the regulatory responses to the regulatory failure in financial markets a decade ago and see whether a plethora of reform proposals and subsequent policy actions in the aftermath of the crisis have made us less vulnerable to another possible crisis of the future. For this evaluation, it is necessary to understand that the potential risks of financial disturbances of tomorrow can be quite different from what we had to struggle with a decade ago. This is even more so as the recent digital transformation in financial markets, epitomized by the rise of Fintech, has reshaped the policy concerns and objectives of financial regulation and presented new types of risks and policy concerns. With the growing dominance of global big-tech companies in financial services, the role of international standard-setting bodies has become more imperative.

1.2 Missing Agendas in Post-Crisis Financial Regulatory Reforms

Amid severe public resentment of the apparent regulatory failure and the urgent need to restore confidence in the financial market, leading economies have adopted ambitious reform measures for regulatory overhaul and have put in place institutional changes to strengthen surveillance in the aftermath of the global financial crisis of 2008.[25] For example, the U.S. has enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 ("Dodd-Frank Act" henceforth) as an ambitious reform package to reform Wall Street and strengthen financial regulation in response to problems raised by the global financial crisis of 2008.[26] As one of

[24] Ibid.
[25] Ferran, 'Crisis-Driven Regulatory Reform' (n 4) 1-2.
[26] Pub. L. No. 111-203, 124 Stat. 1376 (2010). Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank Act 2010).

the most comprehensive and far-reaching post-crisis legislation in the U.S., the extensive scope of the Dodd-Frank Act was meant to create a more stable financial system and provide better protection for consumers and investors while its effectiveness is subject to ongoing debates.[27] Likewise, the E.U. has passed a plethora of regulations on a measure-by-measure basis.[28] At the global level, the Basel III accord set the main ground for the new post-crisis banking regulations among others. Considering the destructive impact of the crisis on the global economy as a whole, most of the major changes in financial regulatory structures such as establishing new regulatory agencies or the restructuring of existing financial regulatory institutions should have been unavoidable. Likewise, more sophisticated rules or coverage of regulations for financial instruments would possibly have improved the capacity of supervisory systems to deter the potential of another systemic failure caused by systemically important financial intermediaries (SIFIs).[29] Nevertheless, it is not clear whether the regulatory reform efforts have contributed to the economic recovery of a handful of countries such as the U.S. For example, the economic recovery of the U.S. is largely comprehended as a result of using expansionary monetary policy, such as quantitative easing (QE), based on its exorbitant privilege of having the dollar as the world's reserve currency, rather than that of effective structural regulatory reforms.[30] More importantly, the devastating social impact of the financial crisis and the increasing level of income inequality even after years of financial regulatory reforms pose serious doubts on the efficacy of the post-crisis reforms. Furthermore,

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[27] Baird Webel, 'The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary' (2017) Congressional Research Service Report.

[28] There is a large volume of literature on the regulatory reform measures taken place in the EU after the global financial crisis of 2008. See generally, Ferran (n 4); Emilios Avgouleas, *Governance of Global Financial Markets* (CUP 2012).

[29] For the stringent financial regulation on the role of securitization in the post-crisis financial system, see Tobias Adrian and Hyun Song Shin, 'The Shadow Banking System: Implications for Financial Regulation' (2009) Federal Reserve Bank of New York Staff Report No. 382.

[30] See generally, Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and The Future of the International Monetary System* (OUP 2011).

it is questionable whether the recovery of financial stability, gained by pouring an enormous amount of public funds not only into the US but also into other crisis-hit economies, has benefited society as a whole or disproportionately allocated resources for the interest of the ailing financial institutions whose recovery added little value to economic and social prosperity as a whole.[31] Indeed, the global health crisis caused by the COVID-19 pandemic demonstrated the vulnerability of the global economy after a decade of ambitious financial regulatory reform efforts. The chronic issues of income inequality and unequal access to quality financial services have been escalating during the lockdown. Moreover, the heavy reliance on digital financial channels and services due to the increased social distancing revealed the crude reality that even the most advanced economies have not been ready to adapt to the unforeseen challenges after years of promoting digital finance and inclusion. Undeniably, many of the ambitious reform measures have been downsized or lagged at the stage of implementation or enforcement as the economic uproar due to the financial crisis gradually stabilized and the political enthusiasm for a fundamental restructuring of the financial regulatory framework placated while the organized power of financial communities regains dominance in lobbying for legislative alteration or exemption.[32] Thus, it is critical to ask whether the overall post-crisis regulatory reforms

[31] See Inci Otker-Robe and Anca Maria Podpiera, 'The Social Impact of Financial Crises: Evidence from the Global Financial Crisis' (2013) World Bank Policy Research Working Paper 6703. The authors provide a fine analysis of how financial crises disproportionately influence the most vulnerable segment of the population in the economy and emphasize the need for well-designed social protection policies by providing statistical evidence. Still, this study is narrowly focused on the resulting phenomenon of the crisis and does not provide the causal relationship between the design/approach of post-crisis financial regulatory reform and socio-economic stability including qualitative indicators.

[32] John Coffee, 'The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated' in Eilis Ferran and others (eds), *The Regulatory Aftermath of the Global Financial Crisis* (CUP 2012) 309-311. See generally, Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (2nd ed., Harvard University Press 1971) for a theoretical analysis on the power imbalance between organized and dispersed groups in seeking influence on legislation or regulatory policy. For a contrasting view, see Roberta Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (2015) 114 Yale Law Journal 1521.; Roberta Romano, 'Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation' (2011) 43 Hofstra Law Review 25.; Henry N Butler and Larry E Ribstein, *The Sarbanes-Oxley Debacle: What We've Learned; How to Fix* (AEI Press 2006).

adequately recognized the root causes of the crisis and the potential of recurring another financial crisis by addressing a fundamental restructuring of financial regulatory systems that could tackle the fertile ground from which the next crisis can spring.[33] There is no doubt that the painful experience of financial crises should not be wasted and the huge cost of reforming the financial regulatory systems should result in fundamental improvement of regulatory systems by removing structural flaws and preventing further mischief.[34] In this sense, it is crucial to evaluate the direct and indirect effects of the post-crisis financial regulatory reforms not only on the stability of financial markets and institutions but also on the social and economic stability of the public to determine whether the decision to pour an enormous amount of public money into bailing out the failing banks can be justified, or the post-crisis regulatory reforms should have taken different paths, preserving the momentum of growth for the wider economy.[35] The heightened emphasis on the negative impact of the rising income inequality worldwide in recent years certainly supports the need for a more thorough review of the adequacy of the post-crisis financial regulatory reforms and their impact on social and economic sustainability.

As noted earlier, it might be fair to say that the post-crisis reforms have succeeded in overseeing

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[33] Tafara, 'Foreword' (n 2) ix.

[34] Alexander, 'Bank Capital Management and Macro-Prudential Regulation' (n 17) 331. For the difficulties of theoretical analysis of the cost and benefit of regulation and the direct regulatory cost of regulation in the US and its international comparison, see Howell Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' (2007) 24 Yale Journal on Regulation 253.

[35] In this regard, Khan and Bashar conducted an empirical study on the impact of social expenditure on economic growth and showed that in the long-run social expenditures impact economic growth positively. See Habibullah Khan and Omar KMR Bashar, 'Social Expenditure and Economic Growth: Evidence from Australia and New Zealand Using Cointegration and Causality Tests' (2015) 49 The Journal of Developing Areas 285. Based on this finding, however, it will be necessary to design another research that can prove the causal link between social expenditure cuts due to the post-crisis reform and economic growth in terms of direct impact as well as lost momentum for growth as this study did not consider the particular economic conditions of the financial crisis as critical factors.

the risks posed by systemically important financial institutions (SIFIs) to some degree, and the occasional stress tests may have given a glimpse of the soundness of financial institutions to the regulators at best. While the prevailing approach to the post-crisis reforms cannot be criticized as entirely inappropriate since strengthened surveillance is certainly a necessity, this approach has made a serious mistake in simplifying the causes of the crisis. Consequently, the overall responses ended up with insufficient remedies that failed to adequately address the intrinsic reasons behind the financial institutions' excessive risk-taking behavior in certain circumstances and the legitimate purposes of financial regulations in a democratic market economy. Above all, the prevailing post-crisis approach to financial regulation explicitly focuses on restraining financial instability by identifying systemic risks posed by internationally active banks or systemically important domestic banks based on the assumption that the control of bank capital requirements or liquidity standards can prevent banks from taking excessive risks that lead to systemic risks which threaten the soundness of the entire financial system.

However, the baseline assumption of this approach lacks a holistic understanding of the nature and operation of the financial services industry. At the same time, the attempt to suppress the desire of investors to seek higher returns by taking higher risks is not an appropriate policy objective of financial regulation in a market economy. Indeed, it has been the long-lasting mistake of regulators in the history of financial markets that they believe it is achievable to control the behaviour of the market by imposing strict rules that are expected to bring back stability to the financial market.[36] Undoubtedly, this has not been the case, at least since the

[36] Brunnermeier, *Fundamental Principles of Financial Regulation* (n 1) 67-73.

demise of the Bretton Woods System in the 1970s. In retrospect, the increasing complexity of financial markets and their increasing global connectedness inevitably gave rise to regulatory arbitrage and created a never-ending spiral of rulemaking and rule-evading.[37]

It is important to note that the problem of regulatory arbitrage is not always because modern investors are prone to escaping the legal boundaries for profit maximization. Often, the unilateral command-and-control approach of regulation easily pushes the subjects of regulation to find alternatives due to the gaps between regulatory costs and incentives of compliance.[38] Therefore, it is essential to understand that the fundamental purpose of financial regulation is neither to predict a crisis nor suppress the motivation of profit-seeking in financial markets. The dynamics of market participants, between the public and the private sector as well as within the private sector, are not what the financial regulations should strive to eliminate or diminish. Instead, it is the quest for financial regulation in a democratic market economy that these very dynamics of the market function well for the benefit of the wider economy and society. Considering the inefficiency due to regulatory arbitrage and uncertainty in the financial market, it is simply not enough to criticize the practice of regulatory arbitrage of financial institutions based on moral consciousness. The root causes of such practices need to be addressed and systemic incentives for constraining the legal techniques of rule evasion should be thoroughly considered.[39]

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[37] Saule T Omarova, 'Wall Street as Community of Fate: Toward Financial Industry Self-Regulation' (2011) 159 University of Pennsylvania Law Review 411, 416.

[38] Charles Goodhart, 'The Boundary Problem in Financial Regulation' (2008) 206 National Institute Economic Review 48. It is noteworthy that "the boundary problem" is persistent in financial regulation as financial institutions who want to avoid the cost of being regulated tend to devise alternatives when the incentive of escaping the regulatory boundary is considerable.

[39] See Victor Fleischer, 'Regulatory Arbitrage' (2010) University of Colorado Law Legal Studies Research Paper No. 10-11 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567212> accessed 20 June 2019.

1.3 Hypothesis and Originality of Research

In reflection of these facts, this research hypothesizes that the post-crisis reforms have exclusively focused on changing technical rules and requirements while paying little attention to addressing the legitimacy of rules and regulations that direct the overarching operation and governance of financial institutions. As mentioned earlier, the post-crisis reform measures reaffirmed the prevailing ad-hoc style of reforms, or "reform by deals," to address immediate threats to the markets rather than taking fundamental overhauls to improve the resilience of the financial market system and regulatory structures.[40] Moreover, regulatory measures are mostly focused on financial sectors subject to formal regulatory supervision, such as banking services or securities transactions, while other important sectors that can contribute to the next financial crisis with real market impacts, such as shadow banking or digital finance, are not adequately addressed. This technical and narrowly focused approach to regulatory reforms has been dominant in post-crisis reforms. It also failed to address the fertile ground of recurring crises with comparable causes and patterns.[41] Despite the intrinsic difference in functional purposes between financial institutions and regulatory agencies, the prevailing regulatory approach in post-crisis reforms tends to be analog to the rationales of financial institutions without paying adequate attention to the legitimacy of rules and regulations governing the conduct of financial institutions based on the fundamental role of law and regulation in a democratic market economy. Legitimacy in regulatory reforms is crucial not only in enhancing the accountability of regulators by limiting the regulatory power within the scope of entrusted competence but also in achieving the efficacy of reform by improving the level of compliance. Considering the

[40] Lawrence A Cunningham and David Zaring, 'The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response' (2009) 78 George Washington Law Review 39. Also, see generally, Steven M Davidoff and David Zaring, (2009) 'Regulation by Deal: The Government's Response to the Financial Crisis' 61 Administrative Law Review 463.

[41] Buckley, 'Reconceptualizing the Regulation of Global Finance' (n 15) 244-245.

high costs of reform that are largely sourced from limited public funds, the legitimacy of post-crisis reforms should be more rigorously examined from the perspective of the role of law in a democratic market economy. In this sense, it is questionable whether the corporatist approach to governance in the financial markets regulatory system is acceptable as a legitimate way of regulation by the government.[42]

At the global level, there have been increasing debates on the legitimacy of the established global economic governance systems dominated by a few international organizations such as the World Trade Organization (WTO), the International Monetary Fund (IMF), and the World Bank (WB).[43] Mostly, the pertinent dissatisfaction with the decision-making procedure of these international organizations for being closed, inconsistent, and undemocratic while paying inadequate attention to the political, economic, and demographic impact of their decisions has led to large social movements that expressively challenge the legitimacy of such organizations.[44] In the same vein, the legitimacy of intergovernmental forums such as the G20 in setting the standards of financial regulations and best practices that ultimately affect the entire global financial markets has been constantly questioned in terms of their exclusiveness in participation. While the formation of the G20 as a premier forum of global economic governance may be laudable as it expanded the membership from the limited number of advanced economies, the G7, to including emerging economies in the discourse of global economic restructuring and governance, the restriction to wider participation and closed negotiations have caused many observers to challenge its legitimacy. For the last few decades,

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[42] Davidoff and Zaring, 'The Three or Four Approaches to Financial Regulation' (n 40) 537.
[43] Chris Brummer, *Soft Law and the Global Financial System* (CUP 2012) 183.
[44] Jonas Tallberg and Michael Zürn, 'The Legitimacy and Legitimation of International Organizations: introduction and framework' (2019) 14 The Review of International Organizations 581.

the discontent of developing countries being less represented in the above-mentioned international organizations and the dominance of a handful of wealthy countries in the discourse of setting international standards that significantly affect the economy of developing countries have been considered as a critical source of the impediment in international economic cooperation that ultimately weakens the resilience of international economic governance. However, there has been surprisingly less scrutiny on the legitimacy of post-crisis financial regulatory reforms, i.e., whether those new rules and regulations imposed as a response to the crisis have been processed in a legitimacy procedure. Moreover, whether the contents of reform are well bound to the legitimate capacity of regulators and placed with respect to the legal principles and legitimate purposes of financial regulation in the modern market economy has not been thoroughly examined.In general literature on financial regulatory reform, compared to the strong demands for a regulatory overhaul in the aftermath of the crisis, robust analyses of the impact of regulatory reforms on the recovery of the non-financial sector of the economy or its link to the growth potential of the economy, by either promoting or prohibiting innovation in the economy, are particularly rare. Instead, a large pool of literature focuses on evaluating the direct or indirect impact of post-crisis reforms on the restoration of financial market stability.[45] While many studies are assessing the post-crisis financial regulatory reforms, most of them are focused on the stability of financial markets and regulatory agency structures. Despite their values and merits in assessing the progress of post-crisis reforms, it is more than crucial to ponder whether the post-crisis reform measures have properly targeted the legitimate purposes of financial regulation and whether the regulatory agencies' power has been properly

[45] Most of these analyses are done by central banks or international financial institutions such as the IMF and BIS and look into the policies for improving financial stability. See Jonathan A Smith, Michael Grill, and Jan Hannes Lang, 'The Leverage Ratio, Risk-taking, and Bank Stability' (2017) ECB Working Paper Series No. 2079; Stijn Claessens and Laura Kodres, 'The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions' (2014) IMF Working Paper WP/14/46.

used to have a more comprehensive picture of the post-crisis regulatory structure that is adequately posed to move forward to sustainable growth and resilient economy. In particular, the existing literature on the legitimacy of financial regulatory reforms mostly focused on the legitimacy of international financial institutions or regulators as to their authority and scope of operation, rather than the contents or procedures of reform facilitated by financial regulators.[46] In this sense, a rigorous analysis of the legitimacy of post-crisis regulatory reforms and their impact on improving the sustainability and resilience of the global economy should fill the gap in this literature and provide a critical perspective on the approach and structure of global financial governance. It is expected that the findings of this research will provide a solid theoretical ground for assessing the adequateness of the ongoing reforms by identifying legitimate principles of financial regulation. In this research, a preliminary definition of legitimacy in financial regulation is that rules and regulations are designed and proceeded in the scope of the principles of democracy and market economy, the two pillars of the modern economy. In this sense, maintaining a high level of legitimacy in financial regulatory reform, both in its substance and procedure, would contribute to the achievement of the efficacy of reform by aligning diverse policy priorities and objectives, thus, reducing the costs of reform and lowering the chances of misallocation of limited resources. Therefore, analyzing the legitimacy of reform including, but not limited to, the legitimate purposes of financial

[46] For in-depth analyses on the governance and legitimacy of global financial institutions, see Avgouleas, *Governance of Global Financial Markets* (n 28); Brummer, *Soft Law and the Global Financial System* (n 43); Chris Brummer, *Minilateralism: How Trade Alliances, Soft Law, and Financial Engineering Are Defining Economic Statecraft* (CUP 2014); Rolf H Weber, 'Legitimacy of the G-20 as Global Financial Regulator' (July 2012) Society of International Economic Law Third Biennial Global Conference, National University of Singapore. Avgouleas (n 28) criticizes the dominance of soft law structures and over-reliance on private sector input in the governance of global financial markets as the cause of the global financial crisis. In contrast, Brummer (n 43 and n 46) asserts that soft law has important advantages as a coordinating mechanism in international financial markets and that the international regulatory architecture provides increasingly democratic features by incorporating administrative features and innovation allowing more inputs for legitimacy and accountability.

regulation, the competence of regulators and the scope of regulation, the alignment of reform measures with democratic principles, and the fundamental role of law and regulation in the market economy will provide a unique perspective on the evaluation of the adequacy of the post-crisis reforms and signify key areas for improvement to discontinue the reiteration of global financial crises. It is necessary to lower the possibility of misusing regulatory power and public resources influenced by the urgency of crisis or the interests of organized interest groups. Furthermore, this is particularly important in assessing the social and economic consequences of post-crisis financial regulatory reforms as the legitimacy of reform is closely linked to the prioritization of policy choices. Considering that the impact of financial institutions' business conduct on the sustainability of the global economy has become a serious policy concern in recent years, this thesis also inquires whether improving the legitimacy of international financial regulation can help support the global policy objectives of sustainable finance.

Consequently, the COVID-19 pandemic has revealed the unpleasant reality that the post-crisis financial regulatory reforms have not been sufficient to improve the resilience of the global economy and some of the measures applied to increase bank resilience have not been well translated to the resilience of the economy as a whole. If the post-crisis financial regulatory reforms paid more attention to the fundamental issues of legitimacy and approached the aim of financial stability within the context of broader economic resilience including such issues as income inequality, financial inclusion, and competitiveness of financial markets, the global economy would have been more ready to absorb the shocks caused by the pandemic. Undoubtedly, the deteriorated multilateral cooperative system certainly added problems while countries have been struggling to find ways out individually despite the interconnected nature of the causes of and solutions for the global health crisis. As the global economy needs to recover from a prolonged recession, it is timely to take an in-depth analysis of the legitimacy of financial regulation and reform.

1.4 Scope of Analysis and Methodology

For the above-described purposes and rationales of this research, the following chapters will critically analyze the legitimacy of global financial regulation and post-crisis regulatory reforms through theoretical and empirical analysis. Part II starts with a theoretical analysis of legitimacy in financial regulatory reform since it is imperative to analyze the theories of legitimacy in law and legal reform in the interdisciplinary scholarships of law, economics, politics, and international relations as this research expects to look into the alignment of post-crisis regulatory reforms to the legal principles of market-based economy and democratic values. Thus, chapter 2 examines the concept of legitimacy in financial regulation and post-crisis regulatory reform by analyzing legitimacy as legality and reasonableness. Furthermore, it discusses whether emergency response and post-crisis regulatory reform should be distinguished as to their different policy priorities and objectives. Chapter 3 discusses the legitimate principles of financial regulatory reform by exploring the universality of legitimate principles of financial regulatory reform and identifying the general principles of financial regulatory reform. In the same vein, the legitimacy of corporate governance and financial conduct reform is examined by revisiting the concept of stakeholders in corporate governance regulation and stakeholders' interests as regulatory objectives. PART III provides an empirical analysis of the regulatory responses to the global financial crisis of 2008 to see how national policymakers and international organizations have acted in the wake of the financial crisis and whether the specific policy objectives and priorities had been established based on the solid theoretical backdrop of the legitimacy of financial regulatory reforms as discussed earlier. For this, chapter 4 examines the legitimacy of international financial architecture to see whether the post-crisis regulatory reform was conducted in a fair and reasonable manner from the perspective of legitimate principles of financial regulation as identified in the earlier chapter. In particular, it analyzes legitimate principles of international rulemaking by examining the power of legitimacy in international law, the stakeholders of international financial regulation, and the legitimacy of soft law as a form of international financial standard setting. By analyzing the issue of legitimacy in the course of reform at diverse political and societal levels and how it has been reflected in policy actions and legislation, it is expected to prove whether the issue of legitimacy has a noticeable impact on the course of regulatory reforms and their contents in practice. To examine the legitimacy of the new international financial regulatory landscape, this chapter also discusses the resilience and sustainability of international financial architecture by considering the conceptual and institutional challenges in international financial architecture in the course of post-crisis regulatory reform. Considering the fast-changing regulatory landscape in financial markets due to digital transformation, chapter 5 analyzes digital transformation in financial markets and the paradigm shift in global financial regulation. It explores digitalization in financial markets by focusing on how the fintech industry's growth has led to meaningful changes in addressing critical issues in global financial regulation, including financial inclusion. Then, the legitimate principles of financial regulation in the digital era are discussed by revisiting the objectives of global financial regulation and examining the role of international financial governance organizations as policy platforms. In doing so, procedural fairness in the rulemaking process and reasonableness of substantive policies are discussed. Part IV concludes the research by recalling the significance of legitimacy in global financial regulation and highlights the importance of moral justification of regulation as uncovered throughout the research.

PART II A Theoretical Analysis of Legitimacy in Financial Regulatory Reform

This part analyses the concept of legitimacy in financial regulatory reform from a theoretical perspective. Considering the complicated nature of financial regulation and regulatory reform in the aftermath of a financial crisis, it is necessary to analyze the theories of legitimacy from an interdisciplinary perspective. Chapter 2 examines the concept of legitimacy in law and legal reform by analyzing the theories of legitimacy in law, economics, politics, and international regulations. It first discusses the concept of legitimacy as legality and reasonableness and how these concepts are related to the integrity of law and justification of authority, respectively. Then, it analyzes the distinction between emergency response and post-crisis financial regulatory reform and explores why and how these two stages should be differentiated from the perspective of legitimacy. Chapter 3 analyses the legitimate principles of financial regulatory reform in three parts. First, it discusses the universality of legitimate principles in financial regulatory reform, focusing on financial globalization, the reconceptualization of regulatory autonomy, and ethical problems of human behavior. Second, it identifies general principles of financial regulatory reform as the responsiveness, efficacy, integrity, and reasonableness of law. Third, the legitimacy of corporate governance and financial conduct regulation is discussed in relation to the evolving concepts of stakeholders and the objectives of financial regulation.

Chapter 2 Legitimacy of Financial Regulation and Post-Crisis Regulatory Reform

This chapter analyzes the theoretical concept of legitimacy in two parts. First, legitimacy as legality is analyzed by using the eight principles of legality suggested by Lon Fuller in The Morality of Law (1964). Legality refers to the integrity of the law, and the reciprocity between the lawgivers and citizens is placed at the center of the principles of legality. From the perspective of legitimacy in international law, it argues that procedural fairness in rulemaking is particularly important considering the system of reciprocity in a community of states. Second, it analyses the concept of legitimacy as reasonableness by examining the moral justification of authority. Considering law as a continuing struggle and challenge of social practice, it argues that legitimacy as reasonableness is highly relevant to the moral justification of any authority in a modern state. In this term, legitimacy is a justification principle that attaches to the authority structure and gives reasons to the citizens for acceptance or obedience.

2.1 Why Does Legitimacy Matter – Legitimacy as an Interactive Concept

A prerequisite to the analysis of legitimacy in the context of financial regulatory reform is a clear understanding of the significance and relevance of legitimacy in the discourse of lawmaking and law-applying. If legitimacy has no substantial impact in the course of lawmaking and law-applying in the real world, there should be little incentive for investigating and assessing the legitimacy of regulatory reforms. This would be more so in the case of regulatory reforms after financial crises as it is difficult to give due consideration to the legitimacy of regulatory reforms during the extreme stress caused by multiple shocks and the anxiety for stabilization in financial markets. Conversely, an even more rigorous examination of the legitimacy of regulatory approaches and policy measures, from the stage of diagnosing problems to the design and implementation of reform actions, is warranted if the impact of legitimacy on the overall course of regulatory reforms proves to be significant enough to alter the paths and consequences of reforms. As noted above, the time constraint and urgency followed by an outbreak of a financial crisis easily give a sense of exemption from going through a rigorous procedure of testing and proving the legitimacy of policy actions and instruments while such an approach often produces critical problems that have negative impacts on the economy and invokes strong demands for revision of the initial proposals afterward.[47] From this perspective, one of the possible methods of analyzing the problem of insufficient scrutiny on the legitimacy of reform in the aftermath of financial crises may include reviewing the frequency of revisions or the duration before the repeal of certain laws and legislations.[48]

Although regulatory reforms initiated after financial crises are meant to address critical problems uncovered or highlighted by the immediate crisis, they are often driven by political and emotional reactions rather than by logic and systematic consistency.[49] One of the critical problems of such an approach is that the financial regulations made in the aftermath of one

[47] Some of the most recent examples of the revision of crisis-driven regulations is the partial repeal of the Volcker Rule in the U.S. following President Trump's signing of a bill rolling back banking regulations into law in May 2018. See, Alan Rappeport and Emily Flitter, 'Congress Approves First Big Dodd-Frank Rollback' *The New York Times* (New York 22 May 2018) <https://www.nytimes.com/2018/05/22/business/congress-passes-dodd-frank-rollback-for-smaller-banks.html> accessed 17 June 2020; Jacob Pramuk, 'Trump Signs the Biggest Rollback of Bank Rules Since the Financial Crisis' CNBC (24 May 2018) <https://www.cnbc.com/2018/05/24/trump-signs-bank-bill-rolling-back-some-dodd-frank-regulations.html> accessed 17 June 2020; See generally, Cunningham and Zaring, 'The Three or Four Approaches to Financial Regulation' (n 40); Eichengreen, *Toward A New International Financial Architecture* (n 16).

[48] As to this point, Charles Calomiris states that much of the post-2008 legislation is already a likely target for repeal or at least significant modification while the reform wrought in 1932-35 in the post-Great Depression era remained in place for decades. *See* Charles Calomiris, 'Restoring the Rule of Law in Financial Regulation' (2018) 38(3) Cato Journal 701-719, 701.

[49] Kern Alexander and Steven Schwarcz, 'The Macroprudential Quandary: Unsystematic Efforts to Reform Financial Regulation' in Ross P Buckley, Emilios Avgouleas, and Douglas W Arner (eds), *Reconceptualizing Global Finance and Its Regulation* (CUP 2015) 129.

financial crisis have less relevance to the financial market sooner or later because risks of financial markets do not always spring from one or two sources, but from unforeseen or less familiar risks erupt over time with the advent of innovative financial services and products enabled by advanced technology. Such newborn or newly intensified risks cannot be adequately addressed by applying existing rules and regulations manually.

While the recurrence of financial crises has made many observers doubt the efficacy of existing approaches and policy tools in dealing with persistent problems in financial markets, there has been surprisingly less scrutiny on the legitimacy of regulatory reforms and how the legitimacy of reform influences the effectiveness of regulation in the existing discourse of financial regulatory reform. The core question here is not a simple choice between what is right and wrong as to regulatory reform measures. It is rather on what ought to be done and what ought to not be done by governments and regulatory authorities both at home and abroad according to the principles of legitimacy in regulatory reforms. Thus, it is important to clarify whether legitimacy is a static concept that merely classifies and stamps certain actions or decisions as legally acceptable based on the pre-established legal architecture or is closely linked to the ongoing responses of national governments and international financial organizations to the respective political, economic, or societal demands and issues at hand as an interactive concept. If testing and proving legitimacy have a practical influence on the course of regulatory reforms and legitimacy itself is proved to be an interactive concept of understanding and dealing with regulatory failures in financial markets, then the issue of legitimacy gets more importance when it comes to devastating financial crises. It is a part of the hypotheses of this study that legitimacy factually matters in the course of regulatory reforms as an interactive concept.

2.1.1 Legitimacy and Financial Regulatory Reform

Having said so, what would be the grounds for analyzing and determining whether legitimacy is a static and abstract idea or an interactive concept in the sphere of financial regulation? In general, two broad categories of analysis can help understand the importance of legitimacy in the discourse of financial regulatory reforms and its economic implications: first, how legitimacy is interpreted in the theory of law and jurisprudence as to the quality and principles of law, and second, how legitimacy has been used as a tool of justification as to the reasonableness of legal actions and political activities manifested through policy objectives and priorities. While the former represents the significance attached to legitimacy regarding the intrinsic quality of law and regulation in principle, the latter provides practical grounds for such contentions on legitimacy in politics and lawmaking processes by revealing how the quest for legitimation is realized by establishing or reinventing the reasonableness of laws and systems both at home and abroad. Practically, analyzing how legitimacy has been dealt with in the discourse of public policy and regulation may well provide critical insights into the importance and relevance of legitimacy to financial regulatory reforms. In this term, it is crucial to explore how the concept of legitimacy including its definitions and meanings attached to it has been perceived by regulators and the subjects and to see the multifaceted rather than singular aspects of legitimacy as a widely debated subject for the public and academic debates. Had it not been so important, why would people have contended for their versions of legitimacy anyway? As a first step, it is essential to note that the usage of the term *legitimacy* has been neither unanimous nor easily agreeable among political and legal thinkers at a fundamental level as well as politicians and administrators at a practical stage. This ambiguity of meanings attached to the term has caused the discourse of legitimacy less clear-cut as to its roots, constitutive factors, and aims. Thus, it is useful to review the definitions attached to legitimacy and distill some of the essential meanings and implications of legitimacy relevant to the discourse of financial regulations and regulatory reforms.

2.1.2 Legitimacy as Legality: The Integrity of Law

As a linguistic term, by definition, the word "legitimacy" has two quite distinct but equally important meanings. First, it means "the quality of being legal,"[50] or "conformity to the law or rules."[51] A synonym of this definition of legitimacy can be *legality* or *lawfulness,* meaning that the particular legislation or laws are equipped with the necessary qualities of law within the established framework of legislative systems. At a glance, in a democratic state that is based on established legislative systems and procedures of rulemaking, it seems less probable that legislation lacks legitimacy when it is concerned with the legality or lawfulness of the legislation as long as the systems of checks and balances are at work. However, a closer examination reveals that the quality of being legal, or the legality, of any legislation or policy measures, cannot be guaranteed only because the legal actions in question are conducted within the pre-established legal systems and regulatory structures when one considers the *internal morality of law* which implies the standards of law to be recognized and respected as legitimate. Indeed, it is too simplistic and naïve to assume that any law enacted by the authorized legislature or government institutions is equipped with the proper quality of law and accepted without question by the governed. This is also why judicial review is important and indispensable as one of the ways of checks and balances in the separation of power in a democratic state so that the rulemaking of the legislative and administrative branches should

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[50] Cambridge Dictionary, 'legitimacy' <https://dictionary.cambridge.org/dictionary/english/legitimacy> accessed 10 October 2020.
[51] Lexico: Oxford English and Spanish Dictionary, 'legitimacy' <https://www.lexico.com/definition/legitimacy> accessed 10 October 2020.

not exceed their boundaries.[52]

The very concept of *internal morality of law* is highlighted by the American legal scholar Lon Fuller (1902-1978) in his book *The Morality of Law (1964).*[53] As standards of scrutinizing the legality of the law, Fuller suggested *eight principles of legality* without which even laws enacted and enforced by established public authorities cannot be accepted and respected as sufficing the conditions of legitimacy. In the sphere of jurisprudence and legal philosophy, the relationship between morality and law has been an important subject of jurisprudential debates which have generated an intensive exchange of ideas and debates among prominent scholars of law, politics, and philosophy.[54] While the theoretical debates on the relationship between law and morality are not the main subject for analysis in this research, the specific standards of legality suggested by Fuller undoubtedly provide critical insights into the analysis of the legitimacy of financial regulation by clarifying specific qualities of law for ensuring the legitimacy of rules and regulations. Considering that many public policy measures and legal actions are often exempt from thorough scrutiny of legitimacy as to the standards of legality,

[52] See generally, David Zaring, 'Reasonable Agencies' (2010) 96 Virginia Law Review 135, 186-87; Richard J Pierce Jr and Joshua Weiss, 'An Empirical Study of Judicial Review of Agency Interpretations of Agency Rules' (2011) 63 Administrative Law Review 515; William Funk, 'Rationality Review of State Administrative Rulemaking' (1991) 43 Administrative Law Review 147.

[53] Lon L Fuller, *The Morality of Law* (rev edn, Yale University Press 1969)

[54] One of the most important scholarly debates regarding the relationship between law and morality was the Hart – Fuller debate which started with HLA Hart's Oliver Wendell Holmes Lecture at Harvard which later published in a famous book, HLA Hart, *The Concept of Law* (OUP 1961). Lon Fuller, who was then Harvard professor and one of the sponsors of Hart's lecture, replied to him by publishing his response to the Harvard Law Review: Lon L Fuller, 'Positivism and Fidelity to Law. A Reply to Professor Hart' (1958) 71 Harvard Law Review 630. Hart's lecture was also published in the same issue: HLA Hart, 'Positivism and the Separation of Law and Morals' (1958) 71 Harvard Law Review 593. Another well-known scholarly discourse on the theme was the Hart – Devlin debate in 1959 which dealt with issues such as the distinction between positive and critical morality, the separation between law and morality, and moral judgments of lawmakers. See HLA Hart, *Law, Liberty and Morality* (OUP 1963); Patrick Delvin, *The Enforcement of Morals* (OUP 1965); Peter Cane, 'Morality, Law and Conflicting Reasons for Action' (2012) 71 *The Cambridge Law Journal* 59; and Robert E Goodin, 'An Epistemic Case for Legal Moralism' (2010) 30 Oxford Journal of Legal Studies 615. See also, Gerald J Postema, *Treatise* of *Legal Philosophy in the Twentieth Century: The Common Law World* (vol 11, Springer 2011).

especially in times of emergency, it is imperative to examine the internal quality of law so that any critic or support for regulatory reform measures can be made based on a robust theoretical ground for legality.

The eight principles of legality prescribed by Fuller are as follows:

> Principle 1: The rules must be expressed in general terms ("*generality*")
>
> Principle 2: The rules must be publicly promulgated ("*promulgation*")
>
> Principle 3: The rules must be prospective in effect ("*prospective*")
>
> Principle 4: The rules must be made understandable ("*clarity*")
>
> Principle 5: The rules must be consistent with one another ("*no contradictions*")
>
> Principle 6: The rules must not require conduct beyond the powers of the affected party ("*no impossibility*")
>
> Principle 7: The rules must not be changed so frequently that the subject cannot orient his action by them ("*constancy*"), and
>
> Principle 8: The rules must be administered in a manner consistent with their wording ("*congruence*").[55]

It is interesting to note that the principles of legality do not impose value judgments on the contents of the law, such as ideology or social demands which can be susceptible to change from time to time, despite the strong emphasis on the "moral" quality of law. Instead, the criterion of legality suggested here reflects the responsibility of lawgivers in the context of institutional duties and responsibilities. In this sense, the principles of legality provided by Fuller are closely linked to the philosophy of social contract in modern society and relevant to the limited scope of legislative authorities in modern democratic states even though Fuller

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[55] Fuller, *The Morality of Law* (n 53) 39. See Chapter II of the Morality of Law (1969) for a more detailed explanation of each principle.

made an interesting analogy with an imaginary monarch named Rex whose ambitious but vain efforts to legal reform manifest the importance of taking the eight principles into account in the course of legislative actions.

At the center of the principles of legality is the *reciprocity* between the lawgiver and citizens.[56] In other words, it requires that the forms of law should embody an internal morality based on the collaborative relationships between citizens and lawgivers, including those who enforce the law, which makes fidelity to the law possible.[57] It is very interesting to note that fidelity to law is important not only in terms of its intrinsic moral value but also in connection with the degree of compliance when it comes to the issue of the effectiveness of regulatory policy measures and reforms. In practice, it is reasonable to say that the core purpose and intention of any law cannot be achieved satisfactorily unless the subjects clearly understand what they are required to do by the given law and are persuaded of its rationales and consequences. In line with this, the quality of law is closely linked to the level of compliance, and it can either increase or decrease the cost of enforcement as a result. One of the key objectives of regulation through policy instruments in a democratic market-based economy is to encourage competition and stability by means of providing direct or indirect incentives to do so. While the regulatory system of legal enforcement can be at play depending on the nature of the given situation or the degree of illegal behaviors of those who are convicted, the general aim of regulation should focus on changing the behaviors of market participants toward the maximization of overall economic prosperity. In this connection, it is important to make it as easy as possible to follow regulatory guidelines or rules so that the regulators can minimize their direct intervention to

[56] Wibren van der Burg, 'The Work of Lon Fuller: A promising Direction for Jurisprudence in the Twenty-First Century' (2014) 64 University of Toronto Law Journal 738.
[57] Id., 740.; Gerald J Postema, 'Implicit Law' (1994) 13 Law and Philosophy 361.

correct problems in the market. This does not mean that regulators should let the market fix its problems naturally without intervening and providing necessary safeguards. However, minimizing the intensity and frequency of regulatory intervention in the market is essential considering the limited public resources the regulators have at hand. At the same time, it is critical to analyze whether people's perception of the legitimacy of policy instruments and the quality or necessity of regulatory reforms impact how they respond to the changing regulatory environment.

Normally, it is hard to expect a unilateral response from the governed. Rather, a variety of reactions and counteractions including attempting detours, such as legal arbitrage or forum shopping, occur, and these are often based on how they understand, accept, and react to the given legal changes by reckoning the costs and benefits of obedience, disobedience, or partial obedience. This aspect is closely linked to the effectiveness of compliance which directly impacts the cost of regulatory reforms. In this sense, it seems clear that the forcibleness of law is less strong a tool for inducing a fundamental change in the subjects' behavior. Despite the established authority of laws and its compulsory power to halt or alter existing practices, it is one of the misleading and too simplistic perceptions of the character of law that the forcibleness of law is what enables the existence of a law or what drives the necessary changes intended by the lawgivers.[58] Even if it may be plausible for some legal theorists, such as legal positivists, and workable for a limited period, how it works, in reality, is a different story. Therefore, fidelity to law is not a static concept, but variable in scope and degree depending on how the subjects perceive and interpret the quality of law and their willingness to obey the given laws.

[58] See generally, Jutta Brunnee and Stephen Toope, *Legitimacy and Legality in International Law: An Interactional Account* (CUP 2010) 24; Fuller, *The Morality of Law* (n 53) 108, 139; Postema, 'Implicit Law' (n 57) 372.

In other words, all governments or regulators rely on the cooperation of the governed in a variety of forms as an attempt to govern the people by the power of a simple despotism cannot be sustained.[59] Eventually, this pragmatic approach to law that Fuller employed in explaining the eight principles of legality is more fitting in understanding how the law works in specific contexts and for specific purposes in the real world than what the conceptual or rigid dichotomies of law can offer to explain.[60] Fuller's theory of law as a purposive enterprise that is shaped by human interaction and meant to influence human behavior provides useful tools of analysis as to why good-intentioned regulatory reforms often fail to achieve their objectives and rather end up encountering, if not producing, unintended consequences.[61]

The linkage between legitimacy and compliance is of particular importance in international law because of the relative difficulty of compulsion among sovereign states. Intrinsically, a belief in the law's legitimacy has a direct impact on the level of compliance by states. As to the question of 'Is international law fair?' Thomas Franck (1931-2009) defines legitimacy as procedural fairness of international decision-making and decision execution.[62] Considering international law as the rule of a community of states based on the system of reciprocity, procedural fairness requires that its decisions are reached and applied following what is already accepted as the "right process" by the parties and this discursive acceptance enables the system to be, or to be seen, effective.[63] Therefore, if the gap between the law's restrictions and the common sense of justice, morality, or fairness becomes too wide, the power of the law to secure

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[59] Alan Cromartie, 'Legitimacy' in Richard Bellamy and Andrew Mason (eds), *Political Concepts* (Manchester University Press 2003).
[60] Id. 740.
[61] Brunnee and Toope, *Legitimacy and Legality in International Law* (n 58) 7.
[62] Thomas M. Franck, *Fairness in International Law and Institutions* (OUP 1995) 5.
[63] Ibid.

compliance is diminished as the law is seen as illegitimate.[64] The same is true for the substance of the law. Franck provides that the question of "fairness" encompasses the moral issue of 'how should we live' and that it is inherently connected to a sense of justice in a society. Considering distributive justice as the substance of fairness, Franck made a very interesting argument on the flexible and evolving nature of law by stating that the pursuit of fairness in international law does not always favor stability and "even the sanctity of contract may be challenged by claims of 'unjust enrichment' and that of treaties by claims of justice based on 'impossibility of performance' or 'fundamental change of circumstance.' "[65]

Indeed, the intrinsic dynamics between lawgivers and the subjects are the most unique and important characteristics of law and the reason why the law is relevant to the lives of their contemporaries. As to the willingness of the governed to obey and the validity of legitimacy, Max Weber (1864-1920) noted that "present in every genuine relationship of rule is a specific minimum of willingness to obey, hence an (outward or inner) interest in obedience."[66] In *The Economy and Society*, Weber used the term 'legitimate' to characterize the type of dominion in which obedience is based on the belief of the subordinate that the command is binding rather than on the objective attribute of powers or coercion.[67] The acceptance of the law or the willingness to obey by the subjects makes a difference in the course of applying new rules and regulations, affecting the effectiveness of rulemaking and enforcement as a result. In the context of financial regulation, the principles of legality influence the efficiency of governance.

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[64] Thomas M Franck, 'Legality and Legitimacy in Humanitarian Intervention' (2006) 47 Nomos 143.
[65] Franck, *Fairness in International Law and Institutions* (n 62) 23. It is interesting to note that the notion of 'impossibility of performance' in this quote echoes the sixth principle of legality as suggested by Fuller that "the rules must not require conduct beyond the powers of the affected party." Fuller, *The Morality of Law* (n 53).
[66] Max Weber, *Economy and Society: A New Translation* (first published 1922, Keith Tribe ed and tr, Harvard University Press 2019) 338.
[67] Cromartie, 'Legitimacy' (n 59) 94.

Without exception, whenever an economic or financial crisis is attributed to regulatory failures, the subsequent reforms often focus on how to enhance the effectiveness of regulatory structure and supervisory mechanisms so that market participants including financial institutions, investors, and customers are induced to behave towards the direction of increasing the overall stability and prosperity of the entire economy. In other words, the adequacy of compliance policies, both in level and scope, is at the core of regulatory reform designs as a parameter of success. Undoubtedly, the regulatory structure and design matter for market participants to comply with the regulatory changes without excessive burdens. For example, in the aftermath of the most recent global financial crisis of 2008, the optimal measures for enhancing compliance of financial institutions and the steep increase in the cost of compliance due to the high level of regulatory uncertainty have been some of the critical issues that made the process of financial regulatory reforms less fair and efficient in the eyes of the public and financial services institutions alike. Accordingly, the recently completed revisions to the Volcker Rule in the U.S., effective as of October 1, 2020, are concerned with alleviating the onerous compliance obligations of banking entities after years of industry requests to clarify and ease the compliance burden on banking entities subject to the Volcker Rule[68] and the agencies' review for several amendments to the 2013 rule since 2018.[69]

Overall, the theoretical discourse on the legality of law suggests that legitimacy is far from a static norm in the field of jurisprudence and legal philosophy. Rather, the vibrant, or fierce at times, debates among legal scholars regarding the forms of law and the morality, or

[68] Securities and Exchange Commission, 'Final Rule: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds' (2020) 17 CFR Part 255, Release no. BHCA-9; File no. S7-02-20, RIN 3235-AM70 <www.sec.gov/rules/final/2020/bhca-9.pdf.> accessed 17 October 2020.

[69] Agencies include Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC).

immorality, of law have represented the crucial importance attached to legitimacy in interpreting and understanding the political and legal systems of our society. Moreover, understanding the implications of legality on the relationship between the lawgivers, or the given laws, and the subjects including obligations, responsibilities, and powers is useful in explaining the actual operation of regulatory systems and the efficiency of governance as to the behavioral changes of the subjects. These issues will be discussed further in detail in the subsequent chapters.

2.1.3 Legitimacy as Reasonableness: Moral Justification of Authority and Objectives

The second definition of legitimacy is *"the quality of being reasonable and acceptable"*[70] or *"the ability to be defended with logic or justification*."[71] A synonym for this definition can be validity or reasonableness. While the first definition of legitimacy as legality is mainly focused on the quality of law and how a law should be equipped with an appropriate level of morality and reciprocity between the lawgivers and the subjects in general, the discourse on legitimacy as reasonableness appears to be broader in scope and multifaceted depending on the nature of institutions in question. In the scholarship of jurisprudence, the reason-giving force of law has been an important subject for discussion, especially among legal positivists, concerning the characteristic of law as giving either normative reasons or motivating reasons to act.[72] While this normativity of law is important in understanding the nature of law and its interpretation in

[70] Cambridge Dictionary, 'legitimacy' <https://dictionary.cambridge.org/dictionary/english/legitimacy> accessed 10 October 2020.
[71] Lexico: Oxford English and Spanish Dictionary, 'legitimacy' <https://www.lexico.com/definition/legitimacy> accessed 10 October 2020.
[72] David Enoch, 'Reasons-Giving and the Law' in Leslie Green and Brian Leiter (eds), *Oxford Studies in Philosophy of Law,* vol 1 (OUP 2011) 15. See generally, Joseph Raz, 'The Problem of Authority: Revisiting the Service Conception' (2005-6) 90 Minnesota Law Review 337; Scott Shapiro, 'On Hart's Way Out' in Jules L Coleman (ed), *Hart's Postscript: Essays on the Postscript to The Concept of Law* (OUP 2001); Jules L Coleman, *The Practice of Principle: In Defense of a Pragmatist Approach to Legal Theory* (OUP 2001).

a society, the pursuit of reasonableness in the discourse of legitimacy is quite different from this positive perception of law as given. Instead, it is more interested in explaining the dynamics of establishing justification for authority, rules, and political decisions among actors in the process of lawmaking and law-applying. In this sense, it is primarily about how authority, either a government, a court, or a regulatory agency, gets authenticity by persuading the governed of the reasonableness of their governance and also how the governed respond to such claims for authority.

Considering the dynamics, the law can be understood aptly as continuing struggles and challenges of social practice rather than as a finished project at a point in history.[73] Indeed, Fuller, who proposed the eight principles of legality, described the law as an 'enterprise of subjecting human conduct to the governance of rules,' borrowing the term 'enterprise' from the ideas of liberal market economics, as a way of emphasizing the incomplete and aspirational quality of law.[74] Regardless of his preference for the liberal market economics which is inapparent here, suffice to say that understanding law as a source and outcome of social interactions or arrangements inevitably takes one back to the reciprocal relationship among actors of lawmaking and law-applying, and the more collectivist forms of purposive institutions.[75] In this vein, autonomy is placed at the center of comprehending law because "law guides human action by addressing reasons for action to agents, but these reasons are of

[73] Fuller, *The Morality of Law* (n 53) 129. Also see, Brunnee and Toope, *Legitimacy and Legality in International Law* (n 58) 22.

[74] Brunnee and Toope, *Legitimacy and Legality in International Law* (n 58) 22. Still, Fuller did not embrace the theory of rational choice which is based on the idea that cooperation could be produced by rational individuals' desire to maximize self-interest. See generally, Jeremy Waldron, 'Why Law – Efficacy, Freedom, or Fidelity?' (1994) 13 *Law and Philosophy* 259, 271; David Luban, 'Rediscovering Fuller's Legal Ethics' in Willem J. Witteveen and Wibren van der Burg (eds), *Rediscovering Fuller: Essays on Implicit Law and Institutional Design* (Amsterdam University Press 1999).

[75] Waldron, 'Why Law – Efficacy, Freedom, or Fidelity?' (n 74) 271-72. See 3.1 of this thesis for a detailed analysis of the reciprocity of law which is the central concept of understanding the legality of the law.

a general nature, and agents must reason further with the norms to apply them in a specific context."[76] Thus, the legitimating theory in political science normally has its starting point from completely separate selves and the state of complete autonomy of the individual,[77] and legitimacy in this context broadly refers to "people's attitudes toward the government, and their willingness to obey its commands."[78]

The use of reasoning, or reasonableness, is quintessential in both lawmaking and law-applying. In law applying, there are very limited, if any, cases where using syllogistic reasoning can help judges find sufficient grounds for understanding and analyzing the circumstances in question.[79] Rather, in the process of analogical reasoning through which one applies abstract norms to specific factual situations, there is no way of determining that a given norm applies to a particular circumstance imprescriptibly and a range of possible legal norms and decisions can be considered as applicable depending on how legal principles and standards are interpreted at the given individual cases.[80] The fact that it may be unclear whether to apply particular rules even when the basic legal characterization of given factual circumstances is clear and that judges are faced with a choice as to how they characterize the facts or whether a certain rule applied to the facts in question manifests the imperative role of reasoning in adjudications.[81] Although consistency and predictability of a legal system, in general, serve to infer like

[76] Brunnee and Toope, *Legitimacy and Legality in International Law* (n 58) 24. Also see, Vaughan Lowe, 'The Politics of Law-Making: Are the Method and Character of Norm Creation Changing?' in Michael Byers (ed), *The Role of Law in International Politics: Essays in International Relations and International Law* (OUP 2001).
[77] Cromartie, 'Legitimacy' (n 59) 94. Also, *See* Antoinette Scherz, 'Tying Legitimacy to Political Power: Graded Legitimacy Standards for International Institutions' [2019] European Journal of Political Theory
[78] Edward L Rubin, *Beyond Camelot: Rethinking Politics and Law for the Modern State* (Princeton University Press 2005) 144. Also, see Rodney Barker, *Political Legitimacy and the State* (Clarendon Press 1990); William Connolly (ed), *Legitimacy and the State* (New York University Press 1984); Ronald Rogowski, *Rational Legitimacy: A Theory of Political Support* (Princeton University Press 1974); Tom R Tyler, *Why People Obey the Law* (rep ed, Yale University Press 1992).
[79] Lowe, 'The Politics of Law-Making' (n 76) 214.
[80] Ibid. Also see, Julius Stone, *Legal System and Lawyers' Reason* (Stanford University Press 1964).
[81] Lowe, 'The Politics of Law-Making' (n 76) 214.

decisions, it is indeed through the collection of individual decisions that a legal system can be said to maintain consistent principles, and identifying the similarities and differences of individual cases may result in treating similar cases differently in the reflection of changing social views and cultural perceptions on particular issues.[82] In many areas of law, reasonableness has an important role and a real impact on courts' decisions.[83] For example, the use of reasonableness is deeply associated with the negligence law which, in the majority of cases, defines an actor as negligent "when he or she fails to use ordinary care, and ordinary care is that which a reasonably prudent person, or a reasonably careful person, would take under like circumstances," although the vagueness or unclarity of the language is often subject to criticism.[84] The use of "unreasonable" is also common in other laws such as the US Fourth Amendment law which forbids "unreasonable" searches or seizures, providing a different scope of permissibility compared to the use of "reasonable",[85] or antitrust law which explicitly prohibits "unreasonable" restraints on trade.[86] The usage of "reasonable" is also salient in financial regulations as well as statutes, case laws, and contracts dealing with financial matters by using such phrases as reasonable rates, reasonable prices, or reasonable compensation.[87]

[82] Id., 215.
[83] See David Zaring, 'Rule by Reasonableness' (2011) 63 Administrative Law Review 525, 525-26. For the practical value of reasonableness, Zaring argues that "reasonableness is tractable, cognizable, and ultimately the right way to design judicial review, especially when courts review the work of agencies."
[84] Benjamin C Zipursky, 'Reasonableness in and out of Negligence Law' (2015) 163 University of Pennsylvania Law Review 2131, 2133-35. For critics, see generally, Alexander Volokh, 'Choosing Interpretive Methods: A Positive Theory of Judges and Everyone Else' (2008) 83 NYU Law Review 769.
[85] U.S. CONST. amend. IV. Normally, forbidding unreasonableness can be more permissible than requiring reasonableness because an unreasonableness standard makes everything except that which is unreasonable permissible. See Zipursky (n 84) 2135-36.
[86] Zaring, 'Rule by Reasonableness' (n 83) 527, 550. The rule of reason is a legal doctrine used to interpret the Sherman Antitrust Act of 1890 (15 U.S.C. §§1-7). In *Standard Oil Co. v. United States*, 221 U.S. 1, 66 (1911), the court held that the standard of reason applies to antitrust restraints of trade under the Sherman Act. See Zipursky, 'Reasonableness in and out of Negligence Law' (n 84) 2136.
[87] See Zipursky, 'Reasonableness in and out of Negligence Law' (n 84) 2137. For example, in federal bankruptcy law, the term "disposable income" is defined as "reasonably necessary to be expended for such child." See, 11 U.S.C. §1325(2) <https://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title11-section1325&num=0&edition=prelim> accessed 26 October 2020.

Considering the increasing usage of "reasonableness" as a standard of judicial review of agency actions,[88] some scholars argue that reasonableness provides judges with a more consistent tool of review than the complex standards of doctrinal review in administrative law, such as the Chevron deference,[89] Skidmore deference,[90] or De novo review,[91] and that "reasonableness", under the Fourth Amendment, should be comprehended in light of other constitutional values, such as property, privacy, equality, due process, and democratic participation, affirmed in other amendments.[92] While some critics of reasonableness argue that reasonableness standards will make political preference play an important role in judicial review, the influence of politics on court decisions is not a particular issue of concern for reasonableness compared to doctrinal standards of review.[93] Indeed, it is hard to eliminate politics from the law in both theory and practice,[94] and a reasonableness inquiry makes administrative agencies more prepared to explain "why the policy choice they made makes sense and does not work a forfeiture on the individuals affected by the regulatory action."[95] Consequently, the most interesting merit of a reasonableness review may be that it demystifies law by taking judges out of the complicated

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[88] Zaring, 'Rule by Reasonableness' (n 83) 532-33. According to his empirical analysis on the frequency of citing the term "reasonable" or "reasonableness" in the Supreme Court and the D.C. Circuit Court from 1980 to 2010, both courts cite the term in a growing majority of their decisions.
[89] *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc*. 476 U.S. 837 (1984). For criticisms of the efficacy of the Chevron deference, see generally, Jack Michael Beermann, 'End the Failed Chevron Experiment Now: How Chevron Has Failed and Why It Can and Should Be Overruled' (2010) 42 Connell Law Review 779, 788-839; William R Andersen, 'Against Chevron - A Modest Proposal' (2004) 56 Administrative Law Review 957, 960; Thomas W Merrill, 'Judicial Deference to Executive Precedent' (1992) 101 Yale Law Journal 969, 998-1003.
[90] *Skidmore v. Swift & Co.* 323 U.S. 134 (1944).
[91] *Motor Veh. Mfrs. Ass'n v. State Farm Ins.,* 463 U.S. 29 (1983).
[92] See Zaring, 'Rule by Reasonableness' (n 83) 543; Akhil Reed Amar, 'The Future of Constitutional Criminal Procedure' (1996) 33 American Criminal Law Review 1123, 1133.
[93] Zaring, 'Rule by Reasonableness' (n 83) 553. Also see, Cass Sunstein and Thomas J Miles, 'Do Judges Make Regulatory Policy? An Empirical Investigation of Chevron' (2006) 73 University of Chicago Law Review 823.
[94] See Richard J Pierce Jr, 'The Role of Constitutional and Political Theory in Administrative Law' (1985) 64 Texas Law Review 469, 471; Jeffrey A Segal and Harold J Spaeth, *The Supreme Court and the Attitudinal Model Revisited* (CUP 2002) 1-2. The authors insist that the history of the Supreme Court decisions is full of judicial policymaking by citing the case of *Bush v. Gore* (2002) as one of the recent, and shameful, example of the partisan ruling.
[95] Zaring, 'Rule by Reasonableness' (n 83) 554.

standards of review, which are often too confusing for the laypersons to comprehend, and alienate reviews from what happened in real-world situations. Instead, it can make things more comparable for the courts with the agencies that find the rules of reason useful for doing jobs for police officers, financial regulators, and the like.[96]

Furthermore, the wide usage of "reasonableness" in many laws is knitted to the "reasonableness of belief." For example, in certain cases of self-defense, determining whether the defendant's use of deadly force can be exculpated, or mitigated, relies on proving the reasonableness of the mistaken belief of the defendant on the necessity of force.[97] Despite a legal wrong committed, certain jurisdictions have decided not to hold the defendant responsible for wrongdoing if his or her action was based on good faith belief and if the belief was not attributable to a faulty exercise of judgment.[98] Moreover, in *Harlow v. Fitzgerald* (1982), the United States Supreme Court significantly expanded its form of qualified immunity, stating that its violation can be acknowledged only when the alleged actions have violated established statutory or constitutional rights.[99] Overall, the reasonableness of belief in such cases is epistemic and applied to the proper exercise of judgment. Likewise, reasonableness in the torts of fraud and negligent misrepresentation is applied as a "reasonable reliance" or "justifiable reliance", treating reasonableness the same as justifiability.[100] The rationale here is that a putative injury cannot be redressed if the reliance on the defendant's misrepresentation stems from a poor, defective, or ungrounded judgment of the claimant.[101]

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[96] Id. 528, 559.
[97] See Zipursky, 'Reasonableness in and out of Negligence Law' (n 84) 2141.
[98] Ibid. See, *State v. Joseph*, 803 A.2d 1074, 1108 (N.J. 2002).
[99] See *Harlow v. Fitzgerald*, 457 U.S. 800, 815-16 (1982).
[100] Zipursky, 'Reasonableness in and out of Negligence Law' (n 84) 2141. See e.g., Lucky 7, LL.C. v. THT Realty, L.L.C., 775 N.W.2d 671, 676 (Neb. 2009).
[101] Zipursky, 'Reasonableness in and out of Negligence Law' (n 84) 2141,

In lawmaking, the interplay between lawmakers and citizens as to the reasonableness of political objectives, decisions, or the very existence of government itself, is hard to exaggerate. While there exist different standards or definitions of legitimacy, legitimacy as a concept is the foremost and ultimate ground for taking any public policy action by public agencies. Of course, the legitimation of actions can be extended to the private sector in terms of universal principles, such as human rights or environmental protection, or given rules and regulations either internally or externally. However, the need for testing and proving the legitimacy of objectives and actions through reasonableness is far more crucial when it comes to the public sector, whether administrative agencies or legislative branches because the legitimacy of their actions or decisions is to be scrutinized by the fundamental values and principles of the society, or country, not to speak of the existing body of laws and regulations. In this sense, the debates regarding the reasonableness of policy actions have been quite more practical than theoretical, and specific strategies have been devised and applied by institutions and organizations that have diverse needs to secure the legitimacy of both their existence and operation. Undoubtedly, the prime interest of establishing and operating public institutions is not to maximize economic profits by virtue of their advanced managerial systems and bureaucratic sophistication or intellectual caliber of the officials, but to serve the purpose of effective realization of socially agreed and sought values or norms which are manifestly known to the public as laws and regulations. Thus, the very existence of a public institution depends on whether its actions are viewed as in line with the legitimate purposes of establishment and authority bestowed by relevant legislation or regulations at the time of establishment and through subsequent amendments. In this sense, public policy decisions are required to be based on pre-established and agreed objectives and procedures, unlike business decisions which can be spontaneous at times to improve profitability or weather unexpected counterparty risks. Therefore, the process of legitimation is always embedded in the course of the establishment and operation of public institutions. At the same time, the reliance on legitimation and the demand for justification vary depending on the structural hierarchy, purposes, and aims of organizations, as well as the types of authority structure, such as autonomous or delegated.

The call for the legitimacy of public policy institutions is closely linked to the cost of regulation. Regulation is not without cost. Any legal action and policy measures accompany economic as well as social costs to society without exception, and it is hard, if not impossible, to retrieve the costs once they are wasted or misused. Regulations come with substantial costs not only to the direct budget of the executive branches and the legislatures for the human resources and direct expenditures associated with reviewing, implementing, and executing specific regulatory actions but also intrinsically related to the growth potential of the economy with long-term influence on productivity and employment. Another reason why the cost of regulation warrants more attention is related to the limited nature of public resources and the prioritization of policy objectives. In particular, the legitimacy of financial regulation is closely linked to the issue of how to distribute limited public resources and how the government can make sure that the resources are adequately distributed to those who are most in need of public support and targeted to the most necessary areas that require government intervention. This is one of the core reasons behind the massive protests in the aftermath of the global financial crisis of 2008, under the catchphrase of *Occupy Wall Street,* as the huge amount of public money spent for saving large financial institutions, most of whom were accused of their reckless business practices and unreasonable investment decisions, was seen unfair and unjust in the eyes of the public. Even though litigations on financial regulation are less frequent compared to other areas of administrative law, such as environment, taxation, and transportation, financial regulation without reasonable or justifiable grounds is hard to survive the demand for rescission or, at least, revision.[102] In retrospect, the quest for establishing, strengthening, or disproving the legitimacy of a system, an institution, a law, or a policy has been present in the history of law and politics at all times while the term "legitimacy" has regained explosive attention in the literature of financial regulation since the 2008 global financial crisis and more frequently mentioned in daily newspapers and policy briefs in the aftermath of the crisis.[103] To be more accurate, it has held a central stage in the discourse of political and legal thoughts for centuries, realized by the writings of great thinkers including Thomas Hobbes (1588-1679), John Locke (1632-1704), Max Weber (1864-1920), John Rawls (1921-2002) and Frederick Hayek (1899-1992), just to name a few. For Hobbes, as the earliest writer concerned with legitimacy, his need to justify new types of government activity urged him to give a systemic account of civil science,[104] and he rested on the concept of a "covenant" between the sovereign and the subjects through which individuals in hostile nature are guaranteed of their survivals by fulfilling obligations.[105] Unlike Hobbes who presumed the motive of individuals to excel which eventually produces hostility in nature due to the competition for limited resources, Locke founded his ideas on the desire for self-preservation of humans and envisioned a government as a protector of individual rights and property.[106] More recently, Rawls maintained that just arrangements were likely to be chosen by free and rational selves regardless of their social

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[102] See Zaring, 'Rule by Reasonableness' (n 83) 543-549.
[103] See generally Shane P Mulligan, 'The Uses of Legitimacy in International Relations' (2005) 34 Millennium: Journal of International Studies 346; Max Weber, *Economy and Society* (n 66); Michael Zurn, Martin Binder, and Matthias Ecker-Ehrhardt, 'International Authority and Its Politicization' (2012) 4 International Theory 69.
[104] Here, science refers to knowledge which produces the like effects when the like causes come into our power, 'when we see how anything comes about, upon what causes, and by what manner.' See, Thomas Hobbes, *Leviathan* (first published 1651, Richard Tuck ed, CUP 1996) 35-36; Cromartie (n 59) 96.
[105] Cromartie, 'Legitimacy' (n 59) 95-98; Hobbes, *Leviathan* (n 104).
[106] Cromartie, 'Legitimacy' (n 59) 100; John Horton and Susan Mendus (eds), *John Locke's Letter on Toleration in Focus* (Routledge 1991) 47.

status or talents, and that "free and rational" is equivalent to "reasonable."[107] As to the inclination to self-justification, Rawls explained that the present culture of our society gives us the desire to justify our actions to others so that they are unable to reasonably refute them.[108] Similarly, Hayek thought that the reasonableness of legal principles was superior to the deliberately articulated rules imposed by a legislator since articulated rules are often imperfect for predictability than a series of judicial decisions.[109]

Overall, thoughts on what makes a government, or an authority, legitimate have represented how the dynamic interactions between the governing and the governed have been interpreted by scholars over time. It clearly shows that the importance of legitimation in modern politics and society is increasing rather than decreasing, and the points of focus have changed over time. In general, the more attention is given to the autonomy and independence of the individual, the stronger the demand for the legitimation of public policy actions. In line with this, far from the underlying meaning of legitimacy in the medieval era when it referred to the status of the king's heir in a hereditary monarchy who bears the right to inherit the title of king and the entire realm as property, legitimacy in the context of a modern state largely implies and emphasizes the moral justification of any type of authority or regime that gives a general imprimatur on the authorized structure of governance in its external relations with its citizens.[110] Therefore, it is noteworthy that legitimacy is distinguished from authority.[111] Even though a government is

[107] Cromartie, 'Legitimacy' (n 59) 103. See John Rawls, *A Theory of Justice* (OUP 1972) 49; John Rawls, *Political Liberalism* (CUP 1993).
[108] Cromartie, 'Legitimacy' (n 59)103.
[109] Frederick Hayek, *Legislation and Liberty* (vol 1 of Law, University of Chicago Press 1973) 118. This argument is in line with the merit of common law, and Hayek thought that common law is superior to civil law in this regard. See also, 'The Rule of Law', *The Stanford Encyclopedia of Philosophy* (2016). <https://plato.stanford.edu/entries/rule-of-law/> accessed 20 April 2020.
[110] Rubin, *Beyond Camelot* (n 78) 144-146.
[111] Allen Buchanan distinguishes between "political legitimacy" and "political authority," and argues that political legitimacy is the more central notion for analyzing the morality of political power than political

deemed to have authority to control its citizens regardless of its political system, such as democratic or autocratic, the mere existence or exercise of authority does not translate to legitimacy unconditionally and does not guarantee the obedience of citizens.[112] While authority describes a structural principle of a government, or government units, and the procedure of exercising commands and rules, legitimacy is a justificatory principle that attaches to the authority structure and gives reasons to the citizens for acceptance or obedience.[113] In this term, the discussion on legitimacy presumes that authority can be non-legitimate, and the legitimacy of authority depends on meeting certain criteria of justification. In a democracy, for example, much of the moral justification of legitimacy derives from the democratic authorization of an exercise of power and the government's protection of basic individual rights so far as democratic institutions and resources are available.[114]

Fundamentally, whether creating new regulatory bodies, abolishing arguably ill-functioning agencies or regulations, or amending the existing institutions or rules, a party or a legislator who initiates and advocates a particular approach or policy measures normally attempts to convince others, and the public at large, by presenting the arguably legitimate reasonings and rationales of their initiatives and the expected, mostly positive, outcomes to be delivered following the adoption of such initiatives. Likewise, it is a common scene of political debates not only in the parliament or administrative agencies, where the practical rules and codes are formally discussed and devised by the elected and the appointed, but also in academic

authority. See, Allen Buchanan, 'Political Legitimacy and Democracy' (2002) 112 Ethics 689.

[112] From the viewpoint of democracy, an authority which is not recognized as being legitimate is not even considered as an authority as the concept of authority derives from the property of legitimacy. See Steven Wheatley, 'A Democratic Rule of International Law' (2011) 22 The European Journal of International Law 525, 533.

[113] Rubin, *Beyond Camelot* (n 78) 148.

[114] Buchanan, 'Political Legitimacy and Democracy' (n 111) 719.

conferences or even at street cafés where people contend for their own terms and versions of legitimacy to bolster their claims for taking, or not taking, certain policy actions to solve problems driven or exposed by a crisis. Regardless of the effectiveness, or logical completeness, of such debates and arguments, they represent the indispensable need for public justification when any significant policy, regulatory reforms, or special crisis intervention measures are implemented by the government or any public authority itself.[115] Most importantly, the modern concept of legitimacy can be interpreted as "the belief in the rightfulness of a state, in its authority to issue commands, so that those commands are obeyed not simply out of fear or self-interest, but because they are believed in some sense to have moral authority because subjects believe that they ought to obey."[116] So far as the relationship between the government and citizens is concerned, legitimacy of government resides in the "belief system of the citizens" who will obey or disobey the government's commands.[117] Whether the citizens believe that the government is justified to make orders has a direct impact on their willingness to obey, as discussed in the above section[118], and the compliance of people is not always based on the coercive power of authority but motivated by diverse reasons including material self-interest, human sociability, which means the natural inclination of human beings to cooperate with others, or concurrence of principles between the government and people.[119] It does not necessarily mean that citizens can rightfully avoid certain laws at their discretion before they are officially abolished. However, they can still choose the degree of their compliance, among

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[115] The Organization for Economic Co-operation and Development (OECD), 'Policy Framework for Effective and Efficient Financial Regulation: General Guidance and High-Level Checklist' (2010) 24 (OECD Policy Framework) ("The choice of instruments, and their mapping to policy objectives, should be made transparent and publicly justified, particularly in the context of any significant policy or regulatory reforms or any special crisis intervention measures.").
[116] Barker, *Political Legitimacy and the State* (n 78).
[117] Rubin, *Beyond Camelot* (n 78) 147.
[118] See 3.1 of the thesis for the practical relationship between legitimacy and compliance.
[119] Rubin, *Beyond Camelot* (n 78) 164-165. Also see 3.1 of the thesis for detailed discussions on compliance and regulation.

full, partial, or no compliance, with the given commands based on their judgment of reasonableness and reasonable belief of likely consequences. Thus, it is important to note that there exists a spectrum of reactions people can take ranging from total compliance to total rejection. In the process of such judgment, people's interaction with the government and other citizens, including societies, NGOs, or even religious groups, has a critical impact on how they understand and respond to the commands. That is why governments and public institutions often adopt diverse methods to justify their authority to command by influencing social interactions with and among citizens. Social interactions can be categorized into three broad contexts: (i) the first context is horizontal, where interactions occur between equal parties, such as in contractual arrangements or business partnerships, or relations among citizens in a political community; (ii) the second context is vertical where interactions occur between authorities and subordinates, such as judges and litigants or lawgivers and subjects; (iii) finally, interactions occur between authorities or officials themselves and can be vertical as between higher and lower courts and horizontal as between courts at the same level or between lawmakers and courts.[120] People's willingness to obey governmental orders can be seen as a cumulative result of interactions among diverse actors, including government, citizens, and institutions, rather than arising from a centralized political authority system. Sometimes, such interactions can be made implicitly as a network of tacit understandings and unwritten conventions rather than explicit laws.[121] Without giving due attention to this implicit dimension of law, it is impossible to fully appreciate the dynamic character of law and the role it plays in human affairs and in offering public good.[122] The realm of legitimacy is certainly beyond explicit laws enacted by authorized lawmaking institutions and this understanding is in

[120] Postema, *Treatise of Legal Philosophy in the Twentieth Century* (n 54) 366.
[121] Id. 361.
[122] Ibid.

line with the virtue of common law tradition. Clearly, at the core of social interactions and a variety of strives for legitimation is the undeniable working of reasonableness in the process of lawmaking and law-applying alike.

Consequently, it is almost impractical to discuss the quality and contents of any regulation without giving due consideration to its legitimacy either implicitly or explicitly. The quest for securing reasonableness is especially important and it is rather common in many fields of law. Understanding the dynamics of lawmaking and law-applying in society is very useful to see how the call for legitimacy works in practice through a variety of interactions among actors at diverse stages of public policy discourse. In theory and practice, legitimacy certainly matters.

2.2 Distinction between Emergency Response and Post-Crisis Financial Regulatory Reform

Before analyzing what may constitute principles and measures of legitimacy in financial regulatory reform, it is imperative to bring close attention to the difference between emergency response and structural regulatory reform. In the event of a financial crisis, while the distinction between the two terms seems self-evident at a glance, the former is often regarded as the latter, and the absence, or the inadequacy, of the latter becomes less noticed when the former takes a great deal of public and political attention. Since noticeable reform actions are most likely to be called under the pressure of extreme financial turmoil and social anxiety, it is easy to confuse emergency response with regulatory reform in terms of assessing the adequacy and efficiency of post-crisis financial regulatory reform. This confusion, whether intentional or unintentional, makes many observers puzzled as to why the global financial markets are always short of adequate regulatory overhaul despite the recurrence of disastrous financial crises and the fervent reform efforts by governments and international financial institutions. Moreover, the muddled understanding between emergency response and regulatory reform makes it difficult to apply the right standards and factors of assessment for post-crisis regulatory reform. To provide an answer to this problem, thus, it is imperative to distinguish between emergency response and regulatory reform so that adequate standards of the legitimacy of financial regulatory reform can be applied to the different priorities and policy objectives. In retrospect, financial crises have a timeline[123], and government responses to financial crises have phases that require distinct understanding and policy reactions. As to the pattern of government responses to financial crises, Davidoff and Zaring categorize the three phases of government responses to a financial crisis as follows: first, the government steps into an initial and ad hoc phase where emergencies are responded to with emergency-style rules and process for the government to keep up with fast-paced and deleterious market events; second, the next phase involves legislative actions following outraged congressional hearings and implementation of criminal investigations that lead to the ex-post punishment; finally, there comes reform – "either reform forgone in favor of blue-ribbon commissions and minor regulatory reorganization, or reform embraced by new legislation and a restructuring of the financial regulatory system."[124] In other words, the initial phase of a financial crisis begins with financial emergencies and it moves to the intermediate phase of legislative actions before ending up with the final phase of post-crisis regulatory reform. Although the three phases are interconnected, understanding these linear yet distinctive phases of government responses to financial crises is very helpful because each stage brings distinctive challenges that justify

[123] Charles Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (4th ed. Wiley 2000).
[124] Davidoff and Zaring, 'Regulation by Deal' (n 40) 532.

different policy priorities or objectives. This distinction is essential to figure out whether the policy responses in question are properly designed and executed to meet the specific challenges posed at each stage.

2.2.1 Financial Emergency and Its Peculiarities

From the standpoint of regulation and public policy, the initial stage of financial emergencies and the late stage of regulatory reform have many differences in terms of policy priorities and objectives because a financial emergency usually requires the government to act as swiftly as possible and, to do so, it is unavoidable to make a broad range of exceptional decisions by using discretionary powers while such decisions would not easily pass the scrutiny of ordinary legal processes without the state of emergency. In reality, it is hard to fit such emergency-related government responses into the frame of ordinary legal procedures and standards of public policymaking. Thus, it is worthwhile to analyze the specific aspects of a financial emergency and how those features tend to lead the government responses at the initial stage of a financial crisis before examining the legitimacy standards of post-crisis regulatory reform. As briefly mentioned above, financial emergencies involve distinctive features as to the scope of government responses and decision-making procedures. Historically, financial emergencies have caused insurmountable shocks to the economy and society at large. It is hard to expect that the negative impact of a financial emergency is limited to the financial industry. Instead, it often serves as a major cause of social disturbance in a country or as a source of conflicts across borders from time to time.[125] Financial emergency itself is a broad topic that warrants thorough

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[125] John Ferejohn, 'Financial Emergencies,' in Tom Ginsburg, Mark D. Rosen and Georg Vanberg (ed.), *Constitutions in Times of Financial Crisis* (CUP 2019) 27. Ferejohn provides historic analyses about the impact of financial emergencies on political turmoil in revolutionary France where a series of social turmoil is attributed to the inability of the regime, whether the Crown or the successive assemblies, to solve the underlying financial problems. The case of Weimar also reveals that financial emergencies cannot be separated from

analyses of the causes and outcomes of historical events by employing an interdisciplinary understanding of politics, economics, and sociology. Thus, the analysis here should be limited to the most salient external features of a financial emergency that affect how the government responds to the event compared to its normal policy reactions without the state of emergency. While every financial emergency has its own paths and consequences, some of the general features of financial emergencies may include that (1) it is hard to anticipate; (2) events move so quickly that established government institutions have limited capacity to respond quickly by using ordinary legal procedures; and (3) it carries high risks such as the potential of destabilizing the economy, the financial system, or even the political system in the worst case.[126] As to the first point, it may be contentious whether a crisis can be anticipated by a wide range of market signals, or is hard to foresee.[127] However, there are particular moments of speedy downfall in the financial market indicators, such as the sharp decline of stock prices or the potential of a series of bank runs, that threaten the operation of the entire financial system both at home and abroad – the state of a financial emergency. This is of particular concern in the modern financial system, which consists of intertwined networks of globalized financial markets, as it is difficult to oversee the complex web of financial transactions effectively without having highly organized international supervisory mechanisms or strong incentives for cross-monitoring within industry.

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political and social transformations.

[126] Ferejohn, 'Financial Emergences' (n 125) 18.

[127] In the economic literature, some scholars argue that financial panics are random while others say that they are the product of asymmetric information. For the former theory, see Douglas Diamond and Philip H. Dybvig, 'Banks Runs, Liquidity, and Deposit Insurance' 91 J Poli Econ 401 (1983). For the latter theory, see Charles W. Calomiris and Gary Gorton, 'The Origins of Banking Panics: Models, Facts and Bank Regulation,' in Glenn Hubbard (ed) *Financial Markets and Financial Crises* (University of Chicago Press 1992) 109, 124-62. In any case, financial panics happen as a consequence of "complicate economic and psychological factors that are hard to predict and control." See Eric A Posner and Adrian Vermeule, 'Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008' (2009) 76 University of Chicago Law Review 1613.

The powerful ripple effects of the global financial crisis in 2008 around the globe proved that the global financial markets are deeply interconnected, and contagion mechanisms are so powerful that default risks are quickly transmitted from financial institutions to their direct and indirect counterparties and to the other sectors of the economy.[128] While an ideal scenario of an emergency response might be that the government has established contingency plans ahead of coming shocks and just applies them when the event occurs, it is less likely that the government as a supervisor can obtain the same level of information as an insider of the failing banks because the banks tend to be reluctant to reveal the real situation to maintain confidence in the systems, and it is difficult to foresee the real character and scope of loss for that reason.[129] Even if a very insightful and vigilant supervisor may read the signs of massive failure ahead of time, there still exist different types of political obstacles including the tendency that regulators and politicians are unwilling to support tighter supervisory rules when the financial markets seem to be still in a good mood and provide sufficient profits to generate tax revenues and jobs. Again, the lack of information on the inside situation of financial institutions often makes it hard for a supervisor to be confident enough to make unpopular decisions opposite to mainstream expectations. Thus, when an event is called a financial emergency, it involves unprecedented shocks, or unconventional routes of shocks, to the economy beyond the normal expectation of supervisory institutions and market participants.

[128] Anat R. Admati, 'Rethinking Financial Regulation: How Confusion Has Prevented Progress' (2015) Rock Center for Corporate Governance Working Paper Series No. 207.

[129] Even on the verge of bankruptcy, banks are often reluctant to tell the true positions to regulators. For example, before the Irish government made decisions on whether they should issue the guarantee to ailing Irish banks, they were missing critical information on the banks' true position in their property market investments. The banks were over-exposed to the property market that was collapsing, and the real problem was a lot bigger than what the banks insisted as a short-term liquidity problem. Some observers argue that the Irish government could be in a position to know about it if regulators did a better job in monitoring exactly what was going on in the Irish banking sector instead of maintaining the light-touch regulation. See RTE, 'Freefall' (2010) <https://www.imdb.com/title/tt1753842/?ref_=ttpl_pl_tt> accessed 20 August 2021.

Second, the time constraint is the most critical factor that shapes the course of emergency response and has the most critical influence on how the government makes critical decisions both in terms of the procedure of decision-making and the substance of policy measures. As noted earlier, the approaches to and priorities of emergency responses and regulatory reforms are distinguishable because they have different purposes and policy objectives. Invariably, the foremost goal of emergency responses is to prevent a systemic collapse of financial markets so that the economy can continue to function and have a second chance to be reformed. No matter how deliberately a decision is made, thus, it has no point if such a decision comes when it is too late to save the economy from falling into a catastrophe. As the term 'emergency' implies, the time allowed to react is extremely limited, and critical decisions should be made before they become futile. For example, when the government should decide on whether to bail out a failing bank, they cannot afford the time to discuss it with diverse stakeholders through normal procedures of consultations or public hearings before making final decisions. Rather, a decision should be reached as quickly as possible, and it normally takes a few days, or less than a day for extreme cases, for relevant government actions to be executed.[130] Therefore, the government uses its broad discretion to handle urgent threats to the entire economy. Interestingly, it is not only because they are allowed to do so by relying on delegated power under the existing legal framework but also out of necessity since the executive branch is the

[130] For example, when the share price of Royal Bank of Scotland (RBS) had plunged 35% in the morning of 7 October 2008 and the bank was going to run out of money the same afternoon, the Chancellor of the Exchequer, Alistair Darling, asked the Bank of England to make emergency loans to RBS. The bailout deal had to be signed off by the Chancellor and the CEOs of the largest UK banks in the early hours of 8 October 2008 and the Treasury announced that morning that it was making ￡50billon of capital available to the banks and ￡20 billion of which were for RBS. See HM Treasury, Financial Support to the Banking Industry, Press Release, 08 October 2008. <https://webarchive.nationalarchives.gov.uk/20100407183642>/http://www.hmtreasury.gov.uk/press_100_08.htm>; Federico Mor, 'Royal Bank of Scotland bailout: 10 years and counting' 12 October 2018, House of Commons Library, UK Parliament <https://commonslibrary.parliament.uk/royal-bank-of-scotland-bailout-10-years-and-counting/> accessed 10 September 2021.

only institution in the system of liberal democracy that can act in a crisis with speed compared to the legislature and the judiciary.[131] While the specific circumstances may differ from country to country, it is the general feature of a modern liberal democracy, which consists of the three branches of the executive, the legislature, and the judiciary, that the executive, through its agencies, is the main player in a crisis because it can act rapidly and often secretly in the face of constantly changing events and heightened uncertainty.[132]

The study of the government's emergency powers can be traced back to John Locke's theory of prerogative or Alexander Hamilton and James Madison's writings in *The Federalist*, in which they advocate the use of discretion by a government, or the one who has executive power, for the public good when it needs to preserve itself from an existential threat.[133] When a country comes to an emergency, it appears to be pointless and self-defeating to try to place strict limits on what a government can do by legal prescription, and the Lokean prerogative power is implied in any political or legal regime that allows the executive, or other entity, to take necessary, even if illegal, actions to preserve the regime.[134] From a legal perspective, it is critical to note that emergencies are rarely handled effectively by using ordinary legal procedures and that the government needs to either use emergency powers of some kind or attempt to find leeway to avoid being restricted by pre-established legal constraints.[135] Ironically, the merits of liberal democracy which respect constitutional values such as the due process of law, transparency, or equal protection can place barriers to handling the emergency

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131 Eric A. Posner, 'Rule-of-Law Objections to the Lender of Last Resort' in Tom Ginsburg, Mark D. Rosen, and Georg Vanberg (eds), *Constitutions in Times of Financial Crisis* (CUP 2019).
132 Id. 49-50.
133 John Locke, *Second Treatise of Civil Government* (first published 1689, G. Routledge and sons 1887); Alexander Hamilton in Federalist 23 and James Madison in Federalist 41.
134 Ferejohn, 'Financial Emergences' (n 125) 20.
135 Ibid.

effectively if the government is strictly bound to ordinary legal procedures and has to wait until the elected body, such as Congress or Parliament, permits it to act. In this context, the use of discretionary powers seems indispensable during the phase of financial emergency, and the lack of capacity or authority of the government to make discretionary decisions may jeopardize the economy to fall into a spiral of vicious defaults without alternative recourse. As to this point, Ferejohn explains that "reliance of ordinary law in an emergency can be disastrous, both because it may fail to end the emergency, and because it may distort or transform the existing constitutional arrangements by incorporating emergency measures into law, or permanently shifting the institutional balance of power."[136] Even though the role of the government, or central bank, as a lender of last resort has been criticized for many years due to the potential to promote moral hazard in financial markets, it is unreasonable to insist that the government should not take immediate actions to address urgent issues on the ground that such actions can be considered or viewed as violating the constitutionality of government in liberal democracy.[137] In this sense, it is not entirely abnormal that the government adopts non-traditional policy tools to extinguish financial emergencies and relies on their discretion when executing policies. Instead of judging the merits and effectiveness of particular policy decisions in the course of emergency response, thus, it is necessary to understand the use of policy discretion by the government as a necessity for a very limited period and pay more attention to systemic issues such as how emergency policy measures can be adequately replaced by or

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[136] Ibid.

[137] One of the most salient problems with the bailout of large financial institutions in financial emergencies involves the use of the 'too-big-to-fail' doctrine because the regulators' judgment on how big is too big to fail can be subjective and discretionary. It may lead to a miscalculation when the regulators are not fully understanding the potential risks for a variety of reasons. However, it does not necessarily mean that the regulators should not be allowed to use their discretion in emergency response. The focus should be on how to improve the supervisory mechanism ex-ante and how to design the post-crisis regulatory system that makes the financial system more resilient. For an analysis of the potential uses of public resources and powers to improve the interests of small economic groups or industries, see Stigler G, 'The Theory of Economic Regulation' (Spring 1971) 2(1) The Bell Journal of Economics and Management Science 3-21.

transited to rule-based regulatory reforms when the immediate need for emergency actions is mitigated. Considering the unusually strong power of discretion that the government can exercise in a crisis economy, it seems necessary to place the burden of policy return from ad-hoc style emergency response to rule-based regulatory reform on the government in terms of accountability rather than depending on the legislature to pass a law in that regard. In any case, however, it does not imply that emergency regulations adopted in haste receive *carte blanche* treatment,[138] and the tension between self-preservation and defending the essence of democratic values has always been at the core of discussions of emergency powers.[139]

Third, a financial emergency comes with high risks of social disruption, and the credibility of the government makes a difference in the course of emergency response. It means that political factors play a critical role in making policy choices when the economy is in a state of financial emergency and the intensified political instability due to the financial turmoil influences the decisions of the government. In the wake of a financial crisis, politics becomes a critical factor when regulators are making decisions for two mutually affecting reasons. Most of all, mismanagement of financial emergencies, which is already clear proof of the ineffectiveness of the existing regulatory system, can easily inflame public anger and lead to anti-establishment or anti-government movements as was witnessed by the Occupy Wall Street movements that spread around the globe in the aftermath of the global financial crisis of 2008. The heightened political pressure due to the insurmountable shocks created by the financial failures of the

[138] OECD, 'Regulatory Quality and COVID-19: Managing the Risks and Supporting the Recovery: Note by the Secretariat in consultation with the Chairs and the Bureaus of the Regulatory Policy Committee and the Network of Economic Regulators' (29 April 2020).
[139] Oren Gross and Fionnuala Ni Aolain, *Law in Times of Crisis* (CUP 2006). This book tackles the question of how to allow the government sufficient discretion and powers to meet crisis while minimizing the danger that such power would be abused even though the main question is as to violent crises involving military actions.

largest financial institutions makes it extremely difficult for the government to make decisions that can bring public criticism for a variety of reasons. Moreover, when the crisis is attributed to the regulatory failure of the government, which was also the case for the global financial crisis of 2008, it adds more burden to the government as a decision-maker to handle an emergency.[140] Social instability makes it difficult to resolve financial distress because the political opposition to the decisions of the government can increase the burden of making swift decisions that are necessary to remove urgent threats to the economy. At the same time, a failure to end an emergency can worsen the credibility of the government even more, and the continued economic instability and devastating losses in production will lead to a total disaster for the economy as was the case of the causes of the Great Depression in the 1930s. In the end, it is hard to imagine that a financial emergency can be effectively handled without the existence of strong political leadership. Consequently, political instability can exacerbate financial turmoil and delay the restoration of stability in the economy. This means that the emergency response of the government is not simply dependent on the nature of the financial risk and that regulators are not entirely free from political reactions. In this regard, the political position and power of the administration at the time of crisis becomes a critical factor that makes a real difference as to how efficiently the government can handle the situation amid conflicting political and economic interests in the country and abroad. In practice, the credibility of the administration as to their capacity for crisis management has a critical impact on the process of crisis-fighting.

[140] At the outbreak of the Global Financial Crisis of 2008, the sense of injustice and inequality was intensified and widely spread from New York to major European cities and other parts of the world. In particular, the popular discontent to political establishments led to subsequent development of political movements in some European countries such as Syriza in Greece and Podemos in Spain. The protests and political movements in general call for a re-examination of the relationship between justice and financial markets. See Rosa M. Lastra and Marcelo J. Sheppard, 'Ethical Foundations of Financial Law' in *Research Handbook on Law and Ethics in Banking and Finance* (Edward Elgar Publishing, 2019) 69-70.

As to the political influence on the trajectory of emergency response by a government, Posner and Vermeule provide an interesting comparison of crisis governance in the administrative state between the 9/11 terrorist attack and the global financial crisis of 2008 in the U.S. and explain similarities and differences between the two cases.[141] In both episodes, they argue that broad political processes, rather than legal or constitutional constraints, operated to create a similar pattern of crisis governance and Congress delegated large new power to the executive with qualifications and oversight mechanisms of uncertain force and scope.[142] The reason for such a broad delegation of power to the executive is attributed to the fact that other actors have no alternative in a crisis despite a widely held concern about the possibility of abusing excessive delegation of power. In other words, in an administrative state, the executive and the agencies are almost always the main crisis managers while “Congress and the courts suffer from crippling institutional debilities as crisis managers” and are reduced to adjusting the government’s response at the margins.[143] This analysis is based on the Schmittian view of emergency governance in the administrative state that the government could no longer act through the idealized liberal pattern in which the legislature frames general rules of law first and then the executive and courts apply the rules; instead, the executive improvises ad hoc measures and exercise broad and vague discretion to particular circumstances.[144] This view is a contrast to the Madisonian view of a deliberative legislature that the executive can only act

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[141] Posner and Vermeule, ‘Crisis Governance in the Administrative State’ (n 127).
[142] Ibid.
[143] Ibid. As to the dilemma for legislatures related to Schmittan view, the authors argue that “before a crisis, they lack the motivation and information to provide for it in advance, while after the crisis has occurred, they have no capacity to manage it themselves.” 1643
[144] Carl Schmitt, Legality and Legitimacy 83 (Duke University Press 2004) (Jeffrey Seitzer, trans)(originally published 1932). Since the legislature lacks the motivation to act before the crisis, “the initial administrative response will inevitably take place under old statutes of dubious relevance, or under vague emergency statutes that impose guidelines that the executive ignores and that Congress lacks the political will to enforce, or under claims of inherent executive authority.” Posner and Vermeule, ‘Crisis Governance in the Administrative State’ (n 127) 1652.

after public debate and congressional authorization or just take interim actions until Congress intervenes. Rather than spending time bargaining the results of the proposal submitted by the executive, the legislature tends to delegate the power to act quickly to the executive as soon as they request it because the cost of the deliberate examination is huge at the brink of economic downfall.

These views are generally based on the institutional qualities and political constraints involved in liberal democracies. Thus, it may be easier to explain by applying the first two features of a financial emergency– that an emergency is hard to anticipate and that it poses time constraints, to give a better understanding of the dynamics of emergency governance and rulemaking among political actors. Even though the Schmittan view that gives more weight to the executive as emergency manager superior to the legislature is more suitable to explain the reality of emergency governance as we have witnessed in modern financial crises including the most recent global financial crisis of 2008, the pressure of the legislature with the public demand for moral judgment and equality in the process of crisis management could not be ignored by the executive in the course of crisis management. To make it more accurate, thus, it would be necessary to draw a line between emergency governance and post-crisis regulatory reform since the former is mostly driven by time constraints, which necessitate the Schmittan approach, while the latter is often shaped by complex political reactions represented by the legislature.

Interestingly, the differences between the two cases of the 9/11 terrorist attack and the global financial crisis of 2008 are found in the different political conditions and the loss of the Bush administration's popularity and credibility between 2001 and 2008.[145] According to Posner and Vermeule, the Bush administration exercised its authority more aggressively after 9/11[146] and the same government "bowed to congressional supremacy and eschewed the claims of inherent and exclusive constitutional power it had used to defy statutes in the earlier episode."[147] While the government's intervention in financial markets in 2008 was no less active and sweeping than it was in 2001, the government responses in 2008 were mainly driven by the Treasury and the Fed, which is an independent agency and not under the direct control of the White House, rather than the President, and the government made no constitutional argument about its authority as it did in 2001.[148] As the Bush administration had lost public confidence in a credible crisis manager and the time was near to the next presidential election, the two presidential candidates, Senator John McCain and Senator Barack Obama, also had to speak in public that they would support the bailout bill to ensure that the U.S. government, whoever would win the election, has both the will and the power to control the crisis.[149] After all, it is difficult to lay a uniform way of responding to a crisis because the political situation has a real impact on emergency responses both from within and outside of the crisis economy.

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145 Posner and Vermeule, 'Crisis Governance in the Administrative State' (n 127).

146 The legal framework for counterterrorism after 9/11 came from Article II of the Constitution, especially the Commander-in-Chief Clause, and from the two statutes of the Authorization for Use of Military Force (enacted on September 18, 2001) and the Patriot Act (enacted on October 26, 2001). For a detailed analysis of the two statutes in the context of crisis governance and rulemaking, see Posner and Vermeule, 'Crisis Governance in the Administrative State' (n 127).

147 Id. 1615.

148 The emergency responses at the time of the global financial crisis in 2008 were driven by the Federal Reserve Chair Ben Bernanke, Federal Bank of New York President Tim Geithner, and Treasury Secretary Hanry Paulson. The President was clearly not seen as the main driving force in the process compared to the government's emergency response in 2001.

149 David M. Herszenhorn, 'Congress Approves $700 billion Wall Street Bailout' *The New York Times* (3 Oct 2008) <https://www.nytimes.com/2008/10/03/business/worldbusiness/03iht-bailout.4.16679355.html> accessed 21 July 2021. For a detailed description of the emergency responses of the government in 2008, see 'Panic: The Untold Story of the 2008 Financial Crisis' HBO (2018) <https://www.youtube.com/watch?v=QozGSS7QY_U> accessed 23 July 2021. The logic is similar when the IMF determines whether they would lend money to a financially troubling country – it is more important for the creditors whether the new or incoming government is willing to follow the agreements signed by their predecessors. For this reason, it is easy to find cases when the negotiators from the IMF want to have a talk with the opposite party leaders or the president-elect before concluding a deal when the chances are high for regime change in a debtor country in the near future.

In any case, emergency responses are largely influenced and shaped by political conditions and constraints. Nevertheless, emergency responses must be grounded on a minimal degree of legitimacy despite the imminent need for government intervention. This is particularly important considering the high potential of regulatory capture in the financial markets where regulators with discretionary power can use it to improve the economic interests or status of the financial industry. As to the sequence, emergency responses set the basic grounds for the subsequent structural reforms and influence the course of reform in setting agendas and mobilizing as well as distributing resources. Therefore, it is important to clarify the objectives of emergency responses and structural regulatory reforms so that the influence of the former does not overburden the latter or pose serious contradictions between the two. In practice, the public belief in the legitimacy of emergency policy measures affects the level of voluntary compliance in the short term and the credibility of the government in the long term.

2.2.2 Legitimate Principles of Emergency Policymaking: COVID-19 and the GFC

In this respect, the COVID-19 pandemic provides useful insights and information on how emergency policy actions should be implemented and executed under the pressure of urgency. The global health crisis showed many similarities with the global financial crisis of 2008 since it revealed that the world has become highly interconnected, and the ever-increasing mobility of people and services due to rapid technological advancement has made countries more vulnerable to shocks and risks originating from other parts of the globe. At the same time, it was manifested that the global risk management system is not sufficiently developed, or not ready to operate if any, to deal with a global crisis due to the weak cooperation among countries and the serious disparity between rich and poor countries. Having said that, international organizations and intergovernmental forums have attempted to promote cooperation among member countries as "platforms" where countries exchange scientific expertise, design evidence-based policies, and align regulatory approaches.[150] For example, the G20 Trade and Investment Ministerial Statement in March 2020 specified that "… emergency measures designed to tackle COVID-19, if deemed necessary, must be targeted, proportionate, transparent, and temporary and that they do not create unnecessary barriers to trade or disruption to global supply chains, and are consistent with WTO rules."[151] Even though policy responses to the pandemic remained mostly at the country level, it is meaningful to review the principles highlighted during the health crisis response at the international level. When collective action is required to ensure the effectiveness and relevance of regulatory efforts worldwide, as is the case of the COVID-19 global health crisis, some of the usual avenues of cooperation among national governments may include the promotion of international evidence gathering and sharing, regulatory alignment and mutual recognition processes for expediting administrative approvals and limiting the regulatory barriers to trade in essential products.[152] According to the report published by the OECD, titled *Regulatory Quality and COVID-19: Managing the Risks and Supporting the Recovery*, the robustness of rapid decision-making, the adaptability of staff, and the capacity for non-digital essential inspections comprise key contributors to the effective regulatory performance of economic regulators in terms of internal

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[150] OECD, 'Regulatory Quality and COVID-19' (n 138). For an in-depth analysis on evidence-based approach to macroprudential policy, see Anat Keller, 'Debiasing Macroprudential Policy: Part 1: An Evidence Based Approach and the Precautionary Principle' (2019) 34(1) Journal of International Banking Law and Regulation 5-16. See also Iris H-Y Chiu, Andreas Kokkinis & Andrea Miglionico, Relief and Rescue: Suspensions and Elasticity in Financial Regulation, and Lessons from the UK's Management of the Covid-19 Pandemic Crisis (2021) 64 Washington University Journal of Law & Policy 63.

[151] G20, 'Trade and Investment Ministerial Statement' (30 March 2020) <http://www.g20.utoronto.ca/2020/G20_Statement_Trade_and_Investment_Ministers_Meeting_EN_300320.pdf> accessed 25 July 2021.

[152] OECD, 'Regulatory Quality and COVID-19' (n 138); OECD, International Regulatory Co-operation: Addressing Global Challenges (OECD Publishing, 2013) <https://read.oecd-ilibrary.org/governance/international-regulatory-co-operation_9789264200463-en>

governance and processes.[153] In short, there are four key aspects of emergency responses as highlighted through the recent global health crisis: the legitimacy of emergency measures, post-implementation review of regulation, transparency for political accountability, and focus on the quality of regulation.

First, the public belief in the legitimacy of emergency measures has a direct impact on the level of compliance with emergency policy measures. For example, in a society where people generally believe that the government's measures are necessary and effective to combat the pandemic, the level of compliance to emergency measures, such as wearing a mask, staying at home, maintaining social distance, or voluntary contact reporting, is high. However, if they see that such measures are inappropriate or ineffective in eradicating the virus, or are suspicious of political intentions behind the scenes, such as using surveillance data for censorship or suppressing democratic social activities, the level of compliance goes down. Furthermore, if the legitimacy of the policy enforcement is questioned on a major scale, it can lead to civil disobedience movements or civil unrest including demonstrations against the enforcement regime and public institutions.[154] Considering that it is more effective to rely on voluntary compliance rather than formal enforcement procedures, the perceived legitimacy of policy measures and trust in the government is crucial for the crisis response to be successful.[155]

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[153] OECD, 'Regulatory Quality and COVID-19' (n 138).

[154] David B. Lewis, 'Policing the Pandemic: The Legitimacy of the Police and the Potential for Civil Unrest; a personal commentary' (May-June 2021) 8(1) Journal of Global Faultlines 133-135. The author argues that there is already both passive and active disobedience in COVID-19 compliance in the U.K. including direct actions and demonstrations in London against COVID-19 restrictions. Moreover, anti-lockdown resistances to a phase of random criminal damage against public buildings have been reported in Sweden, the Netherlands, Belgium, and Germany.

[155] Since the trust in the government, and the public institutions, may degrade depending on the perceived effectiveness of the emergency response, "the use of emergency powers and tools of surveillance technology to track the spread of COVID-19 must be non-intrusive, limited in time and purpose and abide to strictest protections and international human rights standards." United Nations, 'Shared Responsibility, Global Solidarity: Responding to the Socio-Economic Impacts of COVID-19' (March 2020).

Second, emergency measures adopted in haste should be temporary and subject to careful review ex-post. Considering the unprecedented challenges and the broad social and economic impact of emergency decisions, the OECD report on regulatory quality suggests that adherence to good governance practices and robust decision-making processes can help ensure the soundness and predictability of the policy decisions and make them reliable and affordable. For example, regulations adopted through a fast-track procedure should be subject to careful post-implementation review when the crisis is over by applying sunset clauses or obligatory review clauses in the emergency regulations when they are adopted.[156] Considering that the tracking and storing of personal information involve the possibility of violating the privacy of individuals and the underlying human rights, it is imperative to ensure that emergency measures are validated for a limited and specified period and that the relevant personal information stored in emergency circumstances is adequately returned or deleted in due course.[157]In this regard, the best approach to ensure the maximum degree of privacy may include the concept of privacy-by-design, which involves "the use of aggregated, anonymized, or pseudonymous data to provide added privacy protection, or the deletion of data once its purpose is served."[158] A good example is a COVID-19 application developed by the Norwegian Institute of Public Health which is designed to store location data only for 30 days.[159]

<https://unsdg.un.org/sites/default/files/2020-03/SG-Report-Socio-Economic-Impact-of-Covid19.pdf> accessed 28 January 2021.

156 OECD, 'Regulatory Quality and COVID-19' (n 138).

157 The COVID-19 pandemic triggered the discussion about the balance between the fundamental right to privacy and the public interest as to data processing operations by governments to contain the pandemic in the state of emergency. See Emanuele Ventrella, 'Privacy in Emergency Circumstances: Data Protection and the COVID-19 Pandemic' ERA Forum (2020) 21: 279-393; OECD, 'Tracking and Tracing COVID: Protecting Privacy and Data While Using Apps and Biometrics' (April 23, 2020) https://read.oecd-ilibrary.org/view/?ref=129_129655-7db0lu7dto&title=Tracking-and-Tracing-COVID-Protecting-privacy-and-data-while-using accessed 28 July 2021.

158 OECD, 'Tracking and Tracing COVID' (n 157).

159 Ibid.

Third, policy measures must be communicated and adopted transparently so that the public can clearly understand the purpose and necessity of the policy measures. Even though it is often challenging, during the crisis, to consult with all affected parties on urgent matters before making decisions, it is both necessary and possible to be transparent so that those who made decisions are accountable and responsible for their decisions.[160] A rapid policy response should be based on evidence and scientific expertise, and the involvement of experts as advisors in the process of decision-making is imperative.[161]

Finally, emergency policymaking should focus on those who are most vulnerable to shocks and take the impact of emergency measures on social cohesion into account. One of the most salient similarities between the financial crisis and the health crisis is that these are "extraordinary times that require extraordinary measures."[162] Considering the immediate threats posed against the global communities in both crises, national governments and international financial institutions had to support the economies with a large and unprecedented level of public financial packages to keep the global economy running. However, one of the key lessons learned from the past financial crisis is that the quality of policy matters more than the quantity of money devoted to rescuing the economy. Thus, it is important to monitor the progress of the crisis and the direct and indirect effects of policy interventions so that they stay relevant to solving the core problems.[163] Most of all, the COVID-19 pandemic made it clear that lower-skilled and uneducated workers, who cannot work remotely, have been hit the hardest and the

[160] OECD, 'Regulatory Quality and COVID-19' (n 138).
[161] Ibid.
[162] UN, 'Shared Responsibility' (n 155).
[163] Ibid.

inequalities in the labor market, given pre-existing disparities based on race and gender, have exacerbated in many countries.[164] In this regard, one of the overarching principles adopted by the UN includes that the policy interventions are "to focus on families, women, children, youth, persons with disabilities and the elderly, low-wage workers, small and medium enterprises and the informal sector" under the main objective of keeping households and businesses afloat. Such emphasis is relevant because it is highly likely that untargeted and ill-purposed public financial subsidies can be used as a tool for spreading populist agendas in many countries rather than addressing the challenges posed by the pandemic. For example, income support and asset purchase programs to sustain financial market difficulties due to the pandemic must be targeted and gradually move to growth-enhancing policies.[165] As to the debt sustainability in emerging economies, the World Bank points out that "in economies where asset purchases continue to expand and are perceived to finance fiscal deficits, these programs may erode central bank operational independence, risk currency weakness that de-anchors inflation expectations, and increase worries about debt sustainability."[166]

Ultimately, a crisis leaves clear marks on society, and the pandemic will leave long-lasting adverse effects on the global economy due to underinvestment, unemployment, low production, and labor-force declines in advanced economies, to name a few. One of the crucial issues that often emerge after a large-scale crisis is weakened social cohesion which hinders sustainable economic growth and social progress. Even though the past financial crisis seemed to be a

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[164] Francisco H. G. Ferreira, 'Inequality in the Time of COVID-19' (June 2021) Finance & Development, International Monetary Fund <https://www.imf.org/external/pubs/ft/fandd/2021/06/pdf/inequality-and-covid-19-ferreira.pdf> accessed 27 July 2021.

[165] The World Bank, 'Global Economy to Expand by 4% in 2021; Vaccine Deployment and Investment Key to Sustaining the Recovery' (January 5, 2021) Press release <https://www.worldbank.org/en/news/press-release/2021/01/05/global-economy-to-expand-by-4-percent-in-2021-vaccine-deployment-and-investment-key-to-sustaining-the-recovery> accessed 28 January 2021.

[166] Ibid.

matter of the financial services industry at first, it became manifest that the crisis itself and how we responded to the crisis affected the soundness and the trajectory of the global economy. There is no doubt that we are still living in the shadow of the prolonged global economic recession since the global financial crisis of 2008. Most of all, the increasing income inequality and marginalization of wealth are considered the most negative impact of the crisis that made the global economy more vulnerable to another crisis – the COVID-19 health crisis. In this regard, it is a critical consequence of the global response to the financial crisis that the world economy has become less resilient as it failed to provide the most necessary products and medical services, especially for the most vulnerable parts of the globe. Even before the outbreak of the COVID-19 pandemic, almost half of low-income countries were in debt distress and limited fiscal room made it particularly difficult for them to help the poor and vulnerable in the course of fighting the pandemic.[167] In this regard, debt service suspension became an important issue, and the World Bank and IMF in April 2020 called for the suspension of the debt-service payments for heavily indebted countries, supporting the expansion of the Debt Service Suspension Initiative (DSSI). According to the World Bank Global Economic Prospects published in June 2020, global debt has risen to 230 percent of GDP since the global financial crisis, and the emerging markets and developing economies (EMDEs) debt reached a historic high of 170 percent of GDP by 2019.[168] In addition, government debt, in almost 40 percent of EMDEs, is at least 20 percent points of GDP higher than it was in 2007, and more than a quarter of corporate debt in the average EDME is denominated in foreign currency.[169] Following the decade-long global recession since the global financial crisis, many emerging

[167] Paul Blake and Divyanshi Wadhwa, ‘2020 Year in Review: The Impact of COVID-19 In 12 Charts’ (14 December 2020) World Bank Blogs <https://blogs.worldbank.org/voices/2020-year-review-impact-covid-19-12-charts> accessed 28 January 2021.
[168] World Bank, ‘Global Economic Prospects’ (2020).
[169] Ibid.

markets and developing economies (EMDEs) are less prepared to weather a global downturn while they were able to implement large-scale fiscal and monetary responses during the global financial crisis of 2008.[170] As the debt accumulated in the course of responding to the pandemic is rising and places a serious burden on economic growth in the long run because the costs of debt services will be financed by higher taxes, additional borrowing, or cuts in necessary expenditures, more actions on debt relief are deemed as necessary for a sustainable recovery in developing countries.[171] Consequently, it is hard to deny that the two crises are closely related, and the lessons learned from the past financial crisis, and its aftermath, should give policymakers critical insights on how to meet the challenges posed by a global health crisis.

2.2.3 Different Priorities and Policy Objectives

Considering the peculiar features of financial emergencies and the major factors that drive the way of addressing challenges by the government, it is clear that the phase of emergency and its aftermath pose different priorities and policy objectives as to their ultimate concerns and purposes. As a result, the level of legitimacy required at the two different phases cannot be identical. Even though the emergency responses still require the process of justification under the framework of the existing legal frameworks and any government agency may be unwilling to take illegal actions, the state of urgency in the course of emergency responses provides strong grounds for expediting decision-making by the government. As discussed earlier, thus, the scope of discretion afforded by regulators at the emergency phase is often far greater than it may be allowed during regulatory reform under normal situations. The difference between the

[170] Paul Blake and Divyanshi Wadhwa, '2020 Year in Review' (n 167).
[171] World Bank, 'Global Economic Prospects' (n 168).

two occasions is connected to the degree of discretion afforded by the government and the legitimacy of discretionary decisions often depends on the given economic and political circumstances. In this sense, it is quite useful to apply the principle of reasonableness in reckoning the legitimacy of policy actions both in financial emergencies and regulatory reform.

While both emergency response and regulatory reform deal with the same financial markets, the targets and purposes of policy actions should differ from one to another. For example, the purpose and target of emergency policy actions, such as quantitative easing (QE) or massive bailouts of large failing financial institutions in the immediate aftermath of a financial crisis, are different from that of the subsequent regulatory reform measures which are designed to change the overall structure of the financial regulatory systems for a longer-term. This distinction is particularly important at the international level where states tend to be active in cooperation at the outbreak of financial crises due to the imminent risks posed to their economies while less likely to reach decisive agreements when the storm of a financial crisis is lessened and domestic concerns on global financial distress are diminished. In this sense, one of the most problematic aspects of the post-crisis regulatory reform is that policy measures that should have followed the emergency responses to the global financial crisis by national governments and international financial institutions to prevent the entire collapse of the global financial system have not come in its entirety. Although many policy measures to reform the outdated financial regulatory structures had grand starts in the aftermath of the global financial crisis with ardent political support, fundamental reform measures other than emergency responses have not been realized in the years afterward.[172]

[172] Buckley et al. (2016) also argue that none of the vigorous reviews, reform, or legislative measures has implemented truly fundamental changes as was done in the 1930s and that the post-crisis international developments have been very modest rather than reconceptualizing the working and regulation of global

For emergency response, the most important policy objective is to prevent systemic destruction of the financial system. To that end, the government wants to stop the contagion of risks by directly saving failing firms and by giving strong signals to restore market confidence. Any event in financial markets that is called a crisis entails spillover effects that can negatively affect the normal functioning of international financial markets. Thus, it is the foremost objective of the emergency phase regulatory actions that the risks already exposed are contained, if not eliminated, and that those risks are not spread to other economies that are connected as networks of globalized financial markets.

Having said that, any government, or an international financial institution (IFI), such as the IMF or World Bank, does not easily attempt to ignore the legal constraints under the existing regulatory frameworks set before the crisis. However, the urgency understood by the global community of regulators, such as central banks of advanced economies or IFIs, pushes for the faster revision of the existing rules to address the immediate challenges posed to the global economy. Even though the decision-makers are highly regarded professionals and experts in the field of international financial regulations, there is always a risk of misjudgment or confusion due to the time-restricted nature of the crisis phase. For this reason, regulators tend to seek exemption from strict judicial review as to their decisions. One of the most salient examples of such attempts can be found in the initial proposal of the U.S. Treasury Secretary Henry Paulson to Congress where he provided that the Secretary's purchasing decisions would be final and not subject to judicial review.[173] Regulators at the time of a financial crisis use all

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financial markets. See Ross P Buckley, Emilios Avgouleas, and Douglas W Arner, *Reconceptualizing Global Finance and Its Regulation* (CUP 2016).

[173] Posner and Vermeule, 'Crisis Governance in the Administrative State' (n 127) 1624.

the necessary policy choices at their hands and often make detours when they determine such actions are necessary. Saving the economy from a catastrophe gets the priority of emergency response and the existence of legal constraints are regarded as those to be challenged and changed so that the emergency response can make its way forward. Naturally, the emergency response of governments cannot be based on strict standards of public administrative law.

Since financial instability is ultimately an issue of trust among market participants including investors, financial institutions, customers, and even regulators, financial markets fluctuate when new information such as the news about major financial institutions' capital flows or anticipated regulatory implementations is spread in the market regardless of the accurateness of that information or its true implications. Therefore, one of the prime objectives of regulators in times of financial emergency is to restore confidence in the financial market both at home and abroad. To that end, regulators tend to make bold statements and unprecedented policy actions including proactive intervention in the market to give strong signals to market participants that the overall system would not be disrupted or collapsed despite all the bad things that already had happened and that it is safe to run the business as usual. Since modern financial markets are closely connected across borders and capital flows almost simultaneously due to the rapid technological developments in trading and banking services, restoring trust in the crisis-hit financial market is extremely important as a policy objective of emergency response.

At the same time, it implies that such statements might not describe the exact condition of the financial market under distress, and a certain degree of secrecy is justified as news of the possible losses of large financial institutions can cause panic among investors and depositors and make the situation even worse. For example, when U.S. Treasury Secretary Henry Paulson, requested Congress "unspecified authority" to spend $700 billion in buying financial assets to stabilize the economy, he contended that the fact that he had the "unspecified authority" would make it unnecessary for him to use the power because the market would take it as a signal that the government could intervene as much as necessary.

In contrast to emergency response, the primary purpose of regulatory reform is to change or improve the structural aspects of financial markets by making necessary changes to the existing system - adopting new rules, abolishing old ones, and adjusting existing ones to conform with the changing market environment and evolving social standards. Thus, regulatory reform takes a *progressive* rather than *revolutionary* attitude because the goal of reform is an improvement of the present conditions and practices and not necessarily an entire abandonment of the existing system if a careful analysis shows that the existing system is worth retaining.[174] Although progress is sometimes overlooked because it happens gradually rather than radically,[175] the gradual process of organizing ideas, proving the validity of alternatives, and accepting or assimilating to the emerging, or newly highlighted, values as the collective wisdom of the time makes progress as enduring and sustainable. It often takes a considerable amount of time to collect ideas and opinions from a variety of stakeholders who are involved in the subject matter in one way or another. Even though some reforms may be completed within a relatively short period, others may be extended to many years before realizing the

[174] Robert Finley, 'Judicial Administration: What Is This Thing Called Legal Reform?' (1965) 65(4) Columbia Law Review 569-592. In this article, Finley postulates that legal reform is most importantly a state of mind: a willingness to evaluate present conditions and practices objectively based on a simple test – can the present conditions and practices be improved? Consequently, an affirmative state of mind is requisite for substantial legal reform progress.
[175] Ibid. The article limits the scope of legal reform to matters of judicial administration and concerns how the judicial system should be improved from the perspective of the effectiveness of procedural law.

fruits of reform, depending on the time required for a legislative procedure or reaching a political consensus. Without the need for fast decision-making, the extensive use of discretion by the government is considered undesirable or unjustifiable because the need for a quick policy response is diminished as the economy passes the phase of emergency and the event is being controlled despite the remaining uncertainties.

In reality, the regulators are generally unwilling to use their discretionary powers without the pressure of an emergency, and it is not because they have no authority to use the discretionary powers except in an apparent emergency as a matter of law but because it is more efficient and safe to rely on other means of decision-making that are deemed as legitimate to avoid conflicts between different interest groups and to encourage voluntary compliance to regulatory changes. Once the credibility of the government as the trustee of the economy plummeted due to the outbreak of financial crises, the regulators tend to be more cautious and attempt not to provoke further conflicts with the opposite parties or the wider public in the course of undertaking regulatory reform. As will be discussed in the subsequent section on the principles of legitimacy, heavy reliance on discretion and emergency-style ad hoc decision-making are sources of weakening the legitimacy of regulatory reform. In particular, such actions make it difficult for market participants to predict what would come next as to regulatory requirements and hence increase the regulatory risk and the cost of compliance. Amid high uncertainty in the market itself, regulatory risk can serve as a serious cause of market instability by raising the costs and burdens of market participants. Since the credibility of government responses to financial crises plays a key role amid heightened uncertainty in the financial market, continuous ad hoc decision-making based on discretion can ultimately reduce the level of trust between the government and the market. Thus, discretion is less attractive and defendable in the phase of regulatory reform than it is often justified under emergency responses even though, in theory, the executive may still reserve the authority to use discretion.

While the threat of spillover effects and the systemic meltdown of the financial market drives the course of emergency response, the primary concern of the government in the regulatory reform phase is to make the system more resilient so that sudden shocks would not damage the entire system and the economy can recover quickly even if a few financial institutions fail.[176] Ultimately, systemic risk is produced and transmitted by the contagion mechanisms including direct contractual dominos, a credit crunch due to lenders' distress, and the intensity of asset sales in deleveraging, and all of the externalities would be alleviated if the financial market is more resilient to such shocks and can absorb more losses with less distress.[177] This involves a range of steps including legislative actions, and the success of regulatory reform primarily depends on promoting fundamental behavioral changes in the financial market where institutions and market participants are closely interconnected via complex networks of transactions and contracts.

Even though the potential of contagion and systemic risk due to a series of quick bankruptcies in financial markets is lower in the post-crisis reform phase, there still exists financial instability due to the weakened positions of large financial institutions, the sharp increase of public debt, and the high rate of unemployment, just to name a few. From the perspective of

[176] The meaning of resilience is critical in analyzing the adequateness of the post-crisis reform because the prevalence of the too-big-to-fail doctrine inherently assumes that the soundness of the entire system depends on the soundness of the largest financial institutions. The regulatory focus is primarily on preventing them from failing while more competition-inducing policies may enhance the resilience of the overall financial system by allowing the market to choose who wins and lose and make the system less dependent on the business of the largest financial institutions.
[177] Admati, 'Rethinking Financial Regulation' (n 128).

policymakers, thus, the focus is more on changing the business model and investment behavior of financial institutions by devising new rules that can work in the post-crisis environment. For example, the problem of excessive and reckless risk-taking in investment by financial institutions has been one of the important reform agendas and it has a lot to do with the tendency of taking high leverage in the absence of adequate accountability schemes that should have been in place before things become extremely distressed. Thus, regulatory expectations towards senior individuals of financial institutions who are empowered to improve internal risk management function were strengthened and the idea of placing responsibility on senior management was favored by regulators in the post-crisis reform.[178]

Furthermore, while the purpose of emergency responses is quite clear that the troubling financial institutions do not spread the shocks to the wider economy and the risk to the entire financial system is extinguished at all costs, the targets and objectives of regulatory reform usually require more sophisticated analyses in consideration of the condition and capacity of the financial markets. Certainly, there is more than a single goal to be achieved through regulatory reform, and it often involves multifaceted policy goals and agendas. In this process, complicated ideas on what the reformed financial markets should be like often become a primary source of conflicts among different interest groups and stakeholders. Therefore, the legitimacy of reform procedures and policy measures becomes more important as public scrutiny on the progress of regulatory reform is strengthened in the post-crisis environment.

[178] In the UK, this approach was developed from the final report of the Parliamentary Commission on Banking Standards, published in 2013, which acknowledged that a lack of personal responsibility of senior figures had promoted an "accountability firewall" and provided the source of serious problems that led to unethical behaviours not least the scandal of the fixing of the LIBOR rate. See William Blair and Clara Barbiani, 'Ethics and standards in financial regulation' (2019) in Costanza A. Russo, Rosa M. Lastra and William Blair (eds), *Research Handbook on Law and Ethics in Banking and Finance* (Edward Elgar 2019).

Considering law as a continuing struggle and challenge of social practice, legitimacy as legality and reasonableness is highly relevant to the justification of any authority in a modern state. In this term, legitimacy is a justification principle that attaches to the authority structure and gives reasons to the citizens for acceptance or obedience. Considering the distinctive priorities and policy objectives between emergency response and regulatory reform, massive bailouts for large financial institutions cannot be easily criticized as an inappropriate response to the financial turmoil that threatened the survival of the global financial system as a whole. However, leaving the existing rules or even making new ones that strengthened the concept of too-big-to-fail as a de facto standard of international financial markets regulation by giving incentives to financial institutions to maintain the previous ways and means of operation is problematic.

Over a decade after the global financial crisis in 2008, the global financial regulatory system has not been altered at the macro level, and this persistence of the existing regulatory structure makes many observers contend that "another major crisis is coming as we now have a globalized international financial system without a global financial regulator, a global lender of last resort or a global sovereign bankruptcy regime."[179] It is hard to dispute the possibility of another global financial crisis in the years to come without reforming the existing global financial architecture. In this sense, it is not a mystery that we have seen the recurrence of financial crises over the past decades. It is warranted unless the underlying approaches, assumptions, and structures of global financial markets are fundamentally changed by embracing structural regulatory reforms based on the principles of legitimacy.[180]

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[179] Buckley et al., *Reconceptualizing Global Finance and Its Regulation* (n 172) 5.
[180] See chapter 4 of this thesis for an analysis of the underlying approaches and assumptions of liberal financial markets theory and how such predominant ideas have caused problems that led to financial crises.

Conclusion

Legitimacy as legality and reasonableness of law explains what makes a law to be perceived as legitimate in the context of dynamic social interaction between regulators and citizens. Understanding the dynamics of lawmaking and law-applying process in society is very useful in explaining why legitimacy matters in practice through channels of interactions among actors at different stages of public policy discourse. Fundamentally, legitimacy is an interactive concept that factually matters in financial regulation and reform, and interpreting the meaning and role of legitimacy requires an understanding of reciprocity between regulators and citizens in the regulatory ecosystem. The citizens' fidelity to the law significantly impacts compliance with the law and legitimacy as legality is an important factor because people's perception of the quality of regulatory reforms impacts how they respond to the changing regulatory environment. The linkage between legitimacy and compliance is significant in international law considering the relative difficulty of compulsion and enforcement measures among sovereign states. Legitimacy as the reasonableness of the law points to the quality of the law being reasonable and persuasive to those subjected to the law. It is primarily about how authority, either a government, a court, or a regulatory agency, gets authenticity by persuading the governed of the reasonableness of their actions. The reaction of the governed to such claims for authority has a critical implication in establishing the legitimacy of legal actions. In this discourse, the law is understood as continuing struggles and challenges of social practice rather than a finished project at a point in history, and whether the citizens believe that the government's actions are reasonable and justified directly impacts their willingness to obey.

When examining the appropriateness of the post-crisis regulatory response, it is important to note that the phases of emergency response and post-crisis regulatory reform should be distinguished as to the different priorities and objectives of regulatory actions. As noticeable emergency actions taken place under the pressure of extreme financial and social turmoil are often confused with post-crisis regulatory reform, the adequateness of post-crisis regulatory reform has not been properly assessed and this confusion has contributed to the recurrence of disastrous financial crises despite the calls for massive reform actions in the aftermath of financial crises.

The most important policy objective of emergency response is to prevent systemic destruction of the financial system, and governments need to give strong signals to restore market confidence to stop the contagion of risks. In contrast, post-crisis regulatory reform aims to change the structural aspects of financial markets and takes a progressive rather than revolutionary attitude focusing on behavioral changes. Structural changes often happen gradually rather than radically, and require the collective wisdom of diverse parties involved in the reform process. In particular, the extensive use of discretion by the government is normally unjustifiable in this phase because the need for a quick policy response is diminished as the economy passes the phase of emergency and the event is being controlled despite the remaining uncertainties. In this regard, the distinction between financial emergency and post-crisis regulatory reform is crucial to properly assess the adequateness of the reform measures and comprehend the legitimate objectives and principles of structural reform in the long term.

Chapter 3 Legitimate Principles of Financial Regulatory Reform

This chapter aims to identify general principles of financial regulatory reform that should apply to regulatory changes at the national and international levels. It first discusses the universality of legitimate principles in financial regulatory reform by analyzing the phenomenon of financial globalization, the reconceptualization of regulatory autonomy, and ethical problems of human behavior. Based on these analyses, it identifies general principles of financial regulatory reform as responsiveness, efficacy, integrity, and reasonableness of law and legal reform. Finally, the legitimacy of corporate governance and financial conduct regulation is discussed in the context of the evolving concepts of stakeholders in financial regulation. It challenges the traditional theory of shareholder primacy in corporate governance regulation and discusses why stakeholder interests should be reflected in setting regulatory objectives in financial regulation. In this discussion, the increasing demand for corporate social responsibility (CSR) and the nexus between CSR and corporate profitability is analyzed.

3.1 The Universality of Legitimate Principles in Financial Regulatory Reform

Considering the peculiar features of financial emergencies as discussed above, it is clear that the policy priorities and objectives of emergency response and regulatory reform should be distinguished and so are the standards of legitimacy. Thus, this section will be devoted to the analysis of the legitimacy of financial regulatory reform excluding the legitimacy of policy responses which are only valid and accepted under a state of emergency in a liberal democratic state. The prevailing approach to financial regulation in literature tends to over-emphasize the institutional distinctions between domestic and international financial regulatory frameworks and take the two as different businesses and subjects for regulation. An analysis of financial regulation at the international level cannot assume the same political and legal conditions and institutions as the domestic regulatory landscape. However, such distinction between domestic and international financial regulation has made it difficult for many observers to grasp the essence of problems associated with large financial institutions that are most often the causes of financial instability that leads to global crises. Although financial regulatory structure at the global level should be examined in light of the specific features of international decision-making procedures among states and the unique role of non-state regulatory organizations, it is imperative to note that the conduct of financial institutions in international financial markets is not fundamentally different from what they are doing in domestic markets. Therefore, it is essential to draw common ground for the legitimate principles of financial regulation applicable to both domestic and international financial markets. Based on those principles, it may be possible to assess specific standards and approaches to financial regulation under the given political and legal infrastructures of either domestic or international financial markets. Thus, it will be necessary to analyze the general principles of legitimacy and the ramifications in financial regulation regardless of the distinction between international and domestic financial markets. After then, it would be possible to figure out whether such concepts can, or cannot, be applied in international financial regulation in light of the structural settings of international financial business conduct.

3.1.1 The Applicability of General Principles

There are three avenues to demonstrate this proposition that the fundamental legitimate principles of financial regulation should be equally applicable to domestic and international financial regulation. First, it relates to the operational features of large, and internationally active, financial institutions that the essential functions of banks, or other financial institutions, and their business models are more or less similar regardless of whether they operate in domestic markets or international markets by cross-jurisdictional operations. From an economic perspective, this feature has only been reinforced by financial globalization during the past decades. While there would be a different focus on business models depending on the jurisdiction in which the banks operate, the fundamental business of financial intermediation remains unaltered regardless of the place of business. Instead, the increasing financial globalization exposes economies to external shocks and instabilities which substantially affect the domestic regulatory landscape as a result. Second, from a political perspective, the disillusionment with regulatory autonomy in international relations attests that states are rarely autonomous in international regulatory affairs. While many observers assume that states retain sovereignty which translates to autonomy in policy decision-making and attempts to interpret the state of international law or rulemaking as incompetent or illegitimate because it often lacks political frameworks as domestic regulatory systems, a closer observation of regulatory affairs in international relations reveals that it is more common that states share or give away their autonomy for a variety of reasons. These are critical implications in analyzing the legitimacy of international financial regulatory reform. Third, and finally, financial regulation entails fundamentally ethical questions that are equally applicable to both domestic and international financial regulation. In retrospect of the global financial crisis in 2008, the most critical issue raised in the course of saving the global economy from the entire collapse was an ethical question in essence – is it “right” to save the financial institutions with public money when their troubles were caused by the reckless decisions of their executives whose primary purpose of business conduct was to maximize their profits in the expense of the customers and stakeholders at large? This is a question of ethical justification of government intervention and policy choices, and it also implies other critical questions of fairness as distributional justice because the decisions lead to consequences that either discriminate or favor certain groups of citizens. Another important ethical question raised during the global financial crisis was related to the remuneration scheme of executives of large financial institutions. Explaining whether it is justifiable to compensate executives of failing financial institutions while the companies are being rescued by public money was certainly not a legal issue but rather a moral one. Indeed, the apparent discrepancy between legally acceptable and ethically unacceptable was at the center of the tragic failure of our legal and political system exposed by the global financial crisis. In addition to the contradiction of paying a large sum of bonus to the failing executives at the hike of financial turmoil, the prevailing risk-taking culture of financial institutions was understood as a matter of ethics and throws a critical question of whether “greed” should be promoted or prohibited in the market and society. Without addressing these fundamental issues, any analysis of regulatory reform is at risk of missing the roots of chronic problems. These three aspects of financial regulation deserve close examination and should be reflected in the analysis of the legitimacy of financial regulation accordingly.

3.1.2 Financial Globalization

Financial markets are globalized and so is the scope of financial regulation. Financial globalization during the past decades has made financial markets more open to both outside capital flows and external shocks due to the increasing financial interconnectedness, or even integration in some regions. Technically, the rapid progress in financial technologies and the increasing capacity to incorporate technological innovation into financial products and services have made financial markets more interconnected and the business models of banking and financial intermediation, in general, have seen swift changes following a wide range of digitalization. Without noticing these recent developments and new phenomena in global financial markets, it is almost impossible to make any relevant analysis of the legitimacy of financial regulation. Clarifying whether financial markets are globalized is essential to understand the challenges of financial regulation today and to determine the reasonable goals and methods of financial regulation proportionate to the nature of financial markets today. While financial globalization has been a subject of intense debate for some decades as to its positive and negative impacts on national economies, businesses, and individuals, along with more general discussions about the implications of globalization as scholars and commentators contend over whether the world has become a flat or even more curved place than decades before,[181] it is obvious that international financial markets are more deeply interconnected than it was around sixty years ago when exchange rates were fixed and capital controls were the rule within the Bretton Woods system, or some forty years ago when the gold standard was abandoned and exchange rates became flexible under the auspice of the IMF, or some thirty years ago when the possibility of European monetary integration looked less feasible.[182] While it is preliminary to conclude, it is hard to believe that financial markets today could work within the underlying architectures set decades ago, when the landscape of global financial markets is so different.

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[181] Thomas Friedman, in *The World Is Flat: A Brief History of the Twenty-first Century* (Farrar, Straus, and Giroux 2005), argued that the traditional and geographical boundaries are becoming irrelevant due to globalization and the world has become a level playing field in terms of competition. In contrast, David M. Smick presented the opposite view in his book titled, *The World Is Curved: Hidden Dangers to the Global Economy* (Portfolio 2008), where he examines the current threats to global prosperity from a vantage point for analyzing the global financial crisis of 2007-2008. Earlier, Joseph Stiglitz criticized in *Globalization and Its Discontents* (Norton 2002) that neoliberal policies pursued by the IMF, known as the Washington Consensus, disadvantaged developing countries and contributed to bringing financial crises in the 1990s.

[182] Christian Noyer, 'Foreword' in Morten Balling and Ernest Gnan (eds), *50 Years of Money and Finance – Lessons and Challenges* (The European Money and Finance Forum 2013). The link of the dollar to gold was broken in 1971 and fixed exchange rates of the dollar were abandoned by most IMF members in 1973. The European Monetary Union (EMU) emerged in 1999 in light of the global trend towards floating and volatile exchange rates. See Niels Thygese, 'Global and European Monetary Arrangements: From Bretton Woods to EMU' in Morten Balling and Ernest Gnan (ed), *50 Years of Money and Finance – Lessons and Challenges* (The European Money and Finance Forum 2013).

From a broad perspective of global financial markets, the division between capital-exporting and capital-importing countries has become blurred over the past decades with the emerging presence of developing economies in global financial markets, and the direction of capital flows has changed as well. As fast-growing economies accumulate a large amount of reserves, they begin to export capital to slow-growing advanced economies, reversing the direction of capital flows.[183] Contrary to the standard neoclassical economic theory's prediction that capital should flow from rich to poor countries because of the return differentials, empirical studies from the 1970s onward have shown that capital does not always flow from capital-abundant countries to capital-poor countries when capital is allowed to flow freely because of market failures and political risks.[184] This lack of capital flows from rich to poor countries is known as the 'Lucas paradox,'[185] and this phenomenon diminishes when the effect of institutional quality is accounted for, revealing that institutional quality is the most important determinant of capital flows and that is why rich countries receive more foreign investment than poor countries.[186] This shift in the direction of capital exports and imports and the diversified interests of countries beyond the simple classification of advanced and developing economies have affected the positions and capacities of states in international financial markets,

[183] Sebnem Kalemli-Ozcan, 'Cross-Border Capital Flows, Fluctuations and Growth' (2012) NBER Reporter, number 4, 7-10.
[184] Laura Alfaro, Sebnem Kalemli-Ozcan, and Vadym Volosovych, 'Why Doesn't Capital Flow from Rich to Poor Countries? An Empirical Investigation' (2008) 90 The Review of Economics and Statistics 347-368.
[185] See Robert E. Lucas, 'Why Doesn't Capital Flow from Rich to Poor Countries?' (1990) 80 The American Economic Review 92-96. In this work, Lucas compares the marginal product of capital between the United States and India in 1988 and demonstrates that the marginal product of capital in India must be about 58 times of the marginal product of capital in the U.S. With such magnitude of return differentials, according to the neoclassical models, investment goods would rapidly flow from the U.S. and other wealthy countries to India and other poor countries. As this is not the case, in reality, he criticizes the assumptions that are based on the differences in the marginal product of capital and considers alternative assumptions that could explain the opposite direction of capital flows.
[186] Laura Alfaro et al., 'Why Doesn't Capital Flow from Rich to Poor Countries?' (n 184). For poor countries to increase capital flows, the authors suggest that "policies aimed at strengthening the protection of property rights, reducing corruption, and increasing government stability, bureaucratic quality, and law and order should be a priority for policymakers." 365

complicating the formulas of rulemaking in global financial regulation.

From a narrower perspective of the financial industry, bank business models have evolved under the mixed influence of internal and external factors, such as the macroeconomic environment in which banks and their customers operate, the dimension of banking regulation, financial innovation, and technological progress, and the business objectives of banks such as asset growth, market share, or rate of return on equity, just to name a few.[187] For example, the use of new business models of credit-risk-shifting instruments such as credit default swaps (CDSs) exposed banks to low-probability-high-impact risks, and the rapid growth of securitization and structured investment vehicles induced an over-expansion of banking business and excessive risk-taking.[188] The gap between financial innovation coupled with technological progress and regulatory capacity to comprehend the underlying risks is always a potential source of regulatory failure in financial markets. Unfortunately, despite the interconnectedness of financial markets and the increasing volume of complex and non-traditional financial products that required closer attention from regulators, the global system of regulation and supervision of financial markets fell short of addressing challenges posed by the rapidly progressing banking businesses characterized by intensive financial innovation, substantial rise in the volume of trading in complex derivatives, increased inter-connectedness, growth in the value of financial assets and liabilities relative to GDP, among others, during the

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[187] David T. Llewellyn, 'Fifty Years in the Evolution of Bank Business Models' in Morten Balling and Ernest Gnan (eds), *50 Years of Money and Finance – Lessons and Challenges* (The European Money and Finance Forum 2013).

[188] See Id. for the context of structural change of global financial system in the period preceding the crisis. Among others, it is noteworthy that the Bank for International Settlements estimates that the outstanding value of CDS contracts reached over USD 60 trillion right before the onset of the global financial crisis and that one of the features of the pre-crisis business model included a sharp rise in cross-border business among the economies which hit the hardest by the credit crunch.

period preceding the global financial crisis of 2008.[189] To set the right objectives and standards of regulation, thus, it is imperative to understand the extent of financial globalization,[190] because the scope and depth of interconnectedness between financial markets across borders exert a direct impact on the potential of contagion by negative shocks originating from one country to other countries. At the same time, this perceived possibility of transmitting shocks to other economies largely affects how the framework of regulatory cooperation among public regulators should effectively address challenges caused by the traits of financial globalization. One of the most common methods of assessing financial globalization is to examine the volume of cross-border capital flows over time. These flows usually take the form of foreign direct investment, portfolio equity, and debt investment, constituting the financial account.[191]

It is easy to understand that the more capital flows across borders, the more globalized financial markets are. While there is evidence that the increasing amount of cross-border capital flows represents the expansion of financial markets, however, the amount of overall capital flows should be carefully interpreted in light of the overall global economic growth or downturn. For example, global cross-border capital flows, which include annual flows of FDI, purchases of bonds and equities, and lending and other investments, have declined 65 percent from the 2007 peak to 2017. As a combined result of post-crisis regulatory requirements and reassessment of risks and profitability, global banks divested at least $2 trillion of assets between January 2007

[189] Morten Balling and Ernest Gnan, ‘Introduction’ in Morten Balling and Ernest Gnan (eds), *50 Years of Money and Finance – Lessons and Challenges* (The European Money and Finance Forum 2013).
[190] To date, there is no definite measurement of international financial integration as widely agreed. According to an IMF report, however, three direct links are useful to comprehend the scope and nature of integration: standard portfolio diversification, greenfield foreign direct investment, or the acquisition of a foreign firm by a domestic one, and government investment, such as holdings of foreign exchange reserves or sovereign wealth funds. See Philip R. Lane and Gina Maria Milesi-Ferretti, ‘International Financial Integration in the Aftermath of the Global Financial Crisis,’ (2017) IMF Working Paper 17/115.
[191] Sebnem Kalemli-Ozcan, ‘Cross-Border Capital Flows’ (n 183).

and December 2016 by pruning business lines, selling foreign assets, and stopping renewing foreign loans at maturity which naturally allowed their balance sheets to shrink.[192] However, the retrenchment of the largest global banks post-crisis does not mean that financial globalization is in retreat. Rather, financial markets are more deeply interconnected than before, and the risk of contagion remains high. For example, the value of foreign investment as a share of global GDP has shown little change during the same period, and more countries are participating in cross-border financial transactions.[193] In global bond markets, the percentage of bonds owned by foreign investors rose from 18 percent in 2000 to 31 percent in 2015, and the percentage of equities owned by foreign investors around the world also increased from 17 percent in 2000 to 27 percent in 2015.[194] Geographically, when measured by the stock of foreign investment assets and liabilities, advanced economies are the most integrated into the global financial system and financial ties of developing countries are also growing.[195] Moreover, new digital platforms with advanced technologies, such as blockchain and machine learning, are creating new channels for cross-border capital flows with widened participation and diverse investment methods.[196] As a result, financial services have become widely dispersed across the globe for the past decades. This tendency of financial globalization is being accelerated by technological advancement, making cross-border transmission of capital easy and fast.

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[192] McKinsey Global Institute, 'The New Dynamics of Financial Globalization' (2017) McKinsey & Company, <https://www.mckinsey.com/industries/financial-services/our-insights/the-new-dynamics-of-financial-globalization> accessed 15 August 2021.
[193] Lane and Milesi-Ferretti, 'International Financial Integration' (n 190).
[194] McKinsey Global Institute, 'The New Dynamics of Financial Globalization' (n 192).
[195] Ibid. In particular, the report introduces the financial interconnectedness ranking of 100 countries by their total stock of foreign investment assets and liabilities which shows the changing position of individual countries as to their financial connectedness. See Exhibit E5 of the report for more details.
[196] Ibid.

The other side of this interconnectedness is that shocks and volatilities that originated in one economy are also easily transmittable to other economies. A clear example that manifested the state of financial globalization and the increasing connectivity between financial markets was the rapid spread of financial shocks produced by the massive failure of Wall Street financial institutions in 2007 and 2008 to the rest of the world as wildfire. Needless to say, the existence of national borders mattered little, if any, in protecting the abandoned customers and investors of the failing large financial institutions from overseas. While many large banks have reduced their foreign exposures after the crisis, there is still no systemic scheme developed to counter the possibility of cross-border contagion, except that some central banks are extending currency swap lines. Since it is not desirable to control the cross-border capital flows directly by regulatory measures due to the apparent backfire of capital control,[197] a coordinated system of effective capital management among national regulators is warranted. For this reason, in October 2010, the Basel Committee on Banking Supervision published the good practice principles on supervisory colleges to provide enhanced principles to help supervisors cooperate in sharing information and coordinating supervisory activities related to implementing Basel standards.[198]

Other serious risks of financial globalization come from technologically driven vulnerabilities of financial institutions since the connectivity of technologically based business involves technological dependencies that can lead to fatal events such as flash clashes on trading exchanges, major systems outrage for large banks, and cyberattacks on banking and financial

[197] See generally Fernando Broner and Jaume Ventura, 'Rethinking the Effects of Financial Globalization' (2016) The Quarterly Journal of Economics 1497-1542.
[198] Basel Committee on Banking Supervision [BCBS], 'Principles for Effective Supervisory Colleges' (2014) Bank for International Settlement. The 2010 College Principles were updated in 2014 to enhance clarity on the relationship between home and host supervisors in reflection of the experiences.

networks.[199] As the rapid progress of digitalization in financial markets in recent years exposes large financial institutions to the potential of cyberattacks and other technology-related threats, cyber security is at the top of priorities for many internationally active financial institutions. Even when the immediate threat of financial crisis does not appear, the interconnectedness of financial markets implies that the objectives of financial regulation at home and abroad should not be fundamentally different. It also emphasizes that the legitimacy of financial regulation should be derived from the interactive understanding of policy justification and reasonableness of law rather than from codified rules within limited legal frameworks. The current state of international financial markets and the interconnectedness of the financial industry across borders require that the legitimate principles of financial regulation that work at home should be also applicable in the global system and vice versa. Furthermore, international cooperation among national financial regulators and through diverse channels is essential to achieve the policy objectives of financial regulation considering the international nature of the financial system and global macroeconomic linkages.

3.1.3 Reconceptualizing Regulatory Autonomy

From the perspective of regulation, financial globalization has gradually blurred the boundaries of regulatory authority between countries, and internationally active corporations are subject to multi-layered regulatory structures rather than a single national regulator. Even though the home country regulator still exerts primary authority over the conduct of corporations in general, the tension, as well as cooperation, between the home and the host country regulators are becoming more important because policy decisions of one regulator can produce

[199] Lawrence G. Baxter, 'Understanding the *Global* in Global Finance and Regulation' in Ross P. Buckley, Emilios Avgouleas, and Douglas W. Arner (eds), *Understanding the Global Finance and Regulation* (CUP 2016).

unexpected outcomes that disadvantage other regulatory jurisdictions. At the same time, the role of transnational regulators, who are either inter-state agencies or non-state private organizations such as business associations or NGOs, has become indispensable. A closer look at the spectrum of global financial regulation reveals that national financial regulators are not the only actors who exert power over rulemaking and enforcement.[200] For example, supervisory colleges have operated as key forums for sharing information and supervisory assessments about risk profiles and vulnerabilities of international banking groups.[201] Although they are not decision-making bodies, they provide "a framework to enhance effective supervision of international banking groups on a consolidated … basis and can inform decision-making in that regard."[202] In this context, properly reflecting the regulatory implications of financial globalization on regulatory reform is crucial to make reform efforts as relevant and effective as possible in recognition of the traits of globalized financial markets.

In many instances, maintaining the legal authority to regulate domestic financial institutions is one thing, and being affected, either directly or indirectly, by policy decisions made in other jurisdictions of financial regulation is another thing. The pendulum swings back and forth depending on the dynamics of financial globalization and the rise and fall of hegemonic powers reconfigure the structural features of the global economy.[203] From the theoretical perspective

[200] See generally, Charles Chatterjee, *Economic Diplomacy and Foreign Policy-making* (Palgrave Macmillan 2020).
[201] BCBS, 'Principles for Effective Supervisory Colleges' (n 198) 1-2.
[202] Ibid.
[203] During the Cold War, the global economic structure was sharply divided into market economies and planned economies. After the fall of the former Soviet Union (USSR), the global economy moved to a unipolar structure having the U.S. at the center. As the dominance of the U.S. in the global economy weakened, it changed to a multipolar structure in which countries form clusters with like-minded countries including regional trade agreements. More recently, the rise of the Chinese economy and the intensified tension between the U.S. and China pushed the global economy to the G-2 structure in which the two great powers tend to gather their allies in terms of both economic and military policy directions.

of international relations (IR), it is not surprising that national regulators sometimes lose their regulatory autonomy or share it with other foreign entities, either state or non-state institutions, for several reasons. Normally, it is hard to expect that any politician or expert can openly doubt or challenge the sovereignty of a member state in international organizations, such as the World Bank or the IMF, or inter-governmental forums, such as the OECD or the G20. Regardless of the economic or military capacity of individual states, the belief in the sovereignty of a nation-state has become somewhat inexorable in modern international politics since U.S. President Woodrow Wilson recognized the "political independence and territorial integrity of great and small states alike" in his Fourteen Points speech along with the vision of establishing the League of Nations.[204] Empirically, however, the idea of a sovereign state has been often altered or transformed into a new or renewed system of political arrangements with diverse variations or even inventions, and its most noticeable cases are often found in the area of economic and financial relations. It is also evident from what Woodrow Wilson himself contemplated before he upheld the concept of a national state and self-determination in 1918. As to the human assumption of the permanence of the existing political models, Wilson stated:

> Institutions which one generation regards as only a makeshift approximation to the realization of a principle, the next generation honors as the nearest possible approximation to that principle, and the next worships as the principle itself. It takes scarcely three generations for the apotheosis. The grandson accepts his grandfather's hesitating experiment as an integral part of the fixed constitution of nature.[205]

[204] Known as an idealist, President Wilson presented his ideas of peace through a program of fourteen points to a joint session of Congress on January 8, 1918. Among the fourteen points, eight treated specific territorial issues among the combatant nations, five concerned of general principles of a peaceful world (namely, open covenants, freedom of the seas, free trade, reduction of armaments, and adjustment of colonial claims based on the principles of self-determination), and the last point proposed what was to become the League of Nations. See Office of the Historian, U.S. State Department <https://history.state.gov/milestones/1914-1920/fourteen-points> accessed on September 9, 2021.

[205] Woodrow Wilson, 'The Study of Administration' (1887) 2 Political Science Quarterly 197-222.

Probably, his openness to changes and experiments, as indicated in the passage above, enabled him to come up with new ideas of peace which met with both ardent support and fierce criticism from his contemporaries. In retrospect, the idea of nation-states with autonomy and territorial boundaries is more like an anchoring concept than a reflection of the reality in international relations. In this term, it is quite helpful to recall that many of the international political and economic systems that we take for granted today have not been implemented or even contemplated before the two World Wars. The changing ideas and emerging demands of the populace both at home and abroad by undergoing turbulent historical junctures and calamities have a significant influence on the minds of people and their understanding of rights and obligations in general. Even though “people nowadays naturally assume a sense of permanence in the nation-state model just as many of their ancestors assumed absolutist rulers would be permanent and their ancestors assumed that feudal lords would always rule the land,”[206] there is no guarantee as to the permanence of political arrangements and models that dominate the present time.

Historically, the origin of the nation-state model often dates back to *the Peace of Westphalia* in 1648 which marks the modern international system of sovereign states based on the principles of autonomy and territory with the assumption that each sovereign state has exclusive authority within their geographic boundaries.[207] While the Westphalian model of sovereign state has long served as an analytical assumption of political theories such as neo-realism, neo-liberal institutionalism, and various sociological theories of international politics, some scholars argue that “the Westphalian model has never been an accurate description of many of the entities that

[206] Matthew S. Mingus, ‘Dotted Lines: Networks, Quantum Holism, and the Changing Nation State’ (2005-2006) 29 (3/4) Public Administration Quarterly 413-444, 421.
[207] Stephen D. Krasner, ‘Compromising Westphalia’ (1995) 20 (3) International Security 115-151.

have been called states" and the assumption of state as independent rational actor can be rather obscure "because it marginalizes many situations in which rulers have, in fact, not been autonomous."[208] Indeed, the divergence between the theory and practice of treating the term of a sovereign state should be carefully reviewed to see what would be a more desirable system of global financial regulation, which is both legitimate and feasible from a practical viewpoint. Since there is no authority structure to constrain the emergence of alternative models and political arrangements, the Westphalia model has often given way to new institutional forms that involve both territorial violations, such as the British Commonwealth, the European Union, Antarctica, Andorra, and the Exclusive Economic Zone (EEZ) for the oceans, and transgressions of autonomy, such as protectorates in which major powers control foreign but not domestic policy, the constitutional structure of regimes in Soviet satellites during the Cold War, and the acceptance of IMF conditionality by countries under financial bailout programs since the 1960s, among others.[209] According to Stephen Krasner, there are four modalities by which the Westphalian model is compromised in light of whether the behaviour of one actor depends on that of another - conventions, contracting, coercion, and imposition:

> In *conventions*, rulers enter into agreements, such as human rights accords, from which they expect some gain, but their behaviour is not contingent on what others do. In *contracting*, rulers agree to violate Westphalian principles, but only if they are provided some benefit, such as a foreign loan. In *coercion,* the rulers of stronger states make weaker ones worse off by engaging in credible threats to which the target might or might not acquiesce. In *imposition*, the target is so weak that it has no option but to comply with the preferences of the stronger.[210]

Construing the four modalities as categorized above leads to a recognition that the present

[208] Ibid.
[209] Id. 116.
[210] Id. 117.

international regulatory relations among nation-states, which are officially recognized as autonomous political authorities within their territorial boundaries, often take not only one of the variations from the Westphalian model but more often represents a mixture of multiple modalities. Despite the prevailing respect for the sovereignty of states in international relations as stipulated by historical documents of international organizations such as the UN and as reiterated by political leaders at public international forums, it is crucial to acknowledge that the actual working of international relations among states is not identical to the Westphalian model of nation-states with autonomy and territorial boundary and that the motivations or causes of the deviation can be complex rather than uniform. Furthermore, the expanding areas of life that transcend the traditional limits and reaches of the nation-states in recent decades such as the easy access to global online service providers due to the enabling technologies, for example, ordering books on Amazon or purchasing digital music files from Spotify, have persuaded many observers to think beyond the Westphalian system of nation-states and focus on rulemakings at the transnational level which exert real influence on modern life and law.[211]

Another view of reconceptualizing the term sovereignty, which is different from the classical model of autonomy and territory, emphasizes that important elements of "hierarchy" exist in the global system.[212] While it may be uncomfortable, or impolite, to explicitly admit that there is a hierarchy among nation-states in international relations from the view of classical

[211] See generally Susan Strange, *The Retreat of the State* (CUP 1996); Elaine Fahey, *Introduction to the Law and Global Governance* (Edward Elgar 2018) 2-3. Since the mid-90s, the progress in telecommunications technology and globalization, in general, persuaded many scholars to conclude that the authority of states has declined, and organized private arrangements have replaced the states in many areas of global governance.

[212] See David A. Lake, 'The New Sovereignty in International Relations' (2003) 5(3) International Studies Review 303-323. In this article, he argues that publicly acknowledging the existence of hierarchy in the international system "may not only be difficult for subordinate states, but it may also constrain and inhibit imperial projects by powerful states" because "many states have used the principles of juridical sovereignty to hide abhorrent behavior from international scrutiny." 320-321.

conceptions of sovereignty, many IR scholars, especially those who are classified as constructivists, have pointed out that the concept of sovereignty has evolved over time and the meaning and practice of sovereignty varies even within relationships among non-subordinated parties.[213] It is noteworthy that the term sovereignty has two inherently joined faces: internally, it means the ultimate or highest authority within a state and implies a hierarchic relationship between the sovereign and subordinates; externally, it refers to the recognition by other similarly recognized states that this political entity has equal status with them, meaning a relationship of formal equality.[214] Following the ideal of the Westphalian model, the classical view of sovereign states, which is often found in the dialogue of realists and neo-realists, presumes that sovereignty refers to supreme authority over a certain territory that is independent and equal to other sovereign states in international politics. Since it also assumes that the state of international politics is anarchy and considers states as rational actors, whose self-interest drives their own decisions to cooperate or not, the international system is considered structurally different from domestic political systems which have a clear hierarchy between a dominant political power and its subjects.[215] In the absence of absolute power in the international system, thus, hierarchic domestic politics are distinguished from anarchic international politics. This distinction, based on the static and absolute concept of sovereignty, presumably makes the discourse of international regulation confusing and leads to the il-legitimization of some international arrangements primarily because individual "sovereign" states with political autonomy within their territorial boundary could not gain equal access or

[213] For constructivist views on sovereignty in international politics, see Alexander Wendt, *Social Theory of International Relations* (CUP 1999); Christian Reus-Smit, *The Moral Purpose of the State: Culture, Social Identity, and Institutional Rationality in International Relations* (Princeton University Press 1999); Roy Bhaskar, *The Possibility of Naturalism* (Humanities Press 1979); John Searle, *The Construction of Social Reality* (Free Press 1995).
[214] Lake, 'The New Sovereignty in International Relations' (n 212) 305.
[215] See generally, Kenneth M. Waltz, *Theory of International Politics* (Addison-Wesley 1979).

say in the course of rulemaking. At the same time, this distinction between domestic and international polity hinders one from interpreting the dynamic exchanges of political interests and influences between domestic and international polities. For example, many critics of international rulemaking through international organizations as undemocratic because those experts who are involved in making rules lack the authority of elected officials in domestic polity and are not accountable by constitutional obligations.[216] However, governments of many developing countries oftentimes use their entry into international treaties or conventions as an opportunity to facilitate domestic reforms that they wish to push against political opposition. By implementing new rules and regulations according to international agreements, they attempt to reform part of the national legal systems or change social policies in such areas as employment, labor, and environment when it is difficult to persuade domestic constituencies without such external pressure and obligations.

Once taken as enduring givens in international relations, constructivists contend that sovereignty, as well as anarchy in international politics, is a socially constructed trait and more usefully understood as "social facts" or "social kinds" that are produced and reproduced through the practices of states.[217] Even though it constitutes the premises of modern international politics and states have based their behaviors on the concept of the sovereign state with the rhetoric of sovereignty as articulated over time, acknowledging that the classical concept of sovereignty stemmed from the Westphalian model is limited to a few cases, such as

[216] For discussions on democratic accountability in global governance, see Michael Goodhart, 'Democratic Accountability in Global Politics: Norms, Not Agents' (2011) 73(1) The Journal of Politics 45-60; Robert Keohane, 'Accountability in World Politics' (2006) 29(2) Scandinavian Political Studies 75-87; Robert Dahl, 'Can International Organizations Be Democratic? A Skeptic's View' in Ian Shapiro and Casiano Hacker-Cordon (ed.), *Democracy's Edge* (CUP 1999).
[217] Lake, 'The New Sovereignty in International Relations' (n 212) 308.

the cases of great powers rather than minor states in international politics, and that it is rather easy to find varied circumstances where sovereignty is partially limited or even voluntarily shared for a variety of reasons in the international system provide critical insights as to the political dynamics of international rulemaking. A closer observation of global affairs from security to e-commerce reveals that the international system of regulation today is comprised of complex networks of diverse arrangements through which the sovereign power of nation-states is easily constricted for varying reasons.

Uncovering the conceptual or ideological belief in the sovereignty of nation-states is imperative to recognize that the obsession with the concept of absolute sovereignty can be misleading in the pursuit of identifying and analysing the standards of the legitimacy of financial regulation in global financial markets. At the same time, it gives insights into comprehending the interconnectedness of financial regulatory regimes even without specified intergovernmental arrangements or incorporation into official conventions. The state of global financial regulation reveals that there are a variety of ways and methods through which the decision-making power of one country is impaired or substituted by non-state international organizations that are not set up by legally binding treaties. Such impairments are sometimes voluntarily accepted while other times the country has to involuntarily accept particular arrangements as there is no alternative at hand. One clear example is the role of international financial standard-setting organizations such as the Basel Committee on Banking Supervision ('Basel Committee').[218] As the most influential international financial regulator, the Basel Committee produces the standards of banking supervision and regulation that the members of the Committee are

[218] For detailed discussion on the legitimacy of the Basel Committee in the context of international financial rulemaking, see Chapter 4.

recommended to implement in their respective jurisdictions. Although standards such as the Basel Core Principles for Effective Banking Supervision ("Core Principles") are technically non-binding and soft law in nature, they play a de facto role in international financial regulation as "supervisory authorities use the Core Principles as a benchmark for assessing the effectiveness of their regulatory and supervisory frameworks."[219] For example, the IMF and the World Bank use the Core Principles in the context of the Financial Sector Assessment Programs (FSAPs) to assess the effectiveness of countries' banking supervisory systems.[220] In the EU, the Basel standards are implemented as Directives and Regulations, such as the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD), giving effect to the national financial rulemaking.[221]

In this sense, financial regulation in its approach and design must take the factors relevant to the globalized financial markets into account along with accompanying issues of international relations and regulatory affairs. From the perspective of regulation and public policy in general, what was equally provoking to the swift contagion of financial shocks to the global economy was that the core solutions to the problems had to come from very limited sources of public institutions, for example, the Federal Reserve System of the U.S. for the global financial crisis in 2007-2008 or the IMF for the case of the Eurozone crisis in 2012-2013. The overall responding mechanism to the global financial crisis including the dominance of key players on the scene simply reveals the crude fact that the global financial system is not only concentrated

[219] Basel Committee on Banking Supervision [BCBS], 'Core Principles for Effective Banking Supervision' 06 July 2023 <https://www.bis.org/bcbs/publ/d551.pdf>.
[220] Financial Stability Board, 'Consolidated Basel Framework – core principles for effective banking supervision (BCP)' (25 April 2024) <https://www.fsb.org/2024/04/consolidated-basel-framework-core-principles-for-effective-banking-supervision-bcp/>.
[221] European Banking Authority, 'The Basel framework: the global regulatory standards for banks' <https://www.eba.europa.eu/activities/basel-framework-global-regulatory-standards-banks>.

on large financial institutions, which are later termed as Global Systemically Important Financial Institutions (G-SIFIs)[222] by the Financial Stability Board in terms of market dominance, but also that the methods of post-crisis resolution are broadly dependent on the decisions of a handful of dominant regulators who are not necessarily accountable for states, businesses, and individuals affected by their decisions under the existing global financial regulatory systems. In this sense, it might be useful to admit the existence of some hierarchy in the international system of financial regulation to improve the responsibility of dominant actors whose decisions certainly have a wider impact beyond their territorial boundaries. It is noteworthy that recognizing the varying hierarchy in the international system "may not only be difficult for subordinate states, but it may also constrain and inhibit imperial projects by powerful states" when "many states have used the principles of juridical sovereignty to hide abhorrent behavior from international scrutiny."[223] Under the assumption of absolute sovereignty, it is easy to conclude that countries make decisions solely based on their interests while maintaining the capacity to choose one policy from other options. However, acknowledging the reality that there are many occasions when weak countries, in terms of their economic capacities or political powers including military capabilities, have little room for policy choices has practical use in diagnosing the sources of fundamental problems in financial

[222] The Financial Stability Board (FSB) has identified global systemically important financial institutions since 2011 in consultation with national authorities and the Basel Committee on Banking Supervision (BCBS). The FSB publishes the list of the global systemically important banks (G-SIBs) and updates the list annually each November with information on the application of policy measures. Also, the FSB began identifying global systemically important insurers (G-SIIs) in 2013 in consultation with the International Association of Insurance Supervisors (IAIS) and national authorities. However, the G-SII identification was suspended from the beginning of 2020 in light of the finalized holistic framework adopted in November 2019 and will review the need to either discontinuation or re-establishment of the identification of G-SIIs in November 2022. See Financial Stability Board, 'Global Systemically Important Financial Institutions (G-SIFIs)' <https://www.fsb.org/work-of-the-fsb/market-and-institutional-resilience/post-2008-financial-crisis-reforms/ending-too-big-to-fail/global-systemically-important-financial-institutions-g-sifis/> accessed 13 August 2021.

[223] Lake, 'The New Sovereignty in International Relations' (n 212) 320-321.

regulation.

Fundamentally, the predominance of powerful states who write the initial rules and govern the system according to those pre-established rules exert far greater influence on the regulatory space of other states than the ideal of absolute sovereignty would envision. Recognizing the reality of regulatory autonomy leads to the conclusion that states with more power than others in making and operating the economic or political systems should be more responsible as they are often required by their domestic constituencies. This recognition is particularly important in explaining the power dynamics in international financial regulation where the domestic process of lawmaking is sometimes delegated to or substituted by the rulemaking activity of transnational organizations.

3.1.4 Human Behaviors and Ethical Problems

The causes of the global financial crisis of 2008 are complex and multifaceted because they involve not only a few defects in financial products but also the malfunctioning of the financial regulatory system on a global scale. A closer look at the causes of the GFC, however, reveals that the perception of financial services played a key role that led to subsequent actions and decisions of market participants and financial regulators. The intellectual underpinnings of financial regulation have been challenged as some of the key beliefs turned out to be inoperative in practice. According to Lastra and Sheppard, the causes of the GFC can be divided into ten groups as below:

> It is possible to divide the explanations for the crisis into ten groups. These are not mutually exclusive. It is conceivable that they all played a part: (1) Macro-economic imbalances; (2) Lax monetary policy; (3) Regulatory and supervisory failures; (4) Too big to fail doctrine and distorted incentives; (5) Excesses of securitization; (6) Unregulated firms, lightly regulated firms, and the shadow banking system; (7)

> Corporate governance failures; (8) Risk management failures, excessive leverage, and excessive complexity; (9) The 'usual suspects': greed, euphoria, and other human traits; (10) Faulty economic theories. The first four groups put the blame on the authorities – governments, regulators, central bankers. The second five blame mainly the markets – financial products, managers, risk, greed, and leverage. The last group (faulty theories) blames economists. [224]

Interestingly, those ten groups of the causes of the GFC can be summarized into the behavioral aspects of market participants on the one hand, and the regulatory approach to the financial industry on the other hand as major sources of trouble leading up to the crisis. The two categories are also inevitably interrelated because regulators' perceptions of the behavioral aspects of market participants are directly reflected in their regulatory approach. Furthermore, economic theories are almost always built on certain assumptions about the nature of the market and human behaviors in the market. Thus, understanding human nature in economic life and how it is most likely transformed into the dynamics of financial markets is imperative to find out the root causes of financial crises. Indeed, the history of financial crises is not short of events when the assumption of market rationality did not work and was rather thrown by speculative bubbles and herd effects.[225]

Even when the tipping points of a market burst are often related to the particular collapse of large financial conglomerates, those events are just a fraction of the aggregated problems in financial markets over the preceding years or decades. As to the policy direction, many scholars argue that the previous decades of pursuing deregulation in financial markets from advanced economies to emerging markets allowed financial institutions to abuse their freedom under the

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[224] Rosa Lastra and Geoffrey Wood, 'The Crisis of 2007-2009: Nature, Causes, and Reactions' (2010) 13(3) *Journal of International Economic Law* 531-550.

[225] See Hyman Minsky, *Stabilising an Unstable Economy* (MacMillan 1973); Kindelberger, *Mania, Panics, and Crashes* (n 123); Charles Mackay, *Extraordinary Public Delusions and the Madness of Crowds* (originally in 1852, Wordsworth Editions 1999).

legacy of financial self-regulation by taking excessive risks that were detrimental to the interests of their shareholders and the society as well. Most of all, the Turner Review, commissioned by the UK Financial Services Administration (FSA) in 2009 as a comprehensive study of post-crisis financial system reform, was explicit about the criticisms against the intellectual assumptions of previous regulatory approaches.[226] In the report, the UK's financial regulator, once championed the 'light-touch' regulation approach to financial markets along with the U.S. financial regulators who believed in 'self-regulation,' raised questions about the assumptions of the theory of efficient and rational markets and concluded that "policymakers have to recognize that all liquid traded markets are capable of acting irrationally, and can be susceptible to self-reinforcing herd and momentum effects."[227]

The criticisms of the prevalent efficient market theory as described in the Turner review below are closely related to the assumptions on human behavioral aspects in the market:[228]

- Market efficiency does not imply market rationality
- Individual rationality does not ensure collective rationality
- Individual behavior is not entirely rational
- Allocative efficiency benefits have limits
- Empirical evidence illustrates large-scale herd effects and market overshoots.

What do those assumptions on rationality or irrationality of markets, or market participants, mean when it comes to the approach to financial regulation? While armored with complex economic and financial theories, the essential problem lies in the fundamental understanding or assumption of human behaviors, and a deeper insight points to the problems of ethical assumptions in financial regulation. For instance, when 'self-regulation' is the norm of the

[226] Financial Services Authority [FSA], 'The Turner Review: A regulatory response to the global banking crisis' [2009] 39.
[227] Id. 41.
[228] Id. 40-41.

financial regulatory approach, it assumes not only that market participants would seek to maximize their profits but also that human behaviors are primarily influenced by material interests while other motivations of decisions, such as moral judgments, social influence, peer-pressures, and other emotional impetuses such as greed or self-esteem, are largely ignored. In the economics literature, the idea that the person being regulated is primarily motivated by his or her self-interest led to the assumption of the predominant theory in regulation that "the best way to ensure compliance with regulatory regimes is by appealing to self-interest, defined as the rational calculation of the magnitude of liability discounted by the probability of enforcement."[229]

Contrary to the assumption in neoclassical economics that people make rational choices in the market to maximize their gains, it is easy to find examples of massive irrational movements in financial markets,[230] "which reveals that people often do not make decisions in the rational front of the brain as assumed in neoclassical economics, but make decisions which are rooted in the instinctive part of the brain, and which at the collective level are bound to produce herd effects."[231] There is no credible evidence, either empirical or theoretical, that financial markets are immune from the ramifications of human actions and behaviors which are intrinsically

[229] Deborah E. Rupp and Cynthia A. Williams, 'The Efficacy of Regulation as a Function of Psychological Fit' (2011) 12 Theoretical Inquiries in Law 581, 582-3. For a theoretical background of the assumption on self-interest and a one-dimensional view of the person being regulated, see Gary S. Becker, 'Crime and Punishment: An Economic Approach' (1968) 76 J. Pol. Econ. 169.

[230] As to this point, the Turner Review (n 226) illustrates intellectual skepticism about the rationality of markets by explaining that "Keynes's General Theory contains a famous attack on the idea that equity prices are driven by the rational assessment of the available information. Hyman Minsky argued in 1986 that financial markets and systems are inherently susceptible to speculative booms which, if long-lasting, will inevitably end in crisis. Kindleberger's *Manias, Panics, and Crashes* illustrated how the tendency towards occasional speculative excess spanned different markets, countries and centuries." See John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Macmillan 1936); Hyman Minsky, *Stabilizing an Unstable Economy* (Yale University Press 1986); Charles Kindleberger, *Manias, Panics, and Crashes* (n 123).

[231] FSA, 'The Turner Review' (n 226) 41.

linked to complex factors, ranging from emotional reactions to logical judgments. In this regard, the history of financial crises demonstrates the multilayered grounds for human actions beyond rationality.[232]

Interestingly, it is not only true when people act towards destructive ends. The assumption of rational behavior is also challenged by corporate governance scholars who argue that corporate participants cooperate not just because they make rational choices based on external constraints such as legal rules and market incentives, but because "the behavioral phenomena of internalized *trust* and *trustworthiness* play important roles in discouraging opportunistic behavior among corporate participants."[233] While the concept of *homo economicus* as a hyperrational and self-interested actor in neoclassical theory assumes that people cooperate because doing so, rather than mistreating each other, is considered the best way of maximizing their gains, empirical evidence from experimental work on human behavior in "social dilemmas" notes that people choose to behave trustworthily not only because of legal or market incentives but as influenced by the social context such as "individuals' perceptions of others' motivations, beliefs, likely behaviors, and relationships to themselves."[234] Indeed, it is crucial to understand that humans have a range of motivations for action.[235] In the literature of psychology, an increasing volume of empirical and theoretical research proves that human nature and intrinsic motivation, which is not driven by external incentives or self-interest, play

[232] See Russell B. Korobkin and Thomas S. Ulen, 'Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics' (2000) 88(4) California Law Review 1051.
[233] Margaret M. Blair and Lynn A. Stout, 'Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law' (2001) Georgetown University Law Center Working Paper Series in Business, Economics, and Regulatory Law Working Paper No. 241403, 2.
[234] Id. 3.
[235] See Peter J. May, 'Regulation and Compliance Motivations: Examining Different Approaches' 65 Pub. Admin. Rev. 31 (2005).

an important role in influencing prosocial actions.[236] Without resorting to scientific findings of cognitive psychology or neuroscience, the magnum importance of interpreting human behaviors in connection with the diverse motivations in the decision-making process reveals that financial regulation should be anchored in certain ethical principles that have sustained human society.

Ethical principles or boundaries are more important in economies where individuals' autonomy in decision-making is highly valued. Self-regulation or light-touch regulation without ethical limitations is destined to malfunction and the history of financial crises serves as empirical evidence of the risk of relying on human rationality with naivety. In this respect, there are two categories of problems that were epitomized by the Global Financial Crisis. First, financial regulation tends to be indifferent to ethical issues in financial markets, avoiding value-judgment in policy frameworks. The lack of accountability schemes in corporate governance regulation before the crisis and the overall ignorance of moral issues in financial markets represent the prevailing regulatory approach that was indifferent to ethical questions and problems. As discussed above, the business of financial intermediation is intrinsically connected to ethical aspects of human behavior because it is built on trust between parties. While trust has been considered the cornerstone of the financial industry, the recent policy framework did not give adequate attention to ethical issues and rather ignored unethical behaviors in financial markets by assuming that the market will correct those problems.

[236] Rupp and Williams (n 229) 582. The authors point out examples in the literature of individuals acting against their self-interest and acting in the name of norms, cooperation, fairness, empathy, and moral duty. See Ernst Fehr and Simon Gachter, 'Altruistic Punishment in Humans' (2002) 415 Nature 137, 140; Gary Bolton and Axel Ockenfels, 'ERC: A Theory of Equity, Reciprocity, and Competition' (2000) 90 Am. Econ. Rev. 166; Daniel Kahneman, Jack L. Knetsch and Richard H. Thaler, 'Fairness and the Assumptions of Economics' (1986) 59 J. Bus. 285; C. Daniel Batson, 'Prosocial Motivation: Why Do We Help Others?' in Abraham Tesser (ed.), *Advanced Social Psychology* (McGraw-Hill 1995) 332; Carmelo J. Turillo et al., 'Is Virtue Its Own Reward? Self-Sacrificial Decisions for the Sake of Fairness' (2002) 89 Org. Behav. Hum. Decisional Processes 839.

Consequently, "the financial industry's most valuable asset – trust- became the biggest casualty. Public opinion of the integrity of the financial system is still the lowest in a very long time."[237]

The issue of trust involves parties of financial institutions, regulators, consumers, or investors. The crisis reveals that the trust link between financial institutions and customers is seriously broken as those legacy firms were recognized as untrustworthy as intermediaries in financial transactions. One of the core reasons for shifting from legacy firms to new fintech institutions in the aftermath of the financial crisis was that the financial crisis highlighted the corruptness of legal financial institutions and the new generation of financial customers who demonstrated under the theme of Occupy the Wall Street favored financial institutions which are dedicated to building personalized trust with customers with emphasis on transparency and customized services. The other trust link between regulators and financial institutions was also damaged due to the financial crisis because the policy framework of self-regulation in financial markets before the crisis depended on banks to measure and estimate their risks in a good-faith manner.[238] While the Basel II framework was essentially built on the belief that banks would measure and estimate their risks as suitable to their situation, the financial crisis revealed that "banks did not understand the risks and, further, had even manipulated their risk-weightings so that they could hold extraordinarily low levels of capital."[239] Despite the belief that banks would seek their best interest by operating the firm effectively without external interference, it was useless when those subject to regulation were determined to misuse the regulatory framework to exploit profits for themselves at the expense of other stakeholders including

[237] Christine Lagarde, 'The Role of Personal Accountability in Reforming Culture and Behavior in the Financial Services Industry' (2015) International Monetary Fund.
[238] Alexander, *Principles of Banking Regulation* (n 5) 413.
[239] Ibid.

shareholders, investors, and customers.

Second, and more problematically, the existing regulatory frameworks have incentivized unethical behaviors. The too-big-to-fail doctrine, which is still dominant in the global financial regulatory system, provides incentives for unbridled profit-seeking by promoting excessive risk-taking in investment decisions that are unresponsible and harmful to other stakeholders and society. As noted in the earlier section on emergency response, regulators may decide to bail out failing financial institutions when such failures would threaten the survival of the entire economy. However, it is problematic that the regulatory framework itself incentivizes the expansion of large financial conglomerates by giving implicit yet clear signals that the regulators would step in when those "systemically important" large financial institutions are in trouble. Since it became clear that banks misused the self-regulation approach of financial regulation before the crisis, it is too naïve to believe that banks would not consider the possibility of being bailed out by regulators when things go wrong in the future. As to the likelihood of bailing out failing financial institutions in the future, Neel Kashkari, the President of the Federal Reserve Bank of Minneapolis argued that "given the massive externalities on Main Street of large bank failures in terms of lost jobs, lost income, and lost wealth, no rational policymaker would risk restructuring large firms and forcing losses on creditors and counterparties using the new tools in a risky environment, let alone in a crisis environment as we experienced in 2008."[240]

An incentive is a powerful tool in financial regulation, and it should be well-targeted with long-

[240] Neel Kashkari, 'Lessons from the Crisis: Ending Too Big to Fail' (February 2016), Remarks given at Brookings Institution in Washington, D.C. <https://www.brookings.edu/wp-content/uploads/2016/02/KashkariBrookings2162016.pdf>.

term perspectives. While banks should be blamed for their unethical behaviors and irresponsible decisions, regulators should be more concerned about the problems that regulatory frameworks incentivize unethical behaviors in financial markets by making it easier for financial institutions to exploit regulatory loopholes because doing so is considered more effective than complying with regulatory requirements. These issues of evasion of regulation are not confined to a single jurisdiction but rather prevalent in modern financial markets around the world. Some jurisdictions intentionally have loosened regulatory measures so that their markets become more attractive for foreign financial institutions who want to avoid a strict regulatory environment. In response to this problem, regulators have emphasized the integrity of business conduct in financial markets, strengthening the rules of acting honestly and transparently with clients. For example, the Financial Conduct Handbook published by the UK Financial Conduct Authority highlighted integrity as the first of the Principles of Business Standards.[241] In particular, the principle of relationships of trust with customers emphasizes that "a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment."[242] Similarly, the UK

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[241] FCA, 'FCA Handbook: Principles for Business' <https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html> (updated on 10 November 2021) accessed 26 November 2021. The Principles include the following eleven categories: **1 Integrity** – A firm must conduct its business with integrity; 2 Skill, care and diligence - A firm must conduct its business with due skill, care and diligence; 3 Management and control - A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems; 4 Financial prudence - A firm must maintain adequate financial resources; 5 Market conduct - A firm must observe proper standards of market conduct; 6 Customers' interests - A firm must pay due regard to the interests of its customers and treat them fairly; 7 Communications with clients – A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading; 8 Conflicts of interest – A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client; **9 Customers: relationships of trust** (*emphasis added) – A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment; 10 Clients' assets – A firm must arrange adequate protection for clients' assets when it is responsible for them; 11 Relations with regulators – A firm must deal with its regulators in an open and cooperative way, and must disclose to the FCA appropriately anything relating to the firm of which that regulator reasonably expect notice.

[242] Ibid.

Prudential Regulation Authority Rulebook highlights integrity as one of the eight Fundamental Rules applicable to capital requirement regulation firms, along with other rules as to a firm's business conditions and compliance with the regulation.[243] These are positive indicators that regulators learned the lessons from the global financial crisis that financial institutions should be subject to ethical principles when they deal with clients and other market participants. While it is apparent that firms should act with integrity from the general viewpoint of ethics and morality, the impact of making such implicit values as explicit rules cannot be exaggerated. Indeed, ethical behaviors are not subjective moral values but can be identified as qualitative standards of business conduct. As those behaviors have a direct impact on the resilience and stability of financial markets, unethical behaviors of financial institutions are not only bad for their own sake, but their externalities have a destructive effect on the global financial market. However, these recognitions of ethical values should be supported by systemic incentives that encourage financial institutions to act ethically because "if the regulatory and governance framework provides incentives for inappropriate behaviors, even the best-meaning individual will find it difficult to promote an ethical culture."[244] To address these problems, it is more desirable to focus on reducing the possibility of producing harm to society while seeking private gains so that regulatory measures are buttressed by legitimate causes of public policy rather than falling into the trap of paternalism or interventionism that can cause unintended

243 Bank of England Prudential Regulation Authority, 'Prudential Regulation Authority Rulebook: Fundamental Rules' <https://www.prarulebook.co.uk/rulebook/Content/Part/211136/26-11-2021> (updated on 26 November 2021) accessed 26 November 2021. The Fundamental Rules include the followings eight rules: Rule 1- A firm must conduct its business with integrity; Rule 2 – A firm must conduct its business with due skill, care and diligence; Rule 3 – A firm must act in a prudent manner; Rule 4 – A firm must at all times maintain adequate financial resources; Rule 5 – A firm must have effective risk strategies and risk management systems; Rule 6 – A firm must organize and control its affairs responsibly and effectively; Rule 7 – A firm must deal with its regulators in an open and cooperative way and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice; Rule 8 – A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services.

244 Christine Lagarde, 'The Role of Personal Accountability' (n 237).

consequences. In this regard, the Walker Review of Bank Governance, which reviewed corporate governance in UK banks in light of the critical failure of the banking system in 2009, stresses that “the behavioral changes that may be needed are unlikely to be fostered by regulatory fiat, which in any event risks provoking unintended consequences. Behavioral improvement is more likely to be achieved through clearer identification of best practices and more effective but, in most areas, non-statutory routes to implementation so that boards and their major owners feel “ownership” of good corporate governance.”[245]

3.2 General Principles of Financial Regulatory Reform

Based on the premises of financial globalization, constricted regulatory autonomy in international relations, and the ethics of financial business as discussed so far, it is necessary to examine the legitimate principles of financial regulatory reform regardless of the structural distinction between domestic and international regulatory systems. In particular, the importance of behavioral change in financial markets requires that financial regulation should be built on fundamental principles of regulation in the market economy and specific policy measures relevant to the current issues should be based on these legitimate principles of financial regulation. First, considering that the ultimate purpose of regulatory reform is to change the existing rules and institutional structures so that the reformed regulatory system is capable of adequately addressing challenges in the financial market, the responsiveness of law should be considered a legitimate principle of legal reform. The responsiveness of law deals with the question of *why reform is necessary* and ensures that the reform measures adequately

[245] David Walker, ‘A Review of Corporate Governance in UK Banks and Other Financial Industry Entities - Financial Recommendations’ (26 November 2009) The National Archives <https://webarchive.nationalarchives.gov.uk/ukgwa/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 29 November 2021.

address the existing problems in the market in recognition of the dynamics of legal reform in society. Second, it is important to ensure the efficacy of regulation and reform, which refers to the right direction and effectiveness of reform. The concept of efficacy in financial regulation is particularly important in the context of whether the regulatory reforms sought by regulators practically achieved the goals and objectives set at the inception of the reform process. The efficacy of financial regulation and reform measures involves a broader perspective of the usefulness of law rather than a narrower scope of assessing the success of a few policy tools. Third, the general principles of financial regulatory reform should be derived from the legitimate purposes and objectives of law and regulation, based on the earlier analysis of the definitions and implications of legitimacy as the legality and reasonableness of law (see section 2.1). In specific, the former is closely related to the factors of procedural justice, and the latter is often assessed by the substantive aspects of reform. In sum, the general principles of financial regulatory reform can be established under the four categories of the legitimate principles of law and legal reform: (1) responsiveness, (2) efficacy, (3) integrity, and (4) reasonableness of law and regulatory reform.

3.2.1 The Responsiveness of Law and the Relevance of Legal Reform

In an analysis of the legitimacy of regulatory reform, two fundamental questions should be asked and answered: “why reform is needed?” and “does reform work?” The first question is closely related to the responsiveness of law, and it is particularly inquiring about the relevance of reform to contemporary problems. In parallel, the second question is about whether the reform as sought worked in solving the causes of dissatisfaction as defined by the first question and it can be addressed in the context of the efficacy of reform. The question of “why reform is needed” is often neglected in the discourse of the legitimacy of regulatory reform while discussions are often focused on "how and what to reform." Even though it might look self-evident at a glance, considering the failures of fixing problems within the existing regulatory structure before the market breakdown, explaining the reason and justification for reform is more substantial than it appears to be because those explanations with specific ways of reasoning ultimately direct how and what to reform. Without well-defined purposes of reform, it is less likely that any reform effort can result in solving the chronic problems of financial markets. Recalling that one of the critical problems associated with the post-crisis regulatory reform was that those reform measures failed to adequately address the fundamental problems even though a large volume of reform proposals was discussed and new laws were enacted, it is questionable whether the reform efforts were carried based on the idea that the existing regulatory structure should be changed to improve its responsiveness to the existing as well as emerging problems derived by the changing social and economic environment.

Recognizing the responsiveness of law as a legitimate principle of regulatory reform brings close attention to the relevance of law to contemporary problems. In general, the concept of judicial responsiveness refers to "an acknowledgment by judges that the law is not an autonomous field of activity answerable only to its own norms, but is rather a semi-autonomous practice embedded in society which answers to the desire for justice of members of that society."[246] At the same time, it emphasizes the importance of understanding legal reform as a dynamic and interactive process among participants rather than one-way street commands. Considering that many post-crisis reform measures after the Global Financial Crisis were criticized as backward-looking rather than forward-looking in terms of the approach to

[246] Tania Sourdin and Archie Zariski, 'What Is Responsive Judging?' in Tania Sourdin and Archie Zariski (ed.), *The Responsive Judge: International Perspective* (Springer 2018).

diagnosing problems and deploying possible solutions, it is imperative to take the responsiveness of law as an overarching principle of regulatory reform and policymakers should strive to fulfill their responsibilities in recognition of changing landscape of rights, values, interests, and relationships in society. A theoretical analysis of the responsiveness of law can draw implications for the post-crisis regulatory approach by focusing on emerging regulatory issues rather than relying on the models and assumptions of the past. Likewise, the efficacy of regulatory reform would be possibly explained concerning the responsiveness of law because the speed and scope of legal recourse to contemporary problems matter significantly when assessing the efficacy of reform.

In terms of understanding the legitimacy of regulatory reform, it is necessary to grasp the dynamics between the regulator and the regulated within the political and social context of industrial settings. As noted earlier, the law is to be understood as continuing struggles and challenges of social practice at any given point of history rather than a finished project.[247] In retrospect, no field of law is exempt from continuous developments and shifts in defining and interpreting key concepts or values in the subject matter, and the law we see today is the aggregate result of ceaseless struggles and efforts of groups and individuals with different values and interests to change the way our society, as a community, perceives, acknowledges, and embraces, or rejects certain values or interests. Invariably, social progress requires the law to adapt itself in light of the changing social, political, and economic environment of the time.

In 1930, John J. Parker, then a judge of the US Circuit Court of Appeals, wrote about the social

[247] See Chapter 2 of this thesis (2.1.3 Legitimacy as Reasonableness: Moral Justification of Authority and Objectives) for a detailed discussion of the dynamics of law in financial regulation and reform measures.

responsibility of the legal profession in his refute to the critics who accused the law and legal profession as unresponsive to the needs of the fast-changing society. Defining the most important duty of the legal profession as ensuring that the expression of the law keeps pace with the development of society, Parker asserted that "if the law as interpreted by the courts or prescribed by the legislature fails to keep pace with the growth and development of society, it must inevitably result in injustice and hardship to the individual and in hampering the progress of society itself."[248] In this work, he emphasizes the unprecedented changes in social life caused by the massive industrialization that started just over a hundred years ago and claims that much has been accomplished in such areas as the law of master and servant (which refers to the law of individual employment relations of today), workers' compensation laws, child labor laws, and laws limiting the hours of labor in dangerous or important occupations in accordance with changing social and economic life of the time.[249] As one of the pronounced figures of the judicial administration movement of the early twentieth century in the U.S., John J. Parker succeeded the ideology of judicial autonomy pressed by reformers such as William Howard and Henry W. Taft,[250] Roscoe Pound, Herbert Harley, and Thomas A. Shelton, following the Blackstonian perception of the judge as the trained and skilled expert, the law as the embodiment of reason, and the special function of the judiciary in a government of divided powers.[251] Although the reform agendas mainly focused on improving the effectiveness and

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248 John J. Parker, 'Social Progress and the Law' (1930) 16(11) American Bar Association Journal 701-707.

249 Those examples were introduced to emphasize that the conception of rights of private ownership has changed, and new relationships have grown up along with emerging new rights and new dangers due to the great progress in science and invention which "have not only revolutionized industry but have revolutionized as well our very habits of life and processes of thought." See Parker (n 248) 702.

250 See generally Justin Crowe, 'The Forging of Judicial Autonomy: Political Entrepreneurship and the Reforms of William Howard Taft' (2007) 69 (1) The Journal of Politics 73-87 (discussing William Howard Taft's political entrepreneurship by asking "how judicial reform was accomplished and what judicial reform accomplished" in the context of the surrounding politics of American judicial reforms in the 1920s.)

251 Peter G. Fish, 'Guarding the Judicial Ramparts: John J. Parker and the Administration of Federal Justice' (1977) 3(2) The Justice System Journal 105-125.

the efficiency of the administration of justice both in state and federal court systems,[252] tracing the foundation and development of the judicial administrative movement is quite revealing that the prospect of progress in law is born of the belief that the law is not something imposed from without nor a mere collection of rules and forms or precedents, but the law arises out of life in society and its source is embedded in the moral foundation of that society.[253]

While it is hard to conclude that the judicial reform is complete and the court administration system is perfect without challenges, the judicial administration movement, which initially began in 1906 with Roscoe Pound's provoking address to the American Bar Association by questioning the ability and effectiveness of the American court system and calling for efforts to reform court institutions, procedures, and practices, has achieved many changes and progress over the last hundred years including court restructuring and improvements in civil procedure.[254] With the low possibility of seeing major changes in court systems, there are remaining issues such as "delay and expense" as diagnosed by Pound in 1906 that "have created a deep-seated desire to keep out of court … on the part of every sensible businessman in the community"[255] as well as new and varying causes of dissatisfaction.[256] Some of the key points

[252] The judicial administrative movement promoted legal autonomy through "reform of court organization, procedures, jurisdiction, administration, and selection of judges. Several themes coursed through the "reforms" advanced: the negation of popular influence over courts and law, maximum institutional autonomy, judge-control, and internal judicial unification, simplification, and centralization. See Fish (n 251).
[253] Fish (n 251) and Parker (n 248).
[254] Terry Nafisi, 'One Hundred Years Since Pound: Has Court Reform Mattered?' (2006) 27(2) The Justice System Journal 223-236.
[255] Roscoe Pound, 'The Causes of Popular Dissatisfaction with the Administration of Justice - Address Before the American Bar Association' (Aug. 29, 1906) 29 ABA Reports 16-17, reprinted in American Bar Association, National Conference on the Causes of Popular Dissatisfaction with the Administration of Justice 3 (1976); Robert Stein, 'Causes of Popular Dissatisfaction with the Administration of Justice in the Twenty-First Century' (2007) 30 Hamline Law Review 2007.
[256] Daniel Epps, 'Major Supreme Court Reform Is Unlikely. But These Changes Would Be A Good Start' (2021) Washington Post, July 15 <https://www.washingtonpost.com/outlook/supreme-court-reform-minor/2021/07/15/e34729d6-e417-11eb-8aa5-5662858b696e_story.html> accessed 16 August 2021; Daniel Epps and Ganesh Sitaraman, 'The Future of Supreme Court Reform' (2021) 134 Harvard Law Review Forum 398 (concerning the ethics of judges including the possible disclosure requirement of conflicts of interest).

of criticism brought by Pound, as to the competence of the legal profession, such as mechanical jurisprudence, the lack of orientation in legal philosophy among members of the bench and bar, and the procedural technicalities that fostered the "sporting theory of justice," turning litigation into a game of skill, are still valid because "the characteristic alibi of the establishment, that legal matters are technical and complicated and not really understood by laymen"[257] cannot be justified as an excuse of the delayed or complicated system of justice. Nevertheless, it is imperative to recognize that the reformers were concerned with the responsiveness of the law to the needs of their contemporaries in rendering justice by adapting the law to the continued progress of society and being able to achieve consequential changes through court reform.[258] The American court system as we see it today is the fruit of those efforts over a hundred years and, according to a survey of the public's perception of the U.S. justice system,[259] is perceived by a majority of the American public as the best in the world despite its problems and challenges.[260]

Consequently, the aggregate body of laws and legal systems grows through dynamic

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[257] Robert Finley, 'Judicial Administration: What Is This Thing Called Legal Reform?' (Apr. 1965) 65(4) Columbia Law Review 570. 'The characteristic alibi of the establishment' is so common and pervasive in the discourse of financial regulation that financial markets are too complicated to explain in plain language and financial regulation cannot aptly follow the rapid progress in financial markets due to the complexity and innovativeness in product designs.

[258] For details on the transformation of the U.S. court system from the perspective of administration, see Terry Nafisi, 'One Hundred Years Since Pound' (n 254). The article entails interviews of three long-time court administration leaders to comment on the achievements of court reform following questions such as "has court reform mattered? Have the changes in the administration of the courts improved the delivery of justice? Is court administration worthy profession?"

[259] American Bar Association, 'Perceptions of the U.S. Justice System' (1999) <perceptions_of_justice_system_1999_1st_half.pdf> accessed 16 August 2021.

[260] According to the survey, the U.S. Supreme Court received the highest expression of confidence (50% of respondents expressed the highest confidence), lower federal courts received the lesser expression of confidence (34%), and the U.S. justice system in general received a 30% high confidence rating, exceeding those of the state legislatures (19%). However, lawyers received a 14% high confidence rating, higher only than the media which received an 8% high confidence. See American Bar Association, 'Perceptions of the U.S. Justice System' (n 259); Stein, 'Causes of Popular Dissatisfaction' (n 255).

interactions among participants of the legal profession in reflection of evolving interests that suit the evolving social environment of the time. In this sense, the legitimate principle of reform is closely linked to the responsiveness of law and the relevance of reform to contemporary problems which emphasize the importance of reflecting the progress of ideas, rights, and responsibilities as an aggregate result of social progress. Without recognizing the very needs of society at a given time, it is hard to expect that legal reform can achieve its purpose. In the context of post-crisis regulatory reform, thus, the emerging ideas as to the responsibility of the financial industry as an accelerator of global agendas for sustainable development should be seriously examined and applied as suitable to the business conduct of financial institutions. For example, the financial industry has been recognized as an enabler in supporting countries to deliver on their climate goals, and the final report of the COP 26 Climate Pact highlighted that trillions of private-sector financial flows should be mobilized to achieve the goals of the global shift to net-zero and resilient economies.[261] It is noteworthy that banks, insurers, and investors representing 450 institutions responsible for over $130 trillion of private financial assets pledged to net-zero targets through the Glasgow Finance Alliance for Net Zero (GFANZ), within the commitment of coming forward with 2025 or 2030 decarbonization targets.[262] However, those commitments of the private sector should be credibly fulfilled, and regulatory frameworks must be well designed so that private institutions see it as easy and effective to comply with relevant regulatory requirements such as the standards of implementation and disclosure requirements.[263] Considering the size and depth of the global financial markets

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[261] COP26 The Glasgow Climate Pact, 'UN Climate Change Conference UK' (2021) 19-22 <https://ukcop26.org/wp-content/uploads/2021/11/COP26-Presidency-Outcomes-The-Climate-Pact.pdf> accessed 30 November 2021.

[262] Ibid.

[263] To ensure a global approach to the standards of implementation and the disclosure of climate risk to financial markets, the final report states that "over 40 countries – representing over 83% of global GDP – will support a new international body, the International Sustainability Standards Board (ISSB), that will develop sustainability disclosure standards." See COP26 The Glasgow Climate Pact, 'UN Climate Change Conference

today, financial regulation must focus on utilizing the potential of finance for solving new and emerging social problems that have a critical impact on the lives of contemporary people, rather than narrowly focusing on technical policy tools which are designed to work for large financial institutions.

3.2.2 The Efficacy of Financial Regulatory Reform

As mentioned earlier, the responsiveness of law and reform is closely related to the efficacy of reform, which means that reform measures meet the targeted purposes and are executed as effectively as possible. While the responsiveness of law as the relevance of reform to contemporary problems should be carefully considered at the onset of regulatory reform, the efficacy of reform should be ensured throughout the progress of reform and towards the completion of reform periods. Since the responsiveness of law implies that the scope and speed of legal reform are adequate to address the challenges posed by contemporary problems, the efficacy of reform is closely related to the responsiveness of law because it ultimately deals with the question of whether reform is successful in solving the problems as targeted. In an administrative state, the efficacy of reform demonstrates the competency of regulators who are subject to ex-post evaluation as their authorities and powers are conditional to the limited scope of tasks entrusted to them by constitutional or other legal instruments. Thus, efficacy is a critical factor that either strengthens or weakens the legitimacy of legal reform, and the efficacy of financial regulation should be comprehended based on its achievement of legitimate purposes of financial regulation and reform.

UK' (n 261) 22.

In general, the efficacy of regulatory reform asks whether the reform measures are aligned with the purposes of reform and implemented effectively so that the results achieve the policy objectives as projected. In the context of post-crisis reform, the efficacy of reform is determined by whether the reform measures have addressed problems revealed or highlighted by the crisis and are designed to solve those problems with the least cost to society. During economic and political turmoil, reform measures easily deviate from original objectives as targeted and unrelated issues can be incorporated into the process of facilitating legal reform for political intentions of gaining support from opposing parties or other interest groups. In this sense, it is crucial to understand the right standards of success in financial regulation and regulatory reform and make sure that those standards are properly established under the legal and political principles of liberal democracy. At the same time, the conflicting values between different objectives should be carefully reviewed so that a good-intentioned reform does not result in unintended negative consequences. For example, a reform measure to strengthen the protection of customers from fraud or misrepresentation should not result in restricting financial companies from introducing new products or services to the market by using innovative technologies. Similarly, it is problematic if reform measures to improve the transparency of corporate governance end up disadvantaging some companies by revealing critical information that can be harmful to their future positions. Thus, it is necessary to have a clear understanding of the standards for achieving efficacy in financial regulatory reform. The foremost step in this task is to define the meaning of efficacy in the context of financial regulatory reform and identify the factors that determine the level of efficacy.

Despite the importance of measuring and enhancing the efficacy of regulatory reform, it is surprisingly difficult to find a clear and consolidated definition of efficacy when it is used in the scholarship of financial regulation. Although it is not rare to talk about the efficacy of reform, the problem lies in that its meaning is used differently in different contexts without a thorough explanation. For example, economists often use the term efficacy when they refer to the economic efficiency of regulation in terms of the cost and benefits associated with the process,[264] whereas some legal scholars understand efficacy as the competency of the system to serve the ultimate purposes for which the rules are deployed.[265] Still, the interdisciplinary scholarship of law and social psychology often discusses the efficacy of regulation from the perspective of the influence of regulation and regulatory changes on behavioral motivations.[266] The widespread confusion on the term efficacy and its criterion when it is used in financial regulation has been one of the critical causes of making the process of regulatory reform less focused and streamlined. At the same time, the ambiguity of the efficacy of financial regulatory reform and the mixed interpretations of the priorities and targets have made it much more difficult to reach a clear consensus among diverse stakeholders as to the question of whether the reform efforts were successful or not. The lexical meaning of the word efficacy is "*the ability, especially of a medicine or a method of achieving something, to produce the intended result*."[267] In the context of regulation, the two most important contributing factors to the efficacy of regulatory reform are the capacity to identify the method, or targets, most likely to produce the intended result and the actual ability to make it happen. The former may be represented by the appropriateness of reform targets and the latter by the effectiveness of achieving those reform targets.

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[264] See e.g., Jon Danielsson, 'On the Efficacy of Financial Regulations' (Sept. 2009) 13 Financial Stability Report, Banque de France.
[265] See e.g., Waldron, 'Why Law' (n 74).
[266] See e.g., Rupp and Williams, 'The Efficacy of Regulation' (n 229).
[267] Cambridge Dictionary, 'Efficacy' <https://dictionary.cambridge.org/dictionary/english/efficacy> accessed 7 January 2022.

The appropriateness of reform targets is a primary concern of any regulatory reform as it contains an existential reason for the public institutions responsible for reform. Reform targets should be properly matched to policy objectives by asking the following question: "Are the selected combinations of policy instruments appropriate for the identified problems or needs in the financial system?"[268] The ultimate answer to this question is to be proved by the results of the reform. It cannot be simply examined by comparing the initial lists of reform objectives that are turned into policy actions and the results after a set period. While it might look like a straightforward task of comparison that involves fewer discretionary judgments, different opinions exist as to the expected or desired results of the reform objectives and the anticipated level of change. Moreover, the economic and political situations between the two points of comparison may be different and it makes little sense to manually compare the policy objectives over several years.[269] The biggest problem may be that even if initial reform targets are met after several years of the reform process, the final product can be less useful if the economic situation has undergone a tremendous change in the meantime and the previous judgments of desired policy objectives may become less relevant. For example, the objective of improving financial stability may involve different reform approaches and measures, ranging from stringent capital requirements for financial institutions to economic policies that promote diversified growth initiatives in the non-financial sector. While such narrower goals as capital requirements are easy to calibrate and monitor, the efficacy of reform is more likely to be achieved by focusing on broader policy objectives in consideration of connected issues

[268] OECD, 'Policy Framework' (n 115) 49.

[269] It is particularly problematic when regulations are set at the international level as requirements for regulatory principles at the national level are implemented too late in the decision-making process. See Julia Black and Stephane Jacobzone, 'Tools for Regulatory Quality and Financial Sector Regulation: A Cross-Country Perspective' (2009) 16 OECD Working Papers on Public Governance, 10.

such as the overall economic recovery and the sustainability of the financial sector. Therefore, it is more reasonable to target macro-level policy reforms rather than micro-level programs and observe the changes in the long term. It would be even better to consider fundamental issues that connect to systemic problems that have implications for behavioral changes and incentive structures in the market. In this context, Charles Goodhart contends that the solution to the regulatory failures that led to the global financial crisis lies in reforming the governance system and realigning incentives for bank management rather than raising capital and liquidity requirements.[270] To put it bluntly, the decade-long financial regulatory reform since the outbreak of the global financial crisis of 2008 has not targeted fundamental issues to solve the root causes of recurring financial crises and instability in financial markets. The achievement of narrow-focused policy tools such as raising bank capital requirements is hard to ensure that the global financial markets are safer than before unless the large financial institutions act more prudently under the post-crisis regulatory environment. Moreover, the current regulatory framework is particularly vulnerable to threats to financial stability outside the regulated banking sector, namely various forms of shadow banking, and it is doubtful if the regulators could have the authority to address such threats in the future.[271]

One of the most apparent examples of the problem of misdirection of regulatory reform can be found in the objective of ending the too-big-to-fail. When the U.S. Congress passed and President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the primary objective of the Act was to end the too-big-to-fail problem in financial

[270] See Charles Goodhart, 'Has Regulatory Reform been Misdirected?' (2017) Journal of Financial Regulation and Compliance 236-240.
[271] Daniel K. Tarullo, 'Financial Regulation: Still Unsettled a Decade After the Crisis' (2019) 33(1) Journal of Economic Perspectives 61-80, 62.

markets. The preamble of the Dodd-Frank Act states the purpose of the act as:

> To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices

Also, President Obama declared that "The American People will never again be asked to foot the bill for Wall Street's mistakes… there will be no more taxpayer-funded bailouts. Period."[272] While the objective of solving the problem of "too big to fail" is an appropriate policy goal in the post-crisis regulatory reform, the subsequent policy targets were insufficient to carry out the expected objectives. To achieve the goal of reducing the change of any future bailout of financial institutions, regulators attempted to achieve it by increasing the resilience of systemically important financial firms so that they would not fail and by creating an orderly resolution authority with a requirement for resolution planning so that failing firms could be wounded up rather than bailed out.[273] As to the objective of reducing the likelihood of orderly resolution for nonbank institutions or large bank holding companies without government-led bailouts, some experts argue that the post-crisis regulatory reform has provided insufficient safeguards to the problem of unorderly bankruptcy of large financial institutions and that those reform measures are unworkable and the likelihood of government bailouts in the expense of taxpayers' money has become even higher if financial institutions fail next time.[274] The critics

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[272] Office of the Press Secretary, 'Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act' (July 21, 2010) <https://obamawhitehouse.archives.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act>.

[273] Daniel K. Tarullo, 'Financial Regulation' (n 271).

[274] As to the new resolution authorities and the effectiveness of regulatory measures of the US Dodd-Frank Act, critics argue that "Dodd-Frank's new resolution authorities [are] making bailouts more likely by establishing a new process that specifies how bailouts of too-big-to-fail bank holding companies, as well as other SIFIs, would occur in lieu of an orderly winding down by the FDIC." Charles Calomiris, *Reforming Financial Regulation after Dodd-Frank* (Manhattan Institute 2017) 25-27. For other skeptical views, see Robert Bliss and Franklin Edwards, 'The New Failure Resolution Regulation: The Good, the Bad, and the Unknowable' in Robert Bliss and Douglas Evanoff (eds), *Public Policy and Financial Economics* (World Scientific, 2018); Paul H. Kupiec, 'Will TLAC regulations fix the G-SIB too-big-to-fail problem?' (2015) 08 AEI Economic Policy Working Paper. However, in response to the Presidential memorandum to examine the Orderly Liquidation Authority (OLA), the resolution regime under the Dodd-Frank Act, the Treasury states that

of the Dodd-Frank Act's efficacy on this issue contend that the Act failed to make fundamental structural reforms to eliminate the subsidies exploited by large, complex financial institutions (LCFIs), and without the elimination of the subsidies it is hard to prevent future bailouts funded by taxpayers.[275]

Fundamentally, the objective of ending the too-big-to-fail problem should have been approached by changing the incentive structures for LCFIs so that they are forced to internalize the risks and costs of their activities.[276] In specific, the incentive and control system of bank managers should be thoroughly considered because they are the ones who are most well-positioned to determine the optimal level of investment and risk-taking by weighing the potential penalties and profits they would incur as a result of their own decisions. For this purpose, Charles Goodhart points out that the regulation should focus on individuals, namely bank managers and directors, rather than institutions because it is those individuals who make decisions. Under the incentive systems that impose appropriate penalties for failure on the banker, not the bank as an institution, the bankers would choose the best structures for their operation, either large or small, that "would provide them with an acceptably reduced chance of failure."[277] Consequently, efficacy as the adequateness of reform targets to achieve the

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> [T]hough the serious defects in OLA's original design must be corrected, Treasury recommends retaining OLA as an emergency tool for use under only extraordinary circumstances. While bankruptcy must be the presumptive option, the bankruptcy of large, complex financial institutions may not be feasible in some circumstances…without the assurance of OLA as an emergency tool, foreign regulators would be more likely to impose immediate new requirements on foreign affiliates of U.S. bank holding companies, raising their costs of business and harming their ability to compete internationally.

The Department of the Treasury, 'Orderly Liquidation Authority and Bankruptcy Reform' (February 21, 2018) Report to the President of the United States Pursuant to the Presidential Memorandum Issues April 21, 2017.

275 See generally, Arthur E. Wilmarth Jr., 'The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem' (2011) 89 Or. L. Rev. 951.

276 Id. 954.

277 Goodhart, 'Has Regulatory Reform been Misdirected?' (n 270) 238. Similarly, Goodhart suggests that the personal liability of shareholders could be related to their level of access to information and capacity to control. ("Junior employees and outside shareholders, up to a holding of X percent of market value, would keep limited liability. Junior managers, and large shareholders, could have double liability; senior managers, perhaps, treble

policy objectives should be thoroughly examined in the process of setting policy goals and choosing the proper reform measures.

The second category of efficacy is the effectiveness of achieving the reform targets to bring expected changes. The effectiveness of reform is directly related to the success of policy objectives and buttressed by actual changes as projected in the subject areas. Effectiveness is often used interchangeably with efficiency, particularly in the economics literature. While efficiency is an important part of measuring the efficacy of reform, efficiency represents only a part of efficacy as effectiveness. While efficacy as effectiveness focuses on the success of achieving the policy objectives, efficiency is primarily concerned with the costs. Thus, the benefits of efficiency may or may not have a positive relationship with that of effectiveness in financial regulation. In the OECD Policy Framework, the difference between effectiveness and efficiency is described below:

> Government intervention and regulation should strive to achieve these objectives, and their *effectiveness* is measured by the extent to which these efforts are successful. At the same time, intervention and regulation in the financial system carries costs, so that it should be done as *efficiently* as possible without sacrificing the achievement of policy objectives – unless indeed the overall costs of intervention exceed the benefits.[278]

As to the choice of policy instruments, efficiency is sought by taking the least-cost approach that imposes the lowest costs without sacrificing effectiveness as a priority.[279] In the financial market, efficiency means that the financial system allocates capital to the most productive uses, the pricing of financial services reflects the costs and the expected return on financial instruments appropriately reflects risks.[280] Since this definition of efficiency is closely related

liability; and CEOs perhaps unlimited liability").
278 OECD, 'Policy Framework' (n 115) 8.
279 Id. 22 and 24.
280 Id. 17.

to the dissemination of information in financial markets and the pursuit of perfect allocation of resources and maximization of profits, it is hard to apply this concept of efficiency as a legitimate principle of financial regulatory reform. It is not only unpractical to apply due to the limitations considering the diverse, and non-linear, ways through which information is disseminated and understood in the financial markets,[281] but also undesirable because the efficacy of reform encompasses not only the minimization of the costs involved but also the suitability of policy tools for achieving the targeted policy goals.[282] In this regard, one of the most common and problematic misunderstandings of the efficacy of regulatory reform is that the efficiency of policy measures is prioritized without robust standards of evaluation in consideration of the multifaceted context of the political economy of regulation. Although the efficiency of financial regulation is important in areas such as the standardization and consolidation of regulatory standards and rules at the global level, the issues are not purely related to the costs of regulation as political considerations are always involved. While many economic analyses take the term efficiency as the core aim of financial regulatory reform and focus on the allocation of limited public resources, the efficiency of regulatory reform alone does not ensure that reform measures lead to the achievement of targets as expected. Rather, it unduly narrows the scope of regulatory reform and is often incompatible with the legitimate principles of financial regulation such as fairness and non-discrimination.

For compliance and enforcement, there are two aspects of assessing the effectiveness of regulation: first, the ability of regulators to gain immediate and long-term compliance with the

[281] For an analysis of information's role in shaping and operating financial markets regulation, see David Donald, 'Information, and the Regulation of Inefficient Markets' in Emilios Avgouleas and David Donald (eds), *The Political Economy of Financial Regulation* (CUP 2019).
[282] For analyses on the problems of seeking short-term efficiency without knowing the implications of future sustainability risks, see David M. Driesen, *The Economic Dynamics of Law* (CUP 2012).

rules and regulations in particular situations, and second, the ability of legal authorities to encourage general compliance with the law and cooperation.[283] The first aspect is mostly achievable by imposing compulsory rules and monitoring closely the particular areas of regulation with available tools of supervision. The second aspect is harder to achieve but more important in terms of the quality of compliance and the effectiveness of enforcement. Recalling that financial regulation is particularly concerned with influencing or controlling the behavior of market participants,[284] the effectiveness of regulatory reform depends on the ability to encourage people to comply with the law and cooperate without solely relying on compulsory enforcement measures. Thus, it is necessary to use direct and indirect incentives by adjusting the form and strength of directive authority, compulsion, and supervision as appropriate.[285] Indeed, the objective of influencing citizens' behavior depends on the adequateness of policy instruments as using coercive measures without proper justification is not particularly effective in changing behaviors.

In connection with the importance of using appropriate incentives, regulatory design needs to be responsive so that the degree and form of intervention are determined in response to the reactions of those who are subject to regulation. It is not only important for improving the effectiveness of regulation in achieving the targeted objectives but also gives incentives to market participants to choose to be cooperative as voluntarily as possible without sacrificing the integrity of regulatory intervention to correct market problems. The theory of responsive

[283] See Tom R. Tyler, 'Procedural Justice, Legitimacy, and the Effective legality' (2003) 30 Crime and Justice 283-357, 283-284. In this article, Tyler suggests a process-based model of regulation in assessing the two aspects of effective regulation arguing that "the key factor shaping public behavior is the fairness of the processes legal authorities use when dealing with members of the public." The procedural aspects of regulation will be discussed in the following section of procedural justice.
[284] OECD, 'Policy Framework' (n 115) 29.
[285] Id. 34.

regulation contends that government and citizens can design effective regulatory schemes by utilizing the interplay between private and public regulation whereby regulation is responsive to industry structure because different structures will be conducive to different levels and forms of regulatory intervention.[286] Rather than using uniform standards of regulatory intervention, the theory of responsive regulation suggests that the regulatory environment and the conduct of the regulated should be taken into account when deciding a proper level and form of regulation under the assumption that "regulations themselves can affect the structure (i.e. the number of firms in the industry) and can affect motivations of the regulated."[287] Considering that punishment by using authoritative instruments sometimes does not work and increases the burden on regulators, responsive regulation has been quite influential as a starting point for formulating policies to be effective in achieving the projected objectives.[288]

This idea of promoting cooperation between regulators and the regulated by utilizing structural incentives may be particularly useful in improving the effectiveness of financial regulatory reform in that the ultimate goal of financial regulation is to build trust and confidence by promoting behavior changes rather than restricting market activities by adopting restrictive regulatory regimes. One of the most well-known concepts of responsive regulation is *an enforcement pyramid* that depicts a hierarchy of sanctions and a hierarchy of regulatory strategies that regulators may choose interactively in response to the reaction of those being regulated.[289] The initial step is persuasion where regulators attempt to persuade as the

[286] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (OUP 1992) 4.
[287] Ibid
[288] John Braithwaite, 'Types of Responsiveness' in Peter Drahos, *Regulatory Theory: Foundations and Applications* (ANU Press 2017) 118-119.
[289] Ayres and Braithwaite (n 286) 35-40.

presumption of responsive regulation is that the normal response of regulators is to try dialogue first for addressing problems regardless of the seriousness of the problem unless there are compelling reasons not to do so.[290] In this concept, regulators escalate a step when the previous strategy fails to achieve the goal.[291] This form of enforcement pyramid is adopted by Australian financial regulators including the Australian Securities and Investment Commission (ASIC). The former Chairman of ASIC described the Commission's regulatory approach as a tri-partite pyramid: at the base are those who comply with the law and the Commission's role is to guide them to continue to comply; the middle group is composed of opportunists who are ready to escape the legal rules and the Commission aims to influence their views and behaviors; at the height of the pyramid are those who engage in illegal behaviors for whom the full enforcement instruments are adopted by the Commission.[292] In essence, responsive regulation aptly links the effectiveness of regulatory compliance and enforcement to the integrity of regulation by giving heed to the interaction between the regulators and the regulated.[293] By signaling that the degree of regulatory intervention or enforcement measures would be determined based on one's behavior, it is likely to influence the attitude of people toward compliance in the long term. In this sense, responsive regulation requires those who design regulatory schemes to think about the likely reactions of market participants beforehand and choose the best options that would be most effective in achieving the ultimate policy goal by

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[290] John Braithwaite, 'The Essence of Responsive Regulation' (2011) 44 U.B.C. L. Rev. 475-520, 483.
[291] Under the enforcement pyramid, "most regulatory action occurs at the base of the pyramid where attempts are initially made to coax compliance by persuasion. The next phase of enforcement escalation is a warning letter; if this fails to secure compliance, imposition of civil monetary penalties; if this fails, criminal prosecution; if this fails, plant shutdown or temporary suspension of a license to operate; if this fails, permanent revocation of license." Braithwaite, 'Types of Responsiveness' (n 288) 35-36. Although this particular pyramid might be inapplicable to banking or affirmative action regulation, the form of interactive regulatory instruments has critical implications in improving the effectiveness of financial regulation.
[292] Charlotte Wood et al., 'Applications of Responsive Regulatory Theory in Australia and Overseas' (2010) Occasional Paper 15, 12.
[293] See Lynn Stout, *Cultivating Conscience: How Good Law Make Good People* (Princeton University Press 2010).

showing respect in the process of regulatory intervention rather than relying on their legal authority to intervene. Fundamentally, regulators who want to change the behavior and attitude of the regulated must understand that the relationship between them and their subjects is to be interactive, and the approach needs to be flexible and responsive. Therefore, it is also imperative to understand that enhancing the effectiveness of regulation and the reform process is inseparable from other legitimate principles of regulation. As to this approach, John Braithwaite describes the way of implementing responsive regulation as a natural social process of restoring human integrity:

> So we might teach responsive regulation not as rocket science but as a natural social process… unlearning intemperate issuance of directives, undoing the habit of making threats, resisting slavish adherence to protocols when our monitoring suggests they have counterproductive effects. The challenge is renouncing humiliation and habits of disrespect in a return to the more natural form of human engagement which is respectful and trusting.[294]

In the context of financial regulation, it is desirable to maintain the balance between legal enforcement and self-determinative initiatives. The optimal performance of financial regulation is likely to be achieved when the interests of financial firms are properly aligned with the interests of the society with which they are engaged. In this sense, it is important to focus on incentivizing financial institutions to develop "more publicly minded and socially responsible self-regulation."[295] As a way of ensuring that the potential benefits of self-regulation are not undermined, the concept of "embedded self-regulation," which aims to enhance the private sector's ability to increase economic efficiency while increasing their responsibility for the broader economy and society was emphasized in the discourse of post-crisis financial regulation.[296] The Equator Principles (EP) is a good example. The EP has

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[294] Braithwaite, 'The Essence of Responsive Regulation' (n 290).
[295] Saule Omarova, 'Wall Street As Community of Fate' (n 37) 413.
[296] Id. 438-9. See also, Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton

become the financial industry standard for environmental and social risk management in the area of project finance to ensure that the projects they finance are developed by socially responsible practices.[297] It is a voluntary set of standards and has been formulated based on the existing performance standards on social and environmental sustainability imposed by the World Bank Group and the International Finance Corporation (IFC) applicable to public infrastructure financing projects.[298] Although it relies on self-enforcement by the participating financial institutions, those financial institutions that are involved in project finance have become concerned about the principles because project finance loans are nonrecourse and lenders are repaid only through the revenues generated by the projects.[299] The profitability of the lenders is directly related to particular risks that might derail the project, such as human rights and labor issues, indigenous people's rights, environmental issues, and political turmoil.[300] In addition, the adoption of the EPs has been instrumental for banks to reduce reputational risk while financing large infrastructure developments that could lead to a social or environmental disaster. At the same time, they wanted to level the playing field by entering an agreement with other banks so that the choice of limiting lending to socially and environmentally undesirable or risky projects would not disadvantage them while allowing other lenders to take advantage of the improved standards.[301] Reputational risk is a critical factor that motivates lenders of project finance to be vigilant to sustainability-related issues associated with their investment and the EPs have functioned as a systemic tool for identifying

University Press 1995).

[297] See The Equator Principles, <https://equator-principles.com/about-the-equator-principles/> accessed 15 January 2022. As of January 2022, 126 financial institutions in 37 countries have officially adopted the Equator Principles including leading global banks such as Barclays, BNP Paribas, Citi, Credit Suisse, HSBC, ING, and JP Morgan.

[298] Rupp and Williams, 'The Efficacy of Regulation' (n 229) 597.

[299] See John M. Conley and Cynthia A. Williams, 'Global Banks as Global Sustainability Regulators? The Equator Principles' (2011) 33(4) Law & Policy 542-575.

[300] Ibid.

[301] Id. 551

the risks and pricing them correctly.[302]

As to the question of whether the same approach of self-enforcement of governance standards would be adopted for other financial sectors, the ultimate answer depends on the possibility of aligning the interest of financial institutions to the interest of society so that financial institutions strive to internalize the externalities associated with their investment decisions and practices. After all, the competency of regulators depends on how effectively they connect the interest of financial institutions to that of society, and, whether they are politically willing and able to strike the balance by imposing the burden of failure on those who make the investment decisions rather than those who are not involved in the firm's decision-making process.

3.2.3 The Integrity of Law and Procedural Justice

The purpose of encouraging general compliance to the law and cooperation as discussed above is intrinsically related to the perceived legitimacy of the law by those who are subject to the law. As to the question of why people would perceive a legal system more legitimate than others, the integrity of law represented by procedural justice provides critical insights.[303] Procedural justice is often associated with the fairness of a legal system in terms of the process of identifying, promulgating, and executing legal actions. Although there are many reasons financial institutions should take responsibility for the consequences of their mistakes and bad judgments, the quality of financial regulation ultimately depends on what the regulators do in

[302] See Christopher Wright, 'Setting Standards for Responsible Banking: Examining the Role of the International Finance Corporation in the Emergence of the Equator Principles' in Ann Schreyrogg et al. (ed), *International Organizations in Global Environmental Governance* (Routledge 2009) 51-70.

[303] See Toni Makkai and John Braithwaite, 'Procedural Justice and Regulatory Compliance' (1996) 20(1) Law and Human Behavior 83-98 (detailing the study of corporate compliance as to the capacity of organizational actors to "pass on" resentments fueled by perceived injustice.)

the first place. In retrospect, the global financial crisis underlined that not only financial institutions but also financial regulators failed to pay due attention to the emerging systemic risks in the global financial market while the rapid expansion of financial institutions has remarkably increased the influence of the financial industry on the health of the entire global economy. The narrowly focused policy objectives of financial regulators and the lack of due consideration of the firm's activities in the context of social stability and the fairness of wealth distribution structures in the economy seriously degraded the quality and trustworthiness of financial regulation. Indeed, the behavior traits of market participants cannot be completely alienated from the regulatory environment in which they operate by interacting with regulators. Thus, the legal system of financial regulation must promote the integrity of human character and not degrade it by giving false impressions on compliance or negative incentives for intentional violation of rules.

This problem reminds Fuller's eight principles of legality as discussed earlier (in section 3.1) because an analysis of the integrity of law should come first before discussing the integrity of business conduct. The integrity of business conduct is generally sought through corporate governance regulations which define the standards of management for a firm regarding its diverse obligations to stakeholders in the market and, more broadly, in society.[304] Other regulatory measures, such as capital requirements or competition policy, also serve as a means of achieving the standards of integrity in financial markets.[305] However, the integrity of law

[304] For example, the Policy Statement of the PRA Fundamental Rules says that "The Fundamental Rules are high-level rules, which collectively set out the PRA's expectations of firms and act as an expression of the PRA's general objective of promoting the safety and soundness of regulated firms and insurance objective of contributing to securing an appropriate degree of protection for those who are or may become policyholders." See the PRA Rulebook 2014 <https://www.bankofengland.co.uk/prudential-regulation/publication/2014/the-pra-rulebook> accessed 26 November 2021.
[305] More detailed analysis of corporate governance-related financial regulations is discussed in the subsequent section 3.3 Legitimacy of Corporate Governance and Financial Conduct Regulation.

from the perspective of financial regulation is less discussed in the discourse of financial regulation in recent years while the effectiveness of policy measures in improving particular aspects of financial markets has been widely discussed in the aftermath of the global financial crisis. For example, many experts in financial markets and public policy have analyzed whether the post-crisis regulatory reforms by major economies such as the Dodd-Frank Act of the US, or by international financial institutions such as the Basel III were effective in reducing the likelihood of bankruptcy of systemically important financial institutions in the global financial markets. However, these analyses fail to address fundamental problems of financial regulatory systems which involve complex relations between regulators, financial institutions, and customers. Moreover, these analyses gave little attention to the general approach of financial regulation in the context of the integrity of the law and whether those reform measures were adequately formulated and executive following the principles of legitimacy in market-based democratic economies.

The Integrity of Law and the Law's Respect for Human Dignity

According to the analysis of the legitimacy of law so far, how law recognizes humans in society is more important than many contemporary observers of financial regulation may perceive.[306] Indeed, it has been the limits of the financial regulation scholarship which has given inadequate attention to the organic relations between the law and human actions while the central issues of financial regulation are intrinsically linked to the rights, obligations, and systemic features of the law. In this regard, how those factors are dealt with in the scholarship of jurisprudence, in general, may give insights into the assumptions and systemic characteristics of financial

[306] Jeremy Waldron, 'How Law Protects Dignity' (2012) 71 Cambridge Law Journal 200–222. For discussions on integrity and culture in financial systems, see generally, Justin O'Brien and George Gilligan (eds.), Integrity, Risk and Accountability in Capital Markets: Regulating Culture (Bloomsbury 2013).

regulation. Despite the complexity and technicalities involved in financial regulation which often bars many observers and critics of the financial market from completely understanding the flaws and pitfalls hidden in public policy, the essence of the problem lies in the very basic perception of law and what law can ask its subjects in a reflection of the rights and positions of human in society. When Fuller called the principles of legality a “morality” of law, the usage of the term “morality” clearly signifies that there are certain ways of showing respect for human dignity by observing the principles he suggested.[307] In this sense, a deeper understanding of the integrity of law for human dignity is very useful in improving the legitimacy of financial regulation.

As to the law’s respect for human dignity, Jeremy Waldron brings afresh the idea of “self-application” by referring to the analysis of Fuller that the legal systems count on the capacities of people for practical understanding, self-control, and modulation of their behaviors in reflection of their understandings on the norms and that people normally do not wait until the state intervenes with coercive measures.[308] In this term, he rightfully states that “self-application is an extraordinarily important feature of the way legal systems operate.”[309]
The idea of self-application links to John Rawls’ conception of citizens as free and equal persons. John Rawls provides that the tradition of democratic thought regards citizens as free and equal persons: persons are free in virtue of “what we may call their moral powers and the powers of reason, thought, and judgment connected with those powers,” and they are equal “in virtue of having these powers to the requisite degree to be fully cooperating members of

[307] Id. 205-206.
[308] Ibid.
[309] Ibid.

society."[310] It echoes the dynamics between the lawgivers and their subjects and sets boundaries concerning what the law can demand and the possible changes in human behaviors. In this regard, assessing the legitimacy of regulatory reform should address fundamental questions about the regulatory approach and the quality of regulation based on the moral values of the law in society. In this term, the relationship between the regulator and the regulated in the context of self-application and power dynamics in the regulatory sphere should be carefully examined. Ultimately, the integrity of financial regulation is about ensuring that the regulatory system is equipped with an appropriate level of morality and reciprocity between the lawgivers and the subjects in general so that the legal system is respected as trustworthy. In this perspective, the accountability of the regulators is a key factor that makes a regulatory system legitimate and trustworthy. As discussed earlier, the reciprocity of law depends on the attitude and ethics of regulators in terms of their adherence to established procedural rules and responsiveness to the reaction of those who are subject to regulation. Thus, the integrity of law should be assessed in terms of the quality of regulation as it refers to the trustworthiness of the regulatory system as a whole. The level of trustworthiness affects the effectiveness of regulation and reform efforts because the higher the level of trustworthiness of the legal system, the lower the chances of incompliance with the law through legal arbitrage or other ways of regulatory evasion.

Fairness of the Legal Procedure: Procedural Justice

Fundamentally, the integrity of the law and the trustworthiness of the regulatory system depend on the fairness of the legal procedure. The success of regulatory reform is determined by the

[310] John Rawls, 'Justice as Fairness: Political not Metaphysical' (1985) Philosophy & Public Affairs 224-251, 233.

level of compliance, and the foremost condition of promoting fidelity to the law is that the legal system is perceived as fair by those who are expected to comply with it. Concerning the term "fairness," it is important to note that it does not necessarily denote subjective moral standpoints that prevail in certain political systems. Rather, it represents institutional systems or structures that are agreed by participants as legitimate and that they reasonably accept as everyone else likewise accepts them.[311] In a constitutional democracy, according to John Rawls, the public conception of justice as fairness is by virtue a political agreement between citizens regarded as free and equal persons, and, as the idea of reciprocity or mutuality of law requires, ensuring fairness depends on the condition that all who are participating in the system by following the rules and procedures are "to benefit in some appropriate way by a suitable benchmark of comparison."[312] In this regard, fairness is perceived in the context of society as a system of cooperation between citizens under the assumption that individuals are expected to exercise various rights and duties in social life. As to this point, Rawls highlights a conception of the person as a cooperating member of society:

> There are, of course, many aspects of human nature that can be singled out as especially significant depending on our point of view. This is witnessed by such expressions as *homo politicus*, *homo oeconomicus*, *homo faber*, and the like. Justice as fairness starts from the idea that society is to be conceived as a fair system of cooperation and so it adopts a conception of the person to go with this idea. Since Greek times, both in philosophy and law, the concept of the person has been understood as the concept of someone who can take part in, or who can play a role in, social life, and hence exercise and respect its various rights and duties. Thus, we say that a person is someone who can be a citizen, that is, a fully cooperating member of society over a complete life.[313]

Despite the different levels of capability to understand and comply with the concept of justice

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[311] Id. 232.
[312] Ibid.
[313] Ibid. The phrase "over a complete life" is adopted here because he viewed society as a complete and self-sufficient scheme of cooperation by stating that "[a] society is not an association for more limited purposes; citizens do not join society voluntarily but are born into it, where, for our aims here, we assume they are to lead their lives." Id. 233.

among citizens that make some better qualified for demanding positions or offices to deal with hard cases or make decisions, it is crucial to acknowledge that everyone in society is fully capable of honoring the principles of justice as fully cooperating members of society and that "everyone's sense of justice is equally sufficient relative to what is asked of them."[314] This understanding of equality among citizens gives the basis for procedural justice because everyone is "equally worthy of representation in a procedure that is to settle the fundamental terms of social cooperation."[315] Procedural justice in general refers to the fairness of the decision-making process, and it makes decision-making authorities to be considered legitimate. Procedural justice is an integral component of ensuring the integrity of the law as it legitimizes the decisions of legal authorities both in theory and practice. In particular, the consistency and predictability of the legal process have critical implications for the relationship between the rule of law and individual liberty because individuals can have the possibility of autonomously organizing their lives in a social environment in which authorities are required to exercise their power on a basis of clear and consistent rules.[316]

As to the linkage between the predictability of law and liberty in society, Jeremy Waldron's statement below explains the importance of predictability and how it empowers individuals:

> Whatever substantive ends are being pursued, if they are pursued through the law, they define a predictable space in which individuals can plan and act freely. Without this predictability, individuals are apt to become demoralized and disoriented to such an extent that the original aims of government hardly seem worth pursuing. For what is social justice, if people have lost any sense of themselves as free agents? What is prosperity or civilization, if people have become timorous or terrified by the chilling effects of a system of power that leaves them nothing to count on?[317]

[314] John Rawls, 'Kantian Constructivism in Moral Theory' (1980) 77(9) The Journal of Philosophy 515-572, 546.
[315] Ibid.
[316] Waldron, 'How Law Protects Dignity' (n 306); See also Rawls, *A Theory of Justice* (n 107).
[317] Waldron, 'How Law Protects Dignity' (n 306) 266.

The predictability of regulation is obtained by adhering to the appropriate regulatory process that is perceived as fair. In practice, it enables those affected by regulatory changes to prepare in advance as regulatory changes are not implemented arbitrarily. Fundamentally, it refers to the basic concept of the rule of law in a constitutional democratic society that the governance is based on a legal system that clearly defines and explains the boundaries and consequences of actions and that is easily accessible to individuals who make decisions as free and autonomous citizens. In a similar vein to the principles of legality as advanced by Fuller that require the clarity, constancy, prospectiveness, and congruence of law, among others, [318] the principle of legal certainty, delineated by predictability and consistency, was already articulated some 250 years ago in the words of Lord Mansfield in *Vallejo v Wheeler* (1774) that "[i]n all mercantile transactions the great object should be certainty: and therefore, it is of more consequence that a rule should be certain, than whether the rule is established one way or the other. Because speculators [meaning investors and businessmen] then know what ground to go upon."[319] The principle of certainty has been considered a traditional strength of English commercial law.[320] As the first principle of the rule of law, Lord Bingham (2011) provides that "the law must be accessible and so far as possible intelligible, clear and predictable," emphasizing the necessity of accessible and predictable legal rules governing commercial rights and obligations for successful business conduct.[321] In this analysis, he refers to the words of Lord Mansfield in *Hamilton v Mendes* (1761) that "the daily negotiations and property of merchants ought not to depend upon subtleties and niceties; but upon rules easily learned and easily retained, because they are the dictates of common sense, drawn from the truth of the

[318] Fuller (n 53). See 3.1.2 Legitimacy as Legality: The Integrity of Law of this thesis.
[319] Vallejo v Wheeler (1774) 1 Cowp 143, 153.
[320] Lord Mance, 'Should the Law Be Certain?' The Oxford Shrieval lecture given in the University Church of St Mary the Virgin, Oxford on 11th October 2011.
[321] Tom Bingham, *The Rule of La*w (Penguin Books 2011).

case."[322] Similarly, this principle of certainty is also established in public law in the context that a good administration is required "to deal straightforwardly and consistently with the public" and should not allow retrospective changes in the law so that the law is "certain at the time when the subject has to act by reference to it."[323] Consequently, for the rule of law acceptable as a constitutional principle, the legal system should allow a citizen to know, before committing himself to any course of action, what are the legal principles which flow from it,[324] and it further improves the trustworthiness of a legal system.

Recalling that the principles of predictability and consistency are closely related to the attitude and approach of the regulators and does not necessarily mean that particular rules would remain the same over time regardless of the evolving situations in the financial markets. Rather, the principle of predictability also makes the regulatory system adaptable so that market participants are capable of predicting how the regulators would respond to emerging problems or issues without relying too much on speculation. In this term, the quality of predictability has a critical implication on the adaptability of the legal system to technological, cultural, and social changes, demonstrating the competence of the regulatory regime. After all, it is fundamental to the ability of regulation to lead to the effective execution of regulatory objectives and responsibility.[325] Thomas Franck defines legitimacy as procedural fairness which requires that decisions are reached and executed following the pre-established process which is already accepted by the parties as the "right process."[326] In other words, the legal process in question should accord with the existing agreements and not be arbitrary. For

322 Ibid.; Hamilton v Mendes (1761) 2 Burr 1198, 1214.
323 Lord Mance, 'Should the Law Be Certain?' (n 320).
324 Bingham, *The Rule of Law* (n 321).
325 See Calomiris, 'Restoring the Rule of Law' (n 48).
326 Franck, *Fairness in International Law and Institutions* (n 62) 5.

example, the U.S. government's decision to let the investment bank Lehman Brothers down and bail out other large financial institutions such as Bear Sterns and AIG has been criticized as inconsistent and causing huge confusion in the global financial markets at the height of the turmoil. In this regard, the approach of the U.S. government to the global financial crisis has been criticized as excessively discretionary and as being a dealmaker responding deal-to-deal without consistent principles rather than a regulator.[327]

Indeed, procedural justice is the foremost quality of any legal system that is considered legitimate by citizens. Notably, the right to due process is well stipulated in the Fifth and Fourteenth Amendments of the Constitution of the United States. The Fifth Amendment of the U. S. Constitution provides that *"No person shall be … deprived of life, liberty, or property, without due process of law.*"[328] By using the same words, the Fourteenth Amendment of the U.S. Constitution articulates that all levels of American government must provide a fair procedure to all citizens: *"No state shall make … nor shall any state deprive any person of life, liberty or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws*."[329] As was exemplified in *Goldberg v Kelly*, the constitutional due process of the U.S. requires that the administrator should give reasons whenever private parties have the right to an adjudicatory hearing.[330] The relationship between procedural justice and the perception of legitimacy has been thoroughly demonstrated in the scholarship of law and psychology where empirical studies show that people consider authorities as legitimate when they have experienced procedural justice regardless of the favorability of the

[327] Davidoff and Zaring, 'Regulation by Deal' (n 40) 467.
[328] U.S. Const. amend. V.
[329] See U.S. Const. amend. XIV, art.1.
[330] Goldberg v Kelly, 397 U.S. 254 (1970).

outcomes.[331] In short, it is widely acknowledged that four factors affect people's assessments of the fairness of the legal process: the opportunity to present their stories, the neutrality of the decision-maker, the trustworthiness of the third-party authority, and the respect for human rights and legal rights throughout the process.[332] The discourse of procedural justice indicates that the fairness of the process affects the legitimacy of legal authorities and motivates people to comply with the judgments or decisions of the authority in the long term by improving voluntary deference to the legal system.[333] Consequently, the concept of fairness in law and regulation echoes the respect for the fundamental equality of citizens in a democratic society and assures that they are equally entitled to fair legal procedure.

In the literature on criminal law in general, and dispute resolution and litigation in particular, many theoretical and empirical analyses have demonstrated the linkage between citizens' judgments or perceptions about the fairness of the legal procedure and their level of satisfaction with the legal authorities and institutions.[334] In their pioneering studies of the theory of procedural justice, Thibaut and Walker apply the theories and methods of social psychology in the examination of various procedural systems of the legal process and prove that litigants' perception of the fairness of the dispute resolution process influences the satisfaction with dispute resolution decisions.[335] Unlike scientific disputes that are concerned with determining

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331 See generally, Tyler, *Why People Obey the Law* (n 78); see also, Rebecca Hollander-Blumoff and Tom R. Tyler, 'Procedural Justice and the Rule of Law: Fostering Legitimacy in Alternative Dispute Resolution' (2011) 1 J. Disp. Resol. 1-18, 3-5; Celia M. Gonzalez and Tom R. Tyler, 'Why Do People Care about Procedural Fairness? The Importance of Membership Monitoring' in Kjell Tornblom and Riel Vermunt (ed), Distributive and Procedural Justice: Research and Social Applications (Ashgate 2007).

332 Hollander-Blumoff and Tyler, 'Procedural Justice and the Rule of Law' (n 331) 6.

333 Id. 7; Kristina Murphy, 'Procedural Justice and Its Role in Promoting Voluntary Compliance' in Peter Drahos (ed.), *Regulatory Theory* (ANU Press 2017).

334 See generally, Tom R. Tyler, 'What is Procedural Justice? Criteria Used by Citizens to Assess the Fairness of Legal Procedures' (1988) 22(1) Law & Society Review 103-136, 103-104.

335 See John Thibaut and Laurens Walker, *Procedural Justice: A Psychological Analysis* (Erlbaum 1975). For subsequent research that supports their findings, see Jonathan D. Casper, Tom R. Tyler, and Bonnie Fisher,

the "truth" according to a standard and best achieved by employing an autocratic procedure, Thibaut and Walker argue that conflicts about the apportionment of outcomes, such as inconsistent claims to the division of assets or losses, are concerned about the objective of "justice," and such conflicts are best resolved with the aim of achieving distributive justice through legal procedure.[336] In this sense, the appropriate goal of legal procedure is the achievement of justice, and the "procedure which facilitates the fullest possible report of inputs prior to determination of the distribution" is most likely to produce justice because "distributive justice is attained when the ultimate outcomes are distributed to contending parties in proportion to their respective contributions or inputs to the transaction underlying the dispute."[337] Ultimately, procedural justice is both a prerequisite and a consequence of attaining distributive justice, and the objective of legal procedure is to achieve justice both in the process and outcomes.

Taking a step further, Tom Tyler conducted empirical research on the criteria for the assessment of the fairness of legal procedures based on interviews of 652 citizens with recent experiences involving the police and courts and found that procedural fairness of the legal process is the key issue to citizens than the decision itself.[338] In this study, Tyler provides that citizens' judgment of procedural justice is complex and multifaceted rather than unidimensional and that

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'Procedural Justice in Felony Cases' (1988) 22(3) Law & Society Review 483-508; Jean M. Landis and Lynne Goodstein, 'When is Justice Fair? An Integrated Approach to the Outcome versus Procedural Debate' (1986) 11(4) American Bar Foundation Research Journal 675-707; Allan Lind, 'The Psychology of Courtroom Procedure' in N. L. Kerr and R. M. Bray (eds.), The Psychology of the Courtroom (1982); Tom R. Tyler and Allan Lind, 'Procedural Processes and Legal Institutions' in Herman Steensma and Riel Vermunt (eds), *Social Justice in Human Relations: Societal and Psychological Consequences of Justice and Injustice* (Springer 1991).

[336] John Thibaut and Laurens Walker, 'A Theory of Procedure' (1978) 66(3) California Law Review 541-566, 541-542.

[337] Ibid.

[338] Tom R. Tyler, 'What is Procedural Justice?' (n 334) 128. For the method and design of the interview, see pages 110-116.

they pay attention to seven distinct aspects of legal procedure: (1) the degree to which those authorities were motivated to be fair; (2) judgments of their honesty; (3) the degree to which the authorities followed ethical principles of conduct; (4) the extent to which opportunities for representation were provided; (5) the quality of the decisions made; (6) the opportunities for error correction; and (7) whether the authorities behaved in a biased fashion.[339] Among the distinctive aspects of assessment, it is interesting to note that the most used criteria to assess the fairness of the process by the respondents are those more related to procedural issues, such as ethicality, honesty, and the effort to be fair, rather than consistency with other outcomes.[340] Regardless of the problem or issue at dispute, the procedural quality of the legal process played a critical role in judging the fairness of the legal system because respondents could trust the officials involved in the legal process who exhibit politeness and concern for their rights.[341] While the influence of ethicality in procedural justice has not been widely recognized in the literature on dispute resolution, the finding in this study is consistent with an earlier work of Robert Lane in which the importance of ethicality is linked to the importance of procedural justice as providing the sense of self-respect for citizens,[342] and that of Tyler and Folger in which the authors examine the importance of self-respect in the particular context of interaction with legal authorities.[343] More recently, Bruno Frey and others provide that the perception of fairness can be translated into the concept of "procedural utility" which means that people not

[339] Id. 128.
[340] Ibid. Similarly, representation, which is linked to the issue of process and decision control, is an important but not absolute standard of fairness that defines fair processes.
[341] Id. 129. In this study, the concept of ethicality was divided into two categories of politeness and concern for one's rights, and these two were found to be highly correlated while concern for one's rights is more strongly related to judgments of procedural justice.
[342] Robert Lane, 'Procedural Goods in a Democracy: How One is Treated versus What One Gets' (1988) Social Justice Research 2, 177-192. For general discussion of the importance of self-respect to overall psychological well-being, see Angus Campbell, *The Sense of Well-Being in America* (McGraw-Hill 1980).
[343] Tom R. Tyler and Robert Folger, 'Distributional and Procedural Aspects of Satisfaction with Citizen-Police Encounters' (1980) 1(4) Basic and Applied Social Psychology 281-292.

only value outcomes but also the conditions and processes that lead to these outcomes.[344] Similarly, Kees van den Bos and others argue that citizens come to trust their government and accept government decisions based on their perceived procedural justice in this process.[345]

Procedural Justice in Financial Regulation and Administrative Law

While the concept of procedural justice has been taken less seriously in the scholarship of financial regulation, procedural justice has been considered a cornerstone of the theory of legal rulemaking and taken an important part in administrative law that involves a wide range of operations by public authorities including the regulation of the financial sector. After all, financial regulation is a form of administrative governance, and the substantive rules of administrative law would apply in principle.[346] Since the global financial crisis of 2008 revealed many of the defects in financial regulation in general and the relationship between the regulators and the regulated in particular, there appears increasing need for financial regulation to gain its legitimacy by revisiting procedural principles of administrative law relevant to financial regulation. Mostly, scholars from public administration and administrative law have engaged in discussions about the governance of financial regulation from the perspectives of institutional design, politics of regulatory choice, accountability and authority of government, and the relationship between the public and private sectors.[347]

In the case of the U.S., the relationship between financial regulation and administrative law

[344] Bruno S. Frey, Matthias Benz, and Alois Stutzer, 'Introducing Procedural Utility: Not Only What, but Also How Matters' (2004) 160(3) Journal of Institutional and Theoretical Economics 377-401 (introducing the concept of procedural utility into economics with three building blocks of a concept of procedural utility).
[345] Kees van den Bos, Lynn van der Velden, and E. Allan Lind, 'On the Role of Perceived Justice in Citizens - Reactions to Government Decisions and the Handling of Conflicts' (2014) 10(4) Utrecht Law Review.
[346] See Gillian E. Metzger, 'Through the Looking Glass to a Shared Reflection: The Evolving Relationship between Administrative Law and Financial Regulation' (2015) 78(3) Law and Contemporary Problems 129-156.
[347] See generally, Anne M. Khademian, 'A Public Administration Moment: Forging an Agenda for Financial Regulatory Reform' (2009) 69(4) Public Administration Review 595-602.

goes back to the New Deal era during which the overlap between financial regulation and administrative law was substantial as the need to regulate financial markets effectively was central to the emergence of the administrative state.[348] Among the most important government agencies established during the New Deal were agencies oriented to financial regulation, such as the Federal Deposit Insurance Company established in 1933 and the Securities and Exchange Commission established in 1934, and financial regulation provided “a critical impetus for the elaboration of a law and jurisprudence of government administration” in the birth of the modern administrative state.[349] In the 1960s and 1970s, however, the focus on administrative rulemaking shifted from economic regulation to notice-and-comment rulemaking on diverse technological issues with the emergence of new public-interest regulatory legislation in other sectors, such as the environmental and health sector, while the methods of operation for financial regulators were particularly tied to the distinctive characteristics of financial markets with less regard to the general administrative context.[350] Over time, the archetypal objectives of administrative law became political accountability, rulemaking, and judicial review[351] whereas financial regulation prioritized independence, informal supervision, and private regulation.[352] In a comparison between the progress of financial regulation and administrative law, Gillian Metzger argues that administrative law’s strong emphasis on political accountability was essential for obtaining the legitimacy of agencies as they were seen as making decisions among competing interests of society while the neutral expertise model of financial regulation was promoted by the emphasis on the market and economic principles in

348 Robert B. Ahdieh, ‘Notes from the Border: Writing Across the Administrative Law/Financial Regulation Divide’ (Autumn 2016) 66 Journal of Legal Education 64-77, 66.
349 Ibid.
350 Metzger, ‘Through the Looking Glass’ (n 346) 133-134.
351 See Lisa Blomgren Bingham, ‘The Next Generation of Administrative Law: Building the Legal Infrastructure for Collaborative Governance’ (2010) Wisc. L. Rev. 297.
352 Metzger, ‘Through the Looking Glass’ (n 346).

making regulatory decisions.[353] Therefore, it can be seen as a natural tendency that financial regulation became subject to strengthened political accountability and public oversight after the recent financial crisis since the presumed apolitical nature of financial regulation was proved unrealistic and unjustifiable.

A clear example of strengthened procedural aspects of financial regulation can be found in the new administrative process employed by the Dodd-Frank Act in the institutional design of the Financial Stability Oversight Council (FSOC).[354] To exercise its authority to determine that a U.S. nonbank financial company is posing a threat to the financial stability of the U.S., thus shall be subject to supervision by the Board of Governors, a determination should be made by a vote of the voting members of the FSOC and all of these determinations are subject to judicial review and must be reevaluated annually.[355] The statute provides procedural requirements whereby the FSOC notices their determinations to the targeted companies and those companies may request a written or oral hearing within a specified period.[356] For judicial review, the scope of judicial review is limited to whether the final determination was "arbitrary and capricious."[357] The requirement of "the notice-and-comment procedure" and the invalidity of "arbitrary and capricious" actions provides that procedural rules traditionally applied to administrative agencies according to the Administrative Procedural Act (APA) have become increasingly applicable to financial regulation to strengthen the legitimacy of the respective agency's rulemaking. Although the procedural requirements of financial regulation are still

353 Id. 155-156.
354 Dodd-Frank Act § 111(codified at 12 U.S.C. § 5321 (Supp. IV 2011)).
355 Dodd-Frank Act § 113(a), (b), and (h).
356 See generally, Jacob E. Gersen, 'Administrative Law Goes to Wall Street: The New Administrative Process' (2013) 65(3) Administrative Law Review 689-734, 694-695. The requirements are waivable for an emergency under the condition of obtaining the same two-thirds vote with the Chairman voting in the majority.
357 Dodd-Frank Act § 113(h) (codified at 12 U.S.C. § 5321(h)).

distinctive from the general administrative requirements of other industries in many aspects,[358] the importance of the financial industry in the economy warrants more rigorous scrutiny of the administrative process of financial regulation that has long been considered discretionary and informal.

3.2.4 The Reasonableness of Law and Substantive Justice

The principle of reasonableness is closely related to the substance of legal reform because the reasonableness of law is most likely achieved by providing persuasive justification for particular policy goals and subsequent actions to achieve the goals. One of the most common pitfalls of post-crisis financial regulatory reform is that excessive or irrelevant reform measures are taken due to the political circumstances that urge strong policy reactions as to the possible causes of trouble. The deviation or irrelevance of policy goals is not a particular problem of post-crisis regulatory reform as George Stigler noted that "the announced goals of a policy are sometimes unrelated or perversely related to its actual effects, and the truly intended effects should be deduced from the actual effects."[359] Yet the heightened political tension and anxiety for a recovery in the post-crisis environment raises the potential of pushing for unnecessary policy actions. The substance of reform is as important as the procedural aspect of reform and the legitimacy of reform is inseparable from the substance of policy measures. As discussed earlier, the reasonableness of reform measures should be taken as a guiding principle of post-crisis reform because it ensures that the reform measures are considered just and impartial to those who are subject to the reform measures. As procedural justice is sought as a way of achieving distributive justice by adopting the fair process in formulating and implementing

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[358] See Ahdieh, 'Notes from the Border' (n 348); Thomas W. Merrill, 'A Comment on Metzger and Zaring: The Quicksilver Problem' (2015) 78 Law & Contemp. Probs. 189.

[359] George Stigler, *The Citizen and the State: Essays on Regulation* (University of Chicago Press 1975) 140.

regulation, substantive justice means that the approaches and measures of regulation are accepted as reasonable in terms of the achievement of distributive justice in society.

Fundamentally, the idea of reasonableness in law is associated with the concept of mutuality as the phrases “reasonable person” or “reasonably prudent person” normally present the capacity to constrain one’s behaviors and choices in consideration of the needs or wishes of others in society as a community of people.[360] In the common law of negligence, the principle of being reasonable requires “constraining one’s conduct by reference to the perils one creates for others.”[361] This usage of reasonableness is particularly important in financial regulation considering the unusually high level of discretion given to financial regulators,[362] and the requirement of reasonableness in financial regulation has been strengthened after the global financial crisis. For example, the Dodd-Frank Act of the US requires core financial regulators to supervise the financial industry through a reasonableness lens and to ensure that “the government and the private sector are taking all reasonable steps to ensure financial stability and to mitigate systemic risk that would negatively affect the economy.”[363] Furthermore, it is necessary to define how reasonableness should be applied in the context of financial regulatory reform in terms of achieving distributive justice in financial markets and the economy. Focusing on the concept of “mutuality” embedded in the interpretation of reasonableness in jurisprudence, two particular substantive principles of regulatory reform warrant closer attention: first, non-discrimination and proportionality; second, preventing regulatory capture.

[360] Zipursky, ‘Reasonableness In and Out of Negligence Law’ (n 84) 2161.
[361] Id. 2162.
[362] See Zaring, ‘Rule by Reasonableness’ (n 83) (listing the mandates of financial regulators such as the SEC on the use of reasonableness in taking regulatory actions).
[363] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 112(b), 124 Stat. 1376, 1396 (2010). In the full text of the Act, the term “reasonable” appears 156 times in total concerning the time, form, expectations, and costs, among others, associated with regulatory requirements or measures.

Non-Discrimination and Proportionality: Excessive Concentration of Market Power

The problem of discrimination in financial regulation is often implicit rather than explicit and tends to produce discriminatory outcomes as a result of applying arguably neutral standards that are in effect favorable to some groups of market participants over others. It is easily observable when such regulatory measures enable certain firms to expand further at the expense of their weaker competitors when the regulatory measures turn out as a way of strengthening the position of the already dominant players. In general, excessive concentration of market power is a serious concern of a liberal market economy because it distorts the functioning of the market economy by eliminating the opportunities for others to enter the market and also limiting the choices of customers not due to the superiority of their products but due to the network effects primarily caused by the reliance on the existing infrastructures. In financial regulation, the discriminatory effect of regulatory measures is particularly related to the excessive concentration of market power in the financial industry because those who are favored by certain regulatory measures would be in a position to expand their position in the market more easily not because they are superior to others in terms of the quality of services or the efficiency of operation but because they could bear the cost of regulation than their competitors. Since both businesses and customers of financial markets heavily rely on common financial infrastructures for transactions such as payment and clearing systems, excessive power concentration in the financial sector may lead to sub-optimal economic outcomes and a possible inefficient allocation of capital as dominating financial institutions may take an informational advantage and provide unfair contractual terms or sell products with excessive profits.[364] Financial services inherently rely on the quality of information because it is directly related to the profitability of their services and products sold to customers. Primarily, financial institutions use a wide range of customer data, such as credit history and income or asset levels, to determine the terms and conditions of loans and other products. The problem of information asymmetries between buyers and sellers makes the financial systems intrinsically imperfect.[365] The power concentration of financial institutions makes the situation worse because the risk of misusing information may increase in evaluating the credibility of customers, reducing the negotiating power of customers, and depriving them of the ability to access quality financial services, not to mention personal data protection issues. The potential risk of market power abuses is critical in the financial sector as the ability to access quality financial services is essential for individuals and non-financial businesses to participate in economic activities to produce goods and services necessary for the economy. Hence, it is a legitimate policy objective that financial regulation promotes competition in financial markets rather than encouraging the excessive expansion of large financial conglomerates.

As mentioned before, the discriminatory effect is often connected to the cost of regulation that is affordable for some but prohibitive for others. Regardless of the purpose of improving the safety and soundness of the financial industry, new regulatory measures also act as a "tax" on financial firms and those taxed activities become more expensive to produce for firms and to use for consumers.[366] The negative impact of the new regulations is differently realized by the

[364] OECD, 'Policy Framework' (n 115) 14.
[365] Id. 13. ("Asymmetric information arises from imbalances in information that make it very costly if not impossible to monitor perfectly the behavior or situation of others, or to have one's own behavior or situation perfectly monitored…the complexity of financial information, of financial products, services, and transactions, and of the operations of financial institutions, accentuates information asymmetries that can bedevil economic transactions.")
[366] See generally, Global Markets Institute, 'Who Pays for Bank Regulation?' (June 9, 2014) Goldman Sachs.

size of the regulatory burden and the availability of less-regulated alternatives, and small businesses and low-income consumers with fewer or less effective alternatives to sources of finance bear a disproportionate burden than large corporations with a sufficient financial cushion.[367] From a longer perspective, this disproportionate impact of regulatory change poses a serious problem to the sustainability of the economy by accelerating the concentration of market power to large and complex financial corporations while limiting public access to quality financial products. It is critical to note that the regulatory impact is not limited to the performance of financial institutions but also affects the availability of funding sources depending on the financial capacity of non-financial firms. For example, according to a report by Goldman Sachs on the impact of the post-crisis financial regulatory reform in the U.S., the quality of recovery from the financial crisis has widely varied between large and small firms: between 2009 and 2014, revenues for the S&P 500 (excluding financials) grew roughly 6% annually while small firms have not fully recovered from the recession.[368]

For the regulatory reforms in the aftermath of the Global Financial Crisis, the cost of regulatory compliance became a critical determinant of the performance of financial institutions depending on their size and complexity. The regulatory requirements of Basel III and its disproportionate burden to compliance depending on the size of financial institutions illustrate how financial regulatory reforms lead to unwarranted discrimination, producing an undue burden to some groups of financial market participants. In the post-crisis environment, the number of banks has been reduced and the post-crisis reductions in bank numbers were primarily concentrated on smaller banks, except for the failure of a handful of distressed large

[367] Ibid.
[368] Global Markets Institute, 'The Two-Speed Economy' (April 2, 2015) Goldman Sachs.

financial institutions in the euro area.[369] The patterns of concentration were towards greater banking system consolidation, increasing the too-big-to-fail risks in banking systems. Some financial regulators tend to view the increasing concentration in the banking system as a positive factor for financial stability as those large banks could benefit from the economies of scale and get higher profit as well as franchise value from greater pricing power, or consider the concentration of financial markets as irrelevant to financial stability.[370] However, heavy reliance on the performance of a handful of large banks is not only unreasonable due to the difficulty of properly monitoring them[371] but also unjustifiable as a public policy goal considering the unfairness of favoring large financial institutions that would be anti-competition in nature.

To avoid the discriminatory effects of regulatory changes, the concept of proportionality provides useful insights for achieving reasonableness in policy actions and promoting financial inclusion toward the policy objective of promoting sustainable growth. In legal systems, the concept of proportionality is applied in determining the appropriate level of public intervention that is needed to achieve the desired social objectives.[372] In banking regulation, proportionality is particularly relevant to the appropriate scope of applying the prudential requirements in consideration of the operational complexity, international exposure, and sensitivity to systemic risks of banks that are subject to the Basel standards.[373] Considering the purpose of prudential

[369] See generally, Committee on the Global Financial System, 'Structural Changes in Banking after the Crisis' (Jan. 2018) CGFS Papers no. 60, Bank for International Settlements.
[370] See generally, Nicola Cetorelli et al., 'Trends in Financial Market Concentration and Their Implications for Market Stability' (March 2007) FRBNY Economic Policy Review.
[371] Committee on the Global Financial System, 'Structural Changes in Banking after the Crisis' (n 369) 41-43.
[372] Fernando Restoy, 'Proportionality in Banking Regulation' (July 4, 2018) Westminster Business Forum Keynote Seminar: Building a Resilient UK Financial Sector – Next Steps for Prudential Regulation, Structural Reform and Mitigating Risks, London.
[373] Id. 3-4.

risk management, it is not reasonable to apply the same standards to banks that impose an undue burden on small, non-complex, and predominantly domestic banks.[374] As national financial regulators were driven to adopt the Basel standards to promote homogeneity of the domestic prudential rules and to achieve the international recognition of their national regulatory frameworks, the costs of complying with the complex rules required by the Basel standards were disproportionately higher for small and internationally inactive domestic banks.[375] The excessive complexity of the post-crisis banking regulation exhibits the unreasonableness of the regulatory approach that results in unintended yet apparent discriminatory effects in financial markets.

To balance important rights and interests of market participants, the legal concept of proportionality is vital as it allows flexibility in designing reasonable policy objectives and selecting adequate policy instruments concerning institutional structures and market practices.[376] Along with the influence of increased costs of products and services on wider economic activities, it is crucial to recognize that financial regulatory intervention to mitigate prudential risks should not excessively limit the fundamental rights of individuals to conduct a business unless apparent and valid regulatory objectives exist.[377]

[374] Bart Joosen et al., 'Stability, Flexibility, and Proportionality: Towards a Two-Tiered European Banking Law?' EBI Working Paper Series no.20, European Banking Institute.
[375] Restoy, 'Proportionality' (n 372) 3.
[376] See generally, Kern Alexander, 'Financial Inclusion and Banking Regulation: The Role of Proportionality' (2021) 84 Law & Contemporary Problems 129-152.
[377] Id. 145 (according to Article 1(1) of Council Regulation 1024/2013, 2013 O.J. (L 287) 63, such valid regulatory objectives include investor and consumer protection, the stability of the financial system, and market integrity); See also Chiara Zilioli, 'Proportionality as the Organizing Principles of European Banking Regulation' in Theodor Baums et al. (ed.), *Zentralbanken, Währungsunion und stabiles Finanzsystem* (Central Banks, Monetary Union, and a Stable Financial System).

Preventing Regulatory Capture – Demystification of Financial Regulation

The problem of regulatory capture is detrimental to the functioning of financial markets and degrades the public trust in the regulatory system. Regulatory capture occurs when "regulation is consistently or repeatedly directed away from the public interest and toward the interests of the regulated industry, by the intent and action of the industry itself."[378] The causes and consequences of regulatory capture are well-documented over the past decades in the literature of economics, political science, and public administration. Indeed, since the 1960s the theory of regulatory capture has influenced the development of two distinct approaches to regulation, namely the deregulation movement on one hand, and the creation of single executive agencies, on the other hand, depending on how one finds the optimal solution to the problem.[379] However, capture is not a simple and monolithic phenomenon,[380] and it is important to understand the dynamic relations between regulators and the industry rather than assuming that the problem can be solved either by eliminating regulation itself, namely deregulation, or strengthening the power of regulators beyond the reach of the industry.

In financial regulation, regulatory capture is one of the contributory issues that weaken the legitimacy of financial regulation as it leads to decisions that are unreasonable in the eyes of the general market participants, except those who succeeded in capturing the regulators. Fundamentally, regulatory capture in financial regulation may be understood as the aggregate result of misusing the discretionary power of regulators in favor of the regulated industry

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[378] Daniel Carpenter and David A. Moss, 'Introduction' in Daniel Carpenter and David A. Moss (ed), *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (CUP 2014) 13. See also, Stigler, 'The Theory of Economic Regulation' (n 137).
[379] Lawrence G. Baxter, 'Capture in Financial Regulation: Can We Channel It Toward the Common Good?' (2011) 21(1) Cornell Journal of Law and Public Policy 175-200, 175-176.
[380] Ibid. ("Though usually used quite simplistically in economic modeling, capture might take many forms and is likely to be a matter of degree.").

without sufficiently explaining the reasons for such decisions to the wider groups of stakeholders including the public. This definition of regulatory capture involves critical agendas for regulatory reform: first, strengthening the accountability of regulators by requiring a reasonableness test before making policy decisions, and, second, improving structural check-and-balance that prevents the collusive relationship between regulators and the industry: limiting the political power and incentive of financial institutions to capture regulators and improving democratic participation and representation of diverse stakeholders.

While the post-crisis regulatory reform has focused on strengthening the accountability of financial institutions, it is questionable whether the accountability of regulators is also improved so that their actions and decisions are not poorly designed but geared to the achievement of adequate policy objectives of financial regulation. The requirement of explaining the reasons for particular actions is powerful because it makes public officials justify their actions in plain language and also enables the public and market participants to judge the validity of their claims. In other words, regulators who exercise public authority should be able to explain why their decisions and actions were necessary and whether the choices were the optimal ones for carrying out their duty. As discussed in the earlier section on the reasonableness as legitimacy, the process of justifying policy actions can serve as a method of demystifying the functioning of financial markets and regulation so that both financial institutions and regulators would be unable to misuse the complexity of financial products and services to hide their fault. While it is necessary to understand the way financial institutions operate and adjust policy choices to be effective and reasonable, it is problematic that the concerns of financial institutions override the objectives of public interests.

In retrospect, the persistence of prevailing approaches to the global financial system signifies that regulators, in general, are satisfied with maintaining the existing financial systems and have paid insufficient attention to addressing the fatal problems of the existing systems revealed by the crisis including the causes of regulatory failure and the incompetence of global regulatory and supervisory systems. As to the reasons for this tendency, the extraordinary profitability of the financial markets for the past 20 years prior to the global financial crisis and the extraordinary political power and influence of the financial sector have played a key role.[381] In practice, making regulators technically accountable ex-post reform is more difficult than restraining the exercise of discretionary power. Furthermore, while those who were in office at the outbreak of a financial crisis are often forced to leave the office in dishonor, such reputational risk is irrelevant to the capacity of the economy to recover from the damages attributable to the mismanagement and misjudgment of the regulators.

For a domestic setting, change of administration is always at the top of the choices as to the political accountability of government in liberal democratic states. However, it always takes time to bring the transition in public offices and the ruin of the national economy does not make a democratically elected administration incompetent automatically. The issue of regulatory accountability in post-crisis regulatory reform is more problematic when it comes to transnational regulators as the usual mechanisms of the constitutional system in a liberal democratic state do not necessarily exist or operate. Despite the growing concerns about the working of international law and interests in identifying elements of global administrative law among international legal scholars and practitioners, the operation of transnational regulators

[381] Buckley et al., *Reconceptualizing Global Finance and Its Regulation* (n 179) 4.

is not always clearly defined within existing legal and jurisdictional boundaries.[382] Adding to the issue of lack of jurisdictional boundaries and constitutional mechanisms of accountability, it is also difficult to identify exactly who has a right to call them to account and where the boundaries of their accountabilities should be drawn.[383] This discrepancy between the authority and responsibility of regulators, in general, remains one of the primary causes of regulatory failure and has allowed the potential of regulatory capture because regulators are not directly liable for making decisions favorable for financial institutions when such measures are not technically illegal. As neither the approach of deregulation nor centralization of regulatory authority provides adequate solutions to the problem of regulatory capture in the financial industry, it is important to make regulators more concerned about the adequate justification of policy choices, the validity or reasonableness of which are subject to open debates and expert analyses beyond the scope of particular committees that are often composed of individuals appointed from a closed political circle.

In connection with the requirement of justification, the structural problems should be addressed so that it is not necessary to attempt to capture regulators or difficult to achieve the aim of capture because of structural safeguards. The first point is related to the need to capture regulators from the perspective of financial institutions and linked to the benefits financial institutions would get by persuading regulators to support their interests. One of the easiest examples is the government guarantee of the bailout for financial institutions that are categorized as too-big-to-fail. The practice of capturing regulators is often aimed at persuading regulators to buy the idea or position of financial institutions so that regulators are inclined to

[382] Julia Black, 'Constructing and contesting legitimacy and accountability in polycentric regulatory regimes' (2008) Regulation & Governance 2, 137-164.
[383] Ibid.

choose policy measures that are discriminatory to the rest of the market participants and the public.

The belief that some financial companies are too big to fail and that their failure would destabilize the economy is undeniably influenced by the large financial companies that benefit from implicit government guarantees so that they can maintain or expand the size of the company without worrying about the potential cost of failure. In financial markets dominated by financial conglomerates such as the U. S. and the U.K., regulators appear “to be trapped” in the vicious circle of bailouts despite the government’s pledges to refrain from massive bailouts in the future.[384] The doctrine of too-big-to-fail is based on the systemic influence of the large financial institutions that make it extremely costly to let them fail. The political influence of large financial institutions to capture regulators is inevitably related to their importance to the national or global economy due to the size and complexity of such firms.

In relation to the problem of power concentration in the financial market as discussed earlier, thus, it is reasonable to disallow a financial firm to remain too big to fail either by limiting the expansion of the firm or having them downsize so that a failure can be a real option. In a liberal market economy, a company is free to grow and make huge profits so long as its growth is not related to the costs of bailouts by the government. As long as the size of a firm plays a determinant of the government guarantee on the bailout, regulators should dismantle financial institutions that are too big to fail instead of repeating meaningless pledges that there would be no bailout in the future.[385] Furthermore, it is necessary to improve the scope of the democratic

[384] Jonathan R. Macey and James P. Holdcroft Jr., ‘Failure is an Option: An Ersatz-Antitrust Approach to Financial Regulation’ (2011) 120 The Yale Law Journal 1368, 1370-1373.

[385] Id. 1372-1374 (“we note that the approach that we envision requires that there will be a clear statutory

participation of stakeholders in the process of decision-making.[386] Public hearings and consultations are important but not enough to guarantee that regulators are free from capture. In this sense, it is important to reconsider the concept of stakeholders of financial regulation and connect it with the appropriate policy objectives of financial regulation. Understanding the concept of stakeholders is useful in reassessing the legitimacy of regulatory approaches and policy measures because the authority and power of financial regulators should be bound to the needs and interests of the stakeholders.

3.3 Legitimacy of Corporate Governance and Financial Conduct Regulation

The issue of stakeholder interests is an important part of corporate governance regulation because what the law, or any relevant rules, requires the board or executives of firms depends on how to define the scope of stakeholders, the relationship between the firm and their stakeholders, and the boundary of collective as well as individual responsibility of the board or executives to stakeholders. Most of all, the concept of stakeholder plays a critical part in understanding and defining the legitimate purposes and objectives of financial regulation. For example, one of the primary purposes of financial regulation before the collapse of Wall Street financial institutions in 2008 was to create a regulatory environment where financial institutions can maximize their profits with a minimal degree of regulatory intervention. This policy approach was based on the widespread belief in the primacy of shareholders as the most important group of stakeholders of public financial institutions, and financial regulation was

deadline for breaking up financial institutions that have crossed the permissible size threshold.").

[386] See e.g., Ian Ayres and John Braithwaite, 'Tripartism: Regulatory Capture and Empowerment' (1991) 16(3) Law and Social Inquiry 435-496. See also Rachel E. Barkow, 'Insulating Agencies: Avoiding Capture Through Regulatory Design' (2010) 89 Tex. L. Rev. 15.

focused on ensuring that financial institutions are capable of fulfilling this obligation.

However, after the global financial crisis, systemic resilience was taken more seriously in policy design and the adherence to minimal regulatory intervention became not defendable as the systemic risk posed by financial institutions is considered a critical factor due to the detrimental impact of their failures on the entire economy. A prolonged economic recession in the aftermath of the global financial crisis, not to mention the direct financial loss during the crisis, reshaped the concept of stakeholders of financial institutions because the excessive emphasis on share price and the adherence to the minimal regulatory intervention was not beneficial to the majority of stakeholders, including individual shareholders, employees, and the public in general, while a small number of insiders gained an unreasonable amount of profits by taking advantage of the systemic features.

Under this conceptual shift, the scope and components of stakeholders of financial regulation became more important because it sets the stage for determining whose rights should be protected by financial regulation and who should be responsible for financial and regulatory failures. It is noteworthy that the regulator and the regulated are not the only major players in formulating any regulation specific to the industry. Indeed, the rights and interests of a wide range of stakeholders, generally referring to the groups or individuals affected by regulatory changes, should be considered because their claims, either as beneficiaries or casualties, play critical parts in shaping the regulatory landscape. Thus, it is worth taking a close look at the concept of stakeholder and how the term has evolved in the context of financial regulation.

3.3.1 Stakeholders of Corporate Governance Regulation

The initial concept of stakeholder, as appeared in the management literature, referred to those groups, such as shareowners, employees, customers, suppliers, lenders, and society, without whose support the organization could not exist.[387] In a pioneering book on the stakeholder view, Strategic Management: A Stakeholder Approach, R. Edward Freeman defines stakeholders as any group or individual who can affect or is affected by the achievement of the firm's objectives.[388] In this book, Freeman links the concept of stakeholder with strategic management models, arguing that improved stakeholder relations could help firms succeed in turbulent times. In this conceptual framework, stakeholders of the firm include not only traditional stakeholders from the managerial view, such as owners, customers, employees, and suppliers, but also non-traditional stakeholders as corporate constituents, such as governments, customer advocates, competitors, environmentalists, special interest groups (SIGs), and media.

As briefly noted earlier, the rules or strategies of internal governance are invariable within the same financial institution regardless of its territorial presence. It is more or less about the values of the organization and the means of achieving those values. As it is well known, the traditional literature on corporate governance is mostly focused on the relationship between shareholders as owners and managers as agents and is concerned about how to balance the interests of the two sides by using effective incentive mechanisms. Through the lens of the two-dimensional dynamics in corporate governance, the pursuit of profit-maximization of financial institutions is justified as contributing to the general welfare of society. The idea of shareholder primacy

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[387] For a short history of the stakeholder theory, see Bidhan Parmar et al., 'Stakeholder Theory: The State of the Art' (2010) 99 Management Faculty Publications 1-57.
[388] Edward Freeman, *Strategic Management: A Stakeholder Approach* (originally published in 1982, CUP 2010).

has dominated the discourse of corporate governance and regulations have focused on the relationship between managers and shareholders as to the fiduciary duty of the former to the latter.[389] While this analysis and rationale are still meaningful as a way of understanding the operational and structural trait of corporate governance, which mostly originated in Anglo-American traditions and then spread to the rest of the world, the power dynamics of corporate governance has seen tremendous changes since the concept of shareholder primacy first appeared in the now classical book of Adolf Berle and Gardiner Means on modern corporate governance, which was first published in the 1930s.[390]

The position of corporations in the economy and society has changed significantly as the number and types of corporations have increased immensely and their scope of operation has greatly expanded. The unprecedented expansion of financial activity and markets in the last few decades, referred to as financialization, has brought new opportunities for large-scale investments and innovation in the global financial market.[391] However, financialization has also increased the risk of systemic volatility and conflict of interests, hampered sound economic growth, and increased income inequality.[392] In line with this, the rights and

389 See Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89(2) Georgetown Law Review 439-68.; Lucian Bebchuk and Michael Weisbach, 'The State of Corporate Governance Research' (2010) 23(3) Review of Financial Studies 939-61.; Stuart Gillian and Laura Starks, 'Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors' (2000) 57(2) Journal of Financial Economics 275-305.; Stuart Gillian and Laura Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19(1) Journal of Applied Corporate Finance 55-73.; Robin Greenwood and Michael Schor, 'Investor Activism and Takeovers' (2009) 92(3) Journal of Financial Economics 362-375.

390 Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction Publishers 1932).

391 Anat Admati, 'A Skeptical View of Financialized Corporate Governance' (2017) 31(3) The Journal of Economic Perspectives 131-150, 133-135. See also Gerald David, Managed by the Markets: How Finance Re-shaped America (OUP 2011); GRETA Krippner, 'Capitalizing on Crisis (Harvard University Press 2011).

392 See generally, Luigi Zingales, 'Presidential Address: Does Finance Benefit Society?' (2015) 70(4) Journal of Finance 1327-63; Stephen Cecchetti and Enisse Kharroubi, 'Why Does Financial Sector Growth Crowd Out Real Economic Growth?' BIS Working Paper 490; Frank Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Market*s (Public Affairs 2009).

responsibilities of corporations as an important entity of the economy have changed although the legal status of corporations as private entities has not been altered. Following economic globalization since the 1990s, demands for corporations to play an active role in solving critical problems such as eliminating poverty and protecting the environment have increased noticeably as part of society as to their 'corporate citizenship.'[393] In this vein, the concept of stakeholder of a corporation expanded dramatically when the rise of multinational corporations (MNCs) brought critical questions of how to balance between the profits and negative externalities generated by MNCs.[394] This issue has gained more attention when the host countries lack sufficient bargaining power over critical issues such as employees' rights or standards of environmental protection. The emergence of powerful non-governmental organizations (NGOs) that exert political influence on policymaking has added more complexity to the decision-making power of large corporations and their internal corporate governance standards as well.[395]

Internationally active financial institutions are no exception. Whether successful or not, financial institutions also face the same challenge of strengthened demands for improving corporate governance practices, not only within the traditional context of institutional management but also in connection with its influence on the quality of other industrial sectors or policy goals such as green investment or anti-money laundering and counterterrorism. Theoretically, a closer look at the power dynamics over corporate governance reveals that it is

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393 Tom Bigg and Halina Ward, 'Linking Corporate Social Responsibility, Good Governance and Corporate Accountability Through Dialogue' (2004) Discussion Paper, International Institute for Environment and Development.

394 See Joseph Stiglitz, 'Multinational Corporations: Balancing Rights and Responsibilities' (2007) 101 Proceedings of the Annual Meeting (American Society of International Law) 3-60.

395 See Pierre Mazzega, Claire Lajaunie, and Romain Boulet, 'Public Policies, Complexities and Networks' in Romain Boulet, Claire Lajaunie, and Pierre Mazzega (ed.), *Law, Public Policies and Complex Systems: Networks in Action* (Springer 2019).

no longer a simple issue of how to deal with the "principle-agent relation" problem that determines the effectiveness of corporate governance for financial institutions. The number and type of stakeholders who have interests and claims over the way large financial institutions are being governed have increased as the size and influence of financial institutions in the global economy have grown over the past decades. Indeed, the global financial crisis of 2008 served as an occasion in which the gradual changes in power dynamics over corporate governance were epitomized, and it revealed to the eyes of the public some of the most salient defects of the existing system of corporate governance regulation including major gaps in management accountability and regulatory safeguards on intentional mischief.[396] Problems such as excessive compensation mechanisms that induce excessive risk-taking behaviors were prevalent in financial institutions, and the weak oversight incentives through internal monitoring systems made it clear that the traditional model of corporate governance should be revisited to adequately meet the challenges and responsibilities of financial institutions today, not that of decades ago.

Is the Financial Industry Still Special?

The conceptual shift in the scope of stakeholders of corporate governance is inevitably connected to the changing role and function of the financial industry in the economy. Regarding the responsiveness of law as mentioned earlier, the role the financial industry plays today is not the same as it used to be several decades ago. One critical question in this regard is whether the traditionally acknowledged role of intermediation between lenders and borrowers is still central to the increasingly diversified services that the financial industry provides today. In

[396] Brian R. Cheffins and Steven A. Bank, 'Is Berle and Means Really a Myth?' (2009) 121 ECGI Working Paper Series in Law <http://ssrn.com/abstract=1352605> accessed 24 August 2021

other words, does the financial industry still dominate the service of financial intermediation, and should they be provided with the same degree of protection by government subsidies and insurance schemes? Should technology companies that provide specialized banking services, mostly payment service providers so far, be regarded as substitutes for traditional financial institutions and be subject to the same level of regulation and protection as to their emerging roles? Indeed, connecting the changing business models and service portfolios of financial institutions to the adequate form and level of regulation is imperative to clarify the legitimate principles of regulating financial institutions and achieve the goals of reform. For example, post-crisis reform of banking regulation was primarily focused on strengthening the supervisory and regulatory measures for large and internationally active financial institutions, both banks and non-bank financial institutions, as the failure of those financial institutions threatened the entire global financial system. While it is a critical issue that warrants concentrated efforts of policymakers and regulators, this policy drive and reform approach ultimately resulted in worsening the problem of market concentration, making the possibility of failure by large financial institutions more threatening and unrealistic. [397] The regulatory focus on systemically important banks, which are mostly classified as too-big-to-fail (TBTF), discriminated against smaller banks by imposing rules that are costly to comply with their limited resources. Also, it is hard to defend the argument that financial markets are more resilient than before with a lower risk of systemic failures of mega-banks because the sources of the next financial shock can come from somewhere not touched by the post-crisis regulatory reform agendas.[398]

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[397] For types of distortions in the financial system associated with the Too-Big-To-Fail policy, see Joseph Noss and Rhiannon Sowerbutts, 'The Implicit Subsidy of Banks' (2012) Financial Stability Paper No. 15, Bank of England.

[398] Id. See also Xavier Freixas and Jean-Charles Rochet, Microeconomics of Banking (2nd ed. MIT Press 2008).

At the same time, as banks are burdened with higher costs of operation due to the post-crisis regulatory changes, they attempt to recover the losses by imposing higher fees on customers who have lower bargaining power than wealthier customers. Meanwhile, a large scope of banking and financial services has become available to customers through non-traditional financial service providers such as fintech companies. While regulatory reform was not particularly concerned with the need for alternative business models or sources of financial services to reduce the systemic risks posed by TBTF financial institutions, Fintech service providers rapidly grabbed the market share, challenging the traditionally special status of financial business in the economy as an integral intermediator between lenders and borrowers.[399] In this sense, it is required to test if the financial industry is "still special" as to its intermediate role in the economy in light of the emerging technological innovation in financial services markets that allow many non-traditional financial service providers to enter the market as financial intermediaries armored with diversified and convenient financial services for customers who lost trust in the mainstream financial institutions.

For the past decades, the special status of the financial industry in the economy has justified the anti-competitive nature of financial regulation and allowed business practices that are incompatible with other policy concerns in favor of the goal of protecting systemically important financial institutions. This needs to be changed to gain the legitimacy of financial regulation and it has particular importance in the sphere of using finance as a tool for achieving sustainable economic and social prosperity including sustainable investment and financial inclusion.

[399] Hyoeun Yang, 'Fintech as a Strategy of Financial Inclusion in the Age of Digitalization' (2019) 11(2) Journal of APEC Studies 93-106, 93. See also, Hyoeun Yang, 'The UK's Fintech Industry Support Policies and Its Implications' (2017) 17(5) World Economy Brief 1-5.

3.3.2 Shareholder Primacy and Stakeholder Interests as Regulatory Objectives

The increasing importance of considering the interests of a wide array of stakeholders is connected to the need to restrain the boundaries of corporate activities and shape their behaviors so that corporations' profit-seeking activities do not produce externalities that cause significant damage to society. To that end, governments, often through specialized agencies, exercise authority to make the corporations responsible for their conduct using regulation and legislative actions. From the perspective of government, the public, in general, is their most important constituency, at least in theory, to whom they are accountable for policy measures in terms of monitoring and redressing corporate misbehaviors. Even though it is sometimes doubtful whether the government acts on behalf of the public interest or seeks other causes, such as political interests or higher tax revenues, the public interest is one of the most important factors of government intervention in the market while it is sometimes difficult to define who the public is and what the public interest means exactly in a particular circumstance. Nevertheless, a traditional view of corporate governance regulation, in general, has attempted to seek the public interest only indirectly by means of improving shareholder interests through profit maximization.[400] In this regard, Friedman (1970) argued that the firm's responsibility was to maximize its profits for shareholders who 'own' the firm and that governments should manage externalities and produce public goods.[401]

In recent decades, however, unfettered attempts of large corporations to maximize profits at the

[400] Milton Friedman, 'A Friedman Doctrine - The Social Responsibility of Business Is To Increase Its Profits' (1970) *New York Times Magazine*, 13 September <https:// www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html> accessed 5 August 2021.

[401] Id. See also Markus Kitzmueller and Jay Shimshack, 'Economic Perspectives on Corporate Social Responsibility' (2012) 50(1) Journal of Economic Literature 51-84, 52.

expense of other stakeholders have provided ample reasons to reconsider the virtue of profit maximization and emphasize the responsible and ethical behavior of corporations. For example, in the U.S. the infamous financial scandals of prominent companies such as Enron, WorldCom, Xerox, and many others in the early 2000s brought attention to accounting and corporate fraud into the forefront of corporate governance regulation. As a regulatory response, the Sarbanes-Oxley Act of 2002 was enacted which was considered as the most substantial regulatory change to improve U.S. public firms' financial reporting.[402] It created the Public Company Accounting Oversight Board (PCAOB) to oversee and regulate auditing.[403]

The corporate and financial scandals in the United States and the following legislative actions have motivated other countries to reform their corporate governance regulations and principles. As a result of the combined influence of the corporate scandals from the U.S. and the broader framework of reforms driven by the European Community, the revised Combined Code came into effect in 2003 in the UK.[404] The Combine Code required publicly listed companies, those listed on the London Stock Exchange (LSE) and other regulated exchanges, to comply with the Code or explain why they do not comply. Known as the "comply or explain principle," the overall approach of the Combined Code was to improve the internal control systems of large UK companies by giving them the flexibility to find the optimal ways of controlling internal

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402 See John Coates IV, 'The Goals and Promise of the Sarbanes-Oxley Act' (2007) 21(1) Journal of Economic Perspectives 91-116.

403 PCAOB was tasked to oversee auditors while the Securities and Exchange Commission (SEC) was to continue oversee public companies. Ibid.

404 The revised Combined Code in 2003 was renamed the UK Corporate Governance Code in 2010 in the wake of the financial crises in 2008-9. The most recent revision was made in January 2024 and the 2024 Code applies to financial years beginning on or after 1 January 2025. See Financial Reporting Council (FRC), 'History of the Corporate Governance Code' (October 2023) available at https://www.frc.org.uk/library/standards-codes-policy/corporate-governance/corporate-governance-overview/#history-of-the-corporate-governance-code-e5e7888a.

governance and management risks rather than applying a rigid set of rules.[405] The revised Code incorporated the proposals of the Higgs Review, which set forth key descriptions for a well-functioning board by improving the effectiveness of non-executive directors, and the proposals of Sir Robert Smith's report as to the role of audit committees.[406]

Shareholder Primacy and Corporate Social Responsibility (CSR)

These regulatory changes in corporate governance have added reasons for giving a wide array of stakeholders more say in determining the conduct of corporations to ensure that the growth of the industry does not negatively affect the prosperity and sustainability of society. In the arena of corporate governance and management strategy, the growing appetite for corporate social responsibility (CSR) as an integral part of the business has been motivated by devastating corporate scandals that revealed unethical corporate behaviors in pursuit of excessive profit-seeking while jeopardizing the safety or prosperity of other stakeholders.[407] At the same time, some corporations actively adopt CSR strategies, such as increased transparency and stakeholder engagement to have better access to capital by reducing agency costs and information asymmetry. This approach has been considered beneficial to attract new customers as well as to retain existing customers by improving reputation and publicity in competitive

[405] The 2024 UK Corporate Governance Code in particular addresses the issue of internal controls. See Financial Reporting Council, 'UK Corporate Governance Code' (January 2024) available at <https://www.ecgi.global/sites/default/files/codes/documents/uk_corporate_governance_code_2024_krcm5ss.pdf>.

[406] Derek Higgs, 'Review of the Role and Effectiveness of Non-Executive Directors' (January 2003); Sir Robert Smith, 'Audit Committees Combined Code Guidance: A Report and Proposed Guidance by an FRC-appointed group' (January 2003).

[407] CSR has become a high-profile public issue that has increasingly affected consumers' purchase decisions to pay more for products that are perceived as "ethically superior." Kitzmueller and Shimshack (2012); Ipsos MORI, 'Ethical Companies' (2003), available at <Ethical Companies | Ipsos>. In this survey, three-quarters of the British population (74%) said that information on companies' social and community activities would influence their decision to purchase.

markets.[408]

The long-standing debate as to whether corporate social performance (CSP) has a negative or positive impact on corporate financial performance (CFP) is closely related to the question of how to define the role of stakeholders and the corporation's relationship with stakeholders in promoting business performance. A traditional view of shareholder theory, championed by Milton Friedman (1912-2006), argues that corporate social performance and corporate financial performance are negatively related because firms would incur more costs as they engage in socially responsible activities and thus have lower net financial performance.[409] According to Friedman, the pursuit of social responsibility by corporate executives brings an agency problem where managers misallocate shareholders' wealth to pursue social virtues of their choosing while doing so is out of the scope of their responsibility to the owners of the business.[410] An empirical study as to the relationship between corporate social responsibility and profitability by Aupperle et al. also concludes that it is hard to support that such a relationship exists even though "the more economically oriented a firm is, the less emphasis it places on ethical, legal, and discretionary issues."[411] Rooted in neoclassical economic theory, they contend that CSR unnecessarily raises firms' costs and thus makes them less competitive than their competitors.[412]

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408 See Roland Benabou and Jean Tirole, 'Incentives and Prosocial Behavior' (2006) 96(5) American Economic Review 1652-87.
409 Michael L. Barnett and Robert M. Salomon, 'Does It Pay to be "Really" Good?' (2012)
410 Friedman, 'A Friedman Doctrine' (n 400). Friedman stated that the problem of spending on causes of 'social responsibility' is that "the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with this "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is pending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money."
411 Kenneth E. Aupperle, Archie B. Carroll and John D. Hatfield, 'An Empirical Examination of the Relationship between Corporate Social Responsibility and Profitability' (June 1985) 28(2) The Academy of Management Journal 446-463, 461-462.
412 Stephen Brammer and Andrew Millington, 'Does It Pay to Be Different? An Analysis of the Relationship

In contrast, other scholars argue that CSR brings positive outcomes in various ways that are ultimately beneficial for the performance of corporations such as providing better access to valuable resources, retaining higher-quality employees, gaining social legitimacy, and reducing consumer price sensitivity.[413] Unlike the theoretical underpinning of agency theory that focuses on the interests of shareholders in its narrow sense, those who emphasize the positive impact of CSR highlight the function of CSR in managing ties with diverse stakeholders.[414] They emphasize that a corporation's engagement with CSR can attract socially conscious consumers and socially responsible investors.[415]

In particular, in a study analyzing the nexus between CSR and access to capital, Cheng et al. argue that superior CSR performance results in lower capital constraints for two reasons: first, corporations' commitment to and engagement with stakeholders based on mutual trust and cooperation reduces agency and transaction costs, enhancing a corporation's revenue and profit generation through a higher-quality relationship with consumers, business partners, and employees; second, corporations with superior CSR performance are more confident with publicly disclosing their CSR strategies by issuing sustainability report that leads to the reduced informational asymmetry and CSR reporting leads to changes in the internal control system

between Corporate Social and Financial Performance' (2008) 29(12) Strategic Management Journal 1325-1343.

[413] See generally, Thomas M. Jones, 'Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics' (1995) 20 Academy of Management Review 404-437 ("Because the costs of opportunism and of preventing or reducing opportunism are significant, firms that contract on the basis of trust and cooperation will have a competitive advantage over those that do not use such criteria." at 432). See also, Beiting Cheng, Ioannis Ioannou, and George Serafeim, 'Corporate Social Responsibility and Access to Finance' (2013) 35(1) Strategic Management Journal 1-23.

[414] See generally, Freeman, *Strategic Management* (n 388). See also, Edward Freeman, Jeffrey S. Harrison, and Andrew C. Wicks, *Managing for Stakeholders: Survival, Reputation, and Success* (Yale University Press 2007)

[415] See Amy J. Hillman and Gerald D. Keim, 'Shareholder Value, Stakeholder Management, and Social Issues: What's the Bottom Line?' (2001) 22(2) Strategic Management Journal 125-139; Ethan B. Kapstein, 'The Corporate Ethics Crusade' (2001) 80(5) Foreign Affairs 105-119.

that reduces the likelihood of agency costs in the form of short-termism and improves compliance with regulations.[416]

Whether one agrees with the positive or negative nexus between CSR and profitability, it is worth noting that there is a condition for seeking profitability in a market economy. Milton Friedman, who has been considered a champion of liberal market economics, provided a condition for wealth maximization of businesses - the conformity to the basic rules of the society embodied in law and ethical custom:

> "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."[417]

Indeed, the more one traces back to the philosophical foundation of liberal market economics, the clearer it comes to be that the system of a free market and private property is rooted in the fundamental respect of ethics and the morality of law as guiding principles. From the words of Friedman, it is clear that firms should operate as much as they want on the condition that their operation abides by the basic principles of ethical custom and legal rules. While some observers misinterpret the basis of the free-market system and consider wealth maximization as the foremost value of enterprises, such belief is unfound if one considers the spirits and tacit agreements of market participants as the early thinkers had envisioned in their theories of the free-market system.

[416] Cheng, Ioannou, and Serafeim, 'Corporate Social Responsibility' (n 413) 5.
[417] Friedman, 'A Friedman Doctrine' (n 400).

Social Dilemma in the Financial Markets and Public as Legitimate Stakeholders

The shift of focus from shareholders to stakeholders accompanies a noticeable change to the approach of corporate governance regulation as it is directly related to the legitimate objectives of policy direction and choices.[418] One of the foremost questions in this regard is whether financial regulation recognizes the public in general as legitimate stakeholders of financial institutions. In practice, it may depend on whether the decisions of financial institutions have a direct or indirect influence on the economic conditions of the public through diverse channels following the definition of stakeholder as provided by Freeman earlier.[419] In the context of financial distress caused by the decisions of large financial institutions that ended up with financial crises, the welfare of the public, particularly those who are not associated with the operation of such firms in any aspect, is certainly affected by the decisions of large financial institutions and the policy reactions of financial regulators.[420]

The theory of social dilemma provides a useful analysis in this regard. In a situation of a social dilemma, regulations by authorities are necessary to prevent citizens from engaging in anti-societal actions. Strengthening the legitimacy of policy actions is particularly important when individuals' short-term profit-seeking can bring harm to society in the long term. Under the dominance of market fundamentalism, maximizing the short-term returns to financial capital has been a common practice of corporations and become an ideology of capitalist society at

[418] See Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berrett-Koehler Publishers 2012). In this work, Stout argues that many of the recent corporate problems can be traced to the flawed idea of shareholder primacy and that "American corporate law protects directors' power to sacrifice shareholder value in the pursuit of other corporate goals." Ibid. 25.
[419] Freeman, *Strategic Management* (n 388).
[420] See also, Vincenzo Bavoso, 'Chapter 4 Shareholder Value, Emerging Economies and the Need to Reconcile the Corporate Objective with Sustainable and Inclusive Goals' (2016) in F. Ngwu, O. Osuji and F. Stephen (eds.), *Corporate Governance in Developing and Emerging Markets: Debates, Models and New Institutional Economics* (Routledge 2016), Available at https://ssrn.com/abstract=2719511 or http://dx.doi.org/10.2139/ssrn.2719511.

the expense of social and environmental justice.[421] Social dilemmas are defined as situations in which "(a) each individual receives a higher payoff for a socially defecting choice (…) than for a socially cooperative choice, no matter what the other individuals in society do, but (b) all individuals are better off if all cooperate than if all defect."[422] The problems of social dilemmas are taken seriously in cases where the stakes of causing damage to neighbors or the community in general by acting selfishly for one's self-interest are high, such as energy depletion or pollution, and have drawn the attention of scientists, philosophers, and psychologists for the past decades.

In the literature on financial regulation, the conflicting interests of individuals who seek short-term private gains and of society in the long term have not been adequately addressed from the perspective of social dilemmas.[423] Like many other industries, however, the financial industry is susceptible to market abuse, whereby customers and investors in the financial markets may be exploited by unfair and abusive contractual terms and pricing. Not to mention the disastrous events in the run-up to the global financial crisis in 2008, the financial sector has been infamous for the frequency of scandals involving large-scale insider dealings, manipulation of share prices, or misrepresentation of information relevant to important investment decisions, just to name a few. Short-term private profit-seeking behaviors in the financial sector pose great harm to society in two particular ways. First, market abuses incrementally add vulnerability to the

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[421] Ann Florini, Sunil Sharman, and Gordon LaForge, 'Governance for Systemic and Transformational Change: Redesigning Governance for the Anthropocene' (January 2023) IIEP-WP-2023-1.
[422] Robyn Dawes, 'Social Dilemmas' (1980) 31 Annual Review of Psychology 169-93, 169. See also, Margaret M Blair and Lynn Stout, 'Trust, Trustworthiness' (n 233) 1741; Peter Kollock, 'Social Dilemmas: The Anatomy of Cooperation' (1998) 24 Annual Review of Sociology 183-214, 183-184.
[423] For discussion on stock market short-termism, see Marc Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41(3) Journal of Law and Society 416-45. See also, Leo Strine Jr., 'Who Bleeds When the Wolves Bite?: A Fresh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System' (2017) 126(6) The Yale Law Journal 1870-1970.

entire financial system and incite widespread malpractice in the financial markets that ultimately degrade the quality of financial services and healthy competition in the financial market. The instability of one financial institution caused by their malpractices can easily lead to the collapse of the financial system considering the chronic problem of negative spillovers in the financial markets due to the information asymmetries whereby negative information on one person or institution can lead to doubting other persons or institutions indiscriminately and affected parties would initiate their actions which could aggravate the situation by causing further spillovers.

Since the costs of individual actions do not incorporate broader social costs that may be imposed on others from those actions, the negative spillovers cause instability of financial systems as individual actions for avoiding loss amplify the costs for all. Furthermore, such irresponsible actions by individuals damage the long-term reputation of the financial sector and undermine the effective functioning of the entire financial system since the financial system fundamentally relies on trust and confidence among market participants. The collusion between financial institutions and credit rating agencies that significantly contributed to the global credit crunch in 2008 was a clear example of the ultimate long-term consequences of seeking short-term private profits without minding the long-term effects of such selfish actions in the interconnected global financial markets.

Fundamentally, it is an important task of financial regulation to solve social dilemmas by recognizing that the harm caused by short-term private interests in society should be prevented. At the same time, it is necessary to understand the group dynamics and the culture of financial businesses. Recalling that the financial industry is so powerful in political bargaining and agency capture is prevalent, it is important to persuade financial institutions to change behaviors by using not only regulatory sanctions but also channels of self-motivation including social influences and other incentives.[424] For this purpose, the rules must be perceived as beneficial for society and also good for the long-term perspective of the financial industry. Ultimately, it is reasonable to conclude that corporate governance regulation should not be confined to a narrow scope of monitoring the internal governance of financial institutions as to their responsibility to shareholders. Instead, corporate governance regulation should be based on the objective of protecting the interests of a wide array of stakeholders who are affected by corporate decisions either directly or indirectly. Indeed, the recognition of the public as a legitimate stakeholder of financial regulation is essential because it requires policymakers to ensure that the objectives of corporate governance regulation are compatible with the long-term public interests.

Conclusion

This chapter discussed legitimate principles of financial regulatory reform that should apply to regulatory changes at the national and international levels. Although global financial regulatory systems need to be examined in light of the specific features of international decision-making structures among states and the unique role of non-state regulatory organizations, it is possible and desirable to identify general principles of financial regulatory reform applicable at all levels considering the trend of financial globalization, constricted regulatory autonomy in international relations, and the ethical and behavioral dimensions of financial business conduct.

[424] In this regard, scholars have focused on the risk culture that has long been considered as a basis of reckless investment behaviors in the financial industry. See generally, Goodhart, 'Has Regulatory Reform Been Misdirected?' (n 270).

In this regard, financial regulatory reform should be based on the principles of responsiveness, efficacy, integrity, and reasonableness of law and legal reform. These principles are an analytical framework of legitimacy in financial regulation, and this chapter discussed how and why these principles should be thoroughly incorporated in designing and implementing regulatory actions in the post-crisis financial regulatory reform.

The principle of responsiveness is derived from the question of why reform is necessary, and it ensures that the reform measures adequately address the predominant problems in recognition of the demand for legal reform in society. The principle of efficacy refers to the right direction and effectiveness of reform, and it asks whether the regulatory reform measures have been adequately designed to achieve the goals and objectives set at the inception of the reform process. The principle of integrity is associated with the concept of procedural justice in a legal system in which the processes of diagnosing, promulgating, and executing legal actions should be conducted fairly. It makes a legal system legitimate by promoting the predictability and consistency of the law and leads to legal certainty which is necessary for the system of the rule of law acceptable and reliable as a constitutional principle. The reasonableness of law and reform is closely related to the substance of legal reform and requires that legal actions provide persuasive justification for particular policy measures. It is also crucial to the policy objective of preventing regulatory capture which is detrimental to the functioning of financial markets and degrades the public trust in the legal system. The accountability of regulators should be strengthened by requiring a reasonableness test before making policy decisions and improving structural check-and-balance that prevents the collusive relationship between regulators and the industry.

As these principles are based on acknowledging the interactive relationship between regulators and citizens, a thorough understanding of the concept of stakeholders in financial regulation is important. The expanded scope of financial businesses referred to as financialization requires that the concept and scope of stakeholders should be revisited in reflection of the interactive relationships between diverse stakeholders in the global financial regulatory ecosystem.

The unprecedented expansion of financial businesses has increased the potential of systemic risks, and the growing number of multinational corporations whose business activities influence economic, environmental, and social sustainability has caused increased demands for corporations to take active roles in solving critical problems as corporate citizens. In corporate governance regulation, promoting stakeholder interests has increasingly been recognized as a regulatory objective, and whether financial regulation recognizes the public in general as legitimate stakeholders of financial institutions should be carefully considered as it would impact the policy objectives and priorities of financial regulation. Global financial regulation should function as a global public good considering the public as legitimate stakeholders of financial regulation at the international level, and strengthening the legitimacy of policy actions is particularly important when individuals' short-term profit-seeking can bring harm to society in the long term.

PART III An Empirical Analysis of Legitimacy in Financial Regulatory Reform: Post-Crisis Reform of the International Financial Architecture

A theoretical analysis of legitimacy in earlier chapters explored that legitimacy is an interactive concept with significant implications for rulemaking and regulation in reality. The principles of responsiveness, efficacy, integrity, and reasonableness of law and legal reform identified in the theoretical analysis are essential for any law or regulatory action to be considered legitimate. This Part expands the analysis of legitimacy to its practical application in regulatory reform by analyzing whether these principles of legitimacy have been properly applied in the post-crisis financial regulatory reform. This is particularly relevant as to the supposition made earlier that the lack of focus on legitimacy in the procedural and substantive aspects of regulatory reform has resulted in the unsuccessful outcomes of the post-crisis global financial regulatory reform.

In the study of financial regulation, examining the regulatory reforms in post-crisis financial regulation from the perspective of legitimacy is rare partly because legitimacy has not been considered a practical factor in lawmaking and regulatory reforms. Oftentimes, its value has been confined to narrow legal interpretations focusing on legal mandates or legislative actions. Recalling that the legitimacy of lawmaking in its procedure and substantive rules ultimately determines the outcome of legal reform, analyzing the legitimacy of post-crisis financial regulatory reform can provide insightful guidelines for ongoing and future reform efforts. Moreover, it will attest to the previous argument that legitimacy is a dynamic rather than static concept and explain how factors affecting the legitimacy of financial regulation should be considered to improve the quality of international financial regulation. Therefore, an empirical analysis of the legitimacy of post-crisis financial regulatory reforms focusing on exemplary cases can help gain a better understanding of the importance of legitimacy in the real rulemaking process.

For the purpose of assessing whether the specific policy objectives and institutional arrangements have been pursued based on the legitimate principles of financial regulation, this part consists of two chapters focusing on regulatory reform actions and practices that took place at the international level after the global financial crisis of 2008. Chapter 4 takes the case of the international financial architecture and analyses the legitimacy of the post-crisis global financial regulatory systems focusing primarily on the examples of the Basel Committee and G20. In the context of legitimacy problems of soft law in international financial governance, an empirical analysis of the conceptual and institutional challenges in international financial architecture in the context of post-crisis regulatory reform is necessary as it can help explain the most salient legitimacy problems at the international level. Then, chapter 5 discusses the paradigm shift in global financial regulation in the context of digital transformation in financial markets considering the fast-changing regulatory landscape in financial markets caused by digital transformation. It first provides an analysis of the changing regulatory landscape after the global financial crisis and how it led to the rise of Fintech in global financial markets. Then, it discussed whether and how the legitimate principles of global financial regulation should be applied in the digital era in connection with the role of global financial governance organizations as policy platforms.

Chapter 4 The Legitimacy of International Financial Architecture

This chapter starts the analysis by examining the power of legitimacy in international law and the political economy of international financial rulemaking. The changing power dynamics in international financial governance following the economic growth of emerging economies provide a useful analytical tool for explaining the legitimacy claims of developing countries. The growing demand for the investor-state dispute settlement (ISDS) reform is a fine example that shows the practical use of legitimacy claims in international rulemaking and governance reform. Then, the meaning of the stakeholders of international financial regulation is discussed with a particular focus on the recent changes in the Basel Committee as to its membership and the mismatch between participation and influence. In discussing the legitimacy problems of soft law in international financial governance, the standard-setting roles of international financial organizations such as the OECD, IIF, IASB, and FATF are analyzed. In particular, the G20 is taken as an example of a soft law decision-making body that has played a significant role in global financial regulatory reforms. The responsiveness and efficacy of the regulatory reforms led by the G20 are discussed to examine the legitimacy problems exhibited in soft law instruments. The second part of the chapter analyses the resilience and sustainability of international financial architecture by examining the conceptual and institutional challenges in the post-crisis regulatory landscape. Intellectual assumptions and theoretical problems with dominant economic theories, such as the efficient capital market hypothesis (ECMH), are discussed to explain the contradiction between theoretical beliefs and human behaviors in financial markets, contributing to the failure of policy actions in the post-crisis regulatory reforms. In this context, the legitimacy of international financial architecture requires improving the procedural fairness of rulemaking and the reasonableness of global governance by promoting proportionality and equitableness. Finally, the sustainability of international financial architecture is considered in the context of the legitimacy of international financial regulation. Policy initiatives and actions on sustainability risk management led by international financial organizations such as the OECD and Basel Committee are explored to see how policy coordination can promote international financial regulation as a global public good.

4.1. Legitimate Principles of International Rulemaking

For an international organization to achieve its goals, it is imperative to secure its legitimacy by ensuring that it has the power and authority delegated by its members and that it operates within the scope of its mandates along with the associated norms and principles that justify the actions of the organization.[425] Although the administrative function of an international organization, particularly of intergovernmental organizations, is quite different from that of an administrative branch of a state, there are almost always certain rules and regulations established by constituting members and the organization cannot survive unless it operates in compliance with those established rules and regulations. As noted earlier, the absence of a unified constitution or a central government of states does not mean that states or individuals are indifferent to the legitimacy of rules governing global affairs. Fundamentally, the absence of central authority in international affairs does not necessarily lead to the conclusion that values and principles in international relations are different from those underpinning domestic political and legal institutions. Does the concept of transparency or accountability in international regulation differ from how it is perceived in domestic regulation? Isn't it more

[425] Carlo Cottarelli, 'Efficiency and Legitimacy: Trade-Offs in IMF Governance' (2005) IMF Working Paper WP/05/107, 3. See also, Ngaire Woods, 'The Challenges of Good Governance for the IMF and the World Bank Themselves' (2000) 28(5) World Development 823-41.

reasonable to believe that the normative conceptions are identical both at the international and domestic level although methods and procedures of achieving those conceptions may differ as a result of different institutional frameworks?

4.1.1 The Power of Legitimacy and Legitimate Talk in International Law

While legitimacy is often considered in a different context between domestic and international settings, pondering on the political and psychological process of establishing and strengthening legitimacy as a normative concept or belief of people on the quality of legal authority proves that the pursuit of legitimacy in international rulemaking is not necessarily different from domestic rulemaking. Rather, sometimes legitimacy gets more importance in international rulemaking because of the very absence of something like a national constitution or legal enforcement. This is because the legitimacy of any institution is dependent not only on the organizational mandates but also on the norms or values that justify its actions as right.[426] For organizationally developed institutions, such as the WTO or the IMF, their actions "can be described as legitimate or illegitimate, but so can the norms, rules, and principles that undergird and license these actions."[427] In the absence of state-like institutional mechanisms, states attempt to sell their own version of legitimacy in one way or another to gain stronger support from other states and sometimes to deny that their requests are not simply self-interested.[428] On many occasions, talking about legitimacy and legitimacy standards, or 'legitimacy talk,' in international institutions functions as an indirect speech through which states frame their self-serving demands in the form of more generalized legitimacy claims.[429] Although states and

[426] Christian Reus-Smit, 'International Crises of Legitimacy' (2007) 44 International Politics 157-174, 158-159.
[427] Id. 159.
[428] Matthew D. Stephen, ''Can You Pass the Salt?' The Legitimacy of International Institutions and Indirect Speech' (2015) 21(4) European Journal of International Relations 768-792, 782.
[429] Id. 769.

international institutions may have different reasons for the use of legitimacy claims in a given situation, legitimacy has been understood as a key constituting mechanism of international orders, along with coercion and shared interest, and explains that members comply with international institutions out of normative conviction rather than coercion or inducement.[430] In addition to the need for securing the morality of certain actions, legitimacy claims have served as a way of sending a message or signal to opponents without giving definite proof of an explicit claim so that hostile listeners cannot directly refute the claim.[431] Considering the legal or material cost of explicitly taking military actions or economic sanctions in modern international society, building and strengthening legitimacy is a key to success for states in international institutions where states fiercely compete to make the rules more favorable for their interests while minimizing the potential of conflict with other states. The frequent use of legitimacy claims, or legitimate talk, in international relations demonstrates the desperate need to secure justification for states and international organizations. Because legitimacy is fundamentally a social concept, the social endorsement of the norms, principles, and objectives of an international organization is so important, and "no action can be coherently described as legitimate if it is not socially recognized as rightful."[432]

Legitimacy plays a critical role in international financial governance as the interplay of economic and political considerations among states largely shapes the structure and objectives of international financial regulations. Although the national policy on the financial industry

[430] Id. 770. See also, Ian Hurd, 'Legitimacy and Authority in International Politics' (1999) 53(2) International Organizations 379-408; Andrew Hurrell, 'Legitimacy and the Use of Force: Can the Circle Be Squared?' (2005) 31(S1) Review of International Studies 15-32; and Friedrich Kratochwil, 'The Force of Prescriptions' (1984) 38(4) International Organization 685-708.
[431] Stephen, 'Can You Pass the Salt?' (n 428) 774.
[432] Reus-Smit 'International Crises of Legitimacy' (n 426) 159-160. As legitimacy claims are defined as the politics of justifying identities, interests, practices, or institutional structures by actors, legitimacy claims do not necessarily denote legitimacy itself.

varies depending on the stage of economic development and the cost of raising capital for each state, international financial regulation as a product of intergovernmental coordination epitomizes the political economy of international rulemaking where legitimacy is considered one of the key influencing factors. Two of the most salient reasons include that finance is a vital sector for any national economy and that international coordination is inevitable for any financial system operating in the open market. Finance is a sector where states have a vast interest regardless of their stage of economic development. Often, states exert a powerful influence on the financial sector either directly or indirectly. While some industries are more important for an economy and regarded as less important in other economies, finance is central to the operation of any state and the existence of government is inevitably dependent on the soundness of finance in the state. It is not only the case of public finance per se but the way and amount of capital coming in and out of the economy influence the performance of other industrial sectors. Thus, the interest of states in monitoring or controlling such capital movements cannot be exaggerated. At the same time, intergovernmental cooperation is inevitable for any financial system to operate in an open market and the flow of capital between states is essential for making trade and investment available. As an interconnected system of financial markets between states, one state's arbitral action can cause a detrimental consequence in another state, and the domino effect of failing financial institutions easily leads to the destruction of the overall global economy. Naturally, sharing information between national financial authorities is necessary and the effectiveness of the global financial system depends on the quality of coordination among them. Thus, financial regulation at the international level exhibits a high degree of political tension and requires effective cooperation among states. Considering the characteristics of financial globalization as discussed earlier, it is critical to strengthen the cooperative mechanisms between national financial regulators and also promote diverse instruments for monitoring the evolving situations of the global financial markets. One of the most important areas for such keen cooperation is surveillance and risk analysis because it is practically impossible for a single regulator to effectively monitor the progress of the financial markets given the complexity and rapid evolution of the globalized financial system.[433] In particular, it is necessary to promote:

- information-sharing within and across jurisdictions, through formal and informal channels, subject to professional secrecy standards applicable to governmental authorities in the context of any exchange of confidential information;
- collaborative analysis and discussion of the financial system and related developments, risks, and possible contagion channels, domestically and internationally;
- research and analysis, conducted at the domestic and international level, and effective mechanisms to promote such collaborative and information-sharing.[434]

Ultimately, financial regulation cannot be adequately understood without thoroughly understanding the political and economic dynamics between as well as within states where states act both as regulators and stakeholders of financial regulation.

International Relations Theory in Global Financial Regulation

While it is less frequently found in the discourse of financial regulation, understanding the rights and responsibilities of actors in international relations directly, or indirectly, influences the way important decisions are made, communicated, and implemented in the sphere of international financial regulation. It is critical to note that what constitutes the legitimate principles of international law, in general, and international financial regulation, in particular, is inevitably related to one's perception and belief in the system of international relations. In this regard, international relations theory provides useful tools in the analysis of the legitimacy of international financial regulation as debates on the concept and principles of legitimacy in

[433] OECD, 'Policy Framework' (n 115).
[434] Ibid.

international financial regulation are less likely to reach a meaningful consensus unless participants agree on the status of states, individuals, and firms in the context of international relations which provides the basis of rights and responsibilities of each group of actors. Thus, it is not easy to explain why states or individuals disagree on solutions to common and persistent problems without contemplating the theoretical underpinnings of international relations. For example, classical realists who perceive the international environment without authoritative political institutions, legal systems, and commonly accepted standards of conduct, emphasizing the anarchical character of the international system, as distinct from the domestic environment may well be skeptical of the prospect of developing a new international financial architecture and argue that it is legitimate that states who have a strong power over the subject matter dominate the decision-making process and their interests are reflected in the substance of such decisions.[435] Likewise, neorealists who explain the world in terms of the balance of power among actors and perceive the international system as being transfigured by changes in the distribution of capabilities among its units may well contend that decision-making among like-minded states as clubs involves no defect in terms of legitimacy and is more effective to reach desirable outcomes than giving every state the same power in rulemaking.[436] In contrast, idealists view the realist paradigm as increasingly anachronistic and dangerous in the world of growing economic integration and believe that the vision of democratic world order is achievable from the perspective of directional historical progress.[437] For idealists, the

[435] James E. Dougherty and Robert L. Pfaltzgraff Jr., *Contending Theories of International Relations: A Comprehensive Survey* (3d ed., Longman Publishing Group 1997); Jason N. Workmaster, 'A Blackstonian Approach to International Relations' (1999) 12 Regent University Law Review 297.

[436] Ibid.

[437] Andreas Osiander, 'Rereading Early Twentieth-Century IR Theory: Idealism Revisited' (Sep. 1998) 42(3) International Studies Quarterly 409-432, 410. As to the theoretical distinction between Realism and Idealism, the author posits that "the most fundamental difference between Idealism and Realism is their respective philosophy of history – directional, as I seek to establish, in the former case, cyclical, as is well known, in the latter."

fundamental harmony of interests of all states or the benevolent force of public opinion takes the central stage of international order and rulemaking when it comes to the principles of legitimacy while realists often criticize this view as a naïve progressivism based on the outdated nineteenth-century liberal doctrine.[438]

Although global financial governance is often considered a specialized policy area with narrow room for variation, it is the product of intensive negotiations among states with different political and economic standpoints at a given time in history. For example, it was through intensive international negotiations that modern international financial architecture was established in the 1940s at the Bretton Woods. The global financial system that we have had since then is the fruit, either proper or improper, of debates and negotiations among states. Although the legacy of Bretton Woods has not been fundamentally altered except for the abandonment of the gold standard in the 1970s, the changing power dynamics in international political and economic relations in the past decades have gradually influenced the shaping of international financial architecture. The rise and fall of hegemonic powers in international politics and the changing power balance in regional blocks and communities have influenced the process and substance of restructuring or reforming the international financial system over the past decades accompanied by several economic and financial crises around the world.

Understanding the changing power dynamics in the international financial markets is so important as it gives necessary information on the appropriate approach and objectives of global financial governance that work for the global economy of today, not yesterday. Recalling

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[438] Ibid. E. H. Carr states in *The Twenty Yeas' Crisis 1919-1939* that the exponents of idealism privilege 'wishful thinking' over 'critical analysis' and neglect the issue of power. E. H. Carr, *The Twenty Yeas' Crisis 1919-1939* (originally in 1939, ed. by Michael Cox, Palgrave Macmillan 2016).

the concept of responsiveness as a key principle of legitimacy in financial regulatory reform, international financial governance cannot achieve legitimacy unless the governing rules and arrangements reflect the evolving demands and needs of the global economy as a community. In particular, the changing weight of economic power between states and the emergence of new technology, such as fintech, blockchain, and cryptocurrency, that reshape the functioning of the financial markets around the world should be properly recognized in the process of redesigning the international financial system. This is not a particular task for international financial governance but the demand for reshaping the governance system has been widespread in recent decades in the sphere of the international economic system in general. A good example of legitimacy claims in international rulemaking is the recent movements for reforming the investor-state dispute settlement (ISDS) system in international investment arbitration which show how the changing power dynamics between capital-exporting and capital-importing states have reshaped the landscape of international investment rulemaking. For the past years, the treaty-based investor-state dispute settlement (ISDS) mechanism has been subject to heated debates as many critics have raised concerns about the legitimacy of the dispute settlement system by arbitration between states and foreign investors and the conflict of interests between the objectives of public policy and investor protection.[439] The system of investor-state dispute settlement mechanisms, known as ISDS, has been in place since the 1960s and is considered a useful policy tool that provides legal protection for foreign investors against potential damages caused by the host State such as direct and indirect expropriation, denial of justice claims or losses due to insurrection, war, or similar events. As capital-importing countries needed to attract foreign investment, the ISDS system incorporated in most IIAs was designed to provide

[439] Much of the research for this section is summarized in Hyoeun Yang, *The EU's Investment Court System and Prospects for a New Multilateral Investment Dispute Settlement System* (KIEP 2017).

private foreign investors with additional rights to challenge the host State in case of discriminatory acts or expropriation so that their investments can be protected not based on the legal standards of the host State, which is often considered as less favorable for private investors, but that of the agreement signed between the host State and the home State of the investors.[440] Furthermore, the merit of incorporating ISDS lies in that investors can have recourse to investment arbitration in case of raising a dispute against the host State without relying on its home State to bring a claim on its behalf through diplomatic channels.[441] By the end of 2020, the total number of international investment agreements (IIAs) reached 3,360 including 2,943 Bilateral Investment Treaties (BITs) and 417 Treaties with Investment Provisions (TIPs).[442] While states continue to enter into new IIAs, the number of IIA terminations is also increasing each year, and at least 42 IIA terminations entered into effect in 2020 exceeding the number of newly concluded IIAs.[443]

While many scholars and practitioners have criticized the problems of the ISDS as a treaty-based arbitration mechanism including the lack of legitimacy and its negative impact on public policy, the momentum for seeking a comprehensive reform was provided when the EU and the US started the negotiations for the Transatlantic Trade and Investment Partnership (TTIP) which included the provisions on investment dispute settlements. Following intensive public

[440] See Wolfgang Koeth, 'Can Investment Court System (ICS) save TTIP and CETA?' (2016) EIPA Working Paper 2016/W/01.
[441] Mary E. Footer, 'International Investment Law and Trade: The Relationship that Never Went Away' in Freya Baetens (ed), *Investment Law within International Law: Integrationist Perspectives* (CUP 2013).
[442] United Nations Conference on Trade and Development [UNCTAD], 'World Investment Report' (2021)123.
[443] In 2020, at least 18 IIAs that had already been concluded entered into force. Of the 42 IIA terminations, 10 were unilateral terminations, 7 were replacements, 24 were terminated by mutual consent, and 1 expired. The entry into force of the Agreement for the Termination of Bilateral Investment Treaties between Member States of the EU on 29 August 2020 terminated 20 IIAs. The agreement implements the judgment of the Court of Justice of the EU in the *Achmea* case which found that "investor-state arbitration clauses in intra-EU BITs are incompatible with EU law." See Id. 127.

debates on the appropriateness of incorporating the ISDS in the new investment treaty, the European Commission conducted an online consultation from 27 March to 13 July 2014 and received 150,000 responses, most of which called for substantial reform of the ISDS system with indications of concern or opposition to the inclusion of the ISDS in TTIP.[444] In response to the widespread public concerns about ISDS, the European Parliament adopted a resolution containing the Parliament's recommendations for establishing a permanent investment court with an appellate mechanism to replace the arbitration system under the existing ISDS provisions. It contains a detailed picture of the new investor-state dispute resolution system rather than an abstract political statement:

> to ensure that foreign investors are treated in a non-discriminatory fashion while benefiting from no greater rights than domestic investors, and to replace the ISDS system with a new system for resolving disputes between investors and states which is subject to democratic principles and scrutiny, where potential cases are treated in a transparent manner by publicly appointed, independent professional judges in public hearings and which includes an appellate mechanism, where consistency of judicial decisions is ensured, the jurisdiction of courts of the EU and of the Member States is respected, and where private interests cannot undermine public policy objectives;[445]

The European Commission has taken the initiative to reform the investor-dispute settlement systems as a part of its broader policy agenda of building a new standard for global trade that is more sustainable and inclusive. Most of all, the reform agenda is highly focused on the

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[444] European Commission, 'Report – Online Public Consultation on Investment Protection and Investor-to-State Dispute Settlement (ISDS) in the Transatlantic Trade and Investment Partnership Agreement (TTIP)' (January 13, 2015) <https://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153044.pdf.> accessed 3 January 2022. The *report* states that the Commission sought feedback on "whether that proposed EU approach, which is substantially different from other agreements containing traditional investment protection and ISDS clauses, would achieve the right balance between protecting investors and safeguarding the EU's and Member States' right and ability to regulate in the public interest."

[445] European Parliament, 'Negotiations for the Transatlantic Trade and Investment Partnership (TTIP)' (2014/2228(INI)) (Official Journal of the European Union, 8 July 2015) 2(d)(xv).

procedural aspects of the dispute settlement mechanism while it also contains important substantive features. The proponents of reform emphasize the lack of legitimacy and argue that the deficiencies in procedural justice seriously weaken the legitimacy of the system and that it is in conflict with the general legal system that is built on constitutional elements such as transparency, consistency, and correctness. In addition to applying the new investment court system in its bilateral investment agreements with other like-minded states such as Canada or Singapore, the EU also attempts to establish a multilateral investment court in place of ISDS systems to strengthen the legitimacy and accountability of the dispute settlement system between investors and states. The European Commission made it clear that establishing a multilateral investment court is a part of the EU's endeavor to take the initiative in standardizing the rules of international investment agreements for the changing economic and political environment. In the context of bilateral and regional trade and investment agreements, states have attempted to seize the initiative in new international standards as other states are likely to follow the examples of the previously agreed treaties or agreements for handling similar issues. In the world of multipolar powers, international standards for trade and investment have been considered powerful tools for exercising leadership in international relations. As the criticism of the lack of legitimacy in the existing ISDS system increases, states attempt to strengthen their regulatory autonomy by taking different steps and the EU's intention is clear that it would write the rules and make standards for the new international investment relations.

Fundamentally, legitimacy is a critical component of explaining how states act and behave in the absence of a central authority in international relations. Although legitimacy claims would not produce an immediate outcome in comparison with military action or economic sanction, the influence of legitimacy claims on the shaping and reshaping of the international governance system is powerful as states seek to justify their decisions and persuade others to join their causes without using expensive and destructive measures. It is the quest of international institutions, thus, that the role of legitimacy is adequately understood in the process of rulemaking and that the components or principles of legitimacy are well articulated so that participants, either state members or non-governmental actors, would reach a consensus more effectively and reasonably. Consequently, the principles of legitimacy in international financial governance should resonate with the general principles of legitimacy as discussed earlier: responsiveness, efficacy, integrity, and reasonableness of law. At the same time, focusing on the evolving concept of stakeholders in international financial governance may provide an important analytical tool to assess the legitimacy of international rulemaking in recent years. For this purpose, the next section will discuss the stakeholders of international financial regulation and assess the legitimacy of international financial standard-setting as an example.

4.1.2 The Stakeholders of International Financial Regulation

Acknowledging the changing power dynamics in international financial governance is also useful in understanding who should be included as legitimate stakeholders of international financial regulation. As the case of investor-to-state dispute settlement reform demonstrates, the concept of stakeholders in international law has seen a tremendous change over the past decades as the progress of globalization has reconceptualized the rights, authorities, and responsibilities of states, businesses, and individual citizens. From the perspective of physical proximity, technological enablers have made it easier to connect with people in other countries or regions and the scope of commerce has been remarkably expanded. This means that an event that happened in a distant region has multiple implications for the lives of millions of people regardless of the geographic location because the consequences of an event can reach people in other countries through physical movements of people or goods, environmental risks, or economic crises. For example, political or armed conflicts in a region may turn into a crisis of outnumbering refugees seeking shelter not only in neighboring but also in distant regions[446]; the irresponsible use of fossil fuels in an industrializing country may result in environmental crises detrimental to the lives of people in other regions; and mismanagements of banks or insurance companies located or operated in a country easily threaten the financial stability of corporate and individual customers who entrusted their funds to those companies. Recalling the definition of stakeholders provided by Freeman as "any group or individual who can affect or is affected by the achievement of the firm's objective,"[447] it is not an easy task to draw a definite line as to who should be included as stakeholders of an organization or an issue at times. This is more so for international governance issues since the cause of an issue often originates in one country or region, while its impact reaches wider networks or individuals across borders.

From the perspective of psychological contiguity, the reach of a local event also exceeds the boundaries of the local community as it spreads to the other sides of the globe within a minute through multiple channels of communications, not to mention social network services such as Twitter, YouTube, Facebook, and the likes. Sharing pictures or videos of tragic scenes of human

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446 For example, about 400 Afghans arrived in South Korea in August 2021 for seeking asylum through an evacuation operation. This has ignited a public debate on refugee policy in Korea since it first became a social issue in 2018 after about 500 Yemenis came to the island of Jeju. See Seoho Lee and Natalia Slavney, 'Afghanistan Crisis Reignites South Korea's Refugee Debate' (Oct. 2, 201), *The Diplomat*, October 02, 2021 available at <https://thediplomat.com/2021/10/afghanistan-crisis-reignites-south-koreas-refugee-debate/> accessed on June 20, 2022.

447 Freeman, *Strategic Managemen* (n 388).

rights violations through SNS channels helps promote campaigns from around the world calling for actions of states, international organizations, or even fellow citizens to intervene in the situation to save those afflicted. For example, racially discriminatory actions of the police in the U.S. caused anti-racism movements in other continents calling for having respect for life no matter what identity the person is categorized with.[448] Expressions of concerns or desires are not limited to the aspects of one's immediate social life but easily exceed the boundaries of national borders as the increasing accessibility to information from cross-borders makes people engage more easily with events happening from a distance.

The regulatory implications of such an enlarged scope of life are significant. While state governments with sovereignty were considered legitimate stakeholders in discussing international financial governance some fifty decades ago, international governance institutions are increasingly more concerned with how individuals think and act about important decisions made by their government representatives although they are not directly responsible for those citizens. Since an international agreement, or regulatory obligation, signed by the head of state or the relevant ministry should be implemented in the domestic setting, the success of international regulatory reform depends on its reception in the respective state. Whether the process of transplanting an internationally agreed regulatory chance to a domestic policy would be smooth and effective largely depend on the willingness of domestic stakeholders to accept and abide by the international obligation as it is often witnessed by IMF or World Bank programs in a crisis economy. As stakeholder participation in the domestic policymaking process, such as public consultation or feasibility study by subject-matter experts,

[448] Jason Silverstein, 'The Global Impact of George Floyd: How Black Lives Matter Protests Shaped Movements Around the World' *CBS News* (4 Jun 2021) <https://www.cbsnews.com/news/george-floyd-black-lives-matter-impact/> accessed 20 June 2022.

has become a common practice, the demand for stakeholder participation in international rulemaking has also increased and the access to the decision-making process by diverse stakeholders has become a critical factor that affects the legitimacy of an international governance system. In this regard, it is important to examine whether those who are affected by international rulemaking are given adequate access to the decision-making process and whether the decision-making process is legitimate both procedurally and substantially.

A Mismatch Between Participation and Influence

In international financial rulemaking, it is particularly problematic that important decisions are made by a small number of states with the status of advanced economies, such as the member states of the G7, the G20, or the OECD, while the results have a critical impact on the shaping of the global economy as a whole including those who do not have access to those advanced economic circles. Although not every state involved in one of those clubs has an equal and absolute position in terms of making a new international governance standard, access is the first and foremost problem in the structure of international financial rulemaking as it significantly undermines the legitimacy of global financial governance. Considering that the financial markets are highly interconnected, and no country can be safe from the impact of a financial crisis broken in another country or region,[449] the system of international financial

[449] After the Asian Financial Crisis, in September 1999, the Council on Foreign Relations published policy recommendations about the future international financial architecture and emphasized that the U.S. is not immune to financial crises abroad as the economy is more connected to the rest of the world than it was decades ago. In retrospect, it should have been good if the U.S. was indeed able to lead a reform of international financial architecture so that the recent financial crisis broken in the U.S. would not turn into a global financial crisis and a global recession. It is worth reading the conclusion of the paper:

> "To sum up, contrary to recent appearances, the United States is not immune to financial crises abroad. If a serious foreign financial crisis were to occur at a time when our economy was weak or was actually in recession, the impact would likely be much more severe than it has been during this recent episode. The US economy is now much more connected to the rest of the world than it was two or three decades ago. There have been enough losses, close calls, and "might-have-beens" over the past twenty years to remind us that international capital markets – despite their important overall

rulemaking should be more inclusive and equipped with the necessary quality of regulation that is required for any law to be legitimate – responsiveness, efficacy, integrity, and reasonableness. For global governance, stakeholder participation requires that states are provided with adequate access to the decision-making process that has an impact on their domestic financial markets and economic development. Since international financial institutions (IFIs) have become the core instrument for managing financial risks by developing international standards and rules and exchanging information about states' regulatory policies, it is imperative that "all countries and economies subject to these standards exercise a certain degree of participation in the standard-setting process."[450] Since international financial institutions have started as forums in which financial regulators meet and exchange information and are not created by multilateral treaties or agreements with a broad membership, the decision-making process has been criticized as secretive rather than transparent and inclusive. In respect of the legal status, international economic organizations that play important roles in promoting economic development and enhanced financial stability, such as the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO), form public international law with the capacity of establishing binding legal obligations.[451] In contrast,

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> contribution to our standard of living – are risky places. The more successful we are in putting in place an architecture that can reduce the frequency and severity of financial crises – including emerging economies- the better are our chances of safeguarding America's jobs, savings, and national security as well as of promoting global prosperity. Greater financial stability on the part of our trading and investment partners can only be good for us. Like the rest of the world, we have a big stake in a new architecture that can make global financial markets safer."

See Peter G. Peterson, Morris Goldstein, and Carla A. Hills, 'Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture' (1999) Task Force Report, Council on Foreign Relations, Peterson Institute for International Economics.

[450] Kern Alexander, *Global Governance of Financial Systems* (OUP 2006) 34-35.

[451] As established by multilateral treaties, the IMF is empowered by the Articles of Agreement to oversee the international monetary system by exercising surveillance over the exchange rate policies of the member states. Similarly, the Articles of the World Bank allow the Bank to make loans that are conditioned on members undertaking macroeconomic adjustment programs with institutional reforms, and the General Agreement on Trade in Services of the World Trade Organization requires member states to reduce barriers to trade in financial services according to the negotiated commitments. See Id. 47.

international financial regulatory bodies, such as the Bael Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the Financial Action Task Force (FATF), serve as forums where member states exchange information on regulatory practices for promoting cooperation and provides standards of supervisory structures to ensure consolidated supervision of the financial markets.[452] In many cases, developing or underdeveloped economies are not given equal access to the decision-making process compared to developed economies, and this unequal position in international financial rulemaking has served as a critical source of discontent between the global North and South. As developing states are not adequately represented in important decision-making forums, policy issues that are particularly relevant to those developing economies are often neglected while the objective of financial stability is approached from the standpoint of advanced financial markets. The narrow policy focus of financial supervisory organizations or standard-setting bodies has prevented the international financial governance system from addressing critical issues that are important to improve the sustainability of the global financial system. One of the most apparent and relevant cases in this regard can be found in the history of the Basel Committee.

The Case of the Basel Committee

The Basel Committee on Banking Supervision ("Basel Committee"), the most influential international financial regulator, exercises significant influence over the structure of banking law and regulation by producing many important international standards that regulate the amount of capital that banks must maintain against their risks and requiring bank regulators to

[452] Ibid.

oversee the global operation of banks in their jurisdictions under the set standards of supervision – the Capital Accord.[453] The Basel Committee was first composed of the G10 central bank governors and national bank regulators and worked informally relying on decentralized implementation and informal monitoring of compliance rather than adopting legally binding rules. However, its standard has become an international norm of banking regulation and many non-G10 countries have been required to incorporate the Basel standards for many reasons. First, the IMF and the World Bank have required their member countries to adopt the Basel Accord to be qualified for financial assistance programs, such as IMF Financial Sector Assessment programs and World Bank Financial Sector Adjustment programs. Second, all G-10 countries require foreign banks that seek to obtain a bank license to demonstrate that their home country regulators have adopted the Capital Accord and other international financial agreements. Third, the Capital Accord became an international standard of sound banking regulation, and the adoption of the Accord has impacted the international reputation of the non-G10 country as an attractive place for foreign investment.[454] Fundamentally, the Capital Accord functions as a de facto international standard of banking regulation despite its non-binding nature.

The international rulemaking of the Basel Committee has been controversial because it did not give access to the non-G10 countries in the decision-making process despite the huge impact of those decisions on their national markets, and the decision-making structure lacked accountability. Moreover, the exclusion of non-G10 countries resulted in the unsuitability of the standards for developing and emerging economies. As the Global Financial Crisis amplified

[453] Alexander, *Global Governance of Financial Systems* (n 450).
[454] Id., 39.

the criticism as to the irrelevance and exclusiveness of the membership and institutional structure of the Basel Committee, it expanded the membership in 2009 and again in 2014.[455] However, it is still problematic because the simple expansion of membership as a response to the global pressure from the non-G10 economies did not adequately address the problems that have long undermined the legitimacy of rulemaking in the Committee, particularly in terms of accountability and responsiveness of regulatory reform. For accountability in prudential regulation, the regulator must be responsible for providing "an account and explanation of its actions to the relevant government authority and, more broadly, to members of the public. The public may also include regulated firms that should be consulted and kept informed of proposed changes to regulation. There must be clear lines of authority that show where the regulator derives its authority and to which stakeholder interests it is accountable."[456] After the global financial crisis, the process of revising Basel II and adopting Basel III as a new set of banking regulations has been reserved for a rather small circle of advanced economies despite its overwhelming influence in reshaping the international financial regulatory systems. While the pressure of expanding access to decision-making procedures had resulted in the inclusion of more states including emerging economies as mentioned earlier, the accountability scheme has remained almost the same as before the breakout of the global financial crisis. In retrospect, the uncertainty of regulatory reform caused many problems than a solution to the financial markets around the world, and such closed discussions and communications in the process of reform have demonstrated that the institutional structure of providing reasonable justification to meet accountability is still flawed. In addition to many states that were not involved in the

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[455] After the expansion of membership in 2014, the Basel Committee now comprises forty-five members from twenty eight jurisdictions and has nine observers.
<https://www.bis.org/bcbs/membership.htm#:~:text=The%20Basel%20Committee%20comprises%2045,international%20organisations%20and%20other%20bodies.>

[456] Alexander, *Global Governance of Financial Systems* (n 450) 43.

decision-making procedure, important stakeholder groups such as regulated firms and the public are also largely excluded from the process of revising the rules despite the huge impact of such changes on their day-to-day business and financial well-being.

From the perspective of responsiveness, the uniformity of banking regulations has brought a critical problem to developing economies whose domestic financial markets are less sophisticated and without many globally active financial firms that are subject to the regulatory standard of Basel III. While Basel III is concerned with tightening the capital ratio of banks to counter potential risks of systemically important financial institutions, its policy focus has been less relevant to the core problems of developing financial markets. Furthermore, the invariable adoption of new rules has been considered potentially problematic as it would significantly undermine the performance of financial institutions in developing economies while the pressure of adopting the standards is high. At the same time, the more important and urgent policy agendas that pose a significant threat to the stability of the global economy have been largely excluded from the policy discussion of the Committee in the aftermath of the Global Financial Crisis such as fast-growing sovereign debts in developing and underdeveloped economies. It is clear that agenda setting takes an important part in global financial governance and the selection of priorities inevitably reflects the interests and urgent policy objectives of participating states. Although many critical issues of international financial markets are interrelated between developed and developing economies due to the increasing volume of capital movements and investments, it is hard to diagnose the essence of problems in local financial markets without communicating closely with the regulators of those economies. By limiting the discussion of financial rulemaking to similarly situated economies in the global financial market, the members of international financial governance organizations such as Basel limit their capacity to build more comprehensive and sustainable solutions to emerging problems in the global economy.

Consequently, it is necessary to reconsider how to fill the gap between the influence and responsibility of international financial governance organizations that have been largely left untouched even after the global financial crisis. Is the current structure of informal policy coordination legitimate considering the practical influence of those organizations on the global economy? Although it would be too ambitious or impractical to reach a multilateral agreement on such areas in the near future, there should be a more concerted policy effort to build principles and rules that should be observed by those organizations to improve the legitimacy of international financial rulemaking.

4.1.3 Legitimacy of International Financial Standard Settings: Soft Law as Harder Law

As noted earlier, the scope of international regulation has expanded over the past decades and the law of the global community has become a complex and diversified enterprise. International legal standards that govern conflicts between citizens, businesses, and states have become so influential, and some of the regulatory frameworks that have been developed by non-state institutions, such as international business associations or NGOs, exert a strong influence on the conduct of businesses and individuals. In the mid-90s, Thomas Franck aptly described the maturity of international law and the increasing influence of international regulation as below:

> A new international law is developing which governs relations between an international organization and its employees, and between international organizations themselves. This list of relations governed by international law is far from complete; it merely illustrates the breadth of the terrain and the pace of its transformation. Only a few decades ago, international law applied exclusively to states. Today, it is an intricate network of laws governing a myriad of rights and duties that stretch across and beyond national boundaries, piercing the statist veil even while it sometimes

pretends that nothing has changed.[457]

As discussed previously, international regulatory standards have real power regardless of the direct involvement of governments or the status of codification as enforceable treaties. In the realm of global financial governance, in particular, standard-setting practices utilizing legally non-binding rules of conduct or other political instruments, such as declarations, resolutions, or guidelines, have become critical sources of making and enforcing rules and regulations. As discussed earlier regarding the reconceptualization of regulatory autonomy in international financial governance,[458] it is hard to defend that sovereign states monopolize the authorities or means of law-making and law enforcement in financial governance. In reality, "financial regulatory governance is global governance, in fact, governance by soft law, to a considerable extent, or even governance without government."[459] Far from a structured and strict legislative system of state organization, the state of global financial governance organized by layers of soft law instruments has been one close to *governance by communities* that "come together and share a governance structure without the prior requirement of a state or of the government that serves as the incarnation of the state."[460]

As soft law generally refers to rules of conduct that are not legally binding but may have

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[457] Franck, *Fairness in International Law and Institutions* (n 62) 5-6. In recognition of this exponential growth of international law, he argues that the traditional inquiry of international law, whether international law is law, should be replaced by the following questions: "Is international law effective? Is it enforceable? Is it understood? and, most importantly, Is international law fair?"

[458] For a detailed analysis of this, see section 3.1.3 Reconceptualizing Regulatory Autonomy of this thesis.

[459] Friedl Weiss, 'The Device of Soft Law: Some Theoretical Underpinnings' in Friedl Weiss and Armin J. Kammel (eds.), *The Changing Landscape of Global Financial Governance and the Role of Soft Law* (Brill Nijhoff 2015) 47.

[460] Larry Cata Backer, 'Governance without Government: An Overview and Application of Interactions Between Law-State and Governance-Corporate Systems,' in Gynther Handl and Joachim Zekoll (eds.), *Beyond Territoriality: Transnational Legal Authority in an Age of Globalization* (2012) 104, <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568934>. See also, Anna Leander, 'Whitelisting and the Rule of Law: Legal Technologies and Governance in Contemporary Commercial Security' in Monika Heupel and Theresa Reinold (eds.), *The Rule of Law in Global Governance* (Macmillan 2016) 205-236.

practical effects,[461] the existing debate about soft law has been more focused on the effectiveness of non-binding rules in global financial governance as some believe it provides a more effective means of promoting openness and flexibility in global governance while others doubt the effectiveness of soft law instruments in enforcing rules in addition to the threat of the privatization of legal regimes.[462] However, the current dominance of soft law in global financial governance requires closer attention to the actual impact of soft law regardless of its legally non-binding nature, and whether the existing soft law regimes are equipped with the legitimate principles of financial regulation.

The Hardness of Soft Law Standards in International Financial Governance

The strict distinction between soft and hard law has increasingly become blurred and sometimes obsolete as some soft law instruments have exerted more power and influence than codified hard laws. Moreover, it is noteworthy that states have been fond of the device of soft law in financial regulatory governance rather than reluctantly using it in the absence of necessary public law instruments. Unlike a common assumption that states or formal intergovernmental organizations can exert meaningful influence,[463] sovereign states have replaced their traditional reliance on centralized command and control functions with decentralized hybrid forms of public and private regulation with the participation of transnational actors such as NGOs, transnational expert networks, or interest groups in dealing with complex matters of global financial governance.[464] This phenomenon called regulatory capitalism indicates that "capitalism is a regulatory institution – one that is being constituted,

[461] Weiss, 'The Device of Soft Law' (n 459) 51-52.
[462] Ibid.
[463] Tony Porter, 'Why International Institutions Matter in the Global Credit Crisis' (Jan–Mar 2009) 15 (1) Global Governance 3-8, 3.
[464] Weiss, 'The Device of Soft Law' (n 459) 51.

shaped, constrained and expanded as a historically woven patchwork of regulatory institutions, strategies, and functions."[465] In this term, the fact that standards of global financial governance such as OECD guidelines or Basel capital requirements are non-binding does not diminish their practical impact on financial markets nor the regulatory objectives of standard-setters such as state governments or international organizations.

The extent of influence of soft law in global financial governance can be understood in two aspects. First, soft law instruments are often the outcome of unofficial political negotiations between regulators and private sector institutions that play key roles in the governance of global finance. While regulators do not formally negotiate with private sector institutions as to the rules governing the practice of private financial businesses, the proposals of business associations representing important financial institutions such as the Institute for International Finance (IIF) or International Accounting Standards Board (IASB) are highly influential in the process of rulemaking in global financial governance. As an alternative to public regulation, commercial firms have used their business associations to propose self-regulatory arrangements and pre-emptively established monitoring systems for systemic risks in coordination with relevant international organizations.[466] In this process, soft law arrangements have represented the changing power dynamics between private and public institutions in global financial regulation, and the global regulatory response in the aftermath of the global financial crisis has even reinforced the increasing dominance of soft law arrangements where private actors exert greater influence beyond their consultative positions

[465] David Levi-Faur, 'Regulatory Capitalism' in Peter Drahos (ed.), *Regulatory Theory: Foundations and Applications* (ANU Press 2017) 289.
[466] Porter, 'Why International Institutions Matter' (n 463) 4.

in the process of regulatory reforms.[467] In this sense, soft law instruments as rules of conduct may well be considered as located between law and politics,[468] and it allows states and international organizations to express their commitments while allowing private actors to be engaged in writing the terms of regulation that they would be expected to comply with. By doing so, states may be considered as meeting their political obligations towards regulatory reform without being burdened by the potential of resistance by private market participants or other states in disagreement with the proposed rules. Second, despite the legally non-binding nature of soft law standards, a variety of enforcement mechanisms are available, and compliance is often sought by means other than institutionalized or formal procedures such as judges or courts.[469] At times, soft law arrangements do not always stay as they are but can be transposed into domestic law or provide a basis as raw material when codifying or developing international norms. As to the coerciveness of soft law instruments, it is noteworthy that "institutional actors as well as individuals often perceive soft law as hard regulation and behave accordingly, due to a number of effective soft law mechanisms, including persuasion, social pressure, self-interest, imitation, conformity, shaming, opportunity, etc."[470]

Most of all, network effects play a significant role in global financial governance considering the closely connected systems of financial markets and the importance of creditworthiness or reputation in the financial industry. In short, a network effect occurs "when the value of a product or service increases as the number of other agents using the same product or service

[467] Jannike Gottschalk Ballo, 'How and to What Extent Did Private Actors Influence Basel III?' (2012) 13 Papers on International Political Economy (PIPE), Freie Universitat Berlin, Center for International Political Economy.
[468] Weiss, 'The Device of Soft Law' (n 459) 52.
[469] Id., 54.
[470] Id., 55. Also see Filippo M. Zerilli, 'The Rule of Soft Law: An Introduction' (2010) 56 Focaal – Journal of Global and Historical Anthropology.

grows, which in turn draws more users."[471] Considering that legal standards, particularly international financial regulatory standards, are produced to facilitate interaction within the global financial market, standards set by influential actors, such as the G20, OECD, or FSB, inherently bring coercive effects to those states, businesses, or individuals who wish to participate in the relevant financial markets. Although not all soft law instruments are accompanied by a network effect, soft law instruments with network effects gain more traction, and it is useful to consider the below four criteria for network effects in legal standards to assess the degree of network effects produced in international financial standards: (i) the usefulness of a legal standard is that it allows those who subscribe to it to successfully interact with other users; (ii) legal standards must be compatible, i.e. they must be commonly employed; (iii) commercial legal standards often relate to interactions involving vast numbers of people who frequently interact; and (iv) in a transnational context, actors can choose the standards that will govern their interaction.[472]

A good example of this kind is the recommendations by the Financial Action Task Force (FATF) that set out a comprehensive framework of measures to combat money laundering and the financing of terrorism and proliferation which member countries should implement through measures adapted to their particular legal, administrative, and operational circumstances.[473] The FATF standards consist of the Recommendations and their Interpretive Notes and the applicable definitions in the Glossary, and the implementation of the standards is assessed

[471] Bryan Druzin, 'Why Does Soft Law Have Any Power Anyway?' (2017) 7 Asian Journal of International Law 316-362, 361.
[472] Id. 364.
[473] The Financial Action Task Force [FATF], 'International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation' (2012-2022) The FATF Recommendations (Paris, France, Updated March 2022).

rigorously through Mutual Evaluation processes and, importantly, the assessment processes of the International Monetary Fund and the World Bank.[474] In addition to the requirement of submitting self-assessments, members are regularly peer-reviewed by other members and the secretariat, and measures such as reporting on deficiencies in FATF meetings, official letters, or missions sent to the member country follow in the event of non-compliance which significantly damage the reputation and credibility of the country in the international financial communities.[475] The absence of legally binding procedures poses no difficulties for the FATF to induce compliance with member countries as powerful incentives and reinforcing mechanisms exist.

Legitimacy Problems of Soft Law in International Financial Governance

The primary purpose of using informal networks without binding agreements is to improve the efficacy of policy objectives by reducing the cost of involving in complex negotiations and it fundamentally initiated the choice of using networks between states and diverse stakeholders that share common interests and policy priorities. As discussed earlier, the need to achieve efficacy is not incompatible with observing legitimacy principles,[476] and it is even more so when the rules in question have a dominant influence on the actions and choices of stakeholders at all levels. In connection with the problems explored in the previous section regarding stakeholders of international financial regulation, the evolvement and increasing dominance of soft law have brought many concerns about the legitimacy of existing soft law instruments. Considering the multi-layered process of standard-setting which involves not only states but

[474] Id. 8
[475] Anja P. Jakobi, 'Global Networks against Crime: Using the Financial Action Task Force as a Model?' (2015) 70 (3) International Journal 391, 400.
[476] See section 3.2.2 The Efficacy of Financial Regulatory Reform of this thesis.

also a diverse group of stakeholders such as subject matter experts, civil societies, or interest groups, the legitimacy of rulemaking and enforcement is a challenging yet significant part of sustaining any soft law arrangements in international financial governance.

In a historical context, the growing emergence of soft law in international rulemaking is linked to the rise of the new international economic order (NIEO) in the 1970s as it appeared in the Declaration for the Establishment of a New International Economic Order, adopted by the United Nations General Assembly.[477] The NIEO "referred to a wide range of trade, finance, commodity, and debt-related issues, …, focusing on restructuring of the world's economy to permit greater participation by and benefits to developing countries,"[478] and was aimed to provide a better institutional and social environment for development. After decades of progress in international financial governance since the so-called failure of the NIEO and in reflection of the problems revealed by global financial crises since then, it is worthwhile to consider the legitimacy of soft law instruments as the global community has strived to achieve development that is more sustainable and inclusive. In light of the general principles of financial regulatory reform discussed in Chapter 4.2, it is helpful to consider how soft law instruments in international financial governance have addressed the following four principles of legal reform: responsiveness, efficacy, integrity, and reasonableness. For this purpose, the below section will take the G20 as an example of a major soft law decision-making body that has played a key role in global financial regulatory reforms and analyses the responsiveness and efficacy of the G20's response to financial regulatory reform.

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[477] United Nations General Assembly, *Declaration for the Establishment of a New International Economic Order*, 1 May 1974, A/RES/S-6/3201.
[478] Ibid.

Responsiveness

Recalling the principle of responsiveness in regulatory reform, reform efforts are useful when they address contemporary problems by reflecting the needs of participants in the market and society. Therefore, it is important to recall that the law and regulation should be understood as a continuing struggle and challenge of social practice and that the law is embedded in the moral foundation of society rather than a static set of rules or principles. In this sense, the principle of responsiveness involves not only objective policy measures employed but also moral or ethical values that are required to be revisited in the process of regulatory reform. In the wake of the global financial crisis in 2007, the G20 was upgraded to the level of Heads of State of the 20 advanced economies and has played a key role as the premier forum for international economic and financial governance since 2009. Considering that the G20 was first founded as a forum for finance ministers and central bank governors in 1999 as a response to the Asian financial crisis followed by the need for coordinating economic and financial issues among financial regulators, the change of level represented the determination of governments to cooperate and work together to restore the confidence in the global financial systems.[479]

At the initial meeting of the Group of Twenty (G20) held in Washington DC on November 15, 2008, the leaders adopted the *Action Plan to Implement Principles for Reform* that sets forth specific plans to implement the agreed principles for reform as follows - strengthening transparency and accountability, enhancing sound regulation, promoting integrity in the financial markets, reinforcing international cooperation, and reforming international financial

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[479] G20, 'Declaration of the Summit on Financial Markets and the World Economy' (November 15, 2008) Office of the Press Secretary <https://www.g20.org/en/about-g20/#previous-summits>.

institutions.[480] In subsequent meetings from 2008 to 2010 including the meeting held in London in 2009, Pittsburgh in 2009, and Seoul in 2010, the regulatory responses of the G20 members to the global financial crisis dominated the agenda, and important principles of global regulatory cooperation were declared by the Summit Statements. In particular, the London and Pittsburgh Summit Communiques provided principles for a more robust and coordinated supervisory and regulatory framework for avoiding a repetition of crisis or mitigating the negative effects of any potential crisis on the global economy.[481] In this aspect, the global regulatory response through the G20 in the aftermath of the global financial crisis reflected the urgent call for swift policy reaction to prevent a global financial meltdown and to improve the mechanism for cooperation among financial regulators at the international level.

However, the role of the G20 has reportedly shrunk as the immediate threat to the global financial market systems waned and the other emerging issues after the financial crisis that are more threatening to the economic growth of developing economies have not been sufficiently addressed. As the scope of agendas has expanded beyond economic and financial coordination in recent years to include broader global issues such as the future of work, terrorism, climate change, and digital transformation, G20 members have struggled to achieve agreements on addressing critical issues,[482] particularly over how to address economic shocks disproportionately affecting emerging economies and the G20 as a premier forum of global economic and financial governance appeared powerless facing economic competition between

480 Ibid.
481 Alexander, *Principles of Banking Regulation* (n 5) 74.
482 Despite the fact that the G20 agenda for each summit is to be determined by a Troika consisting of the previous, present, and next Presidency to provide consistency and continuation of the discussion, the focus and scope of the agenda in each year vary as the G20 does not have formal criteria for setting the agenda.

great powers such as the U.S. and China.[483] Ultimately, the ad hoc selection of agendas in each summit without mandated agenda-setting rules or a defined scope of agenda has been a challenge for the G20 to be responsive to the growing problems of the global economy as the priorities of advanced economies and emerging economies are difficult to be aligned at any given time.[484] This institutional feature has been pointed out as a source of weakening the utility of the G20 and member countries often pursue their interests by taking unilateral actions or forming ad hoc coalitions.[485]

Efficacy

The two most important contributing factors to the efficacy of regulatory reform are the capacity to identify the measures most likely to produce the intended result, and the actual ability to make it happen. At the initial G20 meeting in Washington, the G20 leaders adopted policy measures for immediate and mid-term actions to be taken by the member countries to stabilize the financial markets and support economic growth amidst the global financial turmoil. In 2008, the G20 decided to the implementation of economic stimulus measures and not to take protectionist policies by creating new barriers to investment or trade. (1) As to the implementation of economic stimulus, the Declaration of the Summit in 2008 states that strong and significant actions were taken "to stimulate our economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies, unfreeze credit markets," but more actions need to be done to restore economic momentum and

[483] James McBride, Anshu Siripurapu, and Noah Berman, 'What Does the G20 Do?' (Nov. 10, 2022) Council on Foreign Relations.
[484] Evren Celik Wiltse, 'The G20 and Global Economic Governance during a Protracted Recession' (Winter 2013) 18(4) Perceptions 7-28, 19.
[485] McBride et al., 'What Does the G20 Do?' (n 483). As to the utility of the G20, some commentators have argued that a G-zero world is emerging "in which countries go it alone or form ad hoc coalitions to pursue their interests."

growth potential in the financial markets.[486] In 2009, further expansionary fiscal measures were agreed upon as stated in paragraph 5 of the Leader's Statement at the London Summit:

> The agreements we have reached today, to treble resources available to the IMF to $750 billion, to support a new SDR allocation of $250 billion, to support at least $100 billion of additional lending by the MDBs, to ensure $250 billion of support for trade finance, and to use the additional resources from agreed IMF gold sales for concessional finance for the poorest countries, constitute an additional $1.1 trillion programme of support to restore credit, growth, and jobs in the world economy. Together with the measures we have each taken nationally, this constitutes a global plan for recovery on an unprecedented scale.[487]

Considering the importance of restoring confidence in the global economy and the need to provide capital resources for supporting trade finance, the concerted agreements of the G20 at the early stage of the financial crisis were essential. (2) Additionally, the agreements on "standstill" that prevented countries from taking new protectionist policy measures for the next 12 months, as first agreed in Washington in 2008 and then extended until the end of 2010 as confirmed in London in 2009 before extended again until the end of 2013 in Toronto in 2010, were considered as crucial parts of the global policy coordination at the early stage of the financial crisis.[488] Since the global financial crisis required a consolidated policy response of governments and a swift decision-making process to reduce uncertainty in the market, the agreements made by the G20 summits provided important guidelines on fiscal policy coordination by member countries and the G20 has been recognized as a premier forum of policy coordination.

For financial supervisory and regulatory reform, the G20, through the establishment of the FSB,

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[486] G20, 'Declaration' (n 479) para 5.

[487] G20, 'London Summit – Leaders' Statement' (April 2, 2009) para. 5 <https://www.g20.org/en/about-g20/#previous-summits> accessed on December 7, 2022.

[488] The standstill policy was extended until the end of 2013.

has focused on improving a macro-prudential regulatory regime and strengthened the regulatory controls and supervisory practices for identifying systemic risk in financial markets.[489]

As a way of institutional reform, the G20 agreed in 2008 to expand the FSF to a broader membership of emerging economies, and the FSB was established at the G20 London Summit in 2009 as an international body that is responsible for developing international financial standards for the control of systemic risk and provide effective oversight of the global financial system. The membership of the new Financial Stability Board (FSB) included all G20 countries, FSF members, Spain, and the European Commission.[490] In the Cannes Summit in 2011, the G20 agreed to give the FSB legal personality and greater financial autonomy and to enhance coordination between the FSB and the International Monetary Fund on macro-prudential financial regulation and oversight of the global financial system.[491] As a soft law institution based on a flexible membership structure, the FSB adopted an overarching strategy of "leading by example" in which members are committed to the following:

- implementing international financial standards, undergoing an assessment;
- undergoing an assessment under the IMF-World Bank Financial Sector Assessment Program (FSAP) every five years;
- disclosing their degree of adherence to international standards, by publishing the detailed assessments prepared by the IMF and World Bank as a basis for the Reports on the Observance of Standards and Codes (ROSCs); and
- undergoing periodic peer reviews using, among other evidence, reports prepared as part of the FSAP.[492]

489 Kern Alexander, *Principles of Banking Regulation* (n 5) 76.
490 G20, 'London Summit – Leaders' Statement' (n 487).
491 The Cannes Communique provides that the leader "agreed to reform the FSB to improve its capacity to coordinate and monitor our financial regulation agenda. This reform includes giving it legal personality and greater financial autonomy." See G20, 'The Leaders' Summit' (2010) para. 16, <https://www.g20.org/en/about-g20/#previous-summits>. See also, Alexander, *Principles of Banking Regulation* (n 5) 75.
492 Financial Stability Board [FSB], 'Framework for Strengthening Adherence to International Standards' (9 January 2010).

While the obligations in principle are not legally binding in comparison to rules and regulations produced by treaty-based international organizations, it is hard to contend that compliance to the standards and codes is flexible or voluntary as the IMF and World Bank exert pressure on countries to adopt international standards, not to mention the significance of market-based reputational sanctions as a result of being perceived as non-compliance with best practice in the global financial markets.[493]

Furthermore, the FSB lists key standards for sound financial systems under the broad policy areas of macroeconomic policy and data transparency, financial regulation and supervision, and institutional and market infrastructure, and these standards are periodically reviewed and updated by the FSB. While the standards are in the form of soft law and represent "minimum requirements for good practice that countries are encouraged to meet or exceed,"[494] these exert a hard impact on national regulations particularly when the standards are endorsed by international treaty-based organizations such as the IMF and World Bank as benchmarks of country assessments or reporting criteria.[495] Considering the importance of facilitating behavioral changes in the market and inducing compliance with rules and regulations by giving proper incentives to the market participants, it is questionable whether the deep reliance on the enforceable mechanisms provided by the IMF and World Bank has been effective in bringing necessary changes to the financial markets. Although it could have achieved efficiency by adopting cooperative mechanisms with the international financial organization with hard laws,

493 Eilis Ferran and Kern Alexander, 'Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board' (2011) Legal Studies Research Paper Series, 36 University of Cambridge Faculty of Law 9.
494 Financial Stability Board [FSB], 'Key Standards for Sound Financial Systems', <https://www.fsb.org/work-of-the-fsb/about-the-compendium-of-standards/key_standards/> accessed 10 December 2022.
495 Ferran and Alexander, 'Can Soft Law Bodies be Effective?' (n 493) 5.

it has rather narrowed the scope of provisions of the FSB as an institutional arm of the G20 to provide more holistic and comprehensive regulatory support that is necessary to make fundamental changes to the global financial system. While the focus on macro-prudential financial regulation at the global level was deemed appropriate and necessary, the coordination between the G20 and IMF on macroeconomic policy regulatory objectives and the binding effect of rules as a result of this enhanced coordination has posed critical issues as the G20 remains as an informal group since confirmed by the Cannes Communique in 2011.[496] Although the efficiency of financial regulation is important for the consolidation of regulatory standards and rules at the global level, the effectiveness of the standards imposed by the FSB has been continuously criticized as unsuccessful in solving fundamental problems of the financial markets including ending too-big-to-fail problems and providing effective solutions for cross-border resolution of failing financial institutions.

Overall, the soft law arrangements adopted by the G20 manifest both the positive and negative aspects of soft law in international financial governance. Considering that soft law mechanisms have become so powerful and that their influence produces the same, if not stronger, impact on the business of market participants as hard law mechanisms would provide, the legitimacy of soft laws in financial regulation should be thoroughly examined as the technical distinction regarding the legally binding or not binding nature makes little difference in practice. In this regard, it is worth reminding that the integrity of the legal system equally applies to the internal law of such associational forms as clubs, churches, universities, and local communities.[497]

[496] As to global governance, the Cannes Communique declared that “the G20 should remain as an informal group.” See para 31 of the Communique.
[497] Fuller, *The Morality of Law* (n 53) 196.

4.2 International Financial Architecture: Resilience and Sustainability

An international financial architecture is not simply represented by a few symbolic international institutions, such as the IMF or World Bank, or the agreements produced by such intergovernmental institutions or forums. It encompasses an entire system of governing the conduct of global financial markets and also the soft and hard infrastructure of financial industries that are necessary for cross-border financial trading and investment. For a proper understanding of international financial architecture, one needs to pay close attention to the actual functioning and impact of systemic features of global financial regulatory structures as well as the influence of technological or cultural changes relevant to the business of finance. This section examines the conceptual challenges in international financial architecture focusing on paradigm shifts in international financial governance and problems with intellectual assumptions. Then, it analyzes the institutional challenges of international financial architecture focusing on the problems of regulatory fragmentation and the need to improve procedural fairness and adopting principles of reasonableness in international rulemaking. Finally, it explores the sustainability of international financial architecture and analyzes the critical role of global financial governance organizations in managing sustainability risks.

4.2.1 Conceptual Challenges in International Financial Architecture

In retrospect, the global financial crisis of 2008 brought paradigm shifts on a few key fronts of the global regulatory systems that govern extraterritorial transactions and related financial businesses. First, the traditionally accepted legitimacy of financial regulators such as central banks or standard-setting bodies was challenged as those highly esteemed financial experts were criticized as unable to prevent or temper the crisis without causing concerns for the public. As will be discussed in the next chapter on digitalization, this change of paradigm in financial markets has led a large portion of customers to look for alternative arrangements for their finance by shifting to emerging fintech services provided by non-traditional financial institutions including technology companies. Most of all, many commentators have questioned whether central banks or specialized financial regulators make fair and effective decisions as they have failed to raise flags for unreasonable conduct of failing large financial institutions despite the authority and information they had. In particular, the political implications of the decisions made by financial regulators at the time of the crisis and its aftermath have been subject to critical debates for many years.

In particular, the traditionally accepted reasons for why the work of central banks is important and the objectives of central banks have been questioned as “a new legitimacy narrative for central banks” has emerged.[498] As the business of financial governance became too important and influential for many individuals who would normally prefer not to be bothered by questioning the legitimacy of central banks, a more structured explanation is requested for the legitimate purposes and objectives of central banks. While the engagement of central banks with public dialogue has been minimal in many countries, explaining why central banks exist and when their actions are legitimate in the context of the evolving economic landscape have gained more importance in recent years.[499] For example, the Danish central bank governors have engaged the broader public in a discussion of the policies and authorities of the central bank by framing their policies in the context of social consensus and social solidarity.[500] More than using figures to justify their policy choices, promoting monetary policies by engaging in

[498] Annelise Riles, *Financial Citizenship* (Cornell University Press 2018) 43.
[499] Id., 50. In this book, the author suggests five key elements for explaining the legitimacy of central banks: resilience, interdependence, collaboration and trust, hard choices, and culture clash.
[500] Ibid.

a legitimacy narrative enabled the central bank to attain public support for their policies as the central bank became embedded in national identity.[501]

Intellectual assumptions and theoretical problems

More importantly, the crisis provided momentum for an intellectual paradigm shift although it is making slow and gradual progress rather than a sharp move to a new intellectual model of explaining the role and function of financial regulation. The prevailing assumptions on the global financial crises and regulatory responses caused the process of financial regulatory reform to be intricate and ineffective for the past decades and it is worth pondering how the intellectual premises has affected the way financial regulations are formed, applied, and resisted in the aftermath of a global financial crisis.[502] In retrospect, it is clear that no alternative to the liberal financial market system has appeared yet and the trend of international financial liberalization continues to accelerate due to rapid technological progress including fintech and blockchain technologies. According to John Kingdon, the prerequisites for major policy changes require the confluence of three developments the recognition of a problem, political circumstances, and the availability of new policy ideas.[503] Overall, the problem in post-crisis regulatory reform is attributed to the absence of available alternatives as policy ideas that are strong enough to refute the existing ones and lay a new paradigm. After every financial crisis on a global scale, it is easy to find that observers of financial market regulation define the problems differently, and the difference in diagnosis of causes often leads to different

[501] Id. 49.

[502] Paul Pfleiderer, 'Chameleons: The Misuse of Theoretical Models in Finance and Economics' (2020) 87(135) Economica 81-107. The author points to the problem of theoretical cherry-picking to emphasize that "since a given result can almost always be supported by a theoretical model, the existence of a theoretical model that leads to a given result in and of itself tells us nothing definitive about the real world."

[503] John W. Kingdon, *Agendas, Alternatives, and Public Policies* (2nd ed. Pearson 2010).

reform proposals as solutions. This divergence is fundamentally attributed to their different views of how the international economic and financial system works or ought to work.[504] Even though imminent causes and problems associated with each crisis may vary from time to time, these fundamental assumptions as to the functioning of the international financial systems persist. Therefore, it is necessary to discern between different assumptions when it comes to evaluating the validity and appropriateness of reform proposals.

In the aftermath of the GFC, some scholars point out that the prevalence of neoliberalism in financial regulation has not diminished. As Mervyn King, former governor of the Bank of England pointed out at the annual meeting of the IMF in 2019, it is quite obvious, after a decade since the devastating global financial crisis swept the world economy, that there had been "no comparable questioning of the basic ideas underpinning economic policy."[505] Despite the severe dis-accreditation of the liberal market economics and the "greed" of those who earn enormous capital gains by exposing investors and customers to excessive risks, private financial actors are less constrained by legal changes or regulatory restrictions due to the subsequent financial regulatory reforms in the aftermath of the global financial crisis than many observers had anticipated at the onset of the worldwide reforms of financial regulations.[506] While it would not have been intended, the policy choices of surviving Too-Big-Too-Fail (TBTF) banks turned to produce a hostile financial market environment for smaller financial institutions and non-financial firms to the extent of threatening their existence. As to the unintended but discriminatory consequences of supporting TBTF banks, many observers

504 Eichengreen, *Toward A New International Financial Architecture* (n 16).
505 King, 'The World Turned Upside Down' (n 23).
506 Graham K Wilson and Wyn Grant, 'Introduction' in Wyn Grant and Grant K Wilson (eds), *The Consequences of the Global Financial Crisis: The Rhetoric of Reform and Regulation* (OUP 2012).

criticize the prevailing approach of bailing out large financial institutions as discriminating against non-TBTF financial entities. The prolonged Great Recession following the crisis was too severe to give high credit to the post-crisis regulatory reforms. Instead, the frustratingly slow global recovery and the high level of global debt to GDP were extremely painful for those who did not have enough financial cushion to withstand the shrinkage of capital in the financial markets.

From the perspective of the general observer of financial regulation, the problem is simply that those who present grand reform proposals rarely make it clear what their theoretical assumptions are when technically intricating policy measures are presented in public. In this regard, Eichengreen provides a useful tool for understanding the general assumptions of those who support the liberalized financial markets system as to the system's imperfection and innate risks in his analysis of the international financial architecture in the aftermath of the Asian financial crisis of 1997.[507] Interestingly, after a decade of the Asian financial crisis which swept the emerging Asian economies and revealed the volatility of financial markets in the region, the phenomenon of market panic and the drastic need for government intervention to prevent the markets from collapsing as observed at the outbreak of the global financial crisis in 2008 are too similar to contend that the global financial system has become more stable and mature to deal with global financial events than a decade ago. Among the six assumptions Eichengreen provides on the operation of the international financial system, the following four

[507] Eichengreen, *Toward A New International Financial Architecture* (n 16). Later, in 2009, Eichengreen proposed more ambitious reforms of the international financial architecture. See Barry Eichengreen, 'Out of the Box Thoughts about the International Financial Architecture' (2009) IMF Working Paper Wp/09/116. For another critical analysis of the need for reforming the international financial architecture in the aftermath of the Asian Financial Crisis, see also Ralph Bryant, 'Reforming the International Financial Architecture' (1999) Brookings Discussion Papers in International Economics, No. 146.

are relevant to the analysis of this research:

a. Liberalized financial markets have compelling advantages compared to other ways of allocating resources that have been tried even though they do not work perfectly.
b. The trend of international financial liberalization and the growing capital mobility are irreversible and financial liberalization is being driven by powerful changes in information and communications technologies.
c. Despite the benefits of financial liberalization, the information asymmetries in Capital markets can give rise to overshooting, sharp corrections, and financial crises and the instability provides a compelling reason for a financial safety net despite the potential risk of moral hazard.
d. Economic policies are shaped in a politicized environment where lobbying and Political pressures inevitably influence policymaking institutions such as the IMF

Among others, the third assumption poses a problem that explains the chronic error in understanding the financial regulatory framework. Even though it is true that information asymmetries in capital markets exist and cause serious problems such as herd behavior or mis-selling, the following two questions warrant an examination. First, is financial instability attributed to the information asymmetries under the liberal financial market system? Second, can the problem of financial instability be redressed mainly by providing a financial safety net in the form of government subsidies or bailouts? While it is rarely pointed out in the discourse of global financial markets regulation, one of the most critical problems of the existing assumptions that contributed to the recurring financial crises and regulatory mismanagements is that the instability of financial markets is attributed to the arguably inherent flaws of the liberal financial markets system such as information asymmetries and that the instability considered as inevitable under the system.

This logical flow has served as a strong excuse for giving central banks and other financial regulatory agencies a great deal of power to supervise and sometimes back up large financial institutions for decades. However, it is worth pondering if financial crises are unavoidable and should be understood and treated as natural disasters. If the underlying assumption that financial market instability is unavoidable is to be accepted, however, the role of regulation ought to be undermined. As to this point, Admati argues that a financial crisis is not a natural disaster because "the extreme fragility of the financial system that gives rise to systemic risk and crises is rooted in the incentives of people within the system and in the failure of regulations to counter these incentives."[508] If financial crises are understood as man-made disasters, there are many ways to prevent them from occurring or minimize the negative impacts by improving the resilience of the system for the benefit of society. In this term, this research argues that regulatory institutions and their decisions, both as supervisors and standard setters, play a far bigger role than is normally understood in market economics theory in terms of shaping the behaviors of market participants. Indeed, one of the most critical problems of this assumption is that the interactive relationship between the regulators and the regulated is not adequately recognized, and the blame is unduly placed on market participants despite the insurmountable influence of the regulatory framework in determining the course of market behaviors. The regulatory landscape largely influences market behaviors, and many problems causing financial instabilities can be attributed to the complexity of the regulatory system or the ill-suited laws and regulations of financial markets. In contrast to the general perception that the complexity of financial markets is the cause of complicated financial regulations, the causality is often reversed as "complexity in regulation leads to complexity in financial structures and

[508] Admati, 'Rethinking Financial Regulation' (n 128). As to the heuristics to consider in determining the optimal approach to financial regulation, see also David Aikman et al., 'Taking Uncertainty Seriously: Simplicity versus Complexity in Financial Regulation' (2021) 30(2) Industrial and Corporate Change 317; Benjamin Friedman, 'Is Our Financial System Serving Us Well?' (2010) 139(4) Daedalus 9.

systems, particularly in light of the efforts of market participants to mitigate the costs and complications induced by regulation, including attempts to engage in regulatory arbitrage."[509]

Normally, investors and financial firms closely monitor what the chairman of the Federal Reserve or the president of the central bank has to say regarding upcoming policy decisions before they make investment decisions. Thus, the more unpredictable the decisions of the government on financial markets, the more confusion grows, exacerbating the instability of the financial markets. Most of all, the preexisting assumptions on the operation of the international financial system largely fail to acknowledge the effect of ever-sophisticated regulatory requirements on international financial transactions and the increasing discretionary power of regulators after every financial crisis that increases the unpredictability in financial markets. Since the intricacies of financial regulation increase the costs of regulation in the form of compliance costs, it automatically creates substantial entry barriers that lead to maintaining too-big-to-fail financial institutions rather than addressing the problem. From the perspective of regulation, the biggest emphasis of the post-crisis financial regulatory reform was placed on reducing systemic risks, and subsequent regulatory measures were made to that end. However, the legitimate boundaries of regulation are getting blurred because the exercise of supervisory controls by regulators has remained unpredictable under the aim of monitoring and preventing financial market turmoil as a policy priority.

[509] Chester S. Spatt, 'Complexity of Regulation' (2012) Harvard Business Law Review Online <https://journals.law.harvard.edu/hblr//wp-content/uploads/sites/87/2012/06/Spatt-Complexity-of-Regulation.pdf>. For discussions on regulatory complexity and arbitrage, see also Jean-Edouard Colliard and Co-Pierre Georg, 'Measuring Regulatory Complexity' (2020) CEPR Discussion Paper No. DP14377 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3535463>; Hendrik Hakenes and Isabel Schnabel, 'Regulatory Capture by Sophistication' (2014) CEPR Discussion Paper No. DP10100 <https://cepr.org/publications/dp10100>; Andrea Minto, Stephanie Prinz and Melanie Wulff, 'A Risk Characterization of Regulatory Arbitrage in Financial Markets' (2021) 22 European Business Organization Law Review 719.

While it is quite clear that the global financial crisis is attributed to global regulatory failure, it does not mean that regulators intentionally made wrong choices. Instead, it is linked to the prevailing theoretical approach to financial markets that influenced financial regulators to adopt the prevailing approach to financial markets regulation before the crisis. From the perspective of regulators, the asymmetry of information is related to the making of financial infrastructure.[510] Despite many known problems associated with the asymmetry of information in financial markets, the efficient capital market hypothesis (ECMH) which assumes that securities prices perfectly and instantly reflect available information and the rational decisions of investors has been accepted as a leading theory of explaining how market prices are set in reflection of reality.[511] From the perspective of regulation, this belief in an efficient market was problematic as it gave a false assumption that information including risks was well reflected in securities prices. However, financial crises of a similar pattern of boom and bust have demonstrated that the asymmetry of information gives rise to the misallocation of risk and the capitalization of some hedge funds which take advantage of market inefficiency.[512]

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[510] Donald, 'Information' (n 281) 41; Ruben Lee, *What Is an Exchange? The Automation, Management, and Regulation of Financial Markets* (OUP 1998) 111. See also Alan Schwartz and Louis Wilde, 'Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis' (1979) 127(3) University of Pennsylvania Law Review 630.

[511] Donald, 'Information, and the Regulation of Inefficient Markets' (n 281). For critical analyses of ECMH in corporate governance and litigation, see William Bratton and Simone Sepe, 'Corporate Law and the Myth of Efficient Market Control' (2020) 105 Cornell Law Review 675.; Bradford Cornell and James Rutten, 'Market Efficiency, Crashes, and Securities Litigation' (2006) 81(2) Tulane Law Review 443.; and Bradford Cornell and John Haut, 'How Efficient Is Sufficient: Applying the Concept of Market Efficiency in Litigation' (2019) 74(2) The Business Lawyer 417.

[512] Donald, 'Information, and the Regulation of Inefficient Markets' (n 281) 40. See also Georgy Soros, *The Alchemy of Finance* (John Wiley & Sons 2003) 25; Vincenzo Bavoso, *Debt Capital Markets: Law, Regulation and Policy* (OUP 2024, forthcoming); Roger Farmer, Carine Nourry, and Alain Venditti, 'The Inefficient Markets Hypothesis: Why Financial Markets Do Not Work Well in the Real World' (2012) NBER Working Paper No. 18647.; William Magnuson, 'The Failure of Market Efficiency' (2023) 48 BYU L. Rev. 827.

Instead of a one-dimensional understanding of the problem in financial markets, it is reasonable to ask whether the post-crisis regulatory reforms paid sufficient attention to the changing behaviors of financial institutions as a result of the crisis and subsequent policy actions. Undoubtedly, the outbreak of the global financial crisis brought enormous changes in financial markets not only from the perspective of the regulatory landscape as given but also in terms of the practice of financial institutions as to the composition of market segments, business models, and consumer or investor behaviors. Considering the imperative roles that central banks and international supervisory agencies play today, it is hard to argue that financial market instability is primarily born of the nature of financial industries and their profit-seeking behaviors. If so, again, what is the point of having regulatory systems that are being operated by using a huge amount of taxpayers' contributions and human resources?

The cost of intervention and intellectual rethinking – moral values beyond the theory

The cost of misjudgment in diagnosing problems and implementing policy measures is enormous as the direct and indirect impact of regulatory change spreads to the entire economy in one way or another. The economic cost of the global financial crisis translates into enormous economic losses resulting from unemployment, homelessness, and social conflicts and turmoil. The political cost is also insurmountable as those economic damages translate into political instability when the fairness, credibility, and capability of the existing global financial market systems are in doubt. Needless to say, the global financial crisis was costly in terms of both the cost of interventions in the financial sector and the cost of lost output. According to an IMF report, the cost of public interventions and public holdings in 1,114 financial institutions between 2007 and 2017 in 37 countries amounted to $1.6 trillion. The amount, including guarantees, reached $3.5 trillion, and larger amounts were allocated to banks with lower levels of capitalization and profitability.[513] It is easily observed that many economists and financial regulators argue that the cost of the entire collapse of the global financial markets outweighs the cost of rescuing the failing financial institutions from a system-wide perspective. Indeed, no one who might be aware of the economic history of the Great Depression back in the 1930s would insist that governments should not take active roles in saving the global financial systems and let the market fix the problem by itself. However, this line of analysis based on a single-dimensional cost comparison is only valid when one compares the costs between the systemic meltdown of the financial markets and the expenditure of supporting financial institutions in a short period and without considering various factors that affect economic recovery and growth for a longer period.[514] Moreover, this rationale can be justified only if the economy recovers relatively quickly as a result of the public intervention so that the net effect of unconventional expenditure of public finance leads to the overall growth of the entire economy, just as the post-Great Depression economy had shown. Whether the enormous amount of public money spent on bailout can be deemed as temporary outlets or irrevocable sunk cost burdening the public finance and economic productivity for a considerably long period is a critical question to ask to determine the validity of the policy choices following the logic provided by those who designed them.

While it is clear that the architects of the post-crisis responses including the leaders of central banks had the experience of the Great Depression in mind when they addressed the post-crisis

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[513] Deniz Igan et al., 'The Long Shadow of the Global Financial Crisis: Public Interventions in the Financial Sector' (2019) IMF Working Paper WP/19/164, International Monetary Fund. This paper analyzes government interventions in the financial sector since the GFC by focusing on the fiscal implications of direct government interventions by compiling a bank-level dataset on government interventions to track public asset holdings from 2007 to 2017.

[514] The above-mentioned IMF report by Deniz Igan et al. argues that "in countries where the government stake remained high relative to the initial intervention, private investment and credit growth were slower, financial access, depth, efficiency, and competition were worse, and financial stability improved less."

policy responses, the prevailing economic conditions and the rigor of political support did not necessarily mirror what had happened during the post great depression era. The notion of secular stagnation describes the state of the post-crisis global economy with sluggish growth and a lower level of investment.[515] The heavy reliance on the old-style monetary stimulus programs misled economic policy on many fronts while neglecting other important policy considerations such as fairness and integrity of financial governance systems. The amount of money spent itself cannot be an absolute standard for evaluating the legitimacy of policy choices. In other words, it is difficult and inappropriate to make a strict line on the amount of money that can be spent as a legitimate level of public expenditure in the course of addressing a financial crisis. At the same time, legitimating the huge scale of government bailouts by comparing the potential capital cost of a systemic meltdown of the financial markets alone cannot be sustained because public policy is more than a simple mathematical calculation and comparison as companies normally keep their commercial accounting books. As discussed in the preceding chapters, the legitimacy of public institutions and policy measures cannot be made solely based on the immediate cost to address the problems or avoided costs following the policy choices, as projected, to the economy. The direction, of laws and regulatory reforms, is as important as the performance, of the policy measures, when it comes to the choices and decisions of public institutions. In this sense, it is undesirable and inaccurate to assess the validity of public intervention in the crisis economy by comparing the estimated costs associated with addressing the crisis alone. Indeed, this simplistic monetary comparison of cost has blinded many observers from discerning the legitimacy of financial regulatory reforms in the aftermath of the crisis and prevented the course of financial regulatory reform from seizing

[515] Lawrence H. Summers, 'Accepting the Reality of Secular Stagnation' (March 2020) Finance & Development 17, International Monetary Fund.

the rare opportunities of bringing fundamental reassessment and overhaul of the overall financial regulatory architecture.

Consequently, the reasoning of public policy is certainly different from betting with a probability.[516] Although searching for growth momentum and productive areas is necessary for economic growth including high-quality job creation in the economy, it is less productive when the government pinpoints specific ways and means of industrial development and is trying to support certain industries or sectors with specific policy instruments. This is indeed where market distortion occurs. Most of all, the global financial crisis of 2008 was perceived as a much more dangerous crisis than its predecessors because of the potential impact of the collapse of large financial institutions on the entire global economic system and the massive scale of their misconduct which was not adequately monitored and regulated by financial regulators. In the absence of the emergence of an alternative intellectual paradigm in economics or finance, strong emphases on moral values or ethical problems have filled the void as environmental and social issues have received attention under the overarching theme of sustainability. Without an institutional or organizational overhaul, international financial institutions have attempted to find ways to adjust their existing work portfolio so that the business of financial companies can be conducted in environmentally and socially sustainable ways. Before turning to the growing importance of sustainability in financial regulation, the subsequent section will discuss some of the institutional problems in international financial architecture that should be addressed to improve the resilience and sustainability of the global financial governance system.

[516] Considering ethical culture in financial markets, see Blair and Barbiani, 'Ethics and standards in financial regulation'(n 178) 25-54.

4.2.2 Institutional Challenges in International Financial Architecture

After a decade of vigorous financial regulatory reform efforts following the global financial crisis of 2008, it is no exaggeration that the overall global efforts that started with a grand ambition ended with more questions and unsolved agendas. Although many reform measures were taken place by governments at the domestic level and international standard-setting bodies also revised some of the outdated rules and guidelines including the Basel III, no fundamental change has been recorded in the International Financial Architecture (IFA) despite the immense needs for improving the legitimacy of the global financial governance systems. While the global financial crisis made it evident that the financial markets are global in scope and a macroeconomic perspective on the world economy as a whole was required beyond the scope of individual national economies or inter-state economic relations, the overall regulatory response has been largely fragmented rather than consolidated.[517] What makes it most troubling for both proponents and opponents of the mainstream post-crisis regulatory responses is the prolonged, much longer than expected, state of low growth since the global financial crisis. Contrary to what had been expected at the inception of the post-crisis regulatory reform that the stabilization of financial markets would lead to a smooth transition to global economic recovery, the subsequent eurozone debt crisis and continuous low growth in the global economy made it difficult to defend the validity and efficacy of the prevailing policy choices in global financial regulation. Moreover, the recent global health crisis has revealed the persisting weaknesses of the global financial systems as emerging and developing economies have suffered from the insufficient global financial safety net during the COVID-19 pandemic,

[517] Matthias Lehmann, 'Legal Fragmentation, Extraterritoriality and Uncertainty in Global Financial Regulation' (2017) 37(2) Oxford Journal of Legal Studies 406, 409

compounding the potential risk of sovereign debt crises.

As discussed earlier, the global economy in the aftermath of the global financial crisis was not lacking institutional capacities to meet the challenges. Despite the increasing criticism of the outdated governance structures of the existing international financial institutions such as the quotas of the IMF membership, the idea of establishing new international financial institutions and abolishing the existing ones due to their incapability to deal with global financial problems appeared to be unrealistic and unnecessary. Unlike the aftermath of the Great Depression that gave momentum to establish the Bretton Woods Institutions to govern the international financial system, the global economy post-global financial crisis required a new way of thinking about global financial governance rather than a new organization – first, a consolidated regulatory approach of national regulators to global financial problems and, second, reform of existing international financial institutions to improve their legitimacy in the procedure and substance of rulemaking and enforcement. Considering that the concept of international financial architecture itself requires one to perceive the global economy as one and whole entity of concern, it should function as a mechanism for promoting mutual respect and long-term progress in the global economy as a community of fate. In essence, macroprudential policies that take a large part of the post-crisis regulatory paradigm are aimed at improving the stability and resilience of the financial system as a whole by strengthening financial systems and reducing excessive risk-taking and high vulnerabilities.[518] However, post-crisis global reform has resulted in more complexity and fragmentation of financial markets rather than providing a consolidated system of governance at the global level. The increasing volume and scope of

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[518] Kadija Yilla and Nellie Liang, 'What are macroprudential tools?' (11 Feb 2020) Brookings Institution <https://www.brookings.edu/blog/up-front/2020/02/11/what-are-macroprudential-tools/> accessed 5 January 2023.

financial regulation primarily implemented by national regulators were not meant to be coordinated with other states despite the apparent extraterritorial impact of those new rules. Regulatory fragmentation has been at the center of the existing problems in IFA and the duplicative and inconsistent regulatory requirements have been sources of systemic risk and barriers to cross-border transactions.[519]

Regulatory fragmentation can lead to the problems of an inadequate global regulatory framework in three possible ways: under-regulation where the regulatory network leaves a gap, over-regulation where two or more nations impose duplicative regulation on the same market participants or products, and complete market fragmentation where two or more regulatory regimes impose contradictory rules and thus cause legal uncertainty.[520] As soft law arrangements based on the voluntary adoption of standards or codes of best practices dominated the rulemaking and enforcement measures of global financial governance for the past decades, the problem of regulatory fragmentation has placed barriers and inconsistencies in the regulatory framework. Although states would not always intend to compete with the regulation, the absence of a centrally coordinated regulatory system resulted in financial instabilities as no state can be sure of the intention or motivation of other states while every state can be affected by financial events that occur outside their jurisdictions.[521]

Since the global financial crisis manifested many deficiencies in the global financial regulatory framework, international standard-setting bodies including the Basel Committee on Banking Supervision (BCBS), the FSB, and the G20 reflected the goal of reducing fragmentation in

[519] Lehmann, 'Legal Fragmentation' (n 517) 407.
[520] Id. 410-411.
[521] Id. 419.

their statements by stressing the importance of improving cooperation, addressing regulatory gaps, and promoting global standards in the post-crisis regulatory reforms.[522] Although much effort has been made in monitoring and assessing the implementation of states by peer reviews that score the degree of compliance with key international standards, the timing and the substance of implementation of internationally agreed financial regulatory reforms are left to the decision of national regulators and the enforcement of rules is mostly subject to the discretion of local authorities.[523] This means that financial institutions operating in more than one jurisdiction experience inconsistencies in regulatory requirements and the increasing costs of financial regulation due to the supervisory burdens discourage market participants from engaging in cross-border activity. While there are certain intended purposes and benefits of fragmentation in financial markets for the objective of financial stability such as the designation of global systemically important financial institutions, the absence of a global resolution framework provides little justification for the policy of segmentation as the overall objective of improving the resilience of the global financial system against the risk of the failure of G-SIFIs was not supported by harmonized rules for an orderly resolution such as a common deposit insurance scheme or other safety nets.[524] While the direct costs associated with compliance with different regulatory requirements pose certain barriers to cross-border financial activities, more important costs of regulatory fragmentation are found in the reduced incentives for innovation and the misuse of regulation to protect incumbents by limiting market access for new entrants and stifling competition, all of which produce negative impact on the long-term stability and resilience of global financial systems.[525] Considering the importance

522 Stijn Claessens, 'Fragmentation in global financial markets: good or bad for financial stability?' (October 2019) BIS Working Papers No 815, Bank for International Settlements 14-15.
523 Ibid. 9.
524 Ibid. 23.
525 John H. Cochrane,' Challenges for Cost-Benefit Analysis of Financial Regulation' (June 2014) 43 Journal of

of improving the resilience of the global financial systems and recalling that the existing policy approach resulted in inconsistency and uncertainty in global financial markets, a more consolidated regulatory approach is required that transcends the current status quo of soft law arrangements. In particular, fundamental changes need to be made in global financial resolution schemes and also in the regulation of funding sources for financial institutions to improve the overall financial stability in the global financial markets.[526]

The integrity of global financial governance – procedural fairness

The perceived legitimacy of the global financial governance system was negatively affected by the global financial crisis, and it also coincided with the increasing discontent with globalization from developing countries as the governance system was perceived as working for the established including large financial companies from developed economies and not for the rest of the world in terms of the increasing income inequality and the reduction of welfare budgets in the course of post-crisis reforms in many countries. The challenge to the legitimacy of the global financial governance systems is in large part attributable to the lack of procedural justice in the governance and decision-making process of regulatory institutions. On the one hand, international financial institutions established by a charter such as the IMF or the World Bank have been criticized as the present organizational structure does not provide adequate governance rules that could hold the staff or the institution itself accountable for their policy actions or decisions.[527] The lack of procedural rules of governance and administration that are

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Legal Studies S63-S105, S81. See also Anat Keller, *Legal Foundations of Macroprudential Policy: An Interdisciplinary Approach* (Intersentia 2020) 125-126.

[526] Cochrane (n 525) S101 ("I think systemic stability would be best addressed if the government required financial institutions to fund themselves in large part with equity, long-term debt, or other liabilities that are not prone to runs, and thus seamlessly impose losses on creditors. In such a system the need for anticompetitive asset and risk regulation would disappear, along with the temptations (other than political) to bail out creditors ex-post.")

[527] Augusto Lopez-Claros, Arthur L. Dahl and Maja Groff, *Global Governance and the Emergence of Global*

required to ensure transparency and accountability of the IMF has led to the increasing tendency of the markets and the borrowing members of the IMF to perceive the Fund as subservient to the developed economies, namely the G7, and has made it costly for the Fund to act effectively as the social and political repercussions to its programs were so high in many episodes of financial crises.[528] The perceived fairness of the rulemaking process is the foremost factor that determines the trustworthiness of any governance institution and influences the behavior of its members as to their willingness to cooperate in the long term or seek short-term political opportunities. Without addressing the structural issues of accountability and transparency, it is hard to expect that the Fund and other international financial institutions can fulfill their mandates effectively and bring fundamental changes to the chronic problems of the global financial markets.

On the other hand, the increasing dominance of regulatory networks that are based on soft law arrangements has provided no better solution regarding the procedural justice of the global financial governance system. For example, the G20 functions as a premier forum for global financial regulation since the GFC where important policy decisions or agreements in global financial governance have been made among the heads of state. While the high level of authorities represented in the G20 and the dominant economic power of the G20 members, both individually and combined, in the global economy add much significance to the decisions or resolutions made at each summit, the informal institutional nature of the G20 without formal procedural rules essential for a public institution in a constitutional democracy undermines the efficacy of the decisions made at summits in the long term, adding little to improving the

Institutions for the 21st Century (CUP 2020) 345.

[528] Id. 338.

sustainability of the global financial systems. Although the G20 embraces values represented in many procedural rules of public organizations such as accountability, transparency, and predictability of regulation, there is no mechanism to translate these values stated in the communique into specific policy measures despite the significant role G20 plays in global financial governance.[529]

The lack of procedural fairness has been one of the most critical problems of the existing international financial architecture that has been increasingly dominated by soft law arrangements. This problem has weakened the legitimacy of global financial governance, resulting in the ineffectiveness and inconsistency of policy actions. Indeed, procedural justice has been the cornerstone of the theory of legal rulemaking and public authorities have employed key components of procedural justice such as accountability, transparency, and predictability in a wide range of public policy operations. The continuing adherence of many state regulators to informal dialogues rather than formally negotiated and binding rules as to global financial governance has been perceived as an irregularity from the perspective of public policy. This tendency is closely related to the progress of financial regulation in many countries where the archetypal objectives of financial regulation have prioritized independence, informal supervision, private regulation, and market forces. However, the significance of the expanded financial sector in the global economy today requires the policy community to recognize the public aspects of financial regulation and acknowledge the political nature of the global financial governance system. This leads to the necessity of employing fundamental administrative rules in the decision-making process and the execution of the policy actions

[529] G20, 'Declaration' (n 479). It is interesting to recall the common principles for reform adopted at the 2008 G20 Summit: strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, reinforcing international cooperation, and reforming international financial institutions.

considering the impact of financial governance on the promotion of global welfare. For this cause, administrative rules need to be strengthened in the existing governance institutions and a higher degree of commitment should be required to make the decisions and policy actions more responsible and accountable.[530]

As discussed earlier, fairness of the legal procedure is perceived in the context of society as a system of cooperation between participants.[531] In particular, the consistency and predictability of the legal process have critical implications for the relationship between the legal system and individual liberty because clear and consistent rules are prerequisites for maintaining a society of autonomous persons who are able and expected to exercise various rights and duties in social life. In this sense, the lack of consistency and predictability found in the existing financial governance institution, regardless of the legal status, is a serious problem for a system of governance to achieve policy objectives effectively, and it leads to the degradation of the integrity of the entire community as the virtue of cooperation cannot be realized in such a social environment. While John Maynard Keynes, one of the architects of the Bretton Woods System, expressed his satisfaction with the outcome of the Bretton Woods Conference in 1944 as a successful experiment in international cooperation, it appears that the cause of cooperation has diminished over the past decades.[532] Regaining the legitimacy of the existing systems would require the adoption of basic administrative procedures so that the decision-making process is perceived as fair and consistent, improving the trustworthiness of those systems.

[530] Metzger, 'Through the Looking Glass' (n 346) 155.
[531] See section 3.2.3. The Integrity of Law and Procedural Justice of this thesis for a detailed analysis of the integrity of law and procedural justice.
[532] Lopez-Claros et al., *Global Governance* (n 527) 345.

The Reasonableness of Global Financial Governance – Proportionality and Equitableness

The power of intellectual persuasiveness has a critical implication in the governance of global affairs as it is hard for any mega-power to obtain the allegiance of states without strong legitimate causes of action – it may last only temporarily and be easily attacked by competing forces. While power politics seem to dominate the global scene of financial governance, conflicting ideas on financial regulation between mega powers such as the U.S. and China have been manifested in many fronts of international finance and hindered the promotion of regulatory cooperation at the international level. However, it is also clear that states always attempt to persuade others to take their sides by advocating the validity of their positions, and the present multipolar systems in global governance have made it more important for any states or regional entities to present their cases with legitimate reasons and justification. The legitimacy of international financial systems is integral to maintaining the ownership of the system and it buttresses the resilience of the system by allowing a wide range of stakeholders to doubt, question, and explain the validity of the system-wide features.

In general, the reasonableness of the global financial governance system requires the two most essential features of any public governance system to be perceived as legitimate: proportionality and equitable treatment. As previously discussed, proportionality has a critical implication for preventing discrimination in financial regulation as certain regulatory measures that apply regardless of different situations of financial companies would cause the discriminatory effect without the need to explicitly discriminate against particular groups or individuals in the market. Considering that regulation entails certain costs and that the same amount of expense can cause different effects on companies depending on their size, product designs, or business models, financial regulation can easily function as favoring some form of business over others. For example, the process of reforming Basel III has been criticized as putting many small and domestic-oriented financial companies at risk by imposing excessive amount of compliance costs.[533] Since large and internationally active financial institutions are much better prepared to absorb the regulatory risks and compliance costs compared to smaller financial companies, the design, and application of Basel III have been considered as accelerating the market concentration of large financial institutions.

Since international financial standard-setting institutions take an integral part in the functioning of modern markets in the absence of a centralized, or state-like, governance system, the legal structures and the rules for operation embedded in the international financial architecture are crucial as "governance is aimed at crafting order, mitigating conflict and realizing mutual gain."[534] Therefore, the concept of proportionality is key to ensuring that rules are designed and applied in a reasonable way in reflection of the objectives of particular regulatory measures.[535] It is also useful in promoting financial inclusion globally because regulators should give more attention to the reasonableness of particular policy measures when they are asked to provide the validity and necessity of their policy actions. While the requirement of justification alone does not guarantee the optimization of policy choices, the concept of proportionality at least ensures that rulemaking entities or individuals should consider how different entities would be impacted by their actions ex-ante. From the perspective of sustainable growth, international financial standard-setting bodies should consider the different development levels of domestic financial markets and ensure that rules imposed would not

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[533] Committee on the Global Financial System, 'Structural Changes in Banking after the Crisis' (n 369); Restoy, 'Proportionality' (n 372).
[534] Florini et al., 'Governance for Systemic and Transformational Change' (n 421) 9.
[535] See Alexander, 'Financial Inclusion' (n 376).

produce an unduly burden on small, non-complex, and internationally less active financial firms when it comes to prudential risk management-related measures.[536]

The perceived legitimacy of the international financial governance system is also closely connected to the equitable treatment of participating states. As the global financial markets are interconnected and risks arising in one country or region can easily transfer to other parts of the globe, the global governance system should pay particular attention to the vulnerabilities of financial systems and markets in developing and less developed countries. The connectedness of global financial markets provides practical reasons to treat states equitably instead of imposing regulatory standards that are more suitable for developed financial markets and unlikely to succeed in achieving policy objectives in developing or less developed countries. For the past decades, the principle of equitable treatment has influenced the international trade and investment discourse and acknowledged that the severity of rigid rules of positive law had to be mitigated to achieve justice.[537] Considering the usual criticism of the international financial governance system that the system works for a few wealthy countries but not for all countries, the international financial governance systems need to encompass the value of equitableness to ensure that the systems are perceived as legitimate and reliable as a form of international law.[538] At the same time, it has been problematic that enforcement rules are often applicable to less developed countries that might be dependent on financial assistance from international financial institutions while it is unlikely to enforce rules against the

[536] See also Bart Joosen et al., 'Stability, Flexibility, and Proportionality' (n 374).
[537] Franck, *Fairness in International Law and Institutions* (n 62) 48-49. See also the Continental Shelf Case (Tunisia v. Libyan Arab Jamahiriya) (Judgment) 1982 ICJ Rcp 60 (para. 71).
[538] United Nations [UN], 'Global Recovery Hinges on Creation of Equitable Financial System, Support for Climate Action in Developing Countries, Secretary-General Tells World Economic Forum,' Press Release, SG/SM/21106, 17 January 2022.

regulatory actions of developed countries. For example, the enforcement authority of the IMF is only valid for borrowing countries through the conditionality it applies to the programs and has no enforcement authority to other countries that are not dependent on the Fund's resources even when these countries are engaged in unsustainable policies that could pose harm to the overall sustainability of the global financial systems.[539] These structural problems should be addressed to improve the trustworthiness of the Fund as a global financial regulator that provides rules that are both fair and equitable to its member countries through a transparent and fair process. As the global financial governance systems are mostly built on networks of regulatory authorities or international financial institutions with non-binding standards, it is important to encompass such normative values as equitable treatments into the practical aspects of the governance system so that rules or standards as discussed and decided at the international level would not discriminate states depending on their financial strengths or weaknesses.

4.2.3 The Sustainability of International Financial Architecture

As discussed earlier, the legitimacy of international financial governance requires that a wide range of stakeholders perceive the governance systems as fair and reasonable. It also requires that the institutional governance structures including procedural rules are carefully designed to allow participating countries to make meaningful contributions to the decision-making process and that the substance of regulatory standards reflect the practical needs of those countries. So far as global systemic risks are concerned, it is important to note the close connectedness of global financial markets and address cross-border challenges that threaten the sustainability of the international financial systems in the context of connected crises such as climate change,

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[539] Lopez-Claros et al., *Global Governance* (n 527) 339.

cost of living, and sovereign debt crisis.[540] On the one hand, it is the interest of developed economies to help solve urgent financial problems in developing or underdeveloped countries such as debt distress or climate crises since mitigating those problems and building resilience to potential shocks would help stabilize those countries. On the other hand, policy changes in developed economies can produce a real impact on developing economies and worsen the financial volatility in those regions if adequate policy coordination is not taken between governments and financial institutions. For example, the U.S. Federal Reserve's sharp interest rate increases to calm inflation domestically were viewed as precipitating a recession in developing economies with heavy debt burdens, as a stronger dollar increases the cost of servicing U.S. dollar-denominated debt and also that of importing food and energy.[541] While the global policy responses to financial regulatory reform after the global financial crises have focused on strengthening oversight and regulatory requirements against financial institutions, the foremost policy goal of global financial governance should be strengthening the multilateral systems of policy coordination regarding connected global issues from the long-term perspective of sustainability. As the global financial crisis revealed the systemic vulnerabilities of the international financial architecture from the perspectives of both developed and developing countries, improving the sustainability of the international financial architecture would help solve the prolonged conflict of interests between developing and developed states which have long been a source of discontents in the global economy. Since the existing governance systems and institutional structures have been found insufficient to solve the

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[540] The Organization for Economic Co-operation and Development [OECD], 'The Reform of the International Financial Architecture: An Opportunity for Scaling up Finance for Water?' (2023) <https://www.oecd.org/water/background-note-global-financial-architecture-9th-RT-on-financing-water.pdf> accessed 29 March 2023.

[541] David McNair, 'Global Economic Turmoil Calls for a Modernized Global Financial Architecture to Address Needs of the Most Vulnerable Countries' (November 15, 2022) Carnegie Endowment for International Peace, <https://carnegieendowment.org/2022/11/15/global-economic-turmoil-calls-for-modernized-global-financial-architecture-to-address-needs-of-most-vulnerable-countries-pub-88400>.

emerging problems and concerns of the global financial markets, particular attention has been paid to the sustainability of international financial architecture in recent years.[542]

The term sustainability has been used to emphasize the significance of ensuring the long-term resilience of the interconnected global financial markets by transforming the way of understanding the purpose and role of the financial industries in the economy and modifying regulatory objectives accordingly. From the perspective of corporate governance and management systems, sustainability implies that businesses need to frame decisions in terms of environmental, social, and human rights effects to ensure long-term value creation rather than short-term gains.[543] Thus, sustainability risks arise when uncertain social or environmental events or conditions cause significant negative impacts on the economy.[544] Sustainability risks are often categorized into Environmental, Social, and Governance (ESG) risks as problems arising in those areas can induce systemic risks that are detrimental to the sustainability of the business and threaten the resilience of the entire financial system. ESG risks causing adverse environmental impacts include greenhouse gas emissions, pollution, biodiversity loss, ecosystem degradation, and human rights issues such as forced labor, child labor, inadequate workplace health and safety conditions, and exploitation of workers, among others.[545]

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542 Ibid.

543 Federation of European Risk Management Associations [FERMA], 'People, Planet, Performance -The Contribution of Enterprise Risk Management to Sustainability' (30 Mar 2021) <https://www.ferma.eu/publication/ferma-issues-first-sustainability-risk-guide-for-european-risk-managers/> accessed 31 March 2023. See also European Commission [EC], 'Proposal for a Directive of the European Parliament and of Council on Corporate Sustainability Due Diligence and amending Directive' (EU) 2019/1937, 23 Feb 2022, COM (2022) 71 final, 2022/0051 (COD).

544 FERMA (n 543) 7.

545 EC, 'Proposal for a Directive of the European Parliament and of Council on Corporate Sustainability Due Diligence and amending Directive' (n 543) 2.

Refocusing the core policy goals of the international financial architecture on sustainability and coordinating regulatory policies for managing sustainability risks of financial institutions' practices is essential to improve the resilience of the global financial systems and reduce the potential of financial crises that threaten the effective functioning of the global financial systems. Global policy goals for improving the sustainability of the international financial architecture require a holistic approach to financial regulation and the dynamic interplay between financial institutions and other stakeholders of financial regulation should be considered when policy measures are designed and applied at the international level. For this purpose, a comprehensive understanding of the regulatory ecosystem is essential as the long-term success of financial institutions depends on the success of their stakeholders and vice versa.

The practices of financial institutions have a significant impact on the sustainability of the global economy as the flow of financing directly affects the business strategies and practices of non-financial industries. For instance, banks play an important role in mitigating the sustainability risks in society "by reallocating credit to more sustainable sectors of the economy and managing the related credit, liquidity and market risks."[546] Although many banks have adopted the Equator Principles that provide environmental and social management standards for project finance, a more comprehensive framework applicable for financial institutions concerning the majority of financial institutions' practices including lending and debt transactions has been called for and this demand has been intensified after the global financial

[546] Kern Alexander and Rosa Lastra, 'International Banking Regulation and Climate Change' (January 9, 2023) Oxford Business Law Blog <https://blogs.law.ox.ac.uk/blog-post/2023/01/international-banking-regulation-and-climate-change> accessed 30 March 2023. See also, Anat Keller, 'The Public Role of Banks: A New Narrative Born?' (2022) Journal of International Banking Law Review 1 (suggesting that "the gatekeeper narrative is used by legislators, regulators and the courts to define, expand and where necessary, confine banks' duties").

crisis.[547] In this context, global financial governance has become an increasingly significant part of the global efforts to promote sustainability as financial institutions play a key role in driving global sustainability through directing financing towards measures to achieve the global goals for mitigating environmental and social risks.[548] After all, the sustainability of the international financial architecture depends on its capacity to act vigilantly before a crisis arising from one region or industrial sector grows to become a global systemic crisis. In this regard, it is important that the policy objectives of international financial governance institutions such as the IMF, the World Bank, and the Bank for International Settlements (BIS) are aligned with non-financial global goals for managing sustainability risks such as the United Nations Sustainable Development Goals (UN SDGs)[549] and the Paris Agreement from the United Nations Climate Change Conference (COP 21)[550] followed by the COP27 cover decision in 2022.[551]

Fundamentally, international financial governance rules should not be alienated from other socially important policy goals both globally and nationally because of the strong bonds

[547] The Organization for Economic Co-operation and Development [OECD], 'OECD Releases the first guidance for environmental and social risk management for corporate lending and underwriting activity' (29 Oct 2019), <https://mneguidelines.oecd.org/oecd-releases-first-guidance-for-environmental-and-social-risk-management-for-corporate-lending-and-underwriting-activity.htm> accessed 31 March 2023.

[548] The Organization for Economic Co-operation and Development [OECD], 'Due Diligence for Responsible Corporate Lending and Securities Underwriting: Key Considerations for Banks Implementing the OECD Guidelines for Multilateral Enterprises' (2019)

[549] The United Nations [UN], Resolution adopted by the General Assembly on 25 September 2015, Transforming our world: the 2030 Agenda for Sustainable Development <https://documents-dds-ny.un.org/doc/UNDOC/GEN/N15/291/89/PDF/N1529189.pdf?OpenElement>

[550] The Paris Agreement is a legally binding international treaty on climate change that was adopted at the UN Climate Change Conference (COP 21) in Paris, France, on 12 December 2015 by 196 Parties and entered into force on 4 November 2016. The overall purpose of the Agreement is "to strengthen the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty," and it aims to hold "the increase in the global average temperature to well below 2 degrees above pre-industrial levels" and to pursue "efforts to limit the temperature increase to 1.5 degrees above pre-industrial levels." See United Nations [UN], Paris Agreement, Article 2, para 1(a). (2015) <https://unfccc.int/sites/default/files/english_paris_agreement.pdf>.

[551] United Nations Climate Change, The Paris Agreement <https://unfccc.int/process-and-meetings/the-paris-agreement> accessed 14 September 2023.

between the financial industry and other industries in the economy. As discussed earlier, the legitimacy of any regulatory framework is to be found from its relevance to the contemporary problems and the needs and priorities of financial governance policies of today must be linked to the problems that are most important to the citizens of today. Considering the increasing expansion of the financial sector in the global economy over the past decades and the role of financial institutions in shaping the practical features of investment at home and abroad, it has become more important that global financial governance regulations are well aligned with other economic and social policy objectives. Moreover, financial industries are prone to social dilemmas where seeking private and short-term gains of individuals can easily produce long-term costs to society. Market disciplines alone have been inadequate to control the externalities in financial markets related to environmental risks because the costs of taking action to reduce externalities are borne in the short run while the benefits of such action are for future generations.[552] The short-termism in financial markets combined with the delayed policy actions for achieving long-term sustainability in many countries have made it more costly to reduce the sustainability risks.[553] To solve this problem, it is necessary to acknowledge that the operational features of financial industries play a key role in the economy and that the objectives of financial regulation are aligned with the aims of social and economic policy goals for achieving sustainability. As individual action would not produce meaningful changes in effectively managing sustainability risks for the global financial systems, the role of global financial governance institutions is imperative in coordinating the policy actions of states and financial institutions.

[552] Alexander and Lastra, 'International Banking Regulation and Climate Change' (n 546)
[553] Ibid.

Climate-related Risks and Financial Stability

Since the adoption of the Paris Climate Change Treaty and the United Nations 2030 Agenda for Sustainable Development Goals in 2015 the global governance institutions have focused on mitigating environmental risks caused by unsustainable industrial practices. Climate-related natural disasters accelerated by inadequate business practices such as pollution or biodiversity loss and ecosystem degradation pose serious threats to the sustainability of the global economy. Beyond direct regulatory measures for protecting nature or preventing excessive exploitation of natural resources, managing the flow of financing towards improving environmental sustainability and mitigating negative impacts due to climate change has a significant influence on bringing fundamental changes to industrial practices. In this regard, the role of financial institutions in promoting responsible investment and managing the investment value chain has been highlighted.[554] It is no longer permissible or accepted as reasonable that the investment decisions of financial institutions are made irrespective of the impact on the environment and society. Financial institutions are increasingly required to take a thorough examination of the risks associated with the investment so that financing on certain projects or products would not entail negative impacts on the planet. Climate change-related risks are normally grouped into the two categories of physical and transitional risks.[555] Physical risks arise from the changes in weather and climate that impact economies such as warming, flood, and other extreme weather events, and transitional risks arise from the transition to a low-carbon economy such as changes in public sector policies, technological innovation, and the investor and consumer perception on a green economy.[556] Climate risks turn to traditional financial risks in the

[554] The EU's Green Deal aims to reorient the entire investment management value chain.
[555] Basel Committee on Banking Supervision [BCBS], 'Principles for the Effective Management and Supervision of Climate-related Financial Risks' (2022).
[556] Ibid.

categories of “credit risk, market risk, liquidity risk, operational risk, and reputational risk” rather than posing a new type of risk.[557] As climate risks negatively affect the stability of the financial systems, banks, and financial institutions are required to assess the potential impacts of climate-risk drivers on their business models and practices.[558]

Mitigating climate change-related challenges requires international policy coordination for effectively managing macroeconomic and fiscal risks and reducing the potential of spillover effects associated with vulnerabilities to extreme events. In recent years, the IMF has been actively seeking to assist its members by systemically covering climate-related issues through its lending and surveillance programs as climate change induces a high frequency of natural disasters due to extreme weather events and affects fiscal positions and debt trajectories.[559] Depending on the economic and institutional capacities of countries to mitigate climate-related challenges such as extreme weather events or reduced productivity, climate change can trigger major challenges for macroeconomic and financial policy management concerning fiscal management and public debt sustainability, financial stability, monetary policy, and trade and exchange rate regimes.[560]

As climate-related challenges have been increasingly perceived as necessitating

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[557] Basel Committee on Banking Supervision [BCBS], ‘Climate-related Risk Drivers and Their Transmission Channels’ (2021) 10.
[558] Id. For a detailed explanation of climate risk drivers and how these are related to the practices of banks, see Kern Alexander, ‘Stability and Sustainability in Banking Reform: Are Environmental Risks Missing in Basel III?’ (2014) CISL & UNEP FI.
[559] International Monetary Fund [IMF], ‘Climate Change, Digitalization, and Inclusion – Major Structural Transformations are Underway: Policymakers Should Seize the Opportunities’ <https://www.imf.org/external/pubs/ft/ar/2022/in-focus/climate-change/> accessed 4 April 2023.
[560] International Monetary Fund [IMF], ‘IMF Strategy to Help Members Address Climate Change Related Policy Challenges: Priorities, Modes of Delivery, and Budget Implications’ (30 Jun 2021) <https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/07/30/IMF-Strategy-to-Help-Members-Address-Climate-Change-Related-Policy-Challenges-Priorities-463093> accessed 14 September 2023.

macroeconomic and fiscal policy responses at the international level, the Fund recognizes that "many of the ensuing policy challenges fall firmly within the realm of the IMF's expertise and for the Fund to live up to its mandate, it needs to assist its members in addressing these challenges."[561] In July 2021, the Executive Board of the IMF approved a strategy to help member states address macro-critical climate-related policy challenges in the coming years and defined climate change mitigation as a "global public good" that "requires an unprecedented level of cross-country policy cooperation and coordination."[562] Recognizing the nature of climate change mitigation as a global public good is imperative as policy coordination at the international level is essential to prevent governments from taking unilateral policy actions that could be harmful to others.

The involvement of the IMF and other financial governance institutions is also necessary to ensure that low-income or climate-vulnerable countries receive adequate financial and technological support to address adaptation and mitigation policies.[563] The demands for strengthened support of the IMF on climate-related issues, particularly for the surveillance and capacity development (CD) capacities of the Fund, have significantly increased in recent years. Mitigation and adaptation policies for managing the transition to a low-carbon economy are regularly covered during Article IV consultations and the Fund's Financial Sector Assessment Program (FSAP) incorporates climate risk analysis as part of an effort to integrate climate change-related risk into the Fund's work.[564] However, the Fund's response to climate-related

561 Ibid.
562 Ibid.
563 Ibid.
564 IMF, 'Climate Change, Digitalization, and Inclusion' (n 559). Climate issues featured in about 30 country reports, including those for the United Kingdom, the United States, Canada, China, Fiji, Germany, Malawi, Mexico, and Barbados.

environmental challenges has been mostly ad-hoc and unstructured and focused on flagship contributions and conducting policy research.[565] Consistency and predictability in policy response are needed for the climate-change mitigation and adaptation activities of the Fund to be successful and effectively address the different challenges of member countries depending on each country's economic and institutional capacities.

Considering the need to promote policy coordination for climate-related financial risk management and supervision at the international level, the Basel Committee issued principles for the effective management and supervision of climate-related financial risks in June 2022 to address climate-related financial risks to the global banking system by improving banks' risk management and supervisory practices.[566] Following a consultation conducted in 2021 with diverse stakeholders, the report sets out 18 high-level principles on corporate governance, international controls, risk assessment, management, and reporting to provide "a common baseline for internationally active banks and supervisors, while maintaining sufficient flexibility given the degree of heterogeneity and evolving practices in this area."[567] It emphasizes the wide-ranging impacts of climate-related risk on banks and requires that banks should consider the potential impacts of climate-related risks on business models and practices in terms of potential risk transmission channels, the high uncertainty related to climate change, and the time of the risks, and the methodologies and data used to analyze the risks.[568]

As it is crucial to foster cross-border collaboration between jurisdictions, the Basel

[565] Id. 9.
[566] BCBS, 'Principles for the Effective Management' (n 555).
[567] Ibid.
[568] Ibid.

Committee's principle requires that "home and host supervisors of cross-border banking groups should share information related to the climate risk resilience of banks and banking groups, leveraging existing frameworks for sharing information and undertaking collaborative work."[569] While it is clear that multilateral governance institutions such as the IMF and the Basel Committee on Banking Supervision play a key role in addressing climate-related risks and providing guidelines on addressing climate change-related problems, the responses of those institutions are still unstructured and based on ad-hoc recommendations which produce inefficiency in the market by undermining fuller and consistency of climate-related policies.

Responsible Investment and Due Diligence

Global governance institutions need to take a holistic approach considering the interaction between the financial systems and other economic systems such as food production, manufacturing, energy, transportation, and media and communications because "a governance approach that ignores the broader system in which an organization, market, or institution is embedded will lack resilience and fail to ensure prosperity, security, and sustainability."[570] In the course of post-crisis regulatory reform, global financial governance institutions have provided guidelines on responsible business conduct (RBC) in recognition of "the role of business enterprises as specialized organs of society performing specialized functions," which requires business enterprises to address adverse human rights impacts associated with their networks and activities.[571] To provide support to enterprises to identify and mitigate the negative impacts related to their operations and throughout their supply chains, the OECD

[569] Id. 9.
[570] Florini et al., 'Governance for Systemic and Transformational Change' (n 421) 6.
[571] United Nations [UN], 'Guiding Principles on Business and Human Rights – Implementing the United Nations "Protect, Respect and Remedy" Framework' (2011), HR/PUB/11/04 <GuidingPrinciplesBusinessHR_EN.pdf (ohchr.org)> accessed 30 March 2023.

adopted the *OECD Due Diligence Guidance for Responsible Business Conduct* in 2018 which aims to explain how due diligence can be implemented for different types of companies and sectors of the economy.[572] Although due diligence was already recommended in the *OECD Guidelines for Multilateral Enterprises* in 2011 to avoid or mitigate adverse impacts linked to their operations, products, or services by a business relationship,[573] the OECD Due Diligence Guidance adopted in 2018 has a significance from the perspective of stakeholder participation as "it was developed through a multi-stakeholder process including representatives from OECD and non-OECD countries, international organizations, business, trade unions, and civil society."[574] It can also be used to respond to due diligence expectations of the UN Guiding Principles on Business and Human Rights and the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy.[575]

Although these are not novel ideas and financial institutions have already paid attention to analyzing the risks associated with their clients in lending and underwriting activities, the paradigm shift in global financial governance can be observed as the responsibility of business and, in particular, that of investment decisions are assessed not based on the individual institution's financial performance but the impacts on the overall value chain. It is certainly a shift of the legitimate purpose of regulating the financial sector, from the maximization of profits to the allocation of financial resources towards sustainable business activities. Once financial institutions are perceived as enablers of sustainable development and economic

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572 The Organization for Economic Co-operation and Development [OECD], 'Due Diligence Guidance for Responsible Business Conduct' (2018), <https://mneguidelines.oecd.org/Flyer-RBC-Due-Diligence.pdf> accessed 30 March 2023.
573 The Organization for Economic Co-operation and Development [OECD], *Guidelines for Multinational Enterprises* (OECD Publishing 2011) para 10-12.
574 OECD, 'Due Diligence Guidance for Responsible Business Conduct' (n 570).
575 International Labor Organization [ILO], 'Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy' (ILO, sixth ed., 2022) <https://www.ilo.org/empent/Publications/WCMS_094386/lang--en/index.htm>.

progress through their critical function of directing financing towards sustainable business activities, due diligence for RBC can significantly improve the legitimacy of financial governance regulation while its success depends on the availability of effective enforcement mechanisms.

Fundamentally, the importance of managing sustainability risks in the financial sector has been increasingly recognized by multilateral governance institutions and national regulatory authorities considering the critical role the financial institutions play in this global endeavor. However, the steps taken so far are not enough to expect fundamental changes in financial institutions' practices and the international financial architecture including regulatory systems. Mitigating sustainability risks caused by global and regional challenges such as the risk of new pandemic outbreaks, the rise of food and energy prices, and the crises of climate change and biodiversity loss requires multilateral governance institutions to be more proactive in addressing these problems.[576] Managing sustainability risks requires consolidated efforts of regulatory authorities at the national and international levels so that governance standards and rules are adequately applied and enforced. The reliance on the voluntary adoption of guidelines or codes has been insufficient to effectively manage sustainability risks associated with business activities. This concern was presented in the European Commission's Proposal for a Directive on Corporate Sustainability Due Diligence as below:

> Voluntary action does not appear to have resulted in large-scale improvement across sectors and, as a consequence, negative externalities from EU production and consumption are being observed both inside and outside the Union. Certain EU companies have been associated with adverse human rights and environmental impact, including in their value chains.[577]

[576] OECD, 'The Reform of the International Financial Architecture' (n 540).
[577] EC, 'Proposal for a Directive of the European Parliament and of Council on Corporate Sustainability Due Diligence and amending Directive' (n 543) 2.

At the same time, inconsistent or duplicative requirements applicable in different countries cause regulatory fragmentation and undermine legal uncertainty.[578] The European Commission's proposal underlines the importance of a consolidated regulatory approach to create a level playing field for companies operating in the Union including third-country companies.

> Union legislation on corporate due diligence would advance respect for human rights and environmental protection, create a level playing field for companies within the Union, and avoid fragmentation resulting from Member States acting on their own. It would also include third-country companies operating in the Union market, based on a similar turnover criterion.[579]

Preventing and managing sustainability risks requires a global response and the delays in consolidating regulatory measures will increase the usual problems of heavily relying on soft law instruments, deteriorating the legitimacy of the global financial governance system.

Conclusion

This chapter discussed the legitimacy of international financial architecture as a case example of post-crisis global financial regulatory reform. Legitimacy has played a key role in international financial governance because the interplay between states as to economic and political considerations and priorities has largely shaped the structure and objectives of global financial regulation. As the case of the ISDS reform discourse in recent decades represents, the changing power dynamics between developing and developed countries and their different interests and priorities require that systems of global financial governance should solve the chronic problem of the mismatch between participation in the decision-making process and the

[578] Michele Siri and Shanshan Zhu, 'Will the EU Commission Successfully Integrate Sustainability Risks and Factors' (2019) 11(22) Sustainability 6292.
[579] EC, 'Proposal for a Directive of the European Parliament and of Council on Corporate Sustainability Due Diligence and amending Directive' (n 543) 3.

unilateral influence of decisions to non-participating countries. Reviewing the channels of applying the standards of the Basel Committee demonstrates that soft law standards exert significant influence on the global economy and the legally non-binding nature makes no difference in its practical effects. Traditionally, international financial regulation has been characterized as soft law regimes, and participating states were allowed to adopt the standards voluntarily. However, the hardness of soft law in the international financial regulatory landscape in recent decades has already blurred the distinction between hard and soft laws in terms of their influence and binding “effects” in practice. Therefore, legitimacy problems of soft law regimes require a thorough examination and improvement to make the international financial governance systems work for the global economy. As a major soft-law decision-making body that has played a key role in global financial regulatory reforms, this chapter examined the G20’s response to the post-crisis global financial regulatory reform. It concluded that the reform measures taken by the G20 did not result in fundamental changes in international financial regulation as the principles of responsiveness and efficacy of regulatory reform were not adequately established from the beginning. With a huge potential and political power to reform the outdated global financial architecture, the G20’s post-crisis regulatory reforms remained unsatisfactory.

Fundamentally, the conceptual and institutional challenges in international financial architecture examined in this chapter manifested that the post-crisis financial regulatory reforms could not solve the predominant problems in international financial regulation. The heavy reliance on economic theories such as the efficiency capital markets hypothesis (ECMH) and the policy objectives of preventing the systemic failure of large financial institutions, namely too-big-to-fail (TBTF), has been found inadequate to bring a necessary change to the global financial markets. The most salient problems were found in the decision-making procedures in soft law standard-setting bodies. Procedural fairness is the foremost condition for improving the legitimacy of the financial governance system and facilitating cooperation at the international level. The heavy reliance on informal dialogues and networks by state regulators needs to be replaced by improved administrative rules on the decision-making process, emphasizing transparency and consistency. With improved procedural fairness, the substantive rules decided in those soft law institutions should be adopted and applied with the principles of proportionality and equitableness. For the pursuit of sustainable development and the resilience of the global economy, international financial standard-setting bodies should consider the different development levels of financial markets and ensure that the rules imposed would not produce an undue burden on small and internationally less active financial firms. The criticisms against the regulatory costs produced in the course of reforming the Basel capital requirements in the aftermath of the global financial crisis attest to the need to reflect these principles more actively. The legitimacy of international financial architecture requires that governance systems are perceived as fair and reasonable by a wide range of stakeholders. Procedural rules should be carefully designed, incorporating administrative rules, and the substance of regulatory standards should reflect the practical needs of countries with different economic situations. Refocusing the policy goals of international financial architecture on sustainability can improve the resilience of global financial systems as it expands the scope of regulatory cooperation between states to a higher level. A comprehensive understanding of the regulatory ecosystem is essential for the long-term sustainability of the global economy, and the legitimate principles of financial regulation should be taken more seriously as guiding principles.

Chapter 5 Digital Transformation and the Paradigm Shift in Global Financial Regulation

The post-crisis regulatory reform that began in the aftermath of the global financial crisis in 2008 is inevitably related to the phenomenon of digital transformation and its impact on financial markets for two main reasons. First, some of the structural problems in financial markets that regulatory reforms aimed to solve have been addressed by changes that emerged in financial markets caused by digital transformation. The rise of Fintech in the post-crisis financial markets is closely linked to the prolonged problems in financial markets that contributed to the global financial crisis of 2008. Understanding the reshaping of the regulatory ecosystem in post-crisis financial markets is essential to having a full-scope understanding of the legitimacy of the post-crisis regulatory reform and finding a way forward. Second, digital transformation has caused significant changes in financial services and regulatory approaches and tools should adapt in response to the emerging risks and policy priorities. Regulatory coordination between countries has become more important due to the transnational nature of financial services and the risks associated with digitized financial services. Therefore, the legitimate principles of financial regulation should be aptly applied in the new regulatory landscape. Against this backdrop, this chapter first discusses the rise of Fintech which has dismantled the traditional boundaries of financial services by introducing new or hybrid business models and led to meaningful changes in addressing critical issues in global financial regulation such as financial inclusion. Then, the responsiveness and efficacy of financial regulation in the digital era are discussed by focusing on policy issues of cybersecurity and governance reform, respectively. Finally, the role of international governance organizations as policy platforms is discussed. It argues that transparency of the rulemaking process and consistency of rules are key to improving procedural fairness and that the principle of proportionality should be reflected in substantive decisions as to the cost of regulatory changes in global financial markets. Recalling the responsiveness of law and legal reform as one of the legitimate principles of financial regulation, the emerging regulatory concerns, such as regulatory issues related to the central bank digital currency (CBDC) projects, due to digital transformation in financial markets should be actively addressed by financial regulators. The role of global financial governance organizations is crucial as to the global impact of new rules and standards.[580] The fairness of procedure and reasonableness of substantive rules are particularly important in the digital era because these new standards will ultimately play a critical role in setting the new rules of the game, and the strong coordination between all parties involved in the rulemaking process is imperative to ensure the successful implementation of new financial systems.[581]

5.1 Digital Transformation in Financial Markets and the Reshaping of Regulatory Ecosystem

While the trends of digitization are observable in a wide array of industrial and economic sectors and exhibit many commonalities such as the automation of production, the use of data analytics, and the launching of AI-based services, digitization has a particular significance in the financial industry because of its heavy reliance on information and data in designing and selling financial products and services to potential as well as existing customers. Information

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[580] See Bank for International Settlement [BIS], 'Central Bank Digital Currency (CBDC) Information Security and Operational Risks to Central Banks: An Operational Lifecycle Risk Management Framework' (2023) Consultative Group on Risk Management; Hyun Song Shin, 'A Blue Print for the Future Monetary System' (Speech at the BIS Annual General Meeting, Basel, 25 June 2023). <https://www.bis.org/speeches/sp230625b.pdf>

[581] See Bank for International Settlement [BIS], 'The Drivers of Cyber Risk' (2020) BIS Working Papers No. 865.; J Wolff and W Lehr, 'When Cyber Threats Look, What Can State and Local Governments Do?' (2018) 19 Georgetown Journal of International Affairs 67-75.

about listed firms, including their profitability, governance, and other economic performance, is the essential source of investment decisions and the quality of such information is directly connected to the success of financial businesses. Considering that the finance function of any entity, financial firms or non-financial firms, has the task of collecting data on transactions and other relevant events of the firm so that this information can be used for making investment or management decisions, it is easy to comprehend that the surge of advanced means of utilizing data in recent years has brought a new phase of progress to the financial industry.[582] The finance industry has largely depended on the transmission and manipulation of digital information since the late 1980s and it has been one of the prime purchasers of information technology products and services, driving the development of the IT industry globally.[583] Following the quantum leap in data science and technological advancement in digital services including artificial intelligence (AI), blockchain, and cloud computing, the depth and width of information available for financial institutions have expanded at a great scale and the technological improvement in collecting and using data has enabled financial institutions to produce innovative financial products that enabled them to exploit diverse segments of financial markets. The fast-growing digitalization has brought many unexpected changes to the financial markets around the world and reshaped the structural layers of financial services. In short, the recent developments in information technology and data science have impacted the financial industry by lowering the costs of data storage, processing, and transfer, and by enabling the collection of big data and the standardized analysis of it.[584]

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582 PwC, 'The Digital CFO: A Survey Study on the Digitization of the Finance Function' (March 2022) 4
583 Douglas Arner et al., 'The Evolution of Fintech: A New Post-Crisis Paradigm?' (2015) 47 University of Hong Kong Faculty of Law Research Paper, 5.
584 Giorgio B Navaretti et al., 'FinTech and Banking. Friends or Foes?' (2017) European Economy – Banks, Regulation, and the Real Sector <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3099337> accessed 18 June 2023.

5.1.1 Digitalization in the Financial Markets and the Rise of Fintech

One of the most noticeable phenomena in the financial markets regarding the recent trends of digital transformation is the rise of FinTech which has dismantled the traditional boundaries of financial services and connected diverse components of financial and non-financial services in unconventional ways. The term FinTech is a combination of two words Finance and Technology and is normally used when referring to financial services or products that are based on new technological components or new business models that distinguish themselves from the existing financial products and services.[585] The types of FinTech services vary depending on the core functions provided such as mobile payments, digital insurance services, or peer-to-peer (P2P) lending platforms among others, and advanced information and communications technologies (ICTs) are enabling financial services to be delivered via mobile applications and online branches without the need of visiting branches and carrying out paperwork.[586] In retrospect, technological development has long been intertwined with finance for a long time since the first major period of financial globalization in the late 19th century came out of the introduction of the commercial telegraph in 1838 and the installation of the first transatlantic cable in 1866 by the Atlantic Telegraph Company.[587] Notably, the introduction of the Automatic Teller Machine (ATM) in 1967 by Barclays Bank was considered the most innovative financial technology in the 20th century that enhanced the convenience of banking

[585] According to the BIS, "FinTech refers to digital technologies that have the potential to transform the provision of financial services spurring the development of new – or modify existing – business models, applications, processes, and products. In practice, the term "fintech" is also broadly used to denote the ongoing wave of new DFS. Examples of these technologies include web, mobile, cloud services, machine learning, digital ID, and application programming interfaces (APIs)." See Erik Feyen et al., 'Fintech and the Digital Transformation of Financial Services: Implications for Market Structure and Public Policy' (July 2021) BIS Papers No. 117, v.

[586] See also Vincenzo Bavoso, 'Financial Intermediation in the Age of FinTech: P2P Lending and the Reinvention of Banking' (2022) 42(1) Oxford Journal of Legal Studies 48-75.

[587] Arner et al., 'The Evolution of Fintech' (n 583).

services.[588]

Nevertheless, the rise of FinTech in the financial markets since the 2008 global financial crisis has critical implications that go beyond the emergence of another set of new finance-related technologies or products in the history of the financial industry.[589] The following three factors are worth pondering: the demand for more convenience in financial services, the supply of new service providers, and the changing social dimension of finance. First of all, it is critical to note that the emergence and exponential growth of FinTech services in the global financial markets are closely linked to the fall of trust in the integrity of the incumbent financial institutions accelerated by the 2008 global financial crisis. Despite a myriad of reform actions taken in the aftermath of the global financial crisis to solve the structural problems in the global financial markets, the business models of large financial institutions were not fundamentally changed. In many places, the benefits of regulatory reform were not reached by the customers and the result is quite the opposite as the contraction of bank lending activities due to the increased capital requirements and the continued regulatory risks caused by heightened legal uncertainty made the traditional financial services more costly and inconvenient for customers. At the same time, the emergence of Millennials who exhibit the characteristics of digital natives as a new population group in the global economy has affected the growing popularity of FinTech services that are easy to access, less expensive, and convenient to use compared with traditional financial services. The Millennials refer to the age group who were born between 1981 and

[588] The invention of the ATM is famously quoted by the former US Treasury Secretary Paul Volker as “the only thing useful banks have invented in 20 years” in the context of criticizing complex financial engineering that is attributed to the cause of the 2008 global financial crisis. See *New York Post*, ‘The only thing useful banks have invented in 20 years is the ATM’ (13 December 2009) <https://nypost.com/2009/12/13/the-only-thing-useful-banks-have-invented-in-20-years-is-the-atm/> accessed 10 September 2023.

[589] Yang, ‘The UK’s Fintech Industry Support Policies’ (n 399).

1996 and grew up with the invention and progress of the internet and digital environment.[590] From the perspective of socioeconomic experiences, the Millennials also underwent the economic and social turmoil of the 2008 global financial crisis and the following great recession. These social changes and experiences altogether influenced them to be digital-oriented as well as conservative financial consumer groups who would seek alternative financial services other than those provided by established financial institutions.[591] In addition, the willingness of the Millennials to share personal data with FinTech service providers to receive personally customized services with reduced costs also contributed to their preference for FinTech services over traditional financial services.[592] Consequently, the mobile-oriented FinTech services satisfied the appetite of the Millennials by not only lowering the cost of using financial services but also providing a better user experience. Considering that the ease of use and the intuitive product design were considered the most important features that enable successful fintech services to retain customers in the major service categories of payment, banking, insurance, and asset and wealth management, it is easy to comprehend how FinTech services have expanded in the global financial markets in line with the emergence of the Millennials as a new cultural group and consumer base.[593]

Second, recent financial innovation has been led by new entrants to the financial markets and

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590 Michael Dimock., 'Defining Generations: Where Millennials end and Generation Z begins' (2019) Pew Research Center, <https://www.pewresearch.org/short-reads/2019/01/17/where-millennials-end-and-generation-z-begins/> accessed 14 September 2023. The report shows that 92% of Millennials (9 out of 10 persons) have Smartphones and 85% of them use popular social network services such as Instagram (52%) or Snapchat (47%) to communicate with friends and family.

591 PwC, 'Redrawing the lines: fintech's growing influence on financial services' (2017), Global Fintech Report <https://www.pwc.com/gx/en/industries/financial-services/assets/pwc-global-fintech-report-2017.pdf> accessed 14 September 2023.

592 Pooja Singh, 'Millennials are less concerned about data security risk' (2018), Entrepreneur Asia Pacific <https://www.entrepreneur.com/en-au/technology/millennials-choose-convenience-over-data-security/317988> accessed 14 September 202.3

593 PwC, 'Redrawing the lines' (n 591).

the new startup trend has increasingly driven structural change within the financial industry, pushing traditional financial institutions to improve their technological competitiveness.[594] In the past, traditional and established financial institutions such as large banks or investment firms have led technological innovation in the financial markets which are often born out of their need and interest in improving profitability by adding new technology to the existing business models and legacy infrastructure such as internet banking and risk management.[595] In contrast, the rapid growth of FinTech services in recent years has been led by many FinTech startups that seek to disrupt the existing markets with lower costs of services or make a new market from the bottom by identifying unserved or less-served populations by the incumbent financial service providers.

The factors affecting customers' decisions to buy a service or invest in a product have been diversified as fintech services often connect financial services with personalized preferences on non-financial areas such as health care, shopping, or safety. For example, retail companies are providing their payment services linked to online shopping applications and car insurance companies reward customers who drive safely and reach a certain level of fuel efficiency by allowing them to pay less or purchase certain types of insurance products. The distinction between banking and other areas of life has become increasingly blurred and fintech companies aim to find opportunities from unexplored possibilities by using advanced data technologies. While the core function of finance is still important and takes a central component of any fintech services, the time and cost associated with accessing and purchasing financial services have noticeably reduced which in turn gave more purchasing power to consumers as the hurdles

[594] Dirk A Zetzsche et al., 'From Fintech to TechFin: The Regulatory Challenges of Data-Driven Finance' (2017), 6 EBI Working Paper Series, 7.
[595] Ibid.

to financial services such as the minimum amount of investment or fees for opening or maintaining bank accounts has been lowered. These market-makers are adding value to the diversity of financial services by expanding the array of services available for the customers while the increasing number of new entrants to the market would require regulatory authorities to be vigilant to the related risks such as consumer protection or cybersecurity measures.

The above-discussed changes in the financial markets have inevitably affected the profitability of traditional financial services and the perceived role of the financial industry in the wider economy. The increasing availability of internet-only or mobile-oriented financial services at a lower cost and with less time due to the growth of fintech services has reduced the comparative value of maintaining offsite branches for in-person financial services as more customers prefer to use online services if they are given choices. The need to reduce staffing and automate the process of diverse functions of financial services from opening a new bank account to managing financial assets and portfolios has forced established financial institutions to resize, restructure, and relocate their resources by modifying business models and public relations strategies. This trend of restructuring the modality of services and the longstanding business models for banking and other financial activities has been accelerated by the COVID-19 pandemic when the demands for virtual financial services have skyrocketed due to the lockdowns and the need to maintain social distance. As the timing and accuracy of delivering assistance were critical during the time of crisis, digital financial platforms were found useful in delivering funds to those in need rapidly and accurately while traditional banks were criticized for their relative slowness in responding to ease the financial difficulties caused by the pandemic.[596] Fundamentally, it reflects the changing roles of the financial industry in a wider economy and society following the changing consumers' expectations of the function of financial services and their providers. While the concept of profitability has long been considered an independent and absolute value in the business of financial services, the social and environmental impact of financial services has been highly emphasized in line with long-term sustainability. The digitization of financial services has been perceived as a means of promoting financial inclusion and social cohesion as it would offer alternative and direct means to distribute capital and mitigate the widening of income inequality. Likewise, the expected role of financial regulation is also affected as emerging technology and novel business models require regulators to adapt their approaches and capabilities to the changing financial environment.

Consequently, financial regulatory reform measures proposed and adopted in the aftermath of the 2008 global financial crisis have been useful but not necessarily transformative enough to bring a fundamental change to the financial markets and solve the root causes of the recurring financial crises. Instead of the intervention of regulatory authorities, the emergence of FinTech services has brought the needed changes that realign the structures of financial markets and put enormous pressure on legacy financial institutions to reassess the competitiveness of their existing business models and consider the reasonable assumptions of customers who are now given more options to choose the most optimal products and services for their situation and preferences. In this regard, it is important to consider the rapid expansion of FinTech services from the perspectives of startups as new entrants to the financial market, consumers who switch

[596] Douglass W Arner et al., 'Digital Finance & The COVID-19 Crisis' (2020) 17 University of Hong Kong Faculty of Law Research Paper <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=35588899> accessed 17 June 2023.

to the new FinTech services, and regulators whose competency and roles should be adapted following the changing financial markets environment. From a regulatory perspective, it is imperative to understand the dynamics of the post-crisis financial markets including the disruptive changes accompanied by the rise of FinTech services.

5.1.2 The Regulatory Implications of Digital Transformation and Regulatory Ecosystem

The widespread distrust in the traditional financial systems in the aftermath of the 2008 global financial crisis as epitomized by the Occupy Wall Street movements in the major financial centers around the globe was fundamentally a claim for restoring the legitimacy of financial regulation that required regulators to consider the interests of diverse stakeholders from a holistic approach rather than narrowly focusing on the stability of the financial markets. The risk of regulatory failures was more costly than the failure of individual financial institutions and the lack of trust and confidence in the global financial systems led to the Great Recession. Although the digital transformation in financial markets would provide many opportunities to revitalize the economy, it is essential to recognize the fundamental problems of trust building in the financial markets, and the responses of regulators to the changing financial market landscape should be based on the legitimate principles of financial regulation.[597] As trust and confidence in the financial systems are the keys to the effective functioning of the financial markets and are underpinned by legal instruments, it is imperative to understand the particular risks and opportunities the digital transformation of finance entails and ensure that the legal frameworks and regulatory approaches are suitable to address the challenges posed by the

[597] According to a global online survey of 28 countries with 33,000 respondents, the financial services sector was ranked the second most distrusted sector only after social media whereas the technology and manufacturing sectors were ranked the most trusted. See Edelman Trust Barometer 2021, <https://www.edelman.com/sites/g/files/aatuss191/files/2021-03/2021%20Edelman%20Trust%20Barometer.pdf> accessed 17 June 2023.

unique features of the emerging financial technologies.[598]

Digital Transformation and Regulatory Ecosystem

Digital transformation, in general, has posed many serious threats to the realm of financial regulation as well as new opportunities. Fundamentally, the speed and amount of transferring data has seen an unprecedented increase and it accompanies new and growing risks of cyber threats that can seriously damage the systemwide safety in the financial markets. In particular, the evolving digitization of the financial services industry has made the industry more vulnerable to cyber-attacks as there is an increasing risk of theft, fraud, and other cybercriminal activities.[599] Thus, ensuring that financial institutions maintain adequate methods of protecting customer data and operate effective cyber safeguards is more than essential. Building trust and confidence in the regulatory systems of the emerging digitized financial markets is particularly crucial as the functioning of diversified or decentralized financial infrastructures and centers should be adequately monitored and regulated while not stifling innovation by too rigid regulatory requirements. While the technical concept of financial decentralization means that the need to trust the central authority and third parties in transactions is eliminated, the need for adequate monitoring and regulation of those newly developed financial instruments is greater than at any time before. For example, decentralized finance (DeFi) attempts to replace the traditional concept of financial centers where information and capital are concentrated with

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598 Dirk A. Zetzche et al., ‘Decentralized Finance’ (2020) 6 Journal of Financial Regulation 172, 176. See also Philipp Paech, ‘The Governance of Blockchain Financial Networks’ (2017) 80(6) Modern Law Review 1073-1110; Andreas Kokkinis and Christian Twigg-Flesner, ‘The Potential Impact of Digitalisation upon the Regulation of Financial Markets and Products’, in Daniel Cash and Robert Goddard (eds.), *Regulation and the Global Financial Crisis: Impact, Regulatory Responses, and Beyond* (Routledge 2020).

599 Douglas W. Arner, Janos Nathan Barberis and Ross P. Buckley, ‘FinTech, RegTech and the Reconceptualization of Financial Regulation’ (2016) Northwestern Journal of International Law (Forthcoming); 35 University of Hong Kong Faculty of Law Research Paper, <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2847806> accessed 17 June 2023.

new forms of technological reliance on decentralized systems where parts of the financial services value chain are decentralized.[600] While DeFi is expected to remove the inherent risks in the concentrated systems of traditional financial markets and the risk of data manipulation by third parties, regulation "needs to focus on the reconcentrated portion of the value chain to ensure effective oversight and risk control" and regulation is "necessary in order to support decentralization, in much the same way that regulation is at the core of securities markets and other financial services."[601] In addition, the risk of regulatory arbitrage should be considered as the different levels of regulatory requirements would allow investors to take advantage of the regulatory differences.

From a regulatory perspective, the rapid digital transformation in financial markets put the regulatory authorities and the governing frameworks to a new trial in terms of the capacity to address the emerging risks in reflection of the evolving dynamics in the interests of diverse stakeholders. Regulatory implications of digitization in financial markets to society should be carefully examined because new opportunities and risks arising from financial innovation affect not only a few but a large number of market players at different stages, including new entrants with specialized services, traditional banks, and financial intermediaries, and technology firms, not to mention diversified groups of consumers as the end-users of financial services.[602] As the structure of financial services and value chains has been diversified due to the emergence of new financial service providers following the rise of FinTech companies and

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[600] See Dirk A. Zetzche et al. (n 598) 174.
[601] Ibid. See also Philipp Paech, 'Securities, Intermediation and the Blockchain – an Inevitable Choice between Liquidity and Legal Certainty?' (2015) 20 LSE Law, Society and Economy Working Papers (2016) 21(4) Uniform Law Review.
[602] Feyen et al., 'Fintech and the Digital Transformation of Financial Services' (n 583). See also Expert Group on Regulatory Obstacles to Financial Innovation (ROFIEG), '30 Recommendations on Regulation, Innovation and Finance, Directorate-General for Financial Stability' (2019) Financial Services and Capital Markets Union, European Commission.

other technological enablers in the financial markets, the composition of stakeholders of financial regulation is also diversified than ever before and the concept of the regulatory ecosystem should be well comprehended to attain the legitimacy of financial regulation in the digital era. The concept of ecosystem was first introduced in 1930 by a British ecologist, Arthur Tansley, to describe the competitive and cooperative interaction between organisms in nature, and later it was adopted in the business analysis as a way of emphasizing the similarity between natural organisms and IT businesses. In 1993, James Moore explored the concept of the business ecosystem in his article published in the Harvard Business Review titled 'Predators and Prey: A New Ecology of Competition' where he argued that the networks of participants are both in competition and cooperation to survive and prosper in the ever-changing market environment.[603]

It is also applicable to the emerging data-based financial services sector because the diversification of service lines as well as the types of services targeting different customer groups, based on age, income, gender, or geographic areas, mean that the interconnectedness between players in the financial market has become more important to build a sustainable financial system. While some Fintech services directly engage with customers and challenge the incumbents by offering similar financial services at a lower cost or providing a new user experience based on mobile technologies, others rely on incumbents for their operations such as storing value or processing payments.[604] In practice, the relationship between fintechs and incumbent financial institutions is both competitive and collaborative and it implies that financial regulation in the digital era should reflect on this interactive relationship between

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[603] James Moore, 'Predators and Prey: A New Ecology of Competition' (May-June 1993) Harvard Business Review. Retrieved from <Predators and Prey: A New Ecology of Competition (hbr.org)>.
[604] Feyen et al., 'Fintech and the digital transformation of financial services' (n 585).

diverse players and the composition of the financial value chain, rather than stereotyping the characteristics of different financial entities and their business models. Moreover, the growing presence of big tech companies in the digital financial services sector demonstrates that "the ability to embed a tailored payment, loan, insurance or other financial services into any economic, business, or social activity may be the most powerful disruptor of traditional financial services" regardless of the original focus of business activities.[605] The increasing complexity of power dynamics in the financial markets requires regulatory authorities to pay close attention to emerging risks and opportunities and ensure that the rules and regulations provided are responsive to the growing problems rather than based on outdated perceptions of financial markets. In this sense, the rise of big tech in the financial services sector is an opportunity to enlarge the potential benefits of digitalization in finance and a cause of concern as they have the power to monopolize and monetize a wide array of customer databases already stored and managed in their ecosystems.[606]

Fundamentally, the regulatory approach should be based on the legitimate principles of financial regulation to ensure that the fast-evolving technological development in the financial markets would not hamper the sustainability of the financial business in the long term. In other words, regulatory structures and instruments should be designed to facilitate sustainable economic and social practices in the digital financial markets rather than to accelerate the power imbalance and income inequality that led up to the past global financial crises.

[605] Ibid.
[606] Id. 28.

Financial Inclusion and Fair Competition

At any juncture of historic progress in science and technology, one of the most challenging regulatory objectives is to harness technological progress to ensure that its benefits are translated to the overall economic progress in society rather than allowing a few individuals or companies to exploit the benefits for their interests and accumulation of power and wealth. In this regard, the legitimacy of financial regulation in the digitized financial markets cannot be alienated from the most critical problems produced by the emerging characteristics of digital financial services. For this reason, two intertwined policy objectives should be carefully considered and addressed to take full advantage of digital transformation in the global financial markets - promoting financial inclusion and preventing the reconcentration of market power. First, before the outbreak of the 2008 global financial crisis and the subsequent phenomenon of digital transformation, financial inclusion had been mostly discussed in the context of development policies where the focus was on the relationship between financial development and economic growth in developing countries as well as the importance of financial systems development for income growth and poverty alleviation for the poorest population.[607] As to the growing importance of consumer protection issues, the realization that the assumption of a broad preexisting consumer base was not applicable in developing countries where the consumer base in these countries would only represent the top of the socioeconomic pyramid of the country, excluding the majority of the population who have no access to financial services, added the need of making the financial base broader and more inclusionary in developing countries.[608] Nevertheless, the potential of reshaping the financial services sector

[607] Thorsten Beck et al., 'Finance, Inequality and the Poor' (2007) 12(1) Journal of Economic Growth 27; Beck et al., 'Reaching Out: Access to and Use of Banking Services across Countries' 85(1) Journal of Financial Economics 234-266.
[608] Joseph J. Norton, 'Banking Law Reform and Users-Consumers in Developing Economies: Creating an Accessible and Equitable Consumer Base from the "Excluded"' (2007) 42 Tex. Int'l L. J. 789, 790.

to be more inclusive and accessible to the majority of the population has not been well discussed, and "the equitable and accessible provision of banking services has never been a core component of modern banking sector legal reform assessment in the developing world."[609] The emergence of new fintech services which demonstrated the potential of significantly improving access to financial services for those previously excluded from banking and financial services in developing countries such as Kenya and China has brought the issue of financial inclusion to the forefront of the policy agenda as digitalized financial services have enabled cost savings and efficiency gains, and improved transparency of budgets and spending programs.[610]

In addition to the market-driven and privately provided fintech services, digitalizing public finance has a huge potential to improve the transparency and efficiency of government spending as digital transactions complicate fraud, eliminate leakage in expenditure, and make it difficult to hide bribery or corruption.[611] For example, an analysis of the gap between expenditures and receipts of government payments in seven developing countries including South Africa, Brazil, China, Mexico, India, Indonesia, and Nigeria, demonstrated that digitizing government payments in developing countries could save roughly 08-1.1 percent of GDP on average, equivalent to $220-320 billion annually.[612] Although the emergence of fintech and other digital financial services is not particularly engineered to achieve the policy objectives of inclusive growth, the use of fintech services has been effective in facilitating

[609] Ibid.
[610] The United Nations Secretary-General's Task Force on Digital Financing of the Sustainable Development Goals, 'People's Money: Harnessing Digitalization to Finance a Sustainable Future' (2020) 23.
[611] Susan Lund et al., 'The Value of Digitalizing Government Payments in Developing Economics' in Gupta et al. (ed.), Digital Revolutions in Public Finance (IMF 2017) 305.
[612] Ibid.

financial inclusion in many developing countries by improving the efficiency of financial transactions and lowering the barriers to quality financial services for the underserved financial consumers.

At the global level, digital finance as a tool for promoting financial inclusion is well recognized in the United Nations' efforts to achieve sustainable development. In 2015, the UN General Assembly adopted the 2030 Agenda for Sustainable Development ('2030 Agenda') which sets out 17 goals that should be achieved by 2030 to end poverty on earth.[613] Digital financial inclusion was recognized as an enabler of SDG progress and relevant to the achievement of SDGs including no poverty (Goal 1), good health and wellbeing (Goal 3), quality education (Goal 4), reduced inequality (Goal 10), and climate action (Goal 13).[614] For example, the goal of no poverty is achievable through digital financial services which help families save money and allow government transfers, wages, or pensions to reach those who need them most.[615] Considering that it was impossible for individuals and families without a bank account, the so-called "unbanked" population, to accumulate savings or build a financial history to access quality financial services, digital financial services such as digital payments or money transfer services have been effective in empowering those previously underserved financial consumers via mobile phones or the internet.[616] To expand the reach of digital finance for every SDGs, the UN Secretary-General established the Task Force on Digital Financing of the Sustainable Developing Goals (SDGs) in 2020 as part of the UN's broader roadmap for Financing the 2030 Agenda for Sustainable Development: 2019-2021 and mandated the Task Force to recommend

613 UN, 'Transforming our world' (n 549).
614 UNSGSA et al., 'Igniting SDG Progress Through Digital Financial Inclusion' (2018).
615 Ibid.
616 Manyika James et al., 'Digital Finance for All: Powering Inclusive Growth in Emerging Economies' (2016) McKinsey Global Institute.

and catalyze ways to harness digitalization in accelerating financing of the SDGs.[617] The benefits of digital finance on achieving economic, environmental, and social SDGs were examined as digital finance tools already enable financing SDGs in many different ways.[618] Fundamentally, governments and private sectors should build a cooperative relationship to promote financial inclusion and expand the benefits of digital finance for ultimately achieving sustainable development at the global level. Providing the necessary conditions for developing digital finance services including "widespread mobile and digital infrastructure, a dynamic business environment for financial services, and digital finance products that meet the needs of individuals and small businesses" should be prioritized as policy objectives.[619]

As discussed earlier, it is imperative to reflect on the influence of data-driven big tech companies on the reshaping of the financial markets as the increasing dominance of big tech companies in the global economy and their influence on financial governance models at the national and global level has increasingly restructured the power dynamics by creating power asymmetries using their capacity to control access to digital platforms.[620] From a regulatory perspective, the problem of reconcentration of market power arises as the dominance of market share by traditional financial institutions shifts to big tech companies which entered into financial services markets in recent years following the trend of digital transformation in the

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[617] The United Nations Secretary-General's Task Force on Digital Financing of the Sustainable Development Goals, 'People's Money: Harnessing Digitalization to Finance a Sustainable Future' (2020).
[618] Id. 33.
[619] James et al., 'Digital Finance for All' (n 616).
[620] Katharina Pistor, 'Rule by Data: The End of Markets?' (2020) 103 Law & Contemp. Probs. 101, 103. In 2021, the combined revenue of the five big tech companies, Google, Apple, Amazone, Meta, and Microsoft, was more than $1.4 trillion, which is more than the entire GDP of Mexico. See Carmen Ang, How Do Big Tech Giants Make Their Billions? Visual Capitalist (2022), <https://www.visualcapitalist.com/how-big-tech-makes-their-billions-2022/> accessed July 29, 2024.

financial services sector. While such issues as providing opportunities to market access to new entrants such as fintech startups by adopting more open regulatory approaches to innovation such as regulatory sandboxes or innovation hubs developed in many advanced financial markets starting from the U.K. and spread to all over the world have been discussed, the focus in recent years has been shifted to broader and paramount challenges to the governance of financial markets where the boundaries of financial service areas are increasingly blurred due to the emergence of big tech companies. In this regard, it is noteworthy that sectoral or industrial boundaries dissolved under the progress of technology and that “the idea of “an industry” as a set of similar firms, or “a market” as a set of readily identifiable substitutable goods, became so approximate that they no longer captured the key aspects of economic behavior.”[621] The rise of big tech companies and their ability to accumulate vast amounts of data as well as control access to the data by others entails serious policy concerns, in particular for competition in the economy, as they use their capacity for surveillance and power to serve two markets – one for direct consumers and the other for sellers who want to acquire information and access the customer database.[622]

Consequently, the policy concerns transcend the traditional boundaries of financial regulation and the concentration of market power based on data possession has become a critical concern as the business models of big tech companies in the financial services sector involve a massive processing of consumer data for monetization including the reselling of it to other service providers. Fundamentally, authorities of financial regulation, competition, and industrial

[621] Michael G. Jacobides and Ioannis Lianos, ‘Regulating Platforms and Ecosystems: An Introduction’ (2021) 30 Industrial and Corporate Change 1131-1142, 1132.
[622] Pistor, ‘Rule by Data: The End of Markets?’ (n 620); See also Beatriz Kira et al., ‘Regulating Digital Ecosystems: Bridging the Gap between Competition Policy and Data Protection’ 30 Industrial and Corporate Change 1337-1360.

regulatory bodies must coordinate the policy objectives and priorities of financial regulation by well-calibrating the "trade-offs between stability and integrity, competition and efficiency, and consumer protection and privacy" that arise from new technologies and market structures.[623] Most importantly, the transformation of market structures following the dominance of digital platforms requires policymakers to address the risks posed by the emerging changes that cannot be resolved by applying the conventional legal frameworks of financial regulation, competition law, and data protection in a fragmented way.[624] The characteristics of the digital ecosystem created and managed by big tech companies should be well-calibrated and reflected in the regulation of financial services provided by digital platforms.

5.2 Legitimate Principles of Global Financial Regulation in the Digital Era

Understanding the structural changes in the financial markets and the dynamics between stakeholders caused by the industry-wide digital transformation in recent years is crucial for making the global financial regulatory system legitimate in the digital era. As new entrants replace some of the key roles of the incumbents in financial markets and the business models of incumbents also change as they adapt to the new market practices and consumer demands, the objectives of global financial regulation should be revisited to ensure that the most critical problems of the global economy are adequately addressed for the benefit of the global community as a whole. An overarching goal of improving the sustainability of global financial

[623] Feyen et al, 'Fintech and the Digital Transformation of Financial Services' (n 585) i.
[624] While the big tech platforms orchestrate multi-actor ecosystems that allow them to leverage their complementors and provide network externalities, the existing regulatory apparatus is ill-equipped to identify and tackle emerging issues. Michael G. Jacobides and Ioannis Lianos, 'Ecosystems and Competition Law in Theory and Practice' (2021) 1 Center for Law, Economics and Society Research Paper Series, University College London. <cles-1-2021.pdf (ucl.ac.uk)> accessed July 12, 2023.; Andrei Hagiu and Julian Wright, 'Controlling vs. Enabling' (2019) 65(2) Management Science 577-795.

systems and the policy implications of pursuing sustainability in the financial market should be adequately contemplated before going through detailed policy objectives. Most importantly, it is imperative to acknowledge that the objectives of financial regulation such as financial stability cannot be alienated from other policy objectives because diverse players in the financial market, either buyers, sellers, or both, always interact with and respond to one another by responding to the changing financial, economic, and social environment at any given time. Considering that the sources of financial crisis can come from diverse issues outside of the internal financial markets such as unusual climate events, the political turmoil of neighboring countries, or excessive government spending, the objective of improving the sustainability of the global financial system requires a holistic and interdisciplinary understanding of the scope and role of financial regulation and governance beyond the static and theoretical focus on selective figures.

5.2.1 Revisiting the Objectives of Global Financial Regulation

Fundamentally, the core principles of legitimacy should be well considered and applied in the process of identifying and designing policy objectives that require focused attention of global governance institutions and financial regulators including international standard-setting bodies because the procedural and substantive aspects of global financial regulation have a huge impact on the sustainability of financial systems in the digital era. The principles of the responsiveness and efficacy of financial regulatory reform should be considered in formulating policy objectives of global financial regulation. First, the principle of responsiveness points to the fact that global problems need global responses. It was evident during the COVID-19 pandemic that the individual responses of countries were not effective enough to solve the problem when the depth and scope of the pandemic required a consolidated effort at the global level. Any problem that is seriously damaging the financial and social stability of one part of the globe can easily affect the well-being of citizens on the other part of it as the transmission channels of risks and externalities have become so diverse and multifaceted due to the ever-increasing interconnectedness.

Responsiveness of financial regulation and cyber security

Ultimately, the objectives of sustainable finance transcend the traditional boundaries of financial regulation, and it requires regulators to make a more consolidated effort in dealing with emerging problems that threaten the stability and prosperity of the global financial markets. In this regard, the objective of global financial regulation in the digital era should be focused on addressing the emerging problems and risks that can only be adequately solved by the global community as a whole.[625] The term global public good can be useful in identifying the policy areas and objectives that global financial governance institutions and financial regulators should focus on despite its abstractness as a guiding concept. One definition of a global public good is that the benefits affect all citizens of the world without rivalry[626] and the provision of which requires collective actions.[627] In this sense, global public goods also include "peace and political stability, protection and improvement of the natural environment, preservation of food security, eradication of hunger and poverty, and so on."[628] Thus, priorities should be established in each institution according to the legitimate policy objectives according to the mandate while the common goals are shared and facilitated for mutually beneficial outcomes.

[625] Pierre-Richard Agenor and Luiz A Pereira da Silva, 'Global Public Goods, Fiscal Policy Coordination, and Welfare in the World Economy' (July 2023) BIS Working Papers No 1106, Bank for International Settlement.
[626] Moya Chin, 'What Are Global Public Goods? Global Institutions Must Coordinate to Preserve the Goods That Benefit Us All" (December 2021) Financial & Development, International Monetary Fund. https://www.imf.org/en/Publications/fandd/issues/2021/12/Global-Public-Goods-Chin-basics
[627] Agenor and Pereira da Silva, 'Global Public Goods' (n 625).
[628] Id. 3.

For financial regulation, it is necessary to recognize the most critical risks arising from the digitalizing financial markets that require a consolidated global policy response.

The most pressing issues of global financial governance have changed in the past decade as technological innovation allowed many new financial services and products to be introduced to the financial markets and transformed the functioning of financial institutions. One of the examples is the increasing risk of cyberattacks in the financial sector as cyber threats to financial systems are growing amid the industry-wide digital transformation.[629] As cyber risks are borderless and affect multiple targets simultaneously, international cooperation is essential to protect the integrity and confidence of the global financial system from increasing cyber risks and incidents.[630] Cyber risk is a term that encompasses “a wide range of risks resulting from the failure or breach of IT systems” and refers to “the combination of the probability of cyber incidents occurring and their impact.”[631] As the Covid-19 pandemic accelerated the demand for online financial services including digital payments, governments and financial institutions around the world have gone through an unprecedented digital transformation.[632] At the same time, the move to working from home during the pandemic allowed new attempts to penetrate IT networks along with other types of financial crime as it was challenging to respond to an operational or cyber incident.[633] The rapid transition to digital financial systems has met with increased attempts of cybercrimes and the financial sector has experienced the

629 Inaki Aldasoro et al., ‘The Drivers of Cyber Risk’ (2020) BIS Working Papers No. 865.
630 Benoit Coeure, ‘Cyber Resilience as a Global Public Good’ (10 May 2019) Speech at the G7 Conference: Cybersecurity: Coordinating Efforts to Protect the Financial Sector in the Global Economy, Paris, <Cyber resilience as a global public good (europa.eu)> accessed 20 October 2023.
631 Inaki Aldasoro et al., ‘Covid-19 and cyber risk in the financial sector’ (14 January 2021) Bulletin No. 37. 5, Bank for International Settlements.
632 Tim Maurer and Arthur Nelson, ‘The Global Cyber Threat’ (March 2021) Finance & Development, IMF, <https://www.imf.org/external/pubs/ft/fandd/2021/03/global-cyber-threat-to-financial-systems-maurer.htm> accessed 20 October 2023.
633 Aldasoro et al., ‘Covid-19 and cyber risk in the financial sector’ (n 631).

second-largest share of Covid-19-related cyber-attacks outside the health sector during the pandemic.[634] Considering the heavy reliance on the quality of data and confidence in financial systems, cyberattacks that intend to disrupt the integrity of financial data such as records, algorithms, and transactions are most problematic. However, there are limited solutions available for such attacks while the risk of seriously threatening the stability and safety of financial systems is high.[635] A systemic and coordinated policy response to the growing magnitude and frequency of cyberattacks at the global level is necessary because the goals of such attacks include not only getting financial gains but also disrupting financial systems with diverse geopolitical and ideological motivations involving states and state-sponsored attackers.[636] It is hard to address effectively the challenges stemming from evolving cyber risks which are particularly significant in the digital era at a country level because networks are highly interconnected where the amplification of an initial shock can occur through operational or financial contagion.[637] In recent years, the European Union has recognized systemic cyber incidents as a source of systemic risks that requires a macroprudential oversight framework for the prevention and mitigation policies and has taken a step to make a pan-European coordination system to deal with the increasing risks and vulnerabilities in European financial markets posed by systemic cyber risks.[638] In fulfilling its mandate of providing the macroprudential oversight of the financial system in the Union, in 2022 the European Systemic Risk Board (ESRB) recommended establishing a pan-European systemic cyber incident

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[634] Maurer and Nelson, ‘The Global Cyber Threat’ (n 632).
[635] Ibid.
[636] Ibid.
[637] European Systemic Risk Board [ESRB], ‘Recommendation of the European Systemic Risk Board of 2 December 2021 on a pan-European systemic cyber incident coordination framework for relevant authorities’ (ESRB/2021/17) (2022/C 134/01).
[638] European Systemic Risk Board [ESRB], ‘Press Release: ESRB Recommends Establishing a Systemic Cyber Incident Coordination Framework’ (27 January 2022), <https://www.esrb.europa.eu/news/pr/date/2022/html/esrb.pr.220127~f1548f677e.en.html>.

coordination framework for relevant authorities (EU-SCICF) in recognition of the fact that major cyber incidents pose a systemic risk by corrupting information and destroying confidence in the financial system.[639] A systemic cyber crisis is defined as "a major cyber incident that causes a level of disruption in the Union financial system potentially entailing serious negative consequences for the smooth operation of the internal market and functioning of the real economy. Such a crisis could result from a major cyber incident causing shocks in several channels, including operational, confidence, and financial."[640] The recommendation points to the need to prepare for the gradual development of a coordinated response in the event of a cross-border major cyber incident and requires the European Supervisory Authorities (ESAs) to jointly work with the European Central Bank (ECB) and the European Systemic Risk Board (ESRB) in mapping and analyzing the current impediments, legal and other operational barriers for the effective development of the EU-SCICF.[641]

Building global financial infrastructures for strengthening cybersecurity is closely linked to the policy objective of financial inclusion. As financial systems have been rapidly digitalized during the past years, the incidents of cyberattacks on softer targets have increased in low- and middle-income countries where the reliance on digital payments is growing in line with the policy objective of improving financial inclusion in those countries.[642] Without providing safeguard frameworks against cyber threats, the pursuit of financial inclusion cannot reach the desired outcome but leave those developing and less developed economies vulnerable to the growing cyber-attacks.

[639] Ibid.
[640] ESRB, 'Recommendation of the European Systemic Risk Board' (n 637) Section 2.1(c).
[641] Id. Section 1, Recommendation A.
[642] Maurer and Nelson, 'The Global Cyber Threat' (n 632).

Efficacy of financial regulation and governance reform

The principle of efficacy sheds light on the importance of pursuing long-term sustainability over short-term gains and requires that policy objectives are adequately established to address the targeted problems. As the principle of efficacy requires the appropriateness of policy objectives and the effectiveness of achieving the expected outcomes, it is imperative to understand what could be achieved practically in the international financial regulation in consideration of the given global political and economic settings such as the absence of centralized regulatory bodies or formal enforcement mechanisms. For the direction of policy objectives, it is appropriate to target addressing the structural problems of the financial sector so that pursuing more sustainable financial practices becomes profitable and sustainable for the financial institutions both in the short and long term. In other words, it is important to tie the prospect of the financial sector to the sustainability of the global economy, and potential policy intervention should take place in areas where rules and regulations promote behavioral changes in the financial sector rather than impose uniform standards that are hard to comply with.

While targeting narrow goals such as capital requirements might be easier to calibrate and monitor, such micro-prudential regulations are less effective in realizing fundamental changes in the financial sector and the efficacy of regulatory reform is more likely to be achieved by focusing on broader policy objectives such as the governance system and the incentives for bank management. In this regard, improving the accountability of individuals in management roles such as senior managers or board members of financial institutions would enable the entire organization to take decisive steps towards more prudent investment decisions and risk management as those individuals who are subject to stringent regulatory scrutiny are in the position of setting the organizational and cultural structure. In this sense, the inclusion of risk and compliance throughout the organization through a code of ethics or best practices is essential. Particularly, when the target is large and complex financial institutions it is more important to clearly allocate roles and responsibilities for risk management tasks.[643] Remuneration schemes provide incentives and "appropriate incentives play a key role in aligning risk-taking behavior with the institution's risk profile and its long-term interest."[644] The factors reflected in the remuneration schemes have significant impacts on the investment and management decisions for both individuals and the entire organization. Remuneration schemes are often based on key performance indicators (KPIs) and important qualitative indicators such as risk management and cultural or behavioral aspects should be reflected rather than excessively relying on financial performance indicators.[645]

Fundamentally, international financial regulation relies largely on a cooperative relationship between diverse stakeholders including governments, international financial organizations, non-governmental networks of financial institutions and interest groups, civil societies representing consumer interests, academic communities, and others.[646] Therefore, the overarching objective of promoting sustainable finance cannot be achieved without promoting voluntary compliance with the proposed rules and standards. As it is impractical to monitor the wide array of financial conducts and impossible to punish misconducts of financial institutions

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[643] European Central Bank [ECB], 'Strong risk culture – sound banks' (15 Feb. 2023) Supervision Newsletter, <https://www.bankingsupervision.europa.eu/press/publications/newsletter/2023/html/ssm.nl230215_3.en.html#:~:text=Risk%20culture%20is%20a%20set,on%20the%20risks%20they%20take> accessed 30 October 2023.
[644] European Banking Authority [EBA], Final Report on Guidelines on Internal Governance under Directive 2013/36/EU, EBA/GL/2021/05, 36.
[645] Ibid.
[646] See Pierre Mazzega, Claire Lajaunie, and Romain Boulet, 'Public Policies, Complexities, and Networks' in Romain Boulet, Claire Lajaunie, and Pierre Mazzega (eds.), *Law, Public Policies and Complex Systems: Networks in Action* (Springer 2019).

beyond jurisdictional boundaries, global regulatory objectives should target promoting fair competition in the global economy by lowering the barriers to accessing financial markets so that financial institutions, either small and new entrants or large and established companies, strive to survive by improving the quality and integrity of their products and services.

The fast-growing digital financial services in the post-pandemic world have provided many opportunities to promote sustainable finance and encourage financial institutions to refrain from businesses that produce negative externalities to society. Most of all, corporate governance concerns play a critical part in determining the level and direction of sustainable financial conduct as the actual investment or lending activities are driven by the structural and cultural features of corporate governance systems in financial institutions. Without addressing prolonged problems in the areas of corporate governance regulation, it is hard to expect any meaningful changes in the financial sector that are necessary to achieve the goal of sustainable finance. Considering that corporate governance concerns are often more problematic in large and complex financial institutions rather than in small and local banks, the international regulatory community including international organizations and networks of financial institutions must make coordinated efforts to address corporate governance-related problems as any externalities produced misbehaviors or inadequate regulatory approach could harm the stability and prosperity of the global economy as manifested by the global financial crisis of 2008.

5.2.2 Reshaping the Global Policy Platforms

As discussed earlier, it is impossible to draw a clear line between domestic and international financial regulation considering the continuing trends of financial globalization and the significant impact of international financial regulatory standards. Digitalization has accelerated the convergence of financial markets around the world and made it even easier to invest in assets that are sold or managed by foreign financial entities. The meaning of regulatory autonomy, as discussed in detail earlier, has become blurred as the ownership and transaction of digital assets surpass the traditional territorial and institutional boundaries. As to the challenges and limitations of governments due to the digital transformation of society, the following three conditions are worth mentioning: first, the rise of inflammatory media exacerbates political polarization; second, the tendency of monopoly and concentration in the information for capitalist democracies; and third, the difficulties for governments to collect the resources needed to manage large-scale collective action.[647] At the global level, these conditions lead to the mismatch between the geographical authority of national governments and the global scope of problems and challenges.[648] Consequently, global cooperation is essential as the regulatory boundaries are becoming blurred and overlapping.

International Financial Governance Organizations as Policy Platforms

Considering the massive changes in the financial markets in recent years caused by rapid digital transformation in the financial sector, the regulatory approach of the global financial governance institutions should reflect the structural changes in the financial sector and the role of governance organizations or standard-setting bodies should be reshaped to provide the

[647] Florini et al., ‘Governance for Systemic and Transformational Change’ (n 421) 8.
[648] Ibid.

necessary assistance and support for the stakeholders. In this regard, the growing importance of improving the sustainability of the global economy and the key role financial institutions play in promoting sustainable investments and economic activities around the world have emphasized that global financial governance institutions, both governmental organizations and nongovernmental networks, should play a role of coordination between diverse stakeholders because the objective of sustainable finance cannot be achieved without a consolidated effort of the global community as a whole. For instance, the policy objective of promoting sustainable finance for environmental risks requires regulators in different jurisdictions to coordinate and cooperate closely regarding the standards, rules, and policy tools for managing environmental risks associated with financial activities because the legitimacy of global regulation, either in the form of hard law or soft legal standards, on sustainable finance is key to achieve the desired objectives.[649] Therefore, the pursuit of sustainable finance requires a global convergence of principles and regulations because it would provide effective and predictable guidelines for market participants and limit the potential of regulatory arbitrage or regulatory discrimination. In this regard, global financial institutions must perform the role of effective policy platforms that serve as forums of discussion and exchange of information and opinions more effectively in consideration of the diverse positions of stakeholders as well as the need for effective coordination between the increasingly diversifying stakeholder groups. This requires the improvement of procedural fairness in the decision-making process and the reasonableness of substantive policies.

[649] Jean-Sylvestre Berge and Genevieve Helleringer, *Operating Law in a Global Context* (Edward Elgar 2017) ("The domestic, European, and international contexts create a complex legal game: far from coexisting in isolation, like Leibnizian monads, rules and legal culture characteristic of each level, intersect, rub against and influence one another. As a consequence, lawyers have to adapt their reasoning to the increasingly global nature of the situations with which they deal.").

Procedural Fairness in the Rulemaking Process

Considering the diversification in financial markets following rapid digitalization, the types of financial services as well as the categories of service providers have expanded beyond the scope of traditional boundaries. While the business of financial services has been exclusively available to established capitalists with certain levels of wealth accumulated, the recent industry-wide innovation powered by technological development in information and data science has enabled people with specialized technical skills or creative business ideas to enter the financial markets by attracting customers with digitized financial services which provide a new level of user experience. The multiplication of market participants and the regrouping of financial service providers mean that it is crucial to reflect the different interests and positions of diverse stakeholders in financial regulation and that the impact of financial regulation on other industrial sectors should be carefully examined considering the interconnectedness between different industries and economic sectors. As digitized financial services and products can reach a wide range of customers and investors globally via technology-driven methods such as digital payments or money transfer services, it is all the more important to ensure that rules are fairly made and applied so that diverse participants in the global financial markets perceive the rules legitimate and fair, which is a precondition for facilitating cooperation among diverse groups of people. After all, the concept of mutuality of law requires that all who are participating in a system by following the rules and procedures are to benefit in some way by comparison of a suitable benchmark,[650] and governance institutions with rulemaking capacities must take full advantage of digitalization to improve the level of cooperation among participants. To support sustainable economic growth and promote innovation in the global

[650] Rawls, 'Justice as Fairness' (n 310).

financial markets and the global economy in the end, it is important to ensure that the market participants are given equal access and opportunities to participate in the financial markets without undue barriers. The existence of entry barriers or the excessive power imbalance in the market caused or exacerbated by discriminatory regulations causes serious problems regarding the sustainability of financial systems.[651] This is particularly problematic when the regulators are more comfortable with existing legacy firms and consider them their major constituencies while having limited communications with new market entrants with limited market powers. In this regard, it is hard to exaggerate the importance of procedural fairness in international financial rulemaking which involves a variety of stakeholder groups and different jurisdictions. It should be the foremost goal of any responsible international governance organization that the opportunity to participate in the discussion is open to relevant stakeholders and the decision-making process is administered fairly based on the pre-established administrative steps and requirements.

The legitimacy of international rulemaking cannot be obtained without clearly understood and known procedural rules of operation, and the mere expansion of participation without fundamental changes in the decision-making structures is meaningless. For example, the G20 has created Engagement Groups, comprising non-government participants from the Member States, to provide recommendations to the G20 leaders in the policy-making process, including official engagement groups of the Business 20 (B20) and Think 20 (T20).[652] However, their

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[651] In this regard, it is noteworthy that the role of law has been crucial in shaping the market economy and the valuation of different types of assets, and Katharina Pistor argues that "decoding capital and uncovering the legal code that underpins it regardless of its outward appearance reveals that not all assets are equal; the one with the superior legal coding tend to be more equal than others." Katharina Pistor, *The Code of Capital: How the Law Creates Wealth and Inequality* (OUP 2019) 5.
[652] Engagement Groups, G20 India Presidency, <https://www.g20.org/en/workstreams/engagement-groups/> accessed 16 September 2023.

real influence on the decision-making process led by governments is not significant and the existence of such engagement groups cannot supplement the level of inclusiveness required considering the significance of decisions reached by the leaders at the summit and by their representatives in the preparation stages. Ultimately, the objectives of sustainable finance cannot be achieved by the efforts of individual countries or a certain group of countries, and any governance institution and standard-setting organizations must achieve procedural fairness in the rulemaking process to gain the legitimacy of the respective rules. The role of standard-setters is extremely important as the digital financial markets are in the making and those who are given the rights to participate can exert enormous influence on the rules of the game while those who do not have access to the decision-making procedures would be forced to follow the rules already set by others. Recalling that fidelity to law is only achievable by persuading those who are subject to the law that the law in question is necessary and important to achieve the common goals and benefit them to some degree, acquiring legitimacy is extremely important at the international level as the functioning of international financial regulation and governance systems heavily relies on the voluntary compliance and self-governance of individuals, firms, and states all of which comprise the global community as a whole.

As the integrity of the law depends on the fairness of the legal procedure, it can be achieved by improving transparency and consistency of the rulemaking process in international financial governance institutions. First, transparency of the rulemaking process is a key to obtaining the legitimacy of regulation in the global economy and it has a critical implication in the digital economy as the impact of regulatory changes made by international organizations can easily reach not only the policy choices of national governments but also the financial activities of individuals and firms. In this regard, transparency is a prerequisite to improve representation or participation in the decision-making procedure as it allows market participants to understand the situation and make known decisions. The lack of transparency, or the dominance of secrecy, has been at the center of criticism against international financial governance organizations which are often based on soft law arrangements. While many inter-governmental organizations are required to publish periodic reports or key data, non-governmental international governance organizations with rulemaking or standard-setting functions such as trans-governmental networks of regulators, international private standard-setters, and secretariats of international conventions are not easily subject to public scrutiny despite the immense influence they are exerting on the operation of the global financial systems.

Transparency is often assessed by examining the accessibility of relevant information including document accessibility and the intelligibility of the decision-making process including the documentation of the decision-making process.[653] While international governance organizations are increasingly making efforts to improve transparency and reach out to stakeholders,[654] it is necessary to establish clear standards of transparency for non-governmental standard-setting organizations considering that transparency is the first and foremost step to improve accountability of those in the decision-making positions. Second, consistency of rules has a critical impact on the capacity of market participants as it empowers them to plan and play according to the given regulatory environment with a certain degree of certainty. For the global financial markets, financial regulators and standard setters must strive

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653 Danai Petropoulou Ionescu and Mariolina Eliantonio, 'Soft Law Behind the Scenes: Transparency, Participation and the European Union's Soft Law Making Process in the Field of Climate Change' (2023) 14 European Journal of Risk Regulation 292, 296-297.

654 OECD, 'International Regulatory Co-operation: The Role of International Organizations in Fostering Better Rules of Globalization' (November 02, 2016), <https://www.oecd.org/gov/regulatory-policy/international-regulatory-co-operation-9789264244047-en.htm> accessed 16 September 2023.

to achieve global convergence of financial regulation in key areas such as fintech and sustainable finance where cooperation and coordination are indispensable.[655] For example, emerging issues in global financial governance such as sustainability risks including environmental, social, and governance (ESG) risks have a growing impact on the functioning of the global financial markets by influencing the industrial and policy landscape of many countries and financial institutions are required to adjust their business models and governance structure to reflect the sustainability risks associated with their investment decisions and risk management activities. In the financial markets, there is also high demand for ESG assets in the market, and total funds invested in ESG-related assets are expected to exceed $40 trillion by 2025.[656] However, the governing rules and standards applicable to financial institutions in different countries and regions are fragmented and this fragmentation of regulation increases the regulatory risk for financial institutions hampering cross-border operations and increasing the price of financial services due to the uncertainty.[657] The lack of interoperability can be costly for both regulators and market participants. At present, ESG practices or financial services under the theme of ESG risk management vary widely and it also leads to the potential risks of greenwashing or mis-selling of so-called green financial products.[658] Greenwashing is a marketing tactic that companies use to attract customers while the actual products or services do not have links with environmental sustainability.[659] To prevent the misuse of green finance and protect consumers from malpractice, it is necessary to improve global coordination in the

[655] OECD, 'International Convergence of Effective and Efficient Financial Regulation', Speech by Greg Medcraft, Director of Financial and Enterprise Affairs, OECD, at the 2020 Eurofi Annual Financial Services Policy Summit (November 5, 2020), <International convergence of effective and efficient financial regulation - OECD> accessed 16 September 2023.
[656] Kelly Anne Smith and Benjamin Curry, 'Greenwashing and ESG: What You Need to Know' Forbes advisor, Aug. 25, 2022 <https://www.forbes.com/advisor/investing/greenwashing-esg/> accessed 20 September 2023.
[657] OECD, 'International Convergence of Effective and Efficient Financial Regulation' (n 655).
[658] Ibid.
[659] Smith and Curry, 'Greenwashing and ESG' (n 656).

areas of standardizing ESG disclosure practices, aligning metrics with financial materiality, and ensuring the comparability of ESG methodologies.[660]

Reasonableness of Substantive Policies

Fundamentally, regulation at any level has the potential of functioning as a tax on certain activities or groups of people depending on its design and objectives, and such 'taxed' activities become more expensive to produce for firms, which makes it expensive for consumers after all.[661] When it comes to global financial regulation, the risk of imposing unreasonable costs or any burden on certain groups of market participants always exists due to the ever-increasing diversification of industrial sectors in addition to the geopolitical interests of different countries. Therefore, it is the role of international financial governance organizations to provide necessary regulatory tools and methods of assessment that give due regard to different positions and interests of states, companies, and individuals at best. In this regard, financial regulation at the international level should be equipped with a sufficient level of reasonableness test to prevent unintended consequences of discrimination against entities with weak bargaining power. The principle of proportionality is important and the difference in the industrial stage and the regulatory environment of economies should be considered when standards and rules are formulated and applied.[662] Recalling that the post-crisis regulatory reform including the Basel III capital requirements has been criticized for its discriminatory effect, imposing excessive costs for smaller financial institutions that are not active internationally and do not necessarily pose systemic risks to the global financial markets, the evolving regulatory discourse for promoting sustainable finance should take the importance of proportionality into account so

660 OECD, 'International Convergence of Effective and Efficient Financial Regulation' (n 655).
661 Global Markets Institute, 'Who Pays for Bank Regulation?' (n 366).
662 Alexander, 'Financial Inclusion' (n 376); Restoy, 'Proportionality' (n 372).

that market participants are in a position of complying with the new rules and regulations without taking excessive risks and burdens. Furthermore, when new regulation is considered, it is crucial to ensure that policy objectives and targets are considered reasonable and adequate to address emerging challenges such as measuring, mitigating, and preventing environmental risks. In particular, the more importance the global community places on environmental sustainability, the more precision and scientific evidence are required of policymakers when they devise relevant policy tools and consider the most effective enforcement schemes so that good-intentioned policies would not create unreasonable burdens on market participants and disincentivize innovation and progress.

While it is not applicable at the international level in principle, the case of the EU Taxonomy Regulation signifies the importance of reasonableness in rulemaking as well as the need for regulatory coordination. The EU Taxonomy Regulation is to determine if economic activity is environmentally sustainable based on harmonized EU criteria.[663] The EU Taxonomy Regulation,[664] designed as a classification system to identify sustainable economic activities and investment criteria, is considered a significant and remarkable step forward in reorienting the overall investment framework of financial institutions in the EU towards sustainable and responsible financial activities and it serves “both as a metric for sustainable reporting and as a benchmark for sustainable financial products.”[665] As the first regulation of its kind, the EU Taxonomy influenced other countries by setting the precedent for sustainability regulation. In

[663] European Commission [EC], ‘Financing Sustainable Growth’ (2019).
[664] European Union, Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Text with EEA relevance).
[665] International Capital Market Association (ICMA), ‘Ensuring the Usability of the EU Taxonomy’ (February 2022), <https://www.icmagroup.org/assets/GreenSocialSustainabilityDb/Ensuring-the-Usability-of-the-EU-Taxonomy-and-Ensuring-the-Usability-of-the-EU-Taxonomy-February-2022.pdf>.

Latin America, Colombia launched a green taxonomy, and other Latin American countries including Mexico, Peru, and Chile are working on taxonomies in their local context. Similarly, Indonesia, Sri Lanka, and Kazakhstan, among others in Asia, have finalized their taxonomy documents.[666] However, several significant problems regarding the usability of the Taxonomy have been raised by market participants including both investors and issuers in such areas as the requirement for highly granular data for TSC purposes,[667] inconsistency in the use of estimates and third-party data, the absence of a proportionality lens for smaller companies and projects, and the use of an economic activity-based classification system.[668] Considering that the EU Taxonomy regulation has a broad impact on the recalibration of sustainable financial activities in the global financial markets and influenced many countries to develop their own green taxonomies, the usability challenges of the EU Taxonomy have critical implications on the further development of global regulation on sustainable finance.[669] At the global level, reasonableness is a critical factor that determines the success of any regulatory initiative in the absence of binding legal frameworks while the bargaining power of large financial institutions that are subject to such regulatory change is still significant. In a broad regulatory objective of sustainable finance, regulations for emerging financial sectors should be approached by a high standard of reasonableness to make any new regulation work for the market as well as safeguard the public interest.

[666] Deborah Thur, 'Green Taxonomies Around the World: Where Do We Stand?' (November 2022) Eco: Fact, <https://www.ecofact.com/blog/green-taxonomies-around-the-world-where-do-we-stand/>.
[667] UN Principles for Responsible Investment (UN PRI), 'Testing the Taxonomy: Insights from the PRI Taxonomy Practitioners Group' (September 2020) <Testing the EU taxonomy (unpri.org)>; United Nations Environmental Programme Finance Initiative (UNEP FI) & European Banking Federation (EBF), 'Testing the application of the EU Taxonomy to core banking products: High-Level Recommendations' (January 2021).
[668] ICMA, 'Ensuring the usability of the EU Taxonomy' (n 665).
[669] Thur, 'Green Taxonomies Around the World' (n 666).

Conclusion

This chapter discussed the paradigm shifts in global financial regulation in the context of digital transformation in financial markets in recent years. Digitalization in financial markets has a huge potential to promote the objectives of sustainable development by using finance as a tool for managing sustainability risks and facilitating financial inclusion. At the same time, with the evolving regulatory ecosystem with new entrants and more complex channels of risk transmission in financial markets, risks are becoming transnational, and global regulatory coordination is more than essential to achieve the core objectives of financial regulation. Understanding that the regulatory landscape has changed due to the emergence and growth of new financial service providers, such as Fintech companies, is important because the policy objectives and priorities should be realigned in reflection of the changing market segments and business models. In this context, the role of international financial governance organizations is key to sharing information and aligning policy responses between regulators to address systemic risks that threaten the resilience and sustainability of global financial systems. Considering that standards once set at the international level are difficult to change in the short term and have significant influence on those parties who were not able to participate in the decision-making process, it is necessary to strengthen the procedural fairness in any rulemaking process as to digital financial services and market practices. In this regard, the participation of diverse stakeholders in the policymaking process is particularly important to properly diagnose problems and comprehend the potential costs and benefits of regulatory actions at the international level.

PART IV Conclusion

Chapter 6 The Legitimacy and Sustainability of Global Financial Regulation

Global financial regulation requires a thorough consideration of multiple interests and indicators in law, economics, politics, and international relations, among others. It is a complex and comprehensive area of public policy that warrants consolidated efforts of regulators, businesses, academics, and civil societies to ensure that the system operates properly by producing the expected outcomes and promoting the overall goal of sustainable economic growth. The rapid digital transformation in financial markets in recent years has strengthened the need for global regulatory coordination and cooperation considering the transnational nature of digitized financial services and associated risks that threaten the resilience and sustainability of the global economy. This thesis examined the role of legitimacy in international financial regulation and post-crisis regulatory reform by analyzing the theories of legitimacy in the disciplines of law, economics, politics, and international relations, and applying the principles of legitimacy to the analysis of the post-crisis financial regulatory reform measures taken place after the global financial crisis of 2008. The findings suggest that legitimacy plays an imperative role in achieving the sustainability of the global financial regulatory system, and it promotes the fairness of the rulemaking procedure and the reasonableness of substantive policy actions. Legitimacy of financial rulemaking is particularly important at the international level contrary to the conventional assumptions that legitimacy is a static concept, confined to established legislations. The absence of central governance and enforcement mechanisms at the international level warrants a higher level of legitimacy in the rulemaking procedure and substantive policy actions in international financial rulemaking.

Legitimacy as an Interactive Concept

Legitimacy is an interactive concept that factually matters in financial regulation and reform. In principle, legitimacy refers legality and reasonableness of law. Interpreting the meaning and role of legitimacy requires an understanding of reciprocity between regulators and citizens and the power dynamics between diverse players in the regulatory ecosystem. First, legitimacy as the legality of the law indicates that certain qualities or standards of law should be met for a legal action to be considered legitimate. The integrity of law is referred to as the internal morality of law and is closely related to the responsibility of lawmakers in modern democratic states. Legitimacy as legality is an important factor for the citizens' fidelity to the law and significantly impacts compliance with the law. The linkage between legitimacy and compliance is particularly important in international law because of the relative difficulty of compulsion among sovereign states. The theoretical discourse on the legality of law suggests that legitimacy is far from a static norm in jurisprudence and legal philosophy. The vibrant debates among legal scholars on legality as to the intrinsic dynamics between lawgivers and the subjects have represented the crucial importance attached to the internal morality of law in interpreting and understanding the political and legal systems of our societies. Second, legitimacy as the reasonableness of the law points to the quality of the law being reasonable or acceptable to those subjected to the law. It is primarily about how authority, either a government, a court, or a regulatory agency, gets authenticity by persuading the governed of the reasonableness of their actions. The reaction of the governed to such claims for authority has a critical implication in establishing the legitimacy of legal actions. In this discourse, the law is understood as continuing struggles and challenges of social practice rather than a finished project at a point in history. The reasonableness of law has taken a central stage in the discourse of political and legal thoughts for centuries from Thomas Hobbes to Frederick Hayek and represented the dynamic relationship between the government and citizens. In this relationship, the legitimacy of government resides in the belief system of the citizens who may choose to obey, disobey, or partially obey the government's commands. Whether the citizens believe that the government's actions are reasonable and justified directly impacts their willingness to obey. In this sense, the compliance of citizens to law is not always based on the coercive power of authority but rather motivated by diverse reasons, including material self-interest or human sociability, which means the natural inclination of human beings to cooperate with others, or concurrence of principles between the government and citizens. Ultimately, it is almost impractical to discuss the quality and contents of the law without giving due consideration to its legitimacy, either implicitly or explicitly. Legitimacy as legality and reasonableness of law explains what makes a law be perceived as legitimate in the context of dynamic social interaction between regulators and citizens. Understanding the dynamics of lawmaking and the law-applying process in society is crucial in explaining why legitimacy matters in practice through channels of interaction among actors at different stages of public policy discourse.

Legitimacy of Emergency Actions and Post-Crisis Regulatory Reform

When examining the appropriateness of the post-crisis regulatory response, it is important to distinguish between emergency response and post-crisis reform. Different priorities and objectives of legal actions in the phases of financial emergency and post-crisis reform have been less discussed in the discourse of financial regulatory reform. However, the confusion between the two phases has made it difficult to apply the right standards and factors of assessment of post-crisis regulatory reform. As noticeable emergency actions taken place under the pressure of extreme financial and social turmoil are often confused with post-crisis regulatory reform, the adequateness of post-crisis regulatory reform has not been properly assessed and this confusion has contributed to the recurrence of disastrous financial crises despite the calls for massive reform actions in the aftermath of financial crises. For emergency response, the most important policy objective is to prevent systemic destruction of the financial system. Thus, governments attempt to stop the contagion of risks by giving strong signals to restore market confidence, which often accompanies political commitments to massive bail-out programs. In contrast, post-crisis regulatory reform aims to change or improve the structural aspects of financial markets by making necessary changes to the existing systems considering behavioral responses in financial markets. In this regard, post-crisis regulatory reform takes a progressive rather than revolutionary attitude. The progress of structural changes is sometimes overlooked because it happens gradually rather than radically and requires the collective wisdom of diverse parties involved in the reform process and sufficient time to reap the intended outcomes. The extensive use of discretion by the government is normally unjustifiable in this phase because the need for a quick policy response is diminished as the economy passes the phase of emergency and the event is being controlled despite the remaining uncertainties. The distinction between financial emergency and post-crisis regulatory reform is crucial to examine properly the adequateness of the reform measures and comprehend the legitimate objectives and principles of structural reform.

The General Principles of Financial Regulatory Reform

Global financial regulatory systems need to be examined in light of the specific features of international decision-making structures among states and the unique role of non-state regulatory organizations. For this reason, the analysis of financial regulation at the international level has been often considered based on the distinctive political and legal grounds from that of domestic regulation. However, such distinction has been problematic at times in understanding the legitimate principles of financial regulation which should apply to financial regulation at all levels. Considering the trend of financial globalization, constricted regulatory autonomy in international relations, and the ethical and behavioral dimensions of financial business conduct, it is possible and desirable to identify general principles of financial regulatory reform that make a legal action legitimate. General principles of financial regulatory reform can be established under the four categories of the legitimate principles of law and legal reform: (1) responsiveness, (2) efficacy, (3) integrity, and (4) reasonableness of law and regulatory reform. These principles are intended to be an analytical framework of legitimacy in financial regulation rather than a limited list of principles. First, the responsiveness of law is required because reform is called for when there is an exclusive need to change the existing systems diagnosed as incapable of addressing emerging challenges in financial markets. The principle of responsiveness is derived from the question of why reform is necessary, and it ensures that the reform measures adequately address the predominant problems in recognition of the demand for legal reform in society. Moreover, regulators are responsible for addressing emerging issues that threaten the sound functioning of financial markets. Therefore, the principle of responsiveness requires regulators to make active steps rather than waiting until the problems become systemic and threaten the sustainability of the financial markets. Second, the principle of efficacy refers to the right direction and effectiveness of reform. The concept of efficacy in financial regulation asks whether the regulatory reform measures have been adequately designed to achieve the goals and objectives set at the inception of the reform process. The efficacy of financial regulation and reform measures involves a broader perspective of the usefulness of law rather than a narrower scope of assessing the success of a few policy tools. Third, the integrity of law and reform is associated with the concept of procedural justice in a legal system in which the processes of diagnosing, promulgating, and executing legal actions should be conducted fairly. The integrity of the law is a prerequisite to achieving the trustworthiness of a regulatory system. It depends on the fairness of the legal procedure because such a legal system would allow citizens to reasonably predict the legal consequences of their actions before committing themselves to any course of action. In this sense, the integrity of the law is closely related to the law's respect for human dignity, and it makes a legal system legitimate by promoting the predictability and consistency of the law. Moreover, the predictability of law is obtained by adhering to the appropriate regulatory process that is perceived as fair based on the consistency of legal measures. In the end, the predictability and consistency of legal action lead to the principle of legal certainty which is necessary for the system of the rule of law acceptable and reliable as a constitutional principle. The predictability of law has a critical implication on the adaptability of the legal system to technological, cultural, and social changes because established laws cannot always address emerging problems that were not anticipated at the time of legislation. Therefore, allowing citizens to anticipate the possible trajectories of legal changes is particularly important in the digital era in which preexisting technical rules are often unsuitable to solve emerging problems. Finally, the reasonableness of law and reform is closely related to the substance of legal reform and requires that legal actions provide persuasive justification for particular policy measures. The reasonableness of legal actions plays an integral part in determining the legitimacy of regulatory reform because reform actions are required to achieve substantive justice by promoting non-discrimination and proportionality of policy measures. It is also related to the policy objective of preventing regulatory capture which is detrimental to the functioning of financial markets and degrades the public trust in the legal system. Regulatory capture is one of the contributory issues that weaken the legitimacy of financial regulation because it leads to unreasonable policy decisions in favor of powerful industrial groups. It is an aggregate result of misusing the discretionary power of regulators without sufficiently explaining the reasons for their decision to wider groups of stakeholders including the public. To solve this problem, the accountability of regulators should be strengthened by requiring a reasonableness test before making policy decisions and improving structural check-and-balance that prevents the collusive relationship between regulators and the industry. Moreover, improving democratic participation and representation of diverse stakeholders in the policymaking process can limit the political power and incentive of financial industries to capture regulators. The weak accountability mechanisms of regulators have contributed to the problem of regulatory capture as regulators are not directly liable for making decisions favorable to financial institutions when such actions are not technically illegal. Since the opposite approaches of deregulation and centralization of regulatory authority failed to provide adequate solutions to this prolonged problem in the financial industry, it is important to make regulators more concerned about the adequate justification of policy choices. Challenging the validity or reasonableness of their policy decisions by improved mechanisms of transparency, open debates, and expert analyses would be more effective than solely relying on particular committees that are often composed of individuals appointed from a closed political circle.

Stakeholders of Financial Regulation and Public Interest

The legitimate principles of financial regulation and reform require a thorough understanding of the concept of stakeholders of financial regulation as these principles are based on acknowledging the interactive relationship between regulators and citizens. While stakeholder interest is often discussed in domestic polity rather than at the international level, the universality of legitimate principles in financial regulatory reform discussed earlier indicates that stakeholder interest is an important factor in financial regulation at the international level.

The expanded scope of financial businesses, referred to as financialization, in the past decades requires that the concept and scope of stakeholders should be revisited as well as the objectives of global financial regulation in reflection of the interactive relationships between diverse stakeholders in the context of the financial regulatory ecosystem. The unprecedented expansion of financial businesses has increased the potential of systemic risks and the growing number of multinational corporations whose business activities influence economic, environmental, and social sustainability has brought increased demands for corporations to take active roles in solving critical problems as corporate citizens. In corporate governance regulation, promoting stakeholder interests has increasingly been recognized as a regulatory objective, compared to the traditional focus on protecting shareholder interests. In this context, whether financial regulation recognizes the public in general as legitimate stakeholders of financial institutions should be carefully considered as it would impact the policy objectives and priorities of financial regulation. In principle, it depends on whether the decisions of financial institutions have a direct or indirect influence on the economic conditions of the public through diverse channels. In the context of financial distress caused by the decisions of large financial institutions that ended up with financial crises, the welfare of the public, particularly those who are not associated with the operation of such firms in any aspect, is certainly affected by the decisions of large financial institutions and the policy reactions of financial regulators. Strengthening the legitimacy of policy actions is particularly important when individuals' short-term profit-seeking can bring harm to society in the long term. In this sense, global financial regulation should function as a global public good, considering the public as legitimate stakeholders of financial regulation at the international level.

The Global Financial Crisis of 2008 and the Legitimacy of Post-Crisis Reform

The legitimacy of financial regulatory reform was put to the test in the aftermath of the global financial crisis of 2008. The global financial crisis of 2008 demonstrated that modern financial markets are highly connected and capital is mobile surpassing the traditional boundaries of regulation. It also showed the structural problems of the global financial regulatory systems that tragically failed to properly perceive the nature and emerging risks in the globalized financial markets. Despite ambitious reform measures and legislative actions taken in the aftermath of the global financial crisis of 2008, the fundamental causes of these systemic problems have not been adequately addressed. When the global health crisis caused by the COVID-19 pandemic broke out a decade after the global financial crisis, it was revealed that the global economy was even more vulnerable to systemic risks despite a decade of ambitious financial regulatory reforms. Fundamentally, the reform agendas and policy objectives were narrowly focused on technical rules and have failed to address fundamental problems of international rulemaking systems. Legitimate principles of financial regulation should have been more thoroughly reflected in the procedural and substantive aspects of international financial regulation to improve the resilience and sustainability of global financial systems.

The empirical analysis of the legitimacy of international financial architecture reform in the post-financial crisis of 2008 demonstrated that procedural fairness and substantive reasonableness should have been reinforced to achieve the desired outcomes and make the global economy more resilient and sustainable. In retrospect, the legitimacy of international financial rulemaking should have been strengthened, considering the practical influence of standards set through soft law mechanisms on the financial markets of many countries. Soft law instruments are often the outcome of unofficial political negotiations between regulators and private sector institutions that play key roles in the governance of global finance. Despite the legally non-binding nature of soft law standards, various enforcement mechanisms are available, and compliance is often sought using indirect procedures. Soft law standards do not always remain voluntary but can be transposed into domestic law or serve as a basis for developing international norms. Moreover, network effects play a significant role in global financial regulatory systems, as following those rules affects the creditworthiness and reputation of financial institutions in global financial markets.

The Sustainability of the International Financial Architecture

Assessing the post-crisis reform of international financial architecture reveals that the inadequate level of reform at the international level was related to the conceptual and institutional challenges to international financial governance systems. Improving the procedural fairness of global financial governance by incorporating strengthened administrative rules and giving access to those who have legitimate interests in international rulemaking is required. The case of the G20 demonstrates that the lack of procedural fairness has been one of the most critical problems of the existing international financial architecture, that weakened the legitimacy of the entire system. At the same time, the substantive policy measures should be developed according to the principles of proportionality and equitableness, considering the cost of regulatory intervention and its uneven impact on national economies. Since international financial standard-setting institutions take an integral part in the functioning of modern markets in the absence of a centralized, or state-like, governance system, the concept of proportionality is key to ensuring that rules are designed and applied in a reasonable way in reflection of the objectives of particular regulatory measures. Also, the principle of equitable treatment has influenced the rulemaking practices in international trade and investment and acknowledged that the severity of rigid rules of positive law should be mitigated to achieve justice.

Considering that the global financial markets are interconnected and risks arising in one country or region can easily transfer to other parts of the globe, the vulnerabilities of financial systems in developing and less developed countries should be seriously considered in the discussion of international financial rulemaking. Ultimately, the sustainability of international financial architecture depends on strengthening the legitimacy of international rulemaking procedures and substantive reform measures. The objectives of international financial governance should not be alienated from other socially important policy goals, both globally and nationally, considering the strong bonds between the financial industry and other industries in the global economy. As financial industries are prone to social dilemmas where seeking private and short-term gains of individuals can easily produce long-term costs to society, the externalities in financial markets related to sustainability risks such as environmental risks should be actively addressed at the international level and the role of global financial governance institutions is imperative in coordinating the policy actions of states and financial institutions.

The Legitimacy of Financial Regulation in the Digital Era

The legitimacy of financial regulation is imperative in the digital era, as the global economy has strived to meet the new challenges posed by digital transformation in recent years. The growth of Fintech as new business models introducing innovative financial products to the financial markets has caused the reconfiguration of the traditional boundaries of financial regulation in several ways. First, the unique function of financial intermediation provided by banks has also been provided by non-bank Fintech companies that integrated financial services as part of their existing services such as e-commerce or social network services. The rise of big techs in financial services and the growing number of startups in the financial markets have questioned the policy justification for the special status of banks that had been dominant in financial regulation for the past decades. Moreover, the conflicting interests between incumbents and new entrants add another layer of complexity to financial regulation, where the reasonableness of substantive policy decisions critically impacts the effectiveness of regulatory actions. Second, the scope of stakeholders in financial regulation has expanded as the reach of financial services easily surpasses the traditional boundaries of national jurisdictions. At the international level, the heavy reliance on soft-law instruments should be supplemented by improved mechanisms of legitimacy in the rulemaking process so that new regulatory standards that impact people's everyday lives are determined by following the legitimate principles of financial regulation. Finally, the digitalized financial environment reinforces the significant role of global governance institutions that take the role of policy platforms. Critical issues such as cybersecurity or data protection require effective regulatory coordination to address challenges effectively.

The concept of a regulatory ecosystem should be thoroughly considered because the rulemaking process should reflect the diverse interests of market participants and give fair access to those parties affected by the new regulatory landscape. As regulators fundamentally rely on mutually beneficial and cooperative relationships with their counterparts, global financial governance institutions should take an active and leading role in promoting regulatory coordination. In addition to national regulators, industrial practitioners, academics, and NGOs should be given adequate access to the information and opportunities to represent their ideas and interests. The reciprocity of law is particularly relevant in the digital era considering the expanded scope of stakeholders and the potential risk of power imbalance in global financial markets. Fundamentally, the regulatory approach in the digital era should be based on the legitimate principles of financial regulation to ensure that the fast-evolving technological development in the financial markets would not hamper the sustainability of the global economy in the long term.

Conclusion

This thesis attempted to analyze the role of legitimacy in global financial regulation and reform by demonstrating the practical implications of legitimacy in the procedural and substantive aspects of international financial rulemaking. Based on a theoretical analysis of legitimacy, it identified legitimate principles of financial regulatory reform applicable to international financial rulemaking and applied these principles in assessing the legitimacy of the reform actions taken in the aftermath of the global financial crisis of 2008. Considering the new and emerging challenges in the global financial markets of today and the need for regulatory coordination at all levels, it is necessary to examine whether the ongoing reform actions are properly based on the legitimate principles of financial regulation. In this term, these principles are expected to serve as an analytical framework for assessing the legitimacy of global financial regulatory reform rather than an exclusive list of principles. An in-depth analysis of legitimacy revealed that the sustainability of the global financial regulatory system depends on a fair rulemaking procedure and the reasonableness of policy measures in practice. Improving the legitimacy of global financial regulation can solve many of the structural problems that have previously restricted the fundamental reform of the global financial regulatory systems.

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