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Daniel Schwarcz
University of Minnesota Law School, schwarcz@umn.edu

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TRANSPARENCY AND CONTRARIAN EXPERTS IN FINANCIAL REGULATION: A BRIEF RESPONSE TO PROFESSOR BRADLEY

DANIEL SCHWARCZ[†]

INTRODUCTION

Transparency is a notoriously malleable concept. Nowhere is this clearer than in Professor Bradley's article, *Transparency is the New Opacity: Constructing Financial Regulation After the Crisis.*[1] Focusing on the development of transnational standards for financial regulation, Professor Bradley argues that entities such as the Basel Committee on Banking Supervision (Basel Committee), International Association of Insurance Supervisors (IAIS), and International Organization of Securities Commissioners (IOSCO) are unreasonably opaque because they simultaneously produce too much and too little information. This assessment is largely driven by the premise that transnational standard setters (and financial regulators more generally) have an obligation to make their processes understandable and accessible to ordinary citizens, in addition to sophisticated, and generally self-interested, private entities. Professor Bradley thus suggests—with varying degrees of certainty—that standard setters in financial regulation should translate regulatory documents into multiple languages, draft rules in plain language, pursue simpler regulatory strategies, reduce the volume of information they produce, and coordinate the dissemination of this information to make it less overwhelming. At various times, Professor Bradley summarizes her basic argument as an attempt to promote "communication" about financial regulation, or "real transparency" to "citizens."[2]

[†] Daniel Schwarcz (schwarcz@umn.edu) is an Associate Professor of Law at the University of Minnesota Law School.

[1] Caroline Bradley, *Transparency Is The New Opacity: Constructing Financial Regulation After The Crisis*, 1 AM. U. BUS. L. REV. 7 (2011).

[2] *See id.* at 22 ("But such publication is an example of formal rather than real

This brief response is pessimistic that better communication to ordinary people about financial regulation can meaningfully address regulatory problems such as capture, democratic accountability, and group think. Instead, it argues that the architects of financial regulation should focus their transparency-related efforts on facilitating participation by experts with alternative perspectives on the optimal contours of regulation. Such experts might include public interest groups, academics, designated regulatory staff, and government officials that do not regulate directly in the domain under consideration. But it is not enough to make regulatory processes transparent to these groups. Regulators and standard setters must also affirmatively facilitate and incentivize participation in rule-making and standard-setting by these experts with alternative perspectives and interests. To accomplish this, they might initiate experiments grounded in Tripartism, seeking to empower public interest groups with procedural rights.[3] Alternatively, they could establish affiliated regulatory contrarians to serve as "devils' advocates" or "proxy advocates."[4] Whatever the mechanism, financial regulators and standard setters must affirmatively court informed engagement from knowledgeable sources with alternative perspectives, as both history and logic suggest that this type of engagement will otherwise be substantially absent.

I. THE PROMISES AND PERILS OF TRANSPARENCY IN FINANCIAL REGULATION

As Professor Bradley aptly documents, regulatory transparency has become a dominant theme in recent years. There is good reason for this: transparency can promote pluralism in regulatory processes[5] and ensure regulatory accountability by harnessing the threat of public scrutiny.[6] These forces, in turn, may counteract various well-known regulatory

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transparency or of transparency as opposed to communication.").

[3] *See generally*, IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEGREGULATION DEBATE 54-100 (1992) (advocating for Tripartism, which would empower designated public interest groups with the capacity to participate in the negotiation of regulatory outcomes and challenge industry behavior through the same mechanisms as those available to the regulator).

[4] *See generally*, Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629 (2011) (arguing that regulation can be improved through the use of "regulatory contrarians," which are entities that possess persuasive authority over regulatory outcomes, are affiliated with, but independent of, specific regulators and are tasked with reporting on deficiencies and potential improvements in regulation).

[5] Mark Seidenfeld, *Empowering Stakeholders: Limits on Collaboration as Basis for Flexible Regulation*, 41 WM. & MARY L. REV. 411, 417-18 (2000).

[6] *See generally* Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols versus Fire Alarms*, 28 AM. J. POL. SCI. 165 (1984).

failings, including loafing, intransigence, and capture. Of course, the extent to which transparency can deliver on these lofty goals depends substantially on the underlying regulatory context. In at least some settings, transparency may actually exacerbate regulatory dysfunction by facilitating "information capture,"[7] encouraging the politicization of regulatory decision-making, and perhaps even chilling valuable communication between market participants and regulators.[8]

In the context of financial regulation, the net benefits of existing efforts at regulatory transparency often seem minimal. Professor Bradley emphasizes this point in the context of entities such as the Basel Committee, IOSCO, and IAIS, which purport to embrace transparency while, in practice, relying almost entirely on the work-product of a narrow range of government technocrats and industry lobbyists.[9] But the limits of transparency in financial regulation run deep. For instance, a notable recent study by Kim Krawiec found that industry dominated implementation of the Volcker Rule in the Dodd Frank Act.[10] While the public "formally" participated in the process by submitting thousands of comments, almost all of these were either form letters prepared by public interest groups or comments that did not meaningfully engage the issues.[11] Other studies have shown that this pattern is hardly unique to financial regulation: in various domains, regulatory participation is dominated by regulated entities with similar, self-interested, perspectives.[12]

Professor Bradley suggests that a core explanation for this pattern is a lack of *real transparency*, meaning that the processes of financial regulation are unreasonably opaque for the vast majority of ordinary individuals. First, she argues that financial standard setters make an insufficient amount of information accessible to the public when it comes to specific regulatory documents and industry feedback: regulatory documents are available in a limited number of languages and may be scattered in various locations, while the financial interests of stakeholders are not always apparent. Second, and more fundamentally, Professor

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[7] *See generally* Wendy Wagner, *Administrative Law, Filter Failure, and Information Capture*, 59 DUKE L. J. 1321 (2010).

[8] ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASONING IN THE GLOBAL FINANCIAL MARKETS (2011).

[9] Bradley, *supra* note 1, at 17-18.

[10] Kimberly Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform* (Sept. 16, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1925431.

[11] *Id.* at 19-25.

[12] *See, e.g.*, Jason Webb Yackee & Susan Webb Yackee, *A Bias Toward Business? Assessing Interest Group Influence on the U.S. Bureaucracy*, 68 J. Pol. 128 (2006).

Bradley emphasizes that standard setting bodies produce too much information. Not only is financial regulation inherently complex and technical, but there are multiple regulatory bodies at both the domestic and international levels. Collectively, these forces prevent ordinary individuals from meaningfully engaging with, and even understanding, the underlying regulatory issues.[13]

Although clear-eyed about some of the difficulties of remedying these problems, Professor Bradley exhorts international financial standard setters to work harder to "communicate" with "citizens" about their regulatory efforts. She thus suggests initiatives such as translating regulatory documents into more languages and requiring disclosure of commentators' financial interests. More controversially, she suggests that international standard setters should draft rules in plain language and work to coordinate, and perhaps even limit, their production of information. At one point she argues that they should embrace simpler regulatory approaches because that would improve citizen information (such an approach might be justified on the alternative ground that it places less reliance on regulatory expertise).

Unfortunately, Professor Bradley's pessimism regarding the prospects of "real transparency" in financial regulation is not only understandable, but understated. This is for two basic sets of reasons. First, neither "real transparency" nor better "communication" is likely to increase consumers' actual understanding or interest in financial regulation. Most fundamentally, this is because the beneficiaries of financial regulation are quite diffuse, consisting either of the consumers of financial services (in the case of consumer protection regulation) or taxpayers (in the case of systemic risk regulation).[14] These individuals have limited incentives to invest effort or time in learning about relevant issues, even when that information is readily available.[15] Additionally, most ordinary citizens do not care about financial regulation even when they do have a substantial economic stake in outcomes: the blunt truth is that non-experts generally view financial regulation to be boring, at least when it comes to micro-level issues of implementation.[16] Not only does this further limit the public's

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[13] Krawiec, *supra* note 10, at 21-26.

[14] Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 420 (2006) ("One critical factor stands out: larger, more diffuse groups, such as retail investors, encounter greater difficulty in organizing themselves for collective action, and only exert significant pressure on regulators when their interests are severely affected.").

[15] Saule Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. (forthcoming 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1924546.

[16] Even the current "Occupy Wall Street" movement, which is quite distinctive, is

willingness to consume information about financial regulation, but it also impedes the fund raising capacity of public interest groups who might do this on their behalf.[17]

Second, even if ordinary citizens could somehow be convinced to take an interest in the details of financial regulation, it would be impossible to simplify these details sufficiently to allow citizens to deeply understand, much less meaningfully contribute to, their development. Financial regulation is inherently complex because finance is itself complex. Moreover, financial institutions are dynamic and evolving, often in ways that are specifically motivated by efforts to avoid regulation.[18] These facts require evolving and detailed regulatory structures. Moreover, understanding and contributing to the debate about how these structures should be designed typically requires engagement with industry perspectives on these points. Yet as Wendy Wagner has persuasively argued, industry participation in financial regulation is not only extensive, but often excessively so, because of the lack of any filter that is imposed on this feedback.[19] This is exacerbated, of course, by the financial interests that industry typically has in particular regulatory outcomes as well as the resources at their disposal in presenting and justifying this perspective.[20]

Nowhere were these limitations in transparency more apparent than in the context of pre-crises domestic financial regulation. Although there were clearly numerous problems with financial regulation in the United States during this time period, it is hard to argue that regulatory transparency (as opposed to market transparency) was anywhere near the top of the list.[21] Financial regulators were perfectly upfront about their decisions: indeed, they openly celebrated and defended deregulation in numerous contexts, ranging from derivatives trading to subprime mortgage

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focused on vague and difficult-to-define public distrust of Wall Street rather than specific regulatory ideas. *See, e.g.*, Paul Krugman, *Confronting the Malefactors*, N.Y. TIMES, Oct. 6, 2011, http://www.nytimes.com/2011/10/07/opinion/krugman-confronting-the-malefactors.html?_r=1 ("A better critique of the protests is the absence of specific policy demands. It would probably be helpful if protesters could agree on at least a few main policy changes they would like to see enacted.").

[17] Omarova, *supra* note 15, at 47.

[18] McDonnell & Schwarcz, *supra* note 4, at 1631.

[19] Wagner, *supra* note 7, at 1416.

[20] Rachel Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 22 (2010); Christie Ford, *Macro and Micro Level Effects on Responsive Financial Regulation*, 44 U. B.C. L. REV. (2011) (emphasizing the capacity of industry to shape the implementation of flexible regulation).

[21] While it can certainly be argued that industry influenced these results through opaque mechanisms, none of the regulatory improvements that Professor Bradley suggests for international financial standard setters would have shined a light on this influence.

origination to capital requirements.[22] Regulatory processes were subject to the transparency requirements of federal law, including notice and comment rulemaking and Freedom of Information statutes. And this information was available in a language that any domestic constituency could understand. Despite these facts, the participation and influence of ordinary citizens in domestic financial regulation was obviously de minimis.

All of this suggests that the efforts of financial standard setters or regulators to engage "ordinary citizens" in the nuances of their regulatory processes are ultimately as futile as efforts to coax water from a stone. However, that does not mean that the instrumental goals of regulatory transparency—promoting alternative perspectives in regulatory processes and ensuring democratic accountability among regulators—are unachievable. Instead, it means that these goals must be met through a targeted set of reforms that cultivate and promote non-industry involvement in regulatory processes in ways that include, but extend beyond, transparency. It is to this issue that Part II briefly turns.

II. ADDRESSING THE PROBLEM: EMPOWERED CONTRARIAN EXPERTS

Throughout her article, Professor Bradley often treats "experts" as a monolithic group, composed of individuals with similar ideas and financial interests that stand in opposition to the interests of citizens.[23] In some ways, this perspective is historically accurate: most of the outside experts who have participated in financial regulation are industry funded and therefore, broadly speaking, have similar sets of interests. At the same time, though, there is nothing inevitable about the alignment of expertise and industry. Numerous experts exist who have contrarian orientations and no direct financial interest in regulated industries, including public interest group members, academics, and government officials that do not regulate directly in the domain under consideration.[24]

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[22] *See, e.g.*, KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 7-9 (2011) (describing federal lawmakers' openly deregulatory policies regarding subprime lending).

[23] *See, e.g.*, Bradley, *supra* note 1, at 22 ("Although citizens may need to make decisions about their own mortgages and investment for retirement they do not need to participate in developing rules of financial regulation. This activity remains in the hands of the experts. But the experts are not always right about what needs to be done, and when they are wrong it is others, including the taxpaying citizens, who pick up the pieces.").

[24] Susan Webb Yackee, *Capture in the Regulatory Process*, in PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE IN REGULATION AND HOW TO LIMIT IT (David Moss & Daniel Carpenter, eds.) (forthcoming, 2012 on file with author) (finding that public comments by sub-national government officials exerted significant influence in federal rulemaking).

If we are to achieve the ends that Professor Bradley seeks in financial regulation, it is absolutely necessary to engage these experts in regulatory processes. Accomplishing this would help to defuse some of the cognitive biases that may impact financial regulators and would, in any event, promote consideration of a diverse set of perspectives in the regulatory process.[25] It would also mitigate the risk of capture by increasing the threat of public scrutiny: knowledgeable and expert participants in the regulatory process are well suited to generate public scrutiny in the face of obvious or salient instances of capture.[26]

Various potential strategies might be attempted to actively cultivate this type of broad-based participation in financial regulation. The first, and probably most important, such strategy is indeed transparency.[27] Outside groups cannot meaningfully participate in or police regulatory proceedings without access to relevant information. But this type of transparency is much different—and narrower—than that which Professor Bradley advances. It does not require regulators to translate documents into multiple languages, at least assuming that most potential experts in financial regulation are conversant in English. Nor does it require industry commentators to disclose their financial interests, at least when those interests would otherwise be apparent to a person knowledgeable in the underlying field. Instead, it simply requires that those who are motivated to understand the regulatory process can easily do so if they possess a baseline set of information and knowledge.

But while this narrow form of transparency is surely necessary to promote participation in financial regulation by contrarian experts, it is also hardly sufficient. Most experts with alternative perspectives on financial regulation do not currently have clear incentives to devote a substantial amount of time, effort, and resources to the nuts and bolts of regulation. Public interest groups interested in financial regulation are scarce and those that do exist rarely spend their time on issues that do not fit squarely within the consumer protection domain.[28] Academics are generally not rewarded for direct participation in financial regulation, which is often viewed as insufficiently theoretical to enhance their (or their institution's) reputations.[29] And government officials typically have strong incentives to

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[25] McDonnell & Schwarcz, *supra* note 4, at 1644-51.

[26] Daniel Schwarcz, *Preventing Capture Through Consumer Empowerment Programs: Some Evidence from Insurance Regulation*, in PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE IN REGULATION AND HOW TO LIMIT IT (David Moss & Daniel Carpenter, eds.) (forthcoming 2012 on file with author).

[27] *See* AYRES & BRAITHWAITE, *supra* note 3, at 57.

[28] *See* Omarova, *supra* note 15, at 32-34.

[29] *See* David Moss & John Cisternino, *Introduction* to NEW PERSPECTIVES ON REGULATION 7 (David Moss & John Cisternino eds., 2009).

direct their energies entirely within the narrow confines of their job descriptions.

Tripartism represents one promising approach for incentivizing these groups to participate in financial regulation.[30] Broadly construed, tripartism involves empowering designated public interest groups or academics with certain procedural rights that enhance their capacity to influence regulatory outcomes. So long as this enhanced authority is contestable by alternative groups, tripartism may be able to counteract regulatory capture by requiring industry to expend resources to capture two separate groups. Tripartism can also promote democratic accountability simply because the perspectives that public interest groups and/or academics offer are historically under-represented in financial regulation. Recently, Saule Omarova has proposed a specific tripartite structure for systemic risk regulation.[31] And tripartism already exists in the context of domestic financial regulation and consumer protection.[32]

An alternative approach is for financial regulators or standard setters to establish "regulatory contrarians" that are affiliated with these entities but specifically tasked with presenting alternative perspectives on regulatory issues.[33] Although such contrarians enjoy privileged access to regulators, they do not themselves possess regulatory powers. Instead, they use persuasion and pressure to inform and help shape regulatory policy. In doing so, of course, contrarians are meant to challenge prevailing wisdom and advocate for perspectives that are insufficiently represented in the existing regulatory fray. Examples of such contrarians include inspectors general, research arms of regulatory bodies, and independent "proxy advocates" such as the Taxpayer Advocate in the Internal Revenue Service.[34]

These are hardly the only promising strategies for actively encouraging participation in financial regulation by contrarian experts. For instance, regulators and standard setters could offer monetary payments or prestigious awards for public-benefiting comments or consultations.[35] Alternatively, they could maintain advisory panels comprised of experts

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[30] AYRES & BRAITHWAITE, *supra* note 3, at 57.

[31] *See* Omarova, *supra* note 15, at 4.

[32] Schwarcz, *supra* note 26. Similarly, the Consumer Safety Product Commission reimbursed non-industry participation in notice and comment rulemaking for some time. *See generally* Carl Tobias, *Great Expectations and Mismatched Compensation: Government Sponsored Public Participation in Proceedings of the Consumer Product Safety Commission*, 64 WASH. U. L.Q. 1101 (1986).

[33] *See* McDonnell & Schwarcz, *supra* note 4, at 1644-51.

[34] *See id.* at 1651-66.

[35] Wagner, *supra* note 7, at 1416.

with distinctive viewpoints.[36] Yet another approach would be for regulators to encourage firms themselves to hire individuals with different perspectives in an attempt to generate more diverse perspectives from within regulated firms.[37]

CONCLUSION

Financial regulation is a technical, difficult, and inherently opaque topic. In this context, regulatory transparency can only do so much. Rather than seeking to reach unachievable levels of democratic accountability, financial regulators and standard setters should attempt to ensure that their efforts are guided by a diverse set of informed, outside perspectives. Their best chance of achieving this goal is to selectively target contrarian experts such as academics, public interest groups, and government officials and incentivize their participation in regulatory processes through initiatives such as tripartism and the establishment of regulatory contrarians.

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[36] *See generally*, Barkow, *supra* note 20, at 78 (discussing Dodd-Frank's creation of a "Consumer Advisory Board" to advise and consult with the Consumer Financial Bureau, but suggesting that such a structure is a poor substitute for a vigorous, full-time public advocate).

[37] *Cf.* Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL'Y 807, 836-37 (2010).