Finance: The Discreet Regulator

How Financial Activities Shape and Transform the World

Edited by Isabelle Huault and Chrystelle Richard

Foreword by Michael Power

Finance: The Discreet Regulator

How Financial Activities Shape and Transform the World

Edited by

Isabelle Huault

and

Chrystelle Richard

palgrave
macmillan

First published 2012 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN 978–0–230–35579–8

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

10 9 8 7 6 5 4 3 2 1
21 20 19 18 17 16 15 14 13 12

Printed and bound in Great Britain by
CPI Antony Rowe, Chippenham and Eastbourne

Notes on Contributors

Laurent Deville is CNRS Research Fellow and Associate Professor of Finance at EDHEC Business School. His research is primarily devoted to the analysis of index derivatives and exchange traded funds with a focus on market efficiency, liquidity and competition. He also studies the social side of the construction and development of these financial markets.

Isabelle Huault is Professor of Organization Studies at Paris Dauphine University. She is head of the DRM Management Research Center (UMR CNRS 7088). She researches the sociology of financial markets, neo-institutionalism and critical studies with a focus on the social studies of finance and the social construction of markets and organizations.

Anne Jeny-Cazavan is Professor of Accounting at ESSEC Business School, Paris. She is head of the Accounting and Management Control Department. Anne's research primarily focuses on investigating financial information and capital markets, with a special emphasis on intangibles (and R&D) and IFRS transition.

Paul Lagneau-Ymonet is Assistant Professor of Sociology at Paris Dauphine University (IRISSO, UMR 7170). He researches stock exchanges competition in Europe and the sociology of financial elites.

Emmanuel Lazega is Professor of Sociology at Paris Dauphine University and a member of IRISSO-CNRS. His research interests are in neo-structural sociology of organizations and markets. He runs the Observatoire des Réseaux Intra- et Inter-Organisationnels (ORIO), a team specialized in using research on social and organizational networks to track the emergence of new forms of collective action.

Marc Lenglet is Professor of Management and Strategy at the European Business School, Paris. With interests in phenomenology and anthropology, his research focuses on financial regulation and technological controversies within financial markets.

Jérémy Morales is Assistant Professor of Management Accounting and Control at ESCP-Europe. His research interests focus primarily on how management control practices and technologies shape, and are shaped by individual and collective representations, actions and projects. He is also interested in the intersections between accountability, subjectivity and power asymmetries in organizations and society.

Lise Mounier is Researcher at Centre Maurice Halbwachs (CNRS). She works in the field of sociology of organizations and social networks in collaboration with Emmanuel Lazega.

Mohamed Oubenal is a Ph.D. candidate in the Department of Sociology at Paris Dauphine University where he is studying 'The social process of legitimating financial products: The case of Exchange Traded Funds (ETF) in France'. His research interests include social studies of finance, media-business relations and social network analysis.

Elise Penalva-Icher is Assistant Professor of Sociology at Paris Dauphine University and member of IRISSO Social Sciences Research Center (UMR CNRS 7170). She is also a member of ORIO: the observatory of intra- and inter-organizational networks. Her research interests are economic sociology, social construction of markets and corporate social responsibility.

Anne Pezet is Professor of Management at HEC-Montréal. Her research interests lie in business and management history. She is also interested in the issues raised by the managerialization of society.

Michael Power is Professor of Accounting and Director of the Centre for the Analysis of Risk and Regulation (CARR) at the London School of Economics. His research interests focus on regulation, accounting, auditing, internal control and risk management. His major work, *The Audit Society: Rituals of Verification* (Oxford, 1999), has been translated into Italian, Japanese and French. *Organized Uncertainty: Designing a World of Risk Management* (Oxford, 2007) has been translated into Japanese.

Hélène Rainelli-Weiss is Professor of Finance at the Sorbonne Graduate Business School. Her research interests are in the sociology of financial markets, the organization of the financial industry and the epistemology of finance.

Carlos Ramirez is Associate Professor of Accounting at HEC Paris. Trained as a sociologist, he specializes in the study of professional groups. His current work focuses on the constitution of a transnational market for accounting and auditing services, with special reference to the role played by the big multinational audit firms in standard-setting processes.

Chrystelle Richard is Associate Professor of Accounting and Auditing at ESSEC Business School. Her primary research interests focus on the quality of auditing and assurance services. She is also greatly interested in the controversies with respect to public–private partnerships.

Angelo Riva is Professor of Finance at the European Business School. He is the head of the research department of finance. His researches focus on the long-run dynamics of market micro-structures and the stock-exchange industry.

Benjamin Taupin is Associate Professor of Organization Studies at Pôle Universitaire Léonard de Vinci, and is a research member of Dauphine Recherches en Management (DRM). He is devoted to the study of maintenance processes in the industry of credit rating, using a neo-institutional approach. As a temporary employee of the French Autorité des marchés financiers (AMF), Benjamin recently took part in the registration of the credit rating agencies according to the European Regulation.

Foreword

The present age has been described as one of 'regulatory capitalism' and its most obvious manifestation is the expansion in the number and range of regulatory agencies across fields and jurisdictions. And yet, despite the emergence of these organizations with an explicit mission to regulate, we also know that regulatory processes extend far beyond their boundaries. Indeed, dedicated agencies may derive much of their efficacy from resources beyond their immediate organizational limits and located in wider institutional environments. Such a recognition of the dispersed nature of regulatory activity forces us to look beyond binary accounts of the relationship between regulator and regulated in terms of concepts of 'independence' or 'capture'. Indeed, scholars have generated a number of guiding analytical concepts to enable the exploration of this non-binary world. Ideas of enforced self-regulation, mutual regulation, meta-regulation, delegated authority, reflexive regulation and soft law may all be subtly different, but they represent similar efforts to characterize regulatory dependence, hybridity and dispersion.

The hybrid nature of regulation requires us to be symmetrical in our treatment of regulatory agencies and regulated firms. We should not assume that either of them are easily characterized as unitary actors. There are methodological and policy attractions in assuming that organizational hierarchies are overseen by senior management steering capacity or in assuming that discreet legal entities correspond to the 'organization'. However, there is plenty of evidence, not least from agency theory, to suggest otherwise. One implication of this view is that the public–private distinction is highly questionable when applied to the analysis of organizations as totalities. Large corporations themselves will be combinations of both private economic and publicly normative elements.

From all this we can infer that regulation is a field in which different entities, sub-entities and actors interact in varying relationships of power. Capture theorists have long recognized how regulation provides multiple public stages for private actors, particularly those enrolled into technical committees, commenting on draft rules and, as in the case of Quantitative Impact Studies for Solvency 2, enlisted to participate in pilot studies. This recognition is at the heart of lobbying and influence studies which examine the role of actor interests in generating observable outcomes. And yet the idea of regulation as a field, or *apparatus* in the philosopher Michael Foucault's sense, reminds us that these interests are also endogenous and emerge from a rich micro-context of spreadsheets, best practice documents, legal interpretations, accounting standards, risk maps and many other normative textual devices.

Regulation as a form of activity also generates transnational epistemic communities which straddle and combine elements of public and private organizations. In particular, 'regulatory capitalism' is characterized by a certain degree of professionalization of the field in which regulators refer increasingly to other regulators for their legitimacy and sense of identity, and where compliance communities straddle organizational boundaries. The strength of such regulatory epistemic communities has been visible in the recent history of the International Accounting Standards Board which preferred to focus on its own ideals of good accounting rather than the needs of real users of accounts. In short, regulators generate regulatory activity not only because that is what they are paid to do but also because they come to see the world in a particular way.

All these themes are represented in the contributions to this important volume. The financial crisis, which enters a new phase of uncertainty at the time of writing this foreword, makes the focus on financial regulation all the more pertinent. The volume as a whole speaks to a process which might best be described as the *financialization of financial regulation.* The 'discreet' regulator of the title can be understood not only in terms of the regulatory power of those whom we imagine to be the 'regulated', but also as a body of knowledge called 'financial economics'. The latter has grown in significance over the last 20 years and permeates the process of financial regulation. Indeed, one might think of this body of knowledge as being *disciplinary* in Foucault's sense, which is to say that it determines both the regulator and the regulated as subjects who must act and govern according to its precepts and imperatives.

So understanding financial regulation is not just a matter of tracking the significant and obvious actors as they move in regulatory space. Financial regulation must also be understood as the product of epistemological changes in regulatory knowledge which can be traced back to the early 1990s and the eventual acceptance of in-house models for market risk purposes in the Basel 2 framework. From this point of view, financial economics is a new kind of *regulatory science,* displacing the prudentialism of older legal frameworks. Actors compete with one another for the right to exercise discretion and to interpret regulatory rules, but all these strategies take place within a system of thinking whose reach is pervasive. Indeed, the sociologist Donald MacKenzie has argued that the financial crisis is as much an epistemological problem as it is a product of greed, regulator incompetence and governance failure. It is easy to blame specific bankers and regulators for failure; it is much harder to blame entire systems of knowledge. And we know that systems of thought are hard to shift until the anomalies become unbearable and a new model is available.

Another important issue at stake in the world of discreet regulation is the ambivalent nature of transparency. First, the pervasive influence of financial economics creates access issues for many actors; the entry conditions for reasoned debate are high and to reach such entry conditions one is necessarily socialized into the very system of thought which needs to be challenged. Second, it follows that financial regulation is neither completely private and secret, nor wholly public. Rather, the degree of transparency depends on the relative position of an observer in the field of financial knowledge. And the ensuing chapters remind us that the system by which regulatory consensus is achieved is rather invisible despite heavy investment in consultative due process and the public availability of documents such as comment letters. The reality of regulation as a network of alliances and pathways of influence poses significant empirical challenges about how and *where* to study it as well as normative challenges about how to make it more democratically sensitive. The conventional visible proxies of regulator activity which are favoured by empirical researchers using large data sets may yield little insight into these discreet processes of financial regulation.

Finally, it should be recognized that financial regulation is a powerful model for other forms of regulation, even as it stands discredited by the financial crisis. This is not surprising since developments in financial regulation reflect broader financialization processes in developed societies, symptomized by state efforts to encourage private savings to offset pension funding deficits. From this point of view, though financial economics is far from being a perfectly unitary discipline, many of its basic precepts and assumptions are, and continue to be, very widely diffused into nearly every corner of social and economic life. Behind the shadowy actors who are the discreet regulators of this important book, lies a body of knowledge and practice whose societal reach we are only just beginning to understand.

Michael Power
Centre for Analysis of Risk and Regulation
London School of Economics and Political Science

Acknowledgements

We owe a special debt to the Agence Nationale de la Recherche (ANR) in France for a grant that made it possible to launch a research project on the social construction of markets and organizations in the financial field. We are grateful to Jean-Claude Thoenig for his early and continued support for this project. Taking stock of the results of this research and of the quality of the contributions, we were convinced that there was material for a joint publication around the idea of 'discreet regulation'.

Working towards this publication has involved numerous discussions, comments and revisions and we thank all the authors for their considerable involvement in the project and for the extremely rich interactions we had with them along the way. We would particularly like to express our gratitude to Michael Power for his support, his encouragement and his stimulating intellectual contribution.

We are also tremendously appreciative of many members of our intellectual community. We benefited in multiple ways from their advice, papers, articles, books and reviews as well as conference discussions and coffee chats. We would especially like to thank Marie-Laure Djelic, Sigrid Quack, Emmanuel Lazega, Donald MacKenzie, Glenn Morgan, Yves Scheimel, André Spicer and Richard Whitley.

At Palgrave Macmillan, we benefited from the excellent service and professionalism of Lisa von Fircks, Gemma d'Arcy Hughes and Beverley Copland. We are also thankful to Ann Gallon for her assistance in preparing the final version of this manuscript. We further benefited from the research environments of our respective institutions, Université Paris Dauphine and ESSEC Business School, and from the help and encouragement of many of our colleagues.

Last, but far from least, the continued patience, understanding and affection of Nicolas, Thomas, François and Clément Huault, Michel and Martin Grange and Frédéric Richard have been essential to bringing this book to fruition.

Isabelle Huault and Chrystelle Richard

Contents

List of Tables and Figures

Tables

Figures

Introduction: The Discreet Regulator

Isabelle Huault, Emmanuel Lazega and Chrystelle Richard

Introduction

The global financial crisis that began in the summer of 2007, and was accelerated in September 2008 by the collapse of Lehman Brothers, has made financial actors generally – and large investment banks more specifically – the centre of attention. Some commentators condemn their ability to circulate vast amounts of capital with no geographical limits, and thus to create damaging competition (Arnoldi, 2004; Bryan and Rafferty, 2006; LiPuma and Lee, 2004, 2005; Pryke and Allen, 2000). The legitimate question of stronger regulation and supervision that would limit their freedom of action arises acutely in this context (Davis, 2009).

While many analyses focus on the way finance can be regulated in the topical context of the economic crisis (Morgan, 2011), the objective of this book is slightly different. It aims to show how financial activities shape and transform the world. Highlighting the fact that the true regulators of the economy are not exclusively public regulatory authorities, its objective is to demonstrate that the financial sphere really does contribute to rule-setting. This questions conventional state-centred approaches to power and command posts, 'highlighting how power is variably dispersed across a wider set of actors who are unified by shared interests, issues or discourse' (Zald and Lounsbury, 2010: 965).

At a time when regulation of the financial sector is the talk of the global village, this volume argues that the organizations in the financial industry are a powerful 'rule-making engine' (Zald and Lounsbury, 2010: 965) and are themselves discreet regulators of the markets in which they do business. Based on a series of case studies related to the construction and structure of financial markets, or the emergence of new financial arrangements, the book shows that financial markets are the seat of regulatory processes initiated and developed by core-capitalist financial institutions such as banks and audit firms. It emphasizes the growing role of finance, financial markets and shareholder conceptions of value as 'key drivers of capitalism' (Davis, 2000, 2009; Fligstein, 1990; Zald and Lounsbury, 2010: 968). It brings out the fact that actors that appear to be the objects of regulation, or at least to intervene only at its fringes, are in fact 'discreet regulators' (Lazega, 2011a) supplying the institutional framework that fosters market creation and globalization.

The US mortgage meltdown and the economic collapse of 2008 brought the financial industry under the spotlight, but we think that this sector is worth careful scrutiny for more specific reasons. More than any other economic or commercial activity, it raises the acute question of the duality between the private and the public sphere. Playing an intermediary function, the financial system occupies a central, strategic role in the operation and financing of the whole economy. Banks, due to their importance, have long been subject not only to regulation established by national or supranational authorities, but also to supervision – see, for example, the role of the Basel Committee.[1] However, successive waves of liberalization and securitization, and the growth of interbank markets in the 1980s, have brought about a shift in the public–private boundary, to the benefit of private actors. Their role, their strategy and the range of their activities have radically evolved. As Zald and Lounsbury (2010: 974) state, this neoliberal approach to financial market regulation and financialization was enabled not only by the rise of financial economics as a valorized body of knowledge (Whitley, 1986), but also by the increasing role of financial expertise (Lounsbury, 2002). The growing influence of such expertise then became the driving force behind reconfigurations of power, organizational forms and 'command posts'. The reduction of the State's role has been accompanied by a transnational non-governmental approach to finance that can be observed in the growing importance of financial governance associations (Hussain and Ventresca, 2010: 162). These bodies play an important part in promoting global finance by bringing experts together to promote it (Lounsbury and Lee, 2005). For example, the ISDA[2] (Huault and Rainelli, 2009; Morgan, 2008), an association of investment banks and other market agents, has addressed the questions of contract definitions, legal qualifications and revision of standards on OTC markets, over a lengthy time span.

The huge transformation of regulatory processes that is now taking place at a meso-level deserves robust analysis. By meso-level, we refer to all organizational forms of collective action that exist at an intermediate level between the State and society: for example, firms, professions and all kinds of collective interests. This view is compatible with DiMaggio and Powell's notion of the 'organizational field' (1983), which sees organizations as being embedded in networks of relationships, and organizational action as constrained by normative and cognitive pressures. In these configurations, as regards access to resources, individual and organizational actors may simultaneously have divergent interests, and interdependent and multilateral relationships. They take advantage of these interdependencies to explore, design and promote new forms of coordination and collective action. The stakes and resources are very unevenly distributed between actors, and this leads the actors with the most power and the greatest interests to take structuring and, as a result, most de facto regulation of their businesses into their own hands. This entails an obligation for financial actors to set up joint actions, get involved in collaborative activities and cooperate even with rivals. Cooperation between competing agents appears to be one of the ingredients of the rule-setting process (Huault and Rainelli, 2009; Lazega, 2009).

This regulatory process – a political process par excellence– can be considered as the definition of norms, valid for the collective as a whole, but through which powerful actors seek to defend their own particular interests. The greater the role assigned to markets, the more private actors' capacity to defend their regulatory interests is reinforced. A continuous balancing of power between the State and financial actors is observed for the design, organization and regulation of markets and society. Financial actors manage interdependencies strategically in order to work on the formulation and implementation of norms and standards they intend to impose on society. They have an extensive ability to move the frontiers between the public and the private sphere, to influence broader institutional changes while at the same time defining what they contend to be the public interest. These regulators are 'discreet' because generally the heterogeneity and multiplicity of their types of status are not highly visible. While they do not actually hide, they do not seek to be out in the open; they are often to be found behind the scenes, in the shadow of the business world. Their visible, official power shows no dramatic increase, but their ability to regulate markets discreetly in the background gives them unrivalled power.

The objective of this book is to understand how society is in fact jointly regulated by public authorities and private actors, and to explore