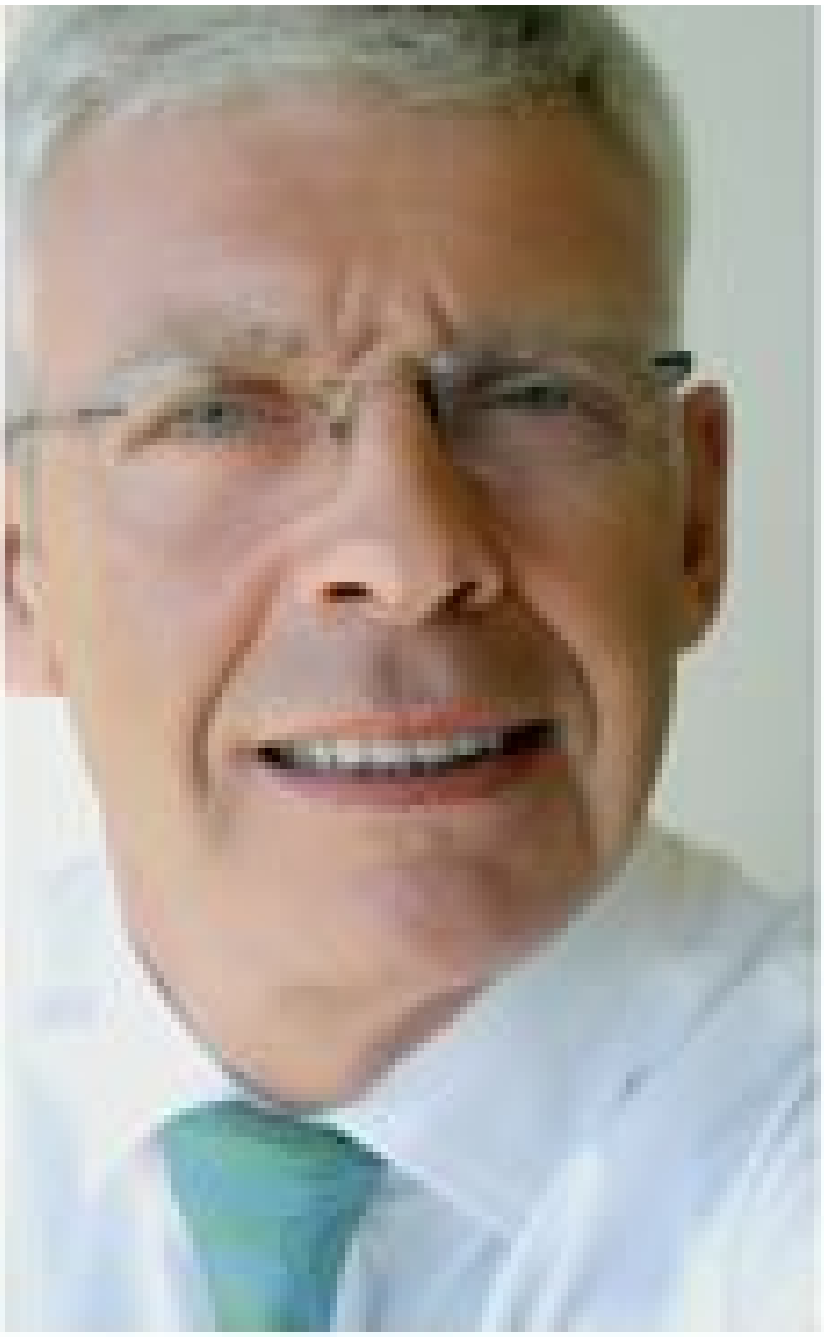
THE REGULATORY DILEMMA: LEGAL CERTAINTY OR TRUST THE REGULATORS, MANUEL CONTHE

Posted on 30/08/2009



"The nature of legal services will continue to evolve and improve but the driver for innovative change should now be the clients themselves."

Category: Opinions

Despite the scale of the legislation now emerging in response to the financial crisis, regulatory and legal certainty will always prove a challenge, says Manuel Conthe

Incluso con las mejores intenciones, el ideal de la seguridad jurídica es complicado en el mundo actual, especialmente cuando las normas van dirigidas a una realidad tan frágil, cambiante y que evoluciona rapidamente como los mercados financieros, dice Manuel Conthe. A pesar del volumen normativo que se está desarrollando como respuesta a la crisis financiera, la seguridad jurídica absoluta supone un desafío.
Even in the face of the best intentions, absolute judicial and legal certainty are difficult ideals to attain in the real world, especially when the rules are aimed at a reality as fragile, innovative and rapidly evolving as the financial markets.

The regulatory and institutional changes which have emerged in response to the financial crisis, and are now being approved in Europe and the US, share common traits.

The first is the tacit recognition that central banks should focus not only on price stability but also financial stability. More specifically, there is agreement that central banks should play a more prominent role in the identification and prevention of systemic financial risks, undertaking the macroprudential supervision of financial markets that has recently been found to be wanting.

A second common feature is that this prudential supervision – aimed at avoiding the risk of insolvency or lack of liquidity – should no longer be limited to depository or credit institutions, but reach out to any entity whose collapse might cause a crisis in the financial markets.

In my view this will likely lead to the abandoning of both the current sectoral monitoring scheme – with distinct supervisors overseeing credit institutions, the stock markets and insurance companies – like the one currently in force in Spain, and the model of "integrated financial supervision" – as represented in the UK by the FSA.

The new approach will lead, probably, to some variant of the "twin peaks" model, where one or more public institutions, led by the Central Bank, are responsible for the prudential supervision of all institutions of a financially systemic nature, while a separate public institution monitors the conduct of institutions in the financial markets and protects financial consumers.

The supervisory role of authorities will not extend to new entities, but will encompass areas previously considered beyond the regulatory realm, such as executive remuneration, or not considered so far a priority, such as liquidity policy.

A third common trait is that regulation and supervision, especially prudential, must also use legal techniques that are capable of adapting to the evolving nature of modern financial systems.

In my opinion, legal techniques necessary to effectively regulate and supervise a modern financial system include at least two key elements: Firstly, delegating regulatory authority, as the European Union has done under the so-called "Lamfalussy approach", under which higher level rules – directives, regulations or national laws – are limited to general principles, and authorise their implementation and adaptation by rules issued at a lower level.

Secondly, resorting to some "openended" legal concepts and principles (eg "preserving financial stability"), to be applied or enforced in specific cases at the discretion of the relevant administrative authorities. This will inevitably create some tension between the concept of "legal certainty" and the need to prevent crises as well as "moral hazard", which is at the base of the old debate on the limits of "constructive ambiguity" when defining the role of the lender of last resort.

Recent years have seen the growing importance of the "precautionary principle" as an essential element of regulatory policy, particularly in the environmental area – reflecting the belief that it is 'better to be safe than sorry'. In my opinion, this approach is also inevitable in financial markets.

Financial supervisors may therefore be empowered to take preventive measures even though they may not have conclusive evidence that would 100% justify their adoption. The paradox of course is that, even if successful, such measures may be perceived as excessive, especially by those that suffer from their implementation.

In addition, legal rules will always, due to the inherent ambiguity of language, have an "open texture". Thus, the certainty of the law will never be perfect and the ideal of legal certainty, so dear to every lawyer should be supplemented by another principle of similar importance: trust in the institutions and professionals called to interpret and enforce the rules.

Even if legislators attempt to establish a new comprehensive financial regulation, with no discretionary or interpretative elements, they will likely not succeed because laws often struggle to regulate in detail the complex circumstances that are present in real life: as one Spanish lawyer put it in the XVI century " there will always be more business than laws".

Manuel Conthe was previously President of the Spanish Securities Commission (CNMV) and Financial Sector Vice President of the World Bank. He made a keynote speech at the recent Club Español de Arbitraje annual conference.