Finance: The Discreet Regulator

How Financial Activities Shape and Transform the World

Edited by Isabelle Huault and Chrystelle Richard

Foreword by Michael Power

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and

Chrystelle Richard

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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.

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Isabelle Huault and Chrystelle Richard

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

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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 how this joint regulation is dominated by financial actors. The rest of this introductory chapter is structured accordingly. First, we define the notion of regulation. From a brief overview of some regulation approaches, we defend a systemic, neo-structural (Favereau and Lazega, 2002: 1–28; Lazega, 2011b) perspective on the regulatory or rule-setting process, focusing on the concept of joint regulation and avoiding a stark dichotomy between the State and private actors. Second, we highlight the role, characteristics and strategies of financial actors in the making of rules and norms, with a particular emphasis on their multipositionality and their fluidity. The third and final part presents the other chapters contributed to this volume.

Defining the concept of regulation: Beyond the 'regulator/regulated' dyad

The general question of regulation has been largely debated in the academic literature. However, while most analyses concentrate on the creation of rules or the regulator/regulated dyad, we argue that the tension between the State and private actors needs closer examination.

A first dimension of the concept of regulation relates to compliance mechanisms, where the issue at stake is why and how regulatees do or do not comply (Djelic and Sahlin-Andersson, 2006: 6). According to Hawkins (1984), two types of regulatory strategies can thus be distinguished. The first is a compliance strategy: a cooperative, problem-solving relationship between the regulator and the regulatee. The objective is to achieve conformity with regulatory requirements; criminal sanctions are considered a last resort because they are viewed as a failure of the regulatory system. The second is a deterrence strategy: an arm's-length regulatory style in which regulatees must meet regulatory requirements or face punitive sanctions, typically prosecution. Punitive sanctions are viewed as indicative of the regulatory system's success in enforcing legal requirements. Real-world regulation is in fact based on a mix of these two strategies, vacillating between 'penalties are necessary' and 'penalties are counterproductive'. Ayres and Braithwaite (1992) reconcile the two approaches by proposing the concept of responsive self-regulation. They argue that regulators should have a range of compliance and enforcement tools, so that they can respond cooperatively to cooperative regulatees, and punitively to the rest. Initial regulatory cooperation until a regulatee fails to comply is always the preferred approach. This process is conceptualized as what Ayres and Braithwaite called the Enforcement Pyramid, a model in which regulatory tools comprise a broad basis of cooperative measures, including persuasion, regulatory advice and technical consultations. Non-compliance is dealt with using a range of increasingly punitive measures, from warning letters to civil and criminal sanctions, and ultimately to the regulatory capital punishment of licence termination. According to Ayres and Braithwaite, the more punitive the ultimate sanctions available to the regulator, the more likely it is that regulation occurs at the base of the Enforcement Pyramid, through a cooperative relationship between regulator and regulatee. In the same vein as Hawkins' regulatory strategies, responsive self-regulation focuses on two-party regulation, involving only the regulator and the regulated. These regulatory patterns also see regulation as encompassing not only rule creation, but also rule enforcement. Creation and enforcement of rules impact each other and develop systemically, as Shapiro (1987) demonstrated. In his book on *The Audit Society*, Power (1997) showed that the redefinition of the State's role as an external controller of public services was concomitant with a discussion on the necessity of self-regulation at the public and private levels. As more efficient self-regulation was expected, a multitude of regulatory strata appeared; since auditors acted as intermediaries between those strata, this contributed to an 'audit explosion'.

The regulatory arena thus emerges as a result of interactions, conflicts and cooperation between a multiplicity of actors, public and private. We study the rule-making process by understanding financial products, organizations, regulators and experts as elements of an interconnected system (Lounsbury and Hirsch, 2011). In this view, private actors not only enforce the rules, they can in fact invent them. The concept of *joint regulation* developed by the French sociologist Jean-Daniel Reynaud (1989) – and extended by Lazega (2003) to the inter-organizational level – fits rather well with the general argument that a web of private actors takes part in the regulation process. This mechanism is not only a way to share the costs of regulation; it is also a way to take advantage of the experience of a number of different stakeholders, and their knowledge of the business world, in order to exercise social control over markets. State authorities and financial actors coordinate their efforts in this process, such that exogenous regulation and endogenous self-regulation can combine (with occasional conflict) (Edelman and Suchman, 2007; Lazega and Mounier, 2003). A context of growing liberalization and declining State power (Dobbin and Sutton, 1998) tends to intensify the endogeneity of law, and the process can sometimes take the form of a power struggle between financial institutions and the State. The coercive pressure of the State expressed in 'hard law' competes with more flexible, informal rules known as 'soft law'. The choice of norms is thus an object of conflict and permanent negotiation. In these struggles, the most powerful players often have the capacity to impose their vision and make their interests prevail (Selznick, 1957). But whatever the situation, external regulation by State authorities and self-regulation cannot be analysed separately. Building on Zald and Lounsbury (2010: 977), we call for close examination of the interpenetration between the State regulator and private financial experts that shape the policy and dynamics of economics and society in ways that favour the financial industry.

The combination of traditional State regulation and private regulation can have surprising effects. Rules may be in conflict, building a highly ambiguous system that lacks consistency. This ambiguity features strongly in contemporary systems of norms based on polynormativity (Lazega and Mounier, 2009). Polynormativity is synonymous with both regulatory creativity and normative inconsistency, a process that often produces 'sub-optimality', conflict or instability, at a macro-level. Being highly politically active, financial actors defend their regulatory interests in a very partial, fragmented and short-term – in a word, 'discreet' – conception of what is good for markets and society. The role of these financial actors, apparently the keystone of the system of norms in the economic sphere and society more generally, is not clearly identified and insufficiently analysed, and needs to be explored further.

Exploring discreet regulation by financial actors

Exploring the discreet role of financial actors in the real-world regulation of the economic sphere raises several simple but essential questions. Why are financial actors the most influential and powerful actors? How are they involved? What are their key features? How do they define rules? And how do they succeed in promoting their regulatory interests and turning *precarious rules* into *priority rules* (Selznick, 1957)?

Neo-institutionalist theorists would say that financial actors act as 'institutional entrepreneurs', and try to establish institutional arrangements in order to realize interests they value highly (DiMaggio, 1988). One key feature of their impact on institutional change appears to be the actors' position (Battilana, Boxenbaum and Leca, 2006), which can deeply affect both their perception of the field (Dorado, 2005) and their access to resources (Lawrence, 1999).

In this view, the regulatory process cannot be studied simply by asserting that the strongest players impose their rules. In real life, as Simmel ([1908] 1955) reminds us, individuals are embedded in a number of group affiliations and belong to 'multiple social circles of communities' (Djelic and Quack, 2010: 25; Mills, 1956). Influential actors are often in a situation of multipositionality and possess heterogeneous, inconsistent forms of social status (Lazega, 2001). Thanks to their multiple types of status, these actors are able to combine their power (technical expertise, financial resources, efficient time management, etc.) with a certain form of legitimacy (in other words, a capacity to speak credibly on behalf of the community). Sometimes paradoxically, multipositionality combined with status inconsistency in fact facilitates legitimacy building through (partial, relative or feigned) sacrifices of resources. The combination of power and legitimacy allows actors to dominate in the Weberian sense so as to influence the definition of priority rules, in particular by convincing the community that they are ready to give up resources for the common good. Although such 'sacrifices' have a cost in terms of resources, the inconsistency of the actors' multiple forms of status means they can lose on some dimensions but win on others, thus remaining protected and holding on to their power.

The institutional entrepreneurs who best defend their regulatory interests are often those who are able to benefit in this way from their multipositionality and the status inconsistencies that characterize their social milieu. Organizationally, they often belong to several regulatory bodies, that is, influential micro- and macro-political rule-making settings created to combine top-down and bottom-up institutional pressures. Based on a culture of consultation, they are able to build consensus by mobilizing good interpersonal skills. Financial actors thus participate in different groups, personalize their relationships and use them to control and dominate the construction of a consensus. The creation of a new rule results from negotiations between State authorities and the financial actors in partially visible regulatory colleges. Halliday and Carruthers (2010) show, for example, how representatives of ministries, professions and creditors, often a small number of delegates with highly developed personal networks even at global level, have been able to dominate global bankruptcy law-making over the past generation. They build a consensus on individual rules without discussing the overall set of rules; its construction is thus less visible. Power (2009) similarly argues that after the financial scandals of 1990–2000 highlighted regulatory concerns regarding corporate governance, the regulated organizations chose to self-regulate in order to avoid regulatory interference and escalation. As a result, the regulatory focus shifted from external audit to internal audit as the essential mechanism of control. Internal control is seen as a way to organize uncertainty (Power, 2007). The regulatory process is complex because it is sometimes based on a strategy of fragmentation leading to a system of rules that is much more stable than any single rule considered separately, but not discussed as such as a system. Here discreteness thus serves discretion.

Multipositionality stems in particular from the hypermobility and fluidity of the financial elites (Huault and Rainelli, forthcoming). Elites are constantly on the move (Boltanski and Chiapello, 2005). They are very willing to change, relocate and move not only between financial centres (Sassen, 2001) but also between different statuses, arenas and regulatory colleges. The very boundaries of these elites are fluid and under permanent renegotiation (Djelic and Quack, 2010; Hannerz, 1996). As Djelic and Quack (2010: 19) note, research on the internationalization of professional service firms in fields such as accounting or consulting has pointed to the emergence of international networks of professionals. This can give rise to transnational communities of experts – or 'epistemic communities' as Haas (1992: 3) calls them – that is 'a network of professionals with recognized expertise and competence in a particular domain and authoritative claim to policy-relevant knowledge within that domain or issue of area'. Scheimel (2004: 87) studied how a consensus is created within the World Trade Organization and the World Meteorological Organization, and explained that 'to be influential their politicians must become experts and their experts must learn politics'. These leaders, politicians and experts, are ultimately becoming more influential and more effective than the official networks and communities.

However, expertise, extreme technicization and sophistication sometimes destabilize the negotiation and consensus-building process. The social capital enjoyed by financial actors, their technical knowledge, their ability to innovate continuously (Huault and Rainelli, 2011) and the prestige of their position, enable them to impose their own logic and game rules in a regime of pure domination (Huault and Rainelli, forthcoming). Domination refers here to a capacity to 'restrict critical space, or what ultimately amounts to the same, to deprive criticism of any leverage on reality' (Boltanski, 2009: 176). The hyper-instrumentalization and ultra-technicality of the products financial actors invent put them in a position to set the rules for a game that only they understand (Huault and Rainelli, forthcoming). This complexity prevents other actors, State or citizens, from intervening, criticizing or even debating. The rise in technicality increasingly distances the financially uninitiated from democratic decision-making. As Boltanski has commented (2009: 200), 'the often technical character of statements and the measures taken makes it difficult or even useless to transmit them to the public at large.' Finance is becoming the exclusive preserve of experts who base their legitimacy on the authority of science, models and technology. This leads to the formation of ultra-technical markets and institutions, where only the inventors really understand the rules of the game.

This book seeks to highlight the multiplicity of regulatory actors, in addition to capital markets and the financial regulator, participating in the rule-making process in the financial industry. We depict the nature of the actors involved, their local activities, their key features, and how they introduce and spread financial logics. From major investment banks to financial controllers, from rating agencies to compliance officers, we look at a variety of key players who are active at the very core of the regulatory process. We examine how they make sense of the rules governing the financial game, and how they enact norms and perform control (Lenglet in this volume). We see how, even though their role is recurrently criticized as financial scandals and economic crises arise, financial actors are able to maintain their regulatory power and legitimacy (Taupin in this volume). We also show the way they can encourage thinking rooted in the frames of the financial world, thus engaging in subtle forms of regulation and naturalizing the discourse of financialization (Morales and Pezet in this volume). This discreet regulation by financial actors, acting as boundary spanners between public and private spheres, can be risky and creates confusion between the defence of the common good and the search for profit (Ramirez in this volume).

Following the argument that the State is not the 'only and central mainspring' (Djelic and Sahlin-Andersson, 2006: 4) of the rule-making process, we also look at the complex interactions between the State and private actors, in a context where the boundaries between public and private spheres are increasingly blurred. The corresponding tensions and power game are carefully examined, with a particular focus on private actors trying to take part in the design and governance of the market. We study how they attempt to shape and control institutional arrangements, at the expense of the State and the public interest (Penalva-Icher et al. in this volume). To make their own regulatory interests prevail, financial actors sometimes strike up alliances with public authorities that fail to restrain the self-interested preference expressed by the dominant market participants (Lagneau-Ymonet and Riva in this volume). This can happen in the form of 'institutional capture', a process by which the financial industry designs and redesigns markets, and effectively runs State institutions (Lazega and Mounier in this volume).

Finally, we depict the rule-making process, arguing that it is based on the construction of legitimacy and the way actors handle ambiguities. We scrutinize how actors spread their ideas, establish acceptance of their practices and construct game rules through relational resources (Penalva-Icher, Deville and Oubenal in this volume). But the production of rules can also result from the way actors collectively resolve ambiguities stemming from the specific design of certain products (Huault and Rainelli in this volume). In such situations they carry out collaborative action to impose their view, and engage in a range of social processes that shape markets in very specific ways. They construct a cognitive, political community, taking the role as creator of the game rules.

Content of the book

The concept of 'discreet regulation' is the backbone around which the chapters of this volume are organized. Part I focuses on the actors themselves as networks of influence, and their characteristics. Part II highlights the tension between the State and the Market, and the different kinds of joint regulation empirically identified. Finally, Part III examines the concrete processes of rule-making.

Polymorphic actors as networks of influence

In Part I, Chapters 1 to 4 present four types of actors that relay the power of finance in addition to the major investment banks. We look at these actors as intermediaries of financial markets who disseminate the market logic throughout the socio-economic system.

In Chapter 1, Morales and Pezet seek to advance understanding of how the notion of financialization materializes and operates in a concrete organization. Rather than focusing on the role of financial markets, they analyse how financial rationales are mobilized, enacted and appropriated in a firm. They illustrate the role played by the financial controller in framing organizational practices, influencing micro-practices and shaping the subjectivity of participants. The process of regulation studied in this chapter is local and acts as a discreet power. Morales and Pezet conclude that financial controlling processes materially embed the discourse of financialization and internalize financial patterns of management and control, giving rise to subtle regulation processes that influence organizational practices.

In Chapter 2, Ramirez studies the role played by the group of multinational audit firms, known as the Big Four (Deloitte, KPMG, PricewaterhouseCoopers and Ernst & Young), in the implementation of an international system of standards for accounting and auditing. The production of these international standards, which are applicable in large areas of the world, is supposedly independent of the influence of any particular individual or group. This chapter argues that agencies such as international standard-setters are not the true regulators acting in lieu of national States at supranational level; to be able to function efficiently, these regulators need the backing of organizations such as the Big Four audit firms. According to Ramirez, the importance of the Big Four as the actual discreet regulators is not devoid of risk, for they operate at the junction between the public (accounting and auditing as a public good in need of regulation) and the private (accounting and auditing as lucrative professional services).

In Chapter 3, Lenglet analyses the daily routines unfolding in financial firms and markets. He looks at the very end of the regulatory chain, within organizations where regulatory texts are applied, that is, translated, adapted and put into action. For Lenglet, being compliance officer is one of the functions taking an active part in this interpretation and translation, building on their ambivalent position in the organization. In their enactment of internal norms and performance of control, compliance officers are actors of the regulatory architecture that now exists at a global level across the whole economy. More precisely, Lenglet documents how compliance officers interpret regulatory texts, how they manage ambiguities and how they use written devices to spread regulation through practices, thus contributing to the actual design of markets.

In Chapter 4, Taupin examines perpetuation of the regulatory order by the stakeholders of the credit rating industry, by analysing the 340 comments collected during the public consultation held by the Securities and Exchange Commission (SEC) in the 2000s to debate the proposed regulation of the credit rating industry. He shows from this longitudinal study that while examining the new criticisms of credit rating revealed by the subprime crisis, the public debate is actually reproducing the concept of a self-regulated industry (more transparency, disclosure and competition to achieve more efficiency). In Taupin's opinion, what looks like a new, irresistible force for social change in the rating industry is actually a new form of a recurrent historical process in which credit rating agencies, investors, rating users, academics and the SEC all play a substantial role through their discursive work.

Balance of power between markets and states, and forms of joint regulation

Part II and Chapters 5 to 7 turn to the relationships between the State and the Market regarding financial regulation. We observe various institutional arrangements and diverse forms of *joint regulation,* where the types of actors intervening in regulation combine in variable ways, historically as well as geographically.

Chapter 5 by Penalva-Icher et al. underscores the central role played by the banking sector in joint regulation. The authors describe the banks' contribution to the construction of a new institutional system combining public procurement and private contracts, through the promotion of Public–Private Partnerships (PPP) in France. They portray a tool that has introduced new arrangements for economic relationships between private and public sectors, embedded in a system of heterogeneous actors. The PPP underpins structuring of a new type of regulation, mixing public preoccupations and private interests but where the regulatory power of banks is huge. Thanks to its dominant position, the financial world holds a powerful role, and is able to impose its own vision of the PPP contract and dictate its concept of risk.

In Chapter 6, Lagneau-Ymonet and Riva offer a critical analysis of joint regulation through a study of the revision of MiFID (the Markets in Financial Instruments Directive). European law-making has been designed to integrate regulated and regulating bodies. The authors point out that financial matters intertwine public and private interests, and therefore business, administrative and political institutions. Drawing on socio-economics and financial history, this chapter demonstrates how the revision of the MiFID has left the 'standards-surveillance-compliance regime' (Wade, 2007) untouched, although it gives the industry the upper hand in regulation of financial activities. Finally, Lagneau-Ymonet and Riva propose some tracks to restore the balance of power between public and private actors in the making of European financial joint regulation.

In Chapter 7, Lazega and Mounier scrutinize one of the ways in which the financial industry can run a State institution, through analysis of the operations of a judicial institution, the Paris Commercial Court. They underline how this court handles bankruptcy proceedings, observing the composition of chambers, the judges' networks and the normative choices made by bankers acting as judges at the court. The results highlight the financial industry's domination of this institution, and its huge influence. The authors advocate re-examination of the operation of economic and legal institutions, from the perspective of protecting the common good in a regulatory context where the public/private sector boundaries are blurred.

The rule-making process

In Part III, we explore the process of rule-making. We argue that financial actors produce rules, standards and norms, with reference to the production of ideas and the construction of legitimacy (Chapters 8 and 9), and to the way the main players tackle ambiguities (Chapter 10).

In Chapter 8, Penalva-Icher considers that the financial focus on Socially Responsible Investment (SRI) is the result of discreet regulation by the financial sector in a context that could have been influenced by a number of other actors. This chapter examines the way SRI is defined through the actions of three specific players, namely the State, finance and trade unions, which operate through a large number of relational networks. It shows how finance is successfully imposing its view, using the trade unions' strategy and giving them incentives to enter the market provided they comply with the financial cognitive framework.

In Chapter 9, Deville and Oubenal investigate how the market for Exchange Traded Funds (ETFs) was created and has been promoted in France since 2000. They provide empirical evidence that ETF promoters discreetly exercised social control, showing not only how they convinced the markets of the relevance of the innovation and negotiated the game rules with the regulator, but also how cooperation between competing issuers helped in the legitimization process. Deville and Oubenal describe in detail the mechanisms through which social discipline developed on this market and contributed to construction of the field and the rule-making process.

Finally, Chapter 10 by Huault and Rainelli-Weiss analyses the process of social construction concerning the market for credit derivatives. A specificity of credit derivatives is that they are not easily defined, categorized, legally qualified or valued. They also induce doubts as to who will benefit from the development of the market. In response to these difficulties, the large investment banks took the lead and jointly committed to standardization and normalization processes. The manner in which political and cognitive ambiguities are handled by the actors, with the greatest interest in development of the market and the most resources to devote to the cause, is central in explaining the structure of the market, its concentration and its lack of transparency. Overall, this final chapter documents the central role played by private actors in managing ambiguities, and hence in market shaping.

Notes

1. The Basel Committee is a committee of banking supervisory authorities. It formulates standards and guidelines, and more specifically the capital adequacy standards for banks.
2. International Swaps and Derivatives Association.

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Part I
Polymorphic Actors as Networks of Influence

1
Financialization through Hybridization: The Subtle Power of Financial Controlling

Jérémy Morales and Anne Pezet

Introduction

Globalization, financialization, neoliberalization: these concepts, although widely mobilized, are usually defined in a rather abstract, theoretical way. Their use seems to suggest that contemporary societies are caught up in an overwhelming general trend of redefining an ever-increasing number of issues and settings in economic and financial terms. These definitions usually highlight one central actor, namely the markets, especially capital markets, and one key set of mechanisms, namely regulation. This chapter seeks to advance understanding of how these notions materialize and operate in a concrete setting, and thereby contribute to debates about financial management in organizations and society.

A case study is used to explore relatively under-researched aspects of financialization. Rather than focusing on the role or operation of financial markets, we analyse how financial rationales are mobilized, enacted, appropriated and modified in a specific organization. This helps denaturalize the concept of financialization, through illustrations and reminders that its mechanisms are neither deterministic – organizational behaviour does not automatically match speculators' expectations – nor universal, being instead locally situated and shaped through their relationship in a particular setting. The study provides empirical content for the notion of regulation by illustrating the role played by several actors and processes in framing organizational practices, favouring new norms of behaviour without the need to enforce any mandatory rules, and shaping the subjectivity of organizational participants.

This chapter is not interested in officially sanctioned regulatory frameworks, but in the processes influencing micro-practices within

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organizations. The processes of regulation studied here are built on local, situated activities and representations, and shape and orientate daily practices in a subtle, non-coercive way. They are also materially embedded in a proliferation of diverse yet mutually consistent and reinforcing processes, and hence act as a discreet power. These processes of regulation not only influence actions, decisions and behaviours, but also affect individual subjectivity, and the study examines how the discursive and material practices of financialization influence interpretive schemes and identification patterns within specific situations.

We analyse a case where financial controlling practices encounter alternative local managerial traditions, and show how this confrontation alters managers' practices and perceptions. However, we also document how controlling practices are modified in the process, thus hybridizing the financialization discourse with local traditions. We conclude that financial controlling processes materially embed the discourse of financialization, giving rise to subtle regulation processes that influence organizational and managerial practices. 'Financial controlling practices and processes' does not refer to the work of management accountants. Financial control, like any other management controlling system, is primarily exerted by managers through hierarchical discipline and accountability; however, in contrast to other systems, financial controlling is almost entirely framed within an accounting field of knowledge, as opposed to an operational field. As this chapter shows, although financialization is promoted by accountants and supported by their pedagogical work, its main influence relates to managers internalizing financial patterns of management and control.

In the case studied here, managerial practices are embedded in a technical discourse. This discourse relates to the company's magnificent past, and serves a long-standing and deep-rooted cultural tradition of technical excellence. In such a 'world of engineers', even though financial issues are central to decision-making, they seem too important to be left to accountants and are instead subordinated to the 'true' performance criteria of innovation and technical excellence. Managerial and controlling systems are primarily designed by engineers to monitor the work done by other engineers and technicians. As a result financial controlling has difficulty integrating into this cultural context, being perceived as a restriction on engineers' autonomy and independence. Engineers are not unwilling to be accountable for their actions, but they believe accountability should rely on social rather than formal processes, and more importantly should be considered in technical, not financial terms. However, the financial rationale has links with contemporary cosmopolitan ideals of globalization and financialization. We thus trace the points of confrontation, then analyse the claims of each group and the consequences of this contest over control. We argue that this confrontation gives controllers an opportunity to promote the introduction of financial controlling, which serves financialization through hybridization of the local rationales with financial management rationales. We thus show how financial controlling acts as a subtle form of regulation by orientating behaviours and individual subjectivities.

The remainder of the chapter is structured as follows. After reviewing the literature on the power of financial controlling, we present our empirical findings. Firstly, the ideals and rationales shaping the organization's culture are identified. The forms of confrontation between rationales are then described, showing how several individuals attempt to redefine the style of management in their company. Thirdly, the focus turns to accountability processes, to show how they influence managers' practices and subjectivity. Finally, we discuss our findings and draw implications for the study of financialization, discreet regulation and financial controlling.

The power of financial controlling to constitute norms of behaviour and categories of perception

Accounting literature has documented the power effects of financial controlling systems. Their influence takes the form of imposing norms of behaviour, but also, and maybe more importantly, orientating individual perceptions: financial controlling processes frame individual interpretive schemes by presenting specific categories of thought and calculative mechanisms as the most appropriate for making decisions and understanding organizational life. It must not be assumed that the power of such regulation diminishes the role of actors, as some of them are able to question and redefine its logic. But since most of the literature documents increasing financialization within organizations and society, it usually concludes that accounting regulation has an overwhelming influence.

Drawing inspiration from the works of Foucault (1975), several researchers have argued that accounting creates regimes of knowledge to render individuals governable within organizations (Hoskin and Macve, 1986; Miller and O'Leary, 1987). Introducing standard costing and budgeting, for instance, makes inefficiencies and wastes visible at the level of each individual. These systems create visibilities that provide a basis for allocation of individual responsibilities through measures of individual contributions to overall efficiency, thus imposing norms of behaviour on everyone (Miller and O'Leary, 1987). Under the gaze of an 'accounting eye', every member of an organization is encouraged to conform to a distant, impersonal and invisible imperative (Hopwood, 1987).

Calculation practices are thus a way to make individuals calculable, and also bring them to see themselves as 'calculating selves' (Miller, 2001). Miller argues that calculating practices transform individuals into self-regulating calculating persons, meaning that the use of numbers to build judgements and make decisions creates a setting in which individuals remain free to react to situations they encounter as they see fit, but are constrained by a limited field of possible responses and reactions – a field limited by the frames of accounting principles and mechanisms. Accounting orientates individual choices while preserving the freedom of agents (Miller, 2001; Miller and O'Leary, 1987). In putting accounting at the centre of accountability and decision-making processes, financial controlling orientates organizational behaviour by framing individuals' free choices.

The studies just referred to portray accounting as a disciplinary power framing organizational members' practices, but financial controlling 'operates both more broadly and more deeply than appears immediately on the surface of specific practices' (Jones and Dugdale, 2001: 36). The categories used to assess performance and build controlling devices influence not only organizational members' behaviour, but also their perceptions of organizational events, the opportunities open to them, and how they should assess and choose between possibilities (Brunsson, 1982; March, 1987; Morgan and Willmott, 1993; Swieringa and Weick, 1987). Financial controlling thus exerts invisible influence on organizational practices, from individual interpretive schemes to widespread organizational rationales.

However, individuals are not passive and completely incapable of understanding the framing power of accounting (Covaleski et al., 1998; Ahrens and Chapman, 2007). When introduced, financial controlling devices generally trigger conflicts, resistance and power struggles (Armstrong, 1985; Berry et al., 1985; Dent, 1991; Ezzamel and Burns, 2005; Ezzamel, Willmott and Worthington, 2004, 2008; Gendron, Cooper and Townley, 2007; Oakes, Townley and Cooper, 1998; Preston, Cooper and Coombs, 1992; Scapens and Roberts, 1993). Several studies have documented the power effects of new financial controlling devices, without downplaying the role of actors and local contexts. Oakes, Townley and Cooper (1998), for instance, show how the introduction of business planning in Canadian museums instilled a more commercial view of their mission, thus translating into a form of institutional change. However, change is not implicit in the system itself; on the contrary, financial controlling changes the situation thanks to the pedagogical efforts of accountants (Oakes, Townley and Cooper, 1998).

Ezzamel and Burns (2005) also show how accountants proposing new management systems can redefine certain phenomena in their own language, which enables accounting to extend its zone of influence. This implementation of 'colonizing tools', however, relies on an organizational group's capacity to define in its own language the problems affecting its organization and the knowledge that enables it to respond to them (Ezzamel and Burns, 2005). Financial accountability is thus particularly widespread when accountants form a dominant alliance, and can therefore impose accounting as a shared language. When new accounting systems are introduced, non-accountants do not necessarily remain passive bystanders to what they sometimes perceive as a threat to their professional identity (Ezzamel, Willmott and Worthington, 2004) and an encroachment into their domain of expertise (Ezzamel and Burns, 2005).

Power struggles between different groups and individuals and their interests, visions and plans underlie change in accountability and management styles within organizations. Collective plans for change can also be facilitated by external contingencies. Financial crises often bring accounting to the fore as a legitimating discourse and help accountants increase their power (Ezzamel and Bourn, 1990). More generally, organizations move towards more financial styles of accountability when facing privatization (Mueller and Carter, 2007), buyout (Ezzamel, Willmott and Worthington, 2004) or greater pressure from regulating agencies (Berry et al., 1985). In the case studied by Berry et al. (1985), financial accountability is decoupled from daily operations, which are controlled through a technical form of accountability based on physical production planning. Dent (1991), in contrast, along with Mueller and Carter (2007), illustrates how engineers lost their hegemonic position with the shift in the style of accountability. In the case described by Mueller and Carter (2007), engineers who previously saw themselves as autonomous professionals become managers. Both external factors (the vision promoted by new shareholders and regulating agencies) and internal factors (the tactics deployed by accountants and early support from some of the engineers for the discourse of 'managerialism') explain the organization's shift in rationale (Mueller and Carter, 2007). Individual agency thus converges with the dominant discourses to change organizational practices.

Most studies, however, illustrate one particular global trend: the victory of financial controlling over any competing organizational approach. Accountants are extending their influence, while other groups try vainly to resist change (Dent, 1991; Ezzamel and Burns, 2005; Ezzamel, Willmott and Worthington, 2004; Fligstein, 1987). Financial domination appears to be considered inevitable by most authors (although exceptions do exist: see, for example, Jazayeri and Hopper, 1999), and this impression is reinforced by the focus on organizations undergoing a financial crisis. The increasing domination of financial controlling thus seems as universal as financialization itself. The accounting literature concludes that financial controlling systems have an overwhelming influence. Detailed understanding of the way they work is required to challenge them, and this creates a strong probability that the actors best equipped to challenge such systems are the very people most likely to take them for granted, and also with the most to lose from their criticism.

We now present the results of our case study, which provides empirical content for the notion of regulation through financial controlling. In the context of the study, the financialization discourse hybridizes with local traditions to produce increasingly financial regulation of organizational practices.

Ideals and rationales: Tradition vs emergent practices

Our analysis is based on an ethnographic study. One of the authors conducted a four-month-long field study at TechCo, a French multinational aeronautic company.[1] TechCo is a medium-sized business (with a workforce of just under 1000) and a subsidiary of a diversified international group (with more than 10,000 employees and sales of €1.8 billion in 2005). It comprises three divisions, each corresponding to a type of product (Division X manufactures fuel circulation systems, Division Y specialises in oxygen masks and Division Z produces components for aircraft control panels). The divisions are themselves made up of three departments: production (sometimes including purchasing management and logistics management), industrialization (design office and works methods) and design (research and development). Two divisions are located in the Greater Paris area, on the same site as the Headquarters, and the third (Division X) is based in south-east France.

TechCo's pride and joy is its 'Design' department, in other words research activities. Since the company sells high-technology products in limited-series production runs, research is considered critical to its future. It is also a way of displaying the particularly high-level expertise of the engineers and technicians concerned: leaving production to move into design is seen as a move up the status ladder. The division directors followed the same career path, moving from production management to responsibilities as directors of design before being made managers of their respective divisions. Technical engineering skills are most highly valued in the company.

However, some people at TechCo are unhappy with this situation. Celebrating the company's technical expertise has effectively pushed financial considerations into second place, and the CFO, vice-CFO and management controllers (hereafter 'the financial officers') consider that finance should play a greater role in operational decision-making. The CFO supervises the head of accounting (who manages a 12-persons strong team, including a chief accountant), the head of management control (who manages a team of three management controllers and two management assistants) and the vice-CFO. Each management controller is attached to a division: as a result, they are in close contact with operational managers and attend their divisions' board meetings (every two months). These close relations provide a daily reminder of the symbolic devaluation of finance in the company, yet still bring controllers into contact with what, under a financial definition of the business, can be considered mistakes or weaknesses on the part of operational managers. Financial officers therefore question a situation they see as inadequate. They resent being perceived as 'interferers' in the work of operational managers.

During an informal conversation, one of the management controllers complained about the lack of financial follow-up in projects:

> *Paul, management controller at Z, in the company canteen*: For the A380, we had to make two calculators. But the costs went sky-high … so now they're selling at a loss! Well, commercially, we had to be in on it … but still! […] The division directors don't draw up enough financial plans, and the studies aren't at all accessible to the finance people. They hide them and keep everything for themselves. So there are no figures before negotiations. [In my former company], there were always financial simulations, and a sales rep couldn't sell a project until it had been validated by a controller. Things are really different here.

In this excerpt, Paul first points towards what he sees as bad operational performance ('they're selling at a loss'), then relates this to insufficient financial controlling ('The division directors don't draw up enough financial plans', 'there are no figures'), meaning that managers should make more use of accounting data when negotiating new contracts. His position is directly linked to his desire to be part of decision-making processes, as illustrated by his criticism of the lack of transparency (managers 'keep everything to themselves', meaning he is not involved or consulted), but he compares the situation to his former company, to offer a vision he deems universal of what managerial practices should be. More generally, all the accountants and controllers we met wished that financial controlling processes were considered more legitimate in operational departments, and that accounting had a more central position in managerial processes.

Management controllers (and representatives of financial management in general) thus act as carriers of the financialization discourse, but feel their work is constrained by operational managers. They perceive problems, but cannot react because they are sidelined from the decision-making process. In particular, their position in the organization gives them no power over operational managers, and in practice any demands must take the operational viewpoint into account to have a chance of being heard. Having experienced very different situations in their former companies, controllers find this weakened position difficult to accept. They describe themselves as simple observers, unable to actively participate in decision-making: they see everything that goes on, but are culturally silenced. As a result, they seek to influence managerial decisions by introducing new financial controlling devices (monthly reporting, budgetary procedure) or more ad hoc tools to help managers understand the financial impact of industrial events and decisions. Most of these tools are no more accepted than controller participation in decision-making, but the link they forge between organizational action and accounting provides an opportunity for interaction which is not without consequences, as we will see further.

The TechCo case illustrates a contest over control between two conflicting rationales, technical and financial. The technical rationale is deeply embedded in TechCo's history and culture. The company maintains its historical core through narratives and stories that circulate among employees and thus become mythical. Its website[2] includes a significant section on company history that celebrates TechCo's heroic past, related to the 'conquest of the skies'. It emphasizes TechCo's corporate culture as having its source in technical expertise and excellence, and the creative zeal of its founders. Technical superiority is therefore closely associated with eagerness and fervour, which are seen as very positive values. The financial rationale relates to discourses of a different status. Even though they are shown on TechCo's website, financial figures are not part of the company's multifaceted story. To judge by the 'Strategy' section, financial matters are an insignificant issue compared to the actual key factors of success: high technology, R&D, manufacturing processes and methods. The 'keys to TechCo's success' are presented as linked to its 'mastering [of] the most advanced technologies', and 'continuous presence on the leading edge of innovation and technology'.

The unobtrusiveness of financial discourses on TechCo's website in comparison to current standard practice on most corporate websites (where the discourse of shareholder value is increasingly widespread) shows that the technical rationale is local and deeply ingrained in history and myths. TechCo's management is highly influenced by what is usually called an 'engineering culture', an outlook in which engineers are considered more competent to assess work, and therefore management tools are created by engineers. Controllers must not interfere in new projects, which are designed and sold to clients by the operational managers, with financial advisability remaining a secondary consideration. This engineering culture underpins a technical style of accountability: the division manager is accountable for the products' technical excellence rather than for profitability and margins.

Management controllers feel this culture is no longer acceptable, and argue that TechCo's managerial rationale should move towards greater financial control. Financial officers thus support a competing rationale, and demand a more financial style of accountability in a challenge to the technical culture.

To sum up, two rationales are in confrontation at TechCo. The technical rationale – more legitimate and embedded in the company's history and culture – emphasizes the role and autonomy of engineers. Engineers are responsible for the future of the company and every aspect of management: no one else may interfere in the decision-making process. They form the dominant group, legitimated by tradition. The financial rationale, meanwhile, is more emergent and marginal, and relies on management controllers who are of the opinion that the company now needs a new vision focused on financial controlling. They believe they could improve management efficiency, but feel constrained and sidelined.

The forms of confrontation

Engineers and controllers confront one another in the name of divergent ideals and rationales. Where their worlds meet, engineers and controllers both seek to gain the upper hand and impose their own approach. The technical rationale is dominant, but under challenge.

The two rationales stem from different sources of power. The engineers' technical rationale is based upon traditional, and highly symbolic, sources of power that through past institutionalization have become part of the corporate structure, which makes them the hierarchical source of power. The controllers' financial rationale needs emergent sources of power and legitimacy. It must be noted, however, that power is not their declared goal; on the contrary, their official motivation is not to maintain or increase their power, but to instil sounder management and a long-run vision.

Both groups speak with one voice about improving management in the company, but advocate diverging styles of accountability, management and control. This translates a struggle for power into a struggle over control. In the controllers' view, the behaviour of operational managers is perceived as resistance to control. But this resistance to control is not resistance to the institution, since the operational managers in fact represent the existing institution. Nor is it resistance to change, because the managers are perfectly willing to change processes to improve the company's results – but they focus on manufacturing, productivity, re-engineering and so on, rather than on financial factors. Management controllers act as carriers of a new rationale, threatening TechCo's traditional culture and engineers' key positions. And yet the engineers' stance is not one of blind, fruitless resistance. Both groups are conscious of the need for the company to be financially competitive. But as they disagree over the means to achieve this objective, they support competing ideas. Both lay claim to a shared overarching objective, but promote competing trajectories to achieve it.

One particularly sensitive question is controlling purchasing or investment requests. Controllers are totally excluded from the validation process for raw materials purchases. Although management controllers do take part in the investment request process, they resent its under-instrumentation. Devices they have learned about elsewhere and consider relatively standard in their efforts to legitimize their externally acquired skills are not accepted at TechCo. Management controllers receive investment requests from operational managers, but only at the same time as, if not after, the division directors, with no opportunity to validate them beforehand. They feel they have no rights to see, control, enforce or even speak:

> Formal meeting. No operational managers are present.
> *Bernard (controller of another company in the same group)*: For the investments, we have to put budgetary control in place.

> Someone makes a request: if he has the budget it goes through, otherwise it's blocked. For the time being, anybody can spend 100,000 dollars without our seeing anything!
> Patrice (CFO) contradicts Bernard, but Jean-Michel (accounting director of the same company) agrees with him.
> *Bernard*: It's purely for information! And that goes for the purchasing requests too.
> *Jean-Michel*: There's no algorithm or calculation to do, it's just document management. Management control monitors investments, but only after they've gone ahead!
> Eric (management controller from Division Y) agrees with him.
> *Claire (management assistant)*: I print off a statement every Monday that I send to the budget managers.
> *Fabrice (vice-CFO)*: But it's sent out very informally! So there's no coercion involved. To keep things moving along, people don't get held up.
>
> Description of the purchasing procedure: When a purchase is made, the financial management has no right to oversight or approval; it is the head of purchasing who validates. Likewise, when a delivery takes place, the invoice and delivery note must be reconciled. If the amounts differ, another procedure starts. Within a certain margin (variance of less than 5 per cent), reconciliation is automatically validated, as if the amount were correct. But the verification procedure may be short-circuited: purchasing can 'force through' validation, whatever the amount of the difference. Certain members of financial management and information systems management make the following comment: 'there are no limits any more, purchasing can do whatever they like.' The vice-CFO even talks of a 'failing in internal control'.
>
> But not everyone is surprised by this system: in Claire's opinion, 'we mustn't hold up operations pointlessly'.

As this interaction illustrates, financial officers feel sidelined from controlling processes, and they see this as a high risk for the company. They cannot prevent anyone from spending money, and as long as the amount approximately matches expectations (a 'less than 5 per cent' variation), they are not even informed. More surprisingly, members of the purchasing department can bypass internal control procedures. Controller input always comes after the event and consists of 'document management', as if any internal control procedure enforced by the financial department was considered a useless constraint ('we mustn't hold up operations pointlessly'). While this does not mean that operational processes escape all control, the control does not involve accountants. The accountants would like to know (they lament the fact that spending occurs 'without [their] seeing anything'), but also to control what managers are doing, and try to introduce new calculations in order to frame managers' freedom within specific limits. But their devices do not have enough legitimacy to justify any 'interference' in operations.

This feeling of competition between controllers and managers is frequently spotlighted. Every two months, divisional board meetings bring the two sides together, but at least in the eyes of the controllers, these board meetings only confirm managers' supremacy over controllers. This regular confrontation has become a routine, a daily reminder for management controllers of their lack of legitimacy. They are trapped in a situation they consider totally inappropriate: instead of taking part in decision-making, they feel they are simply there to justify decisions already made. Their role is apparently not to draw attention to particular points, but rather to divert the senior management's attention and prevent it from seeing certain problems arising. This situation ultimately raises doubt as to whether the company's position is 'properly' and 'accurately' (as defined by operational managers) reflected in the financial accounts. There is a loss of confidence in the relevance of accounting data. Management devices cannot therefore be legitimately entrusted to representatives of the financial management.

Presentation of the forms of confrontation between the financial and technical rationales at TechCo improves understanding of the financialization processes. Management controllers act as carriers of financialization principles within their company. However, they enjoy little legitimacy, which makes them ill-equipped to challenge local rituals and institutionalized values and introduce alternative forms of control. Financialization does not automatically align local traditions with the wider, globalized rationales and ideals held by shareholders and financial markets. Managers do not conform to norms of behaviour defined through devices deemed consistent with financial controlling principles of good management, but promote alternative ideas for improving the company's processes. However, as we will now show, this confrontation is not without consequences.

The power within accountability devices

At TechCo, operational managers criticize financial management devices, yet members of the holding company, that is their shareholder's representatives, use those devices to evaluate them and assess their performance. This means that through the monthly reporting routine, management controllers can use accountability rituals to frame managers' perceptions of what constitutes their performance. When managers have to report to senior management, they need controllers to translate accounting numbers into technical matters. This is an opportunity for controllers to exert a sort of pedagogical power (Oakes, Townley and Cooper, 1998), drawing on their own rationale to give meaning to the numbers they produce. As we will now show, the production of numbers itself connects the two groups and as such is an important moment in the confrontation between the two rationales.

During the observation period, an ERP system was introduced. Concessions were necessary from the outset. Rather than using the group's ERP system, TechCo bought the accounting module of the production software already in place. However, since the systems are connected, any software change affects the work of the financial management, and operational managers can no longer change their systems without informing the financial officers. Discussion, interaction and cooperation thus enter daily practices. Eric, a management controller, perceives the new system as useful both for his work and his relations with operational managers:

> Informal discussion, two months before the launch of the new software.
> *Eric*: In [the new software], variance is targeted, which means that because it's a production software, we already have variance accounts into which all the data we need are entered. This could give us the [reporting] book by pushing a single button.
> *Paul*: Yes, because for the time being, the closing takes three and a half days of calculations and a day and a half of analysis.
> *Eric*: But things are going to be better, since it's going to be an ERP.
> *The observer*: But in fact this software seems a lot more operations-oriented, whereas an ERP like SAP seems to be more finance-oriented.
> *Eric*: Ah, that's for sure. But [this software] was bought by the divisions ten years ago, so now we have to adapt. It would be too complicated to get the divisions to change.
>
> One evening, in the company canteen. All members of the financial management and information systems management are invited to celebrate the 'successful' launch of the new software.

> *Eric*: It's working rather well. There are a few difficulties right now, but in the long run it's really very good. It's integrated ... Things will be faster: there are things we do now that we won't have to do any more. And it puts us in a better position with regard to operational managers. It used to be difficult to explain when they asked where a figure for an overspend came from. Now it's easier to go back and it's in [the same software], so we can trace back to things that they input themselves. Then the problem comes either from a wrong entry, or from a real problem.

The changes in Eric's discourse are significant. Before the implementation of the ERP system, his expectation is that the device will speed up production of accounting reports. After beginning to use it, however, he emphasises the 'position' he has gained in relation to managers. What has changed is that he can 'trace back to things that they [managers] input themselves'. In this new system, the controllers can go back to the source of the data, meaning an action performed by operational personnel, and associate it with financial calculations. It is thus no longer possible to blame the accounting translation when variances appear. Eric's discourse may appear relatively naïve, but it clarifies his expectations. First, he wants to know what operational managers are doing, and to be informed of any change they may make to operational processes. Second, he needs to be able to trace any accounting figure to an operational action. He can then point out responsibilities and explain to managers how their actions translate into accounting calculations. Financial controlling systems gain acceptance by getting as close as possible to operations. By producing inscriptions that directly concern operational managers, these systems also orientate their attention towards definitions of performance that are embedded in a financial field of knowledge. The production of figures and their positioning within accountability routines thus tend to frame managers' perceptions and actions within a field of knowledge made up of financial categories and mechanisms.

Financial controlling devices appear to occupy a central position in the tension between the two groups, their ideals, their rationalities and their practices. Although they do not put an end to struggles and controversies, they open up the debate between contradictory points of view and materially embed the compromises reached. Operational managers have to justify their 'results' as formalized in reports that are mainly based on accounting figures but relate to their daily work. Management controllers have thus introduced a new style of accountability, using accounting figures as the main source of information for reporting on an action. The financial rationale is beginning to intersect with operational management processes.

Discussion and conclusion

Operational managers often criticize management control devices for being introduced and used by senior management to increase surveillance and verification, rather than as management processes. For example, standard costing and budgetary controls can make 'inefficiencies' and 'resource wastes' visible. It has been argued that such instruments do not serve resource allocation purposes as much as a willingness to enforce specific norms of behaviour (Miller and O'Leary, 1987); the 'accounting eye' encourages each and every organizational member to comply with a remote, impersonal and invisible imperative (Hopwood, 1987). Financial controlling, and its potential 'panopticon' effect, thus arguably contributes to the creation of 'disciplinary regimes' within organizations: central management can use accounting figures (and quantification more generally) to identify deviations from the norm and discipline organizational members' daily actions accordingly.

But organizations are not prisons, and the hyperbolic analogy between the effects of budgetary controls on managers and Taylorism's effects on workers appears more provocative than convincing. The panopticon metaphor is arguably more useful to understand managers' and controllers' dreams, hopes, and fantasies than to describe the devices deployed at TechCo. Besides, the 'panoptic dream' is based more on the potentialities offered by IT technologies than the capabilities of accounting. This is not to say that financial controlling mechanisms have no impact on operational practices, but we argue that their influence is more flexible than coercive and operates through more subtle forms of regulation.

As Foucault (2004: 360) noted, governing practices are not limited to the law of rulers – they can also take the form of a given 'rationality'. By constituting a field of knowledge around a particular outlook, a rationality can orientate individual behaviour, since the production of measures, norms and standards directs individual attention towards specific issues and encourages people to think with the categories and interpretive schemes, and hence within the boundaries, of that rationality. Rationalities thus influence not only behaviours but also perceptions and subjectivities. The power of authoritarian ruling is thereby replaced by the subtler, invisible power of control by regulation and elicitation (Foucault, 2004).

Recent literature has documented the growing legitimacy of a rationality based on trust in numbers (Porter, 1995). This rationality, which has led to a proliferation of computational practices, not only renders individual behaviour calculable and comparable, but also encourages individuals to think of themselves as 'calculating selves' (Miller, 2001) and develops 'responsible and calculating citizens' (Rose, 1991). In the case studied in this chapter, the financial devices of organizational control lead individuals to regulate themselves by framing actions and perceptions within specific categories – here, within accounting categories. Regulation through financial controlling therefore constitutes a web of devices and practices capable of influencing individuals' choices while leaving them freedom.

Regulation through financial controlling operates through what Foucault (2004) calls 'normalization'. Two different mechanisms, however, are at work. Several management control devices (budgets, standards, forecasts, for example) set up norms and then measure deviations from those norms. Other management control devices can be used to define and fabricate norms. Scorecards (*tableaux de bord*), reporting books and benchmarking tools are technologies to 'observe' what Foucault named 'distributions of normality', meaning that numbers are compiled from different sources to draw patterns and regularities, and thus to define irregularities. This conceptualization advances understanding of what is at stake in the confrontations observed at TechCo, where two groups are in disagreement over what should constitute a distribution of normality. The issue is not whether or not to follow certain norms, but rather which criteria, measures and categories can be used to identify patterns and distributions. Financial controlling positions make accounting figures central in such processes of normalization, whereas operational managers argue that this kind of norm should be formulated in technical terms. Specifically, financial controlling relies on the introduction of specific norms of accountability and performance assessment. As we shall see, this conceptualization clarifies the links between the definition of frames of regulation, orientation of behaviours and the making up of subjectivities.

Introducing financial controlling as a mode of regulation makes accounting figures a primary source for measuring and assessing performance. Accounting holds and promotes very specific conceptions of economic and social purposes, yet it tends to be perceived as a neutral instrument designed to build objective judgement and make rational decisions (Burchell et al., 1980; Hopwood, 1987). Financial controlling devices therefore benefit from accounting's perceived technicality, while promoting specific representations of what an organization is – what organizational goals and values are – and influencing the meaning attached by individuals to their actions. This process is enacted through several mechanisms, including the redefinition of hierarchical accountability patterns. Financial controlling shapes the language of justification, and thus forms organizational participants' sense of responsibility. It lays down the terms of hierarchical negotiations and interactions, defining what constitutes a problem and what can be ignored, the types of goals and interests that should be pursued, and the principles, mechanisms and 'tempo' of choices to be made (Burchell et al., 1980). Regulation through financial controlling thus operates by framing the categories of managerial practices and discourses.

In the financial controlling discourse, managers can and should use these categories and principles to 'modernize' their organization, 'improve' its management and 'rationalize' working processes. When this discourse is enacted, managers progressively appropriate and incorporate accounting principles, and increasingly draw on financial categories to understand their organization or assess the relevance of the decisions made. This form of regulation focuses attention on specific measures and metrics, and hence on certain concepts, in order to understand, explain, evaluate and justify the choices made. Financial controlling devices act as a process of regulation shaping interpretive schemes and classification criteria to assess the relative importance of organizational events. Promoting and changing organizational categories and valuation criteria constitutes an invisible power encouraging organizational participants to think about their work and roles within the frames of financial definitions and conceptualizations (Oakes, Townley and Cooper, 1998). This subtle form of regulation operates by shaping organizational members' subjectivity.

Alvesson and Willmott (2002) noted that organizational control not only influences behaviours, but also individual subjectivities, in what they call 'identity regulation'. This is best described by Covaleski and colleagues (1998) who, drawing on the work of Foucault (1976), show that the combination of two managerial devices (management by objectives and mentoring) can discipline the subjectivity of partners from an auditing firm; these devices lead the partners to think of themselves not as autonomous professionals but as managers working for a business organization (Covaleski et al., 1998). However, they also documented resistance from partners. As Alvesson and Willmott (2002: 628) put it, employees 'are not passive receptacles or carriers of discourses but instead, more or less actively and critically interpret and enact them'.

At TechCo, several devices can be considered as attempts to control managers' subjectivity. Accountability rituals, during which managers must justify their 'results' as defined under the financial controlling rationale, appear to be aimed at changing perceptions and definitions of organizational responsibility. TechCo's managers tend to see themselves as engineers, and to consider product quality and technological innovation more important than costs and profitability (although those factors are taken into account). Financial controlling processes, in contrast, focus their attention on accounting figures, especially indicators presented as the measure of 'shareholder value creation'. The issue here is not only to assess whether 'performance is good' or 'how well the company is managed', but also to turn the engineers responsible for product innovations into managers responsible for value creation, with 'value' defined using financial measures. Regulation through financial controlling therefore operates by developing self-managing subjects who are increasingly focused on financial concerns.

Financial regulation introduces an overarching structuring framework; to be seen to perform well, managers must demonstrate in financial terms that their work complies with shareholder expectations. Unlike power exercised through ruling and procedures, this subtle form of power is difficult to contest: first, because managers remain free to act as they feel fit, and hence do not necessarily perceive the impact of accountability demands on their subjectivity; second, because its influence is mediated by the practices of accountants who, although they are themselves subjected to the financialization discourse and gain no real status or power in the process, are a visible target for criticism and mask the less visible processes of regulation; and third, because contesting financial metrics requires at least some familiarity with accounting mechanisms, which means that only people who have tried to appropriate financial logics can question them, at the risk of being influenced by their 'rationality'. The organizational members who are the most capable of questioning financial controlling are also the most likely to take it for granted. Financial controlling devices act as a subtle form of power and regulation, shaping individual subjectivity so that financialization is less likely to be challenged by the people subjected to it. In other words, normalization through financial controlling naturalizes the financialization discourse, so that it becomes the uncritical and largely unconscious lens through which people understand organizations and society.

However, managers attached to their identity as engineers will not automatically adopt the financial controlling ethos. The encounter between diverging rationalities – in other words, the way TechCo's engineers react to the financial controlling rationale – gives rise to a hybrid ethos of responsibility. Managers are accountable in financial terms, but carry on with operational controls and make daily choices framed by a technical field of knowledge. The local, situated results of regulation through financial controlling are thus unpredictable, and compliance cannot be assumed. Managers can make an outward show of using financial controlling devices while remaining detached from them, or use them with a degree of subversive irony that can partly undermine their normalizing effects. But this does not mean that regulation through financial controlling is inconsequential. It means that financial regulation orientates, but does not determine, perceptions and behaviours.

Notes

1. For reasons of confidentiality, the company's name has been changed and other details, including interviewee comments are presented anonymously.
2. In order to preserve anonymity, we do not disclose the original web reference.

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2
How Big Four Audit Firms Control Standard-Setting in Accounting and Auditing

Carlos Ramirez

The significant expansion over the last 30 years in financial services is one aspect of the phenomenon described as the 'financialization of economies' (Porter, 2005). This financialization goes hand in hand with the globalization of financial activity: free circulation of capital and stock market interconnection have fostered the development of new practices (notably risk management), the emergence of new markets (the derivatives market, for instance) and the rise of new actors (such as pension funds). Financial globalization and the financialization of economies would be practically inconceivable without access to presumably reliable information on the companies (including banks and insurance companies) listed on stock markets worldwide. One source of this information is the ratings agencies such as Moody's and Standard & Poor's (Sinclair, 2005). Another is the companies themselves, which through their accounts report a true and fair view of their assets and the results of their operations. Trustworthy accounting information relies today on the assurance that it has been prepared in compliance with a series of standards known as accounting standards. This assurance is provided by an audit of the accounts. Audit is a practice performed by qualified professionals and is a standardized practice, as these professionals are supposed to follow 'professional service standards' or simply 'auditing standards'.[1] Accounting and auditing are thus areas in which the standardization and internationalization rationales are closely related.

International standardization requires development of specific expertise, whether that expertise concerns development of standards, application of those standards or checking that they have been correctly applied (Loya and Boli, 1999). Four actors control production of this expertise today. Deloitte, Ernst & Young, KPMG and Pricewaterhouse

Coopers are the 'Big Four', the four large multinational auditing firms whose members or former members are active in the standard-setting bodies, where technical departments[2] work to establish a universal interpretation of standards, and whose auditors work closely with those departments to ensure that their clients apply the standards properly. This two-way communication between the stages of the standardization process, in which production of standards feeds on and in turn influences experience of their application, gives the Big Four an unusual role. They occupy a quasi-oligopolistic position on the market for accounting and auditing services to multinational companies, but also as suppliers of expertise to the standard-setting bodies. Between the market and the institution, they occupy an interconnection position that is a prerequisite if such standardization is to be possible at all. Since international standardization is essentially aimed at large listed groups, the experience accumulated by the Big Four over long periods of service to these groups enables them to nourish regulatory activity in the form of standards, and thus help to establish the latter as an indispensable complement to national accounting laws.[3] They also benefit, financially and otherwise, from the need to interpret standards in general and check that they have been correctly interpreted in each specific case, to consolidate their hold on the market for intellectual services to multinational businesses. Over time, the Big Four have thus come to form a kind of obligatory passage point (Callon, 1986) between the flows of knowledge concerning accounting and auditing in the largest companies.

This chapter aims to explain how it is possible for the Big Four to play this role as points of passage. After a brief historical review of the emergence of the multinational firm as a 'business model', we return to the question of how to view the Big Four's current influence on the standardization process: first by seeing how international standardization of accounting and auditing is actually standardization of accounting and auditing of large listed companies, then by showing how the Big Four firms have managed to become practically the only actors to represent a transnational community of experts in these large groups. Finally, we shall see that any attempt to determine the exact role played by multinational firms in the standardization process must consider standardization as a complex process that is not restricted to the standard-setting bodies' activities but combines several operations, such that the Big Four are able to link their expertise in services to multinational companies with their expertise in standardization of accounting and auditing.

The Big Four as 'business model'

Anyone talking of the accounting profession is usually thinking of its most eminent members, the large multinational auditing firms, commonly known as the 'Big Four' or simply the 'Big firms'. The reputation of these firms results primarily from their association with the leading multinational companies, whether as service providers or for their implication in the scandals involving these companies. The Big Four currently top the professional rankings in every industrialized country by volume of fees and workforce numbers (see Table 2.1). Even though they have developed services for smaller companies in some countries, their core clientele remains the large multinational company. A glance at the list of auditors of companies included in indexes such as the Paris CAC 40 or the London FTSE 100 clearly shows the predominance of the names of KPMG, Deloitte, PricewaterhouseCoopers and Ernst & Young.

The Big Four have US/British origins and were originally purely accounting firms. Apart from Arthur Andersen, now defunct in the wake of the Enron collapse, which was American and for most of its history developed under the 'one firm concept',[4] the current Big Four are descendants of the firms that founded the Institute of Chartered Accountants in Scotland and the Institute of Chartered Accountants in England and Wales (Jones, 1981, 1995; Matthews et al., 1998). Peat, Price Waterhouse, Deloitte and Coopers were set up in the second half of the nineteenth century and by the end of that century were already auditing the financial statements of the London Stock Exchange's largest listed companies (Anderson et al., 1996). They soon became established in the US, as early as in 1890 in the case of Price Waterhouse (Allen and McDermott, 1993), bringing with them a conception of professionalism rooted in the ethos of the 'gentleman' (Perkin, 1989). At first they competed with local firms, but before long

Table 2.1 The Big Four (2010 figures)

Firm	Fees ($ bn)	Workforce
Deloitte	26.6	170,000
Ernst & Young	21.3	144,000
KPMG	20.6	138,000
Price Waterhouse Coopers	26.6	161,000

Source: http://en.wikipedia.org/wiki/Big_Four_(audit_firms) a strategy of alliances and mergers began. City of London firms found in the US an economic and legal culture and a view of professionals' role in society similar to their own, echoing their experience in British Empire dominions. Combining *gentlemanliness* with business sense, they offered the most prestigious clients (large firms, but also the State) the resources that resulted from association of several professionals in partnerships, which furthermore employed large numbers of technical and administrative staff. By the Second World War, these partnerships had developed a range of services related to accounting and auditing, such as tax consulting and the beginnings of management consulting, which really took off after 1945 with the constant advances in computer systems (Matthews et al., 1998).

The success of the Big firms' business model was helped along by a regulatory environment that was relatively tolerant of associating auditing and consulting (Robson et al., 1994). Although this association could raise certain ethical dilemmas, compromising the independence of a firm's auditors when they were auditing procedures consultants from their own firm had helped to create, the fact remains that multidisciplinarity was what drove growth at the Big firms. Gradually, they built up a range of products in which auditing, their initial speciality and the service that connected them to the accounting profession, was not only included but became a sort of 'bridgehead' enabling professionals to penetrate a firm and pave the way for sales of much more lucrative consulting services (Cooper and Robson, 2006; Suddaby et al., 2007). Auditing itself reflects the continual innovation in service offerings typical of multinational firms: throughout the twentieth century its purposes and techniques were constantly defined and redefined, until auditing became a kind of insurance product offered to clients as part of a package of broader 'solutions' to reduce the risks of their business (Power, 1999; Robson et al., 2007).

Before going into partnership with local firms,[5] the British and American firms had begun by building up an international network of offices, initially to follow their clients' establishment in other countries and participate in consolidation of local accounts with the parent company accounts. These offices gradually built up a local clientele in their respective countries, largely in response to the demand for audits prior to flotation on the London or New York stock market.[6] Mergers and takeovers of local firms eventually made the Big firms leaders on the auditing market, then more generally on the market for professional services to large businesses. Worldwide expansion changed the nature of these firms. They were turned from essentially British/American entities with a strong accounting dimension into truly multidisciplinary, multinational firms able to produce the same quality of service at any place on the globe (Jones, 1995; Suddaby et al., 2007).

This change was not all plain sailing. In countries unaccustomed to such a liberal interpretation of auditor independence, seeing it less as a state of mind than as the consequence of compliance with a set of rules about what they cannot do, the multinational firms sometimes encountered professionals and authorities with concerns about the power that would be held by the model they represented (Ramirez, 2003). The scandals that have studded the history of capitalism in the early twenty-first century may appear to have reduced the Big Four's capacity to conquer market share, but they have other levers they can use to pursue their expansion, not least the possibility of intervening in the standardization process for accounting and auditing.

The Big Four and the emergence of international standardization of accounting and auditing

Accounting standardization was initially sector-specific (Vent and Milne, 1989) but spread progressively to the entire economy in most developed countries during the second half of the twentieth century. In 'Anglo-Saxon' countries, standardization was delegated from the outset to accounting professionals, with the aim of providing financial investors with relevant information to guide decision-making (Robson and Young, 2009). This type of standardization is thus intended primarily for large groups (Walton et al., 2003). In the US, for example, only companies that are listed and therefore registered with the Securities and Exchange Commission (SEC) are required to comply with accounting standards and to have their financial statements audited by a professional who complies with auditing standards. In other countries, for instance in mainland Europe and France particularly, standardization has often been overseen by the public authorities, in conjunction with social actors other than accounting professionals. Stronger state involvement in the economy and the financial markets' smaller role in economic growth during post-Second World War years have led to a type of standardization that is not restricted to listed companies, with a more macroeconomic objective than in Anglo-American countries.

Auditing standardization originated in the US in the late 1930s, and essentially advanced in line with the institutionalization of the auditing profession, often spurred on by scandals involving major actors from the profession. Standardization of auditing appeared in the wake of the

McKesson & Robbins scandal,[7] and saw major developments after the collapse of Enron, Arthur Andersen's disappearance from the professional scene and enactment of laws such as the Sarbanes-Oxley Act in the US. The laws led to extending the control of independent administrative agencies (the Public Company Accounting Oversight Board in the US) over the professional institutes' production of standards and the quality of the services provided by their members.

Standardization of accounting and auditing began a move towards internationalization in the early 1970s, aiming for harmonization of practices used in countries that were members of the IASB (International Accounting Standards Board, formed in 1973 as the International Accounting Standards Committee) and the IAASB (International Auditing and Assurance Standards Board, formed in 1977 as the International Auditing Practices Committee). The influence of the IASB received a serious boost when the European Commission decided in 2002 to require companies listed on EU stock markets to comply with international accounting standards in their consolidated financial statements. The world thus has two major accounting standard-setters today: the IASB (sometimes called 'the de jure standard-setter' following the decision by EU member states to adopt its standards) and the American Financial Accounting Standards Board (FASB) (sometimes called 'the de facto standard-setter', since many foreign companies listed on Wall Street are obliged to apply FASB standards). The two institutions signed a *memorandum of understanding* in October 2002 that marked the start of a convergence process for their respective sets of standards (Martínez-Diaz, 2005).

Standardization of accounting concerns actors outside the accounting profession: financial statement preparers, financial analysts, even teachers and researchers in accounting. Standardization of auditing essentially concerns members of the auditing profession, since they are its only practitioners. But it is difficult to imagine any standardization of accounting and auditing without Big Four involvement. In the Anglo-American countries, they were its instigators. In the US, the 1933 and 1934 Securities Acts made audits mandatory for publicly traded companies and empowered the SEC to define the accounting standards applicable to those companies. In 1938, the SEC delegated its powers to the profession, which set up a Committee on Accounting Procedure. After the war this was renamed the Accounting Principles Board (1959), and most of its members were representatives of the large firms (Previts and Merino, 1997).

This situation corresponds to a conception of standardization in which the state assigns the mission of defining norms in a given area of economic and social life to experts, rather than politicians or technocrats (Freidson, 1986; Goldstein, 1984). The approach is typical in Anglo-American countries, but the idea of giving the experts primary roles has also gained ground elsewhere, often in supranational bodies (Cutler, Haufler and Porter, 1999; Hall and Biersteker, 2002). As regards accounting and auditing, the Big firm partners, headed by Henry Benson, senior partner of Coopers & Lybrand, were the founders of the IASB's predecessor IASC (International Accounting Standards Committee). In 1977, representatives of these firms again played a key role in the birth of the IAPC (International Auditing Practices Committee), a committee of the IFAC (International Federation of Accountants) in charge of auditing standardization.[8] The experts' hold on international standardization gradually spread to national standard-setters in countries of non-Anglo-American culture, as financial globalization and adoption of international standards often brought about a change in the standard-setters' activity: they began to pay more attention to issues related to the accounts and audits of large multinational firms.

The growing influence of specialists in large businesses' concerns, practically all connected to some degree with the Big Four, is a consequence of this change. One look at the membership of the managing bodies of the various standard-setting bodies shows that the Big firms are everywhere. In the UK, the Accounting Standards Board has ten members, two of whom occupy the full-time posts of Chairman and Technical Director. Both of them started out in a Big firm, and the other eight all trained at one, with three of them dividing their time between the ASB and a job at PricewaterhouseCoopers, Deloitte or Ernst & Young.[9] The IASB has 15 members, nine of whom have worked in a Big firm or a firm that merged with a Big firm in the course of its existence. Big firm domination is even more blatant at the IAASB since, as noted earlier, auditing standardization essentially lies in the hands of professional auditors. Of the 18 board members, ten are appointed by national professional institutes, three are from the public sector and five are representatives of the Transnational Auditors Committee (TAC) whose members come from Big Four firms plus the international firm Grant Thornton. Of the ten members appointed by national professional bodies, six are partners at a Big firm. And this official participation by the Big firms in the auditing and accounting standardization processes does not include all the technical personnel they second to standard-setting bodies, in a contribution that enables those bodies to operate (Chantiri-Chaudemanche and Kahloul, 2010). Very few accounting firms have sufficient resources in terms of people or time to be able to make such a contribution.

The Big Four as a transnational epistemic community

So do the Big firms have a dominant influence on the standardization process for accounting and auditing? The question is not easily answered. Closer inspection shows that many safeguards have been put in place to prevent one actor, or one group of actors, from being able to take control of standard-setters' operations. The American FASB was set up in 1973 to take standardization away from its institutional roots in the American Institute of Certified Public Accountants and thereby remove the process of accounting rule-making from the influence of the accounting profession, especially its most eminent representatives. As an organization that is theoretically free of any professional or other affiliation, the FASB lays down draconian independence requirements for its members. The British Accounting Standards Board and the IASB itself followed a similar pattern. Their respective reforms in 1990 and 2000 were intended to increase the involvement of stakeholders from outside the accounting profession. As noted earlier, legislative reform after the Enron scandal also loosened the grip of the professionals – and the Big firms, in particular – on auditing standardization.

The academic literature began long ago to examine the potential influence of groups of actors on standard-setting bodies, starting with the creation of separate organizations from the professional institutes (the FASB in the US in 1973, and the Accounting Standards Committee in the UK in 1976). Most authors agree that the standardization process is not simply technical but political (Perry and Nöelke, 2005): it involves choosing one of several solutions to a technical issue – for instance, 'how to value intangible investments in the accounts' or 'how to incorporate the impact of inflation into the accounts', independently of the technical difficulty of the problem. Most authors also reject the idea that there is a dominant group in the standard-setting bodies. Application of voting behaviour analysis methods to standard-setting board members' votes on standards, or the positions expressed by process stakeholders in the comment letters they send to the standard-setters, has led authors such as Hussein and Ketz (1980) to conclude that the Big firms do not have a dominant influence. But other researchers have highlighted the essentially informal nature of influence in such an environment, and criticized approaches focusing solely on draft standards that were ultimately adopted, with analysis based only on formally-declared choices by members of the standard-setting bodies or official comments on their work (Pong and Whittington, 1994; Sutton, 1984; Walker and Robinson, 1984). These researchers concentrate on other aspects of the standardization process: for example, setting the agenda which determines the scope of what is to be standardized (Young, 1994).

In addition to their intervention in the standardization process itself, another aspect of the answer to the question of the Big firms' influence is the Big Four's substance as a collective actor. Curiously, their homogeneity as a category has always been assumed – generally when their action is being criticized – rather than actually analysed (Arnold, 2005; Arnold and Sikka, 2001). At first glance it is difficult to consider them as a 'community', primarily because none of these firms now resembles the professional accounting firms they originally were, and each one has followed a different path to its present condition as a complex entity with a strong hierarchy, with a multidisciplinary organization structure covering several types of activity, some of which are regulated, under the same trade name (Allen and McDermott, 1993; Jones, 1981, 1995; Matthews et al., 1998; Spacek, 1989; Wootton, 2003; Wootton and Wolk, 1992). Based on research showing that in the case of the accounting profession, the feeling of belonging to a firm was often stronger than the feeling of belonging to a profession (Grey, 1998), it is questionable whether a 'Big firm' identity exists and takes precedence over a 'Deloitte' or 'KPMG' identity resulting from employment in the firm. It is equally problematic to talk of the Big Four as a single actor for the simple reason that no organization exists to put forward the demands or represent the interests of the Big Four firms alone. Apart from the fact that those interests are not always concurrent and that their demands may differ, the Big Four seem to take great care to not set themselves clearly apart from the other auditing and accounting firms that follow them – although at some distance – in the firm rankings by fee revenues or workforce numbers. Pressure groups, effective or otherwise, such as the IFAC's Transnational Auditors Committee and the European Contact Group in Brussels consequently have members from the Big Four and other firms. Also, former members of the large multinational firms or members seconded to work in a standard-setting body are not involved in these groups, their decision-making units or their working parties, as firm representatives.

With plenty of power in practice but little in law, the Big firms are still dependent on the institutional support provided by the national professions and national standard-setters to exercise their power. This means there is no professional project (Larson, 1977) that might foster the emergence of a community united around its own identity, distinct from existing identities: an identity as 'partner or employee of PricewaterhouseCoopers' or 'registered member of the Institute of Chartered Accountants', for example. Rather than describing them in terms of a 'community', all things considered the Big Four would be much better described in terms of a 'market' (since they have brought the large business audit market under a cartel), an 'organizational field' (Suddaby et al., 2007), or as a 'network', as the Big firms are indeed a partly decentralized constellation of production units with both geographical and professional diversity.

However, as Bucher and Strauss observed as early as 1961, professions are made of segments in constant movement (Bucher and Strauss, 1961). In the accounting profession, many people working for the multinational firms certainly feel their identity is more similar to that of members of the other Big firms than that of the rest of their fellow accountants. This shows that physical proximity is not necessary to form a community: shared knowledge and values produced by complex socialization systems that are transformed into shared expertise, common interests and jointly run projects are enough to define the Big Four as a community, or at any rate a community that is different from other communities within the accounting profession.

The most interesting aspect of construction of this community is that it has had a transnational flavour from the beginning. Although at local level, specificities may subsist as regards the conception of the service sold and the expertise it brings into play, it would appear that only the Big firms truly deserve the adjective 'transnational' in talking of accounting firms. Standardization of recruitment, socialization, promotion, working and quality control methods make the Big firms' professional culture a specific professional culture, which they have successfully reproduced all over the world. It is different from the culture of other firms in the profession, even when they belong to an international network, and forms the essence of what organizational studies teach us about accountants' professional identity. The Big firms have a long tradition of concerted action to defend their interests at international level, whether that action concerns protection of their position on the market for services to large firms (Arnold, 2005), or is intended more generally to favour their own conception of accounting and auditing. The Big firms, then, are not only a community of interests, but an epistemic community as defined by Haas (1992: 3), in other words 'networks of knowledge-based experts that articulate cause-and-effect relationships of complex problems, frame collective debates, propose specific policies or identify salient points for negotiation for politicians'. It can be considered that standard specialists (see note 3) form a separate group within these firms. This group is still distinct from the group of professionals who have directly participated at any level in the standard-setting activity of manufacturing standards. As well as their technical accounting expertise, these participants have also acquired know-how in the elaboration of rules, and can be considered 'specialists in standardization'.

We have already seen how the Big firms were behind the creation of international auditing standard-setting bodies, and how, even when the members of those bodies have not come directly from the Big firms, they are still part of their 'old boy/girl' network. These 'global' firms have succeeded in integrating their accounting and auditing expertise into an offering that is also 'global' in the sense that in management consulting or legal and tax advice, they can offer large companies a range of services that complement the services they already provide as auditors and accounting specialists. Of course, on each of these 'related service' sectors they are up against competition from specialists such as international law firms or consultancy firms. The Enron scandal may have halted their expansion, but they remain the only firms in the accounting profession to have developed this expertise of intellectual services for large multinational groups.

Virtuous and vicious circles

In view of all the aforesaid, the question of the Big firms' 'political' influence in matters discussed by the standard-setting organizations is difficult to answer. Addressing the question of their influence on the process of accounting and auditing standardization, rather than focusing on the organizations and looking at the Big Four's influence there, we should consider the standardization process as one facet, specific although preponderant, of the Big firms' position on the transnational market for intellectual services to large companies. The epistemic community they form as specialists in these services brings them closer to other producers of such services (lawyers, merchant bankers, international consultants and tax specialists), while distancing them from the rest of the accounting profession.

From this standpoint, the true extent of the Big firms' influence on standardization derives from the fact that they are a necessary 'technical' point of passage (Callon, 1986) in its process. Not only do the standard-setters make up a 'small world' with a markedly Big firm complexion, not only do the Big firms send personnel to work at the standard-setting bodies, but much more than this a sort of continuum exists between the standard-setting institutions and the Big firms as entities operating in a market and acting as a laboratory where solutions are prepared to the problems underlying production of standards.

In the auditing field, the forerunners of the Big Four were a testing ground for best practices that were subsequently published as guidelines and other technical documentation for use by professionals, and later came to swell national, then international standards. As early as 1961 the Institute of Chartered Accountants in England and Wales published its *U-series* of recommendations that formed the basis for the work of the Audit Practices Committee set up in 1973 (Sherer and Turley, 1997). However, it is more difficult to see how accounting standardization fits into this explanatory schema of the porosity between quasi-regulatory standardization activities and the commercial activities of the Big firms. Involvement in accounting standardization is not restricted to professional actors, and in certain countries it is still marked by State influence, reflecting the fact that standards are rooted in a highly territorialized legal framework. Through their intrinsic features, international standards enable the Big firms to establish a link between the expertise they provide to serve standardization and the expertise they sell their clients, because those standards are principles-based and leave plenty of scope for interpretation.[10] Effective participation in development of standards is thus difficult without practical experience of their application, which furthermore requires identical interpretation from one country to the next. Expertise in interpreting standards can already be found at the IASB: as well as the Board, there is an International Financial Reporting Standards Interpretations Committee. But as Mary Tokar (2005) emphasizes, this committee is a slow-working structure that can only handle a small number of issues, whereas the needs for interpretation are often numerous and urgent.

The challenge of interpreting IFRS has thus been taken up most 'effectively' by the Big firms themselves.[11] These firms adjusted to the problems arising by increasing adoption of IFRS as mandatory standards for publication of the consolidated accounts, particularly after the European Commission's decision of 2002. The international structure consisting of technical directorates at the national level and global IFRS offices, based in London and therefore near the IASB, have been adopted with slight differences by the Big firms (Tokar, 2005).[12] And thus a parallel body, a sort of *shadow standard-setter* or rather a *standard interpreter*, has gradually come to exist alongside the more 'official' channel of the IASB and its national correspondents, the different member countries' standard-setting bodies which often depend on participation by partners or former partners of the Big firms and where questions are examined by working parties external to the body forming 'a highly efficient, private accounting technostructure, generally deriving from the Anglo-American firms with financial and intellectual resources, and an international network'[13] (Hoarau, 2003: 42).

A triptych formed by participation in elaboration of the standard, practical management of its interpretation and control of its interpretation could be a description of the action of the discreet regulator that the large international auditing firms have become. Their action appears to derive from a power – or at least an influence – whose nature is at once 'legislative' (elaboration of the rule), 'executive' (participation in application of the rule in the role of consultant) and 'legal' (verifying application of the rule and if necessary reporting incorrect application). Hjelström and Schuster (2011) underline the fact that auditors, in the course of their audit engagement, are increasingly reliant on accounting standard specialists in their firms. Of course, these specialists are also attentive to clients when they need advice as to how to apply standards. The Big Four, the masters of correct application, are also the experts on control of correct application. Even though advisory services on IFRS and auditing are generally considered by law as incompatible services, the market for intellectual accounting and auditing services to large listed groups is so oligopolistic that one or the other of these roles is generally assigned to a Big Four firm.

What are the consequences of the Big Four's unusual influence in the standardization process for accounting and auditing? For the large firms, the interconnection between the three roles of developer, interpreter and inspector of the rule is certainly a virtuous circle that sets them up as specialists of the multinational company, its accounting, its audit and more broadly its business issues, which they help to define by proposing 'solutions' claimed to address these issues thanks to the multidisciplinarity that is still there despite the effect of stricter post-Enron legislation. But for other members of the accounting profession, this circle looks more like a vicious circle. It is helping to create a separate world with an unnatural mixture of the institutional domain (the rule, whose conception should involve representatives of all the profession to signify its unity) and the commercial domain (integration of accounting and auditing into a more general service provided to multinational businesses). This 'commercialization' of the standard arises because of a confusion in standardization of accounting and auditing between knowledge declared to be general and the specific know-how of a particular group of actors. In addition, it puts the large firms in a paradoxical position, between the market and the rule, but also between the local and the global. The Big firms' expertise with multinationals makes them the key players in the transformation of national standard-setting bodies, enabling them to become, at national level, the crucial actors they already are at international level. Already conquerors of the market, the Big Four also became conquerors of standardization once the authorities decided that the national bodies should fall into step with the IASB or IAASB and that standard-setting activities should focus primarily on multinational business issues.

Conclusion

In accounting and auditing for large companies, production of the service and production of its standard are inseparable. More than a 'privatization of law' (Chiapello and Medjad, 2009) which, despite a change in the identity of the regulators and the nature of the rules, perpetuates the existing division between the people who make the standards (and incidentally the people who apply them) and the people subject to those standards, this production actually creates a divide between the people concerned by the standards and the rest. In the large firms and multinational companies, an epistemic community of specialists in accounting and auditing appears to have grown up over time, founded on shared experience of standard-related issues. The large firms more specifically occupy a position in the standardization process that can legitimately be considered part of a triptych consisting of 'production of the accounting standard–help with application of this standard through its interpretation–verification of its application with the help of auditing standards'. For players outside the 'global' circle (multinationals and the Big Four), that is, for other members of the accounting profession and other businesses, standardization is synonymous with exclusion or assimilation difficulties. Of course, the differences between the situation of the Big Four and the high-street accountant, or between the large listed group and the small local firm, are variable in scale. Nonetheless, the current features of standardization of accounting and auditing are certainly helping to establish an accounting culture that conveys a view of accounting held primarily by the international listed groups. This culture, which is perhaps more 'natural' in Anglo-American countries, carries with it a hierarchy between 'big' and 'small' economic and social actors, while simultaneously superimposing another: the hierarchy between national and international. It is thus naturalizing a contrast between what counts and what must be made *accountable* and *auditable*, and what in a society either does not count, or counts less and is therefore concerned by other forms of *accountability*.[14] Rather than letting this divide widen, some observers are calling for stronger political control over accounting standardization. Arguing that accounting is a public good, they believe that standardization is too serious to be left to the experts alone. But as this chapter shows, it is difficult to do without them, especially in matters relating to international standards.

All in all, this chapter draws attention to the fact that the Big Four's influence on the dual logic of internationalization and standardization of accounting and auditing may not lie where we think it lies. Graz and Nölke (2008: 2) refer to the concept of private transnational governance to define non-state actors' ability to exercise their authority across borders by establishing rules and behavioural standards with recognized legitimacy. In the case studied here, this governance is reflected less in the imposition of the IASB as an alternative to public international standard-setting (UN or EU-led, for example), than in the fact that this private institution cannot operate without the support of other private actors, here the large auditing firms. And as already noted, this support is not restricted to supplying the specialists needed to prepare standards; it covers the entire triptych of participation in standard production, actual management of interpretation of that standard and control over verifying its interpretation. In this sense, the Big Four are a far cry from the invisible panels of experts referred to by Diana Crane (1972) on the spread of scientific and technical knowledge. The Big Four are powerful organizations, whose expertise in international standards results from the use of large-scale human, technical and symbolic resources, and long-term accumulation of experience with multinational businesses and their problems. The place they have carved out for themselves on the market for services to this type of company legitimates their involvement in the standardization process. In return, their participation guarantees that they will keep, and consolidate, that place. The 'pay to play' principle, in other words the need to have enough resources to participate in the standardization process, is just as much a 'paid to play' principle: the process cannot function without the input of resources by the Big Four, and they in return reap the benefits of providing that input.

Notes

1. Auditors' work can lead to several levels of assurance in the opinion issued on a company's financial statements. The statutory audit provides the highest level of assurance, but auditors may also conduct other types of

audit and/or audits covering a more limited scope. In addition to publishing standards for statutory audits, the IAASB (see further in the chapter) issues *International Standards on Review Engagements*.

2. Such departments have various names ('standards and professional practices', 'methodology and standards', etc.) but in every firm they are made up of specialists considered to have the necessary knowledge for proper execution of engagements at the clients' premises. Formal knowledge (Freidson, 1986) in accounting and auditing is thus progressively extended through examination of the questions put to them by the 'hands-on' engagement teams.
3. Accounting law and auditing law, which is often part of company law and may lay down companies' obligations regarding financial statement publication and audits, must be distinguished from accounting standardization that specifies the treatments to apply to different economic transactions, and auditing standardization, which defines the minimum requirements for verifying that the accounts provide a true and fair view of those transactions (see further in the chapter).
4. That is a firm whose growth was practically solely internal. Mergers with other professional firms came late in the day for Arthur Andersen compared to the other large firms in the profession (Spacek, 1989).
5. From the late 1980s, 'mega-mergers' between Big firms also concerned entities of non-Anglo-American origin. In 1987 the traditional British firm Peat (which in the meantime had merged with the American Marwick Mitchell) merged with Klynveld Main Goerdeler, a business conglomerate with a high proportion of European firms, to form KPMG.
6. See Touron (2005) in the case of France.
7. A scandal of 1938 that involved Price Waterhouse, ancestor of the current firm PricewaterhouseCoopers (Allen and McDermott, 1993; Coffee, 2006). After this scandal, the SEC required the *American Institute of Certified Public Accountants* to implement auditing standardization.
8. For a brief history of the IAPC, which became the IAASB in 2002, see Robert S. Roussey 'The Development of International Standards on Auditing', *The CPA Journal*, October 1999, accessible online at http://www.nysscpa.org/cpajournal/1999/1099/Features/F141099.HTM and 'International Auditing and Assurance Standards Board, A Brief History of its Development and Progress', July 2007, accessible online at http://web.ifac.org/download/IAASB_Brief_History.pdf.
9. Board members of the Accounting Standards Board, accessible online at http://www.frc.org.uk/asb/about/board.cfm.
10. International standards differ on this point from certain American standards which are rules-based and therefore theoretically less open to interpretation in their application. But the desire to cover the largest possible range of situations that a financial statement preparer might encounter can lead to such complexity that the rules become difficult to apply. Also, in contrast to the initial objective of greater clarity and reliability, rules-based standardization in fact facilitates 'arrangements' and accounting 'manipulation' that respect the letter of the rule but violate its spirit.
11. My concern to focus on interpretation of standards in order to understand their operation echoes the approach of Cooper and Robson (2006) and Robson and Young (2009) who consider that the study of the formation

and communication of accounting and financial information has not yet explored the most practical, everyday aspects of the tasks of preparing and submitting the accounts.

12. By the late 1990s, when the IASC was to be reformed as the IASB, the Big firms had already proposed to 'form a sort of partnership at worldwide level between the Big firms, to have a strike force to teach IASC standards the same way everywhere. We joined forces with organizations like the World Bank and universities' (comment by Jacques Manardo, former senior partner of Deloitte in France, at the conference on 'Accounting and Economic War' held on 7 June 2000 under the auspices of the *Association des amis de l'Ecole de Paris du Management*).
13. Author's own translation.
14. The UK's Accounting Standards Board attempted to develop a set of 'Financial Reporting Standards for Smaller Entities' to reconcile its main mission as issuer of standards for listed companies and standard-setter for an EU member state, and therefore subject by virtue of the fourth European directive on accounting to accounting rules for all types of company.

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3
Ambivalence and Ambiguity: The Interpretive Role of Compliance Officers

Marc Lenglet

Introduction

Studies on the regulation of financial activities often recognize a dichotomy between financial entrepreneurs and financial regulators, following Miller's 1986 seminal article. However, such a clear-cut position raises questions about the ability of this 'endless symbolic tennis game' (Millo, 2007: 211) to take on board the subtle nuances of financial market development. This chapter follows another intuition, looking at situations where the description of the financial world cannot be taken at face value or seen as a black-and-white picture. Acknowledging this intuition means assuming that even for financial actors, describing financial objects can prove challenging (Muniesa, 2009; Muniesa et al., 2011). Shifting from objects to practices, we find the same set of issues, especially when the subject is focused not on macro-prudential equilibria (systemic risk), but rather on the daily routines unfolding in financial firms and markets. These routines are generally described in policies and procedures offering a frame for the materialization of regulations: located 'between knowing and acting' (Callon, 2002: 212), procedures provide operators with guides for development of their practical expertise, and help to shape actions as they develop. More specifically, procedures help operators to get rid of ambiguities generated by the fact that practices are embedded in changing contexts: as such, they can be seen as cognitive prostheses facilitating the operators' situated performance.

Those cognitive prostheses, which 'fix' directions for the development of states of reality, originate in laws and regulations (European directives, national regulations) which themselves provide the normative sources necessary for the design of internal procedures. While these

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framing devices are often considered as givens, the process leading to their formation usually remains unexplained and implicit. We shall see that the design and implementation of such normative texts is a contested terrain, making regulation-writing a political activity in itself. And this is true not only at the top, best reflected by international regulatory initiatives such as the Basel Principles issued by the Basel Committee on Banking Supervision, but also at the very bottom of the regulatory chain: in the organizations where these texts are *applied*, that is translated, adapted and put to work in changing contexts. In financial firms, several functions are involved in the reading of new regulations and the resulting interpretations: depending on the nature of the text, accountants, auditors, legal advisors, risk officers and many other functions may seek to understand the regulatory framework in order to make sense of the rules governing the financial game.

Compliance is one of the functions taking an active part in this translation, building on its specific position within the organization. Compliance officers act as employees contributing to the collective construction of profitability, while at the same time ensuring that the resulting practices stay within the paths delineated by law. Bridging representations and communities from the inside, compliance officers embody an agency relationship between management and employees, the company and the market, the inside and the outside, the tacit and the explicit within the organization. In enacting internal norms and performing controls, advising and training employees, compliance officers are actors in the regulatory architecture now in place in the majority of Western-style economies. As such, they are said to manage the 'reputational' or 'image' risk arising from non-compliant practices, thereby encountering the 'morphing meanings of risk' (Arnoldi, 2009: 176).

But what precisely is a 'non-compliant practice'? The question is not easily answered. Financial standards may sometimes prove inapplicable or unsuitable for a given market context, even though they are devised and written with a view to facilitating the deployment of situated actions. Like any other text, rules and regulations need to be interpreted, even after they have been converted into internal policies and procedures. This process involves a series of translations, ranging from transposition of supranational regulations into local legal contexts, to adaptation of newly translated requirements into the specific activities managed by a given market participant. These translations affect the nature of the text, which undergoes an ontological change from conceptual expression to material incorporation into the daily routines activated by market participants. While the definition of non-compliance remains highly problematic, especially in spaces such as financial markets with their overabundance of rules, it also leaves room for the development and expression of interpretive communities with variable levels of power (Fish, 1980). With the need to interpret normative texts and make them fit the context (or vice versa), a careful hermeneutic develops as an integral part of financial practice; and compliance officers are part of this movement.

This is the process explained in this chapter, which shows how compliance officers interpret regulatory texts, and how they use these written devices to instil regulations into the practices contributing to the design of markets. As members of one control function among the long list of market actors usually remaining backstage, compliance officers contribute to internal regulation of the market by managing the *ambiguity* arising from the encounter between texts and contexts. I argue that this process is possible because of the *ambivalent* position they hold within the organization. I also intend to show how the compliance function not only manages ambiguity as one of its daily duties, but furthermore that it is in charge of a positive organization of ambiguity within financial contexts. This sheds light on the process leading to the development of normative frames for the market, and suggests a 'thicker' approach to regulatory studies, in a Geertzian sense. The section 'Delineating compliance' provides a short definition of compliance from a regulatory point of view, followed in the next section, 'Compliance and organizational ambivalence', by a complementary perspective displaying the function's organizational ambivalence. The subsequent section, 'Making things explicit: Managing ambivalence to shape ambiguity', highlights the ways compliance officers try to manage ambiguity in the course of their daily duties. The section, 'The paragon of ambiguity: The possibilities offered by interpretation of MiFID', offers a deeper look into a well-debated case – the development of hybrid marketplaces all over Europe, resulting from textual ambiguities. Then the 'Concluding remarks' section offers a short conclusion to the chapter, commenting on the ambivalent nature of the compliance function.

Delineating compliance

Compliance refers to 'the action, practice, or fact of complying', that is, 'a consenting to act in conformity with'.[1] The general meaning of the term indicates the idea of adhesion by a situation (a given context for the development of a fact or practice) to a frame (a normative stance). For the corporate world, compliance is often associated with the idea of legal requirements: studies have been published on compliance with supranational norms, in the case of international relations (Braithwaite and Drahos, 2000; Koh, 1997; Parker, 2000) or tax regulations (Braithwaite, 2003). Other approaches to compliance have explored areas such as environmental policy (Hutter, 1997; Kagan, Gunningham and Thornton, 2003; Kuperan and Sutinen, 1998), biotechnologies (Corneliussen, 2004) and health care (Hutter, 2008; Lloyd-Bostock and Hutter, 2008). Occasionally, scholars have paid attention to compliance as a profession, describing its features in financial contexts (Weait, 1993, 1994) or providing pointers towards the understanding of its institutionalization (Edelman, 1992; Edelman et al., 1991; Parker, 1999, 2002), especially within the *Law and Society* tradition (Suchman and Edelman, 1996). While offering documented insights into the concept of compliance, these studies are usually limited to a discussion of the notion and offer few, if any, ethnographic accounts of the compliance function at work.

There is as yet no definitive description of 'compliance' and its encapsulation in a dedicated control function, taking place within the overall architecture of financial regulation alongside risk management, internal control, external audit and to some extent legal departments. The notion of compliance appears in recent works by Michael Power, where it is mentioned with reference to the management of reputations (Power, 2007: 147–8), or as part of the risk management framework in place (Power, 2009). One explanation for the scarcity of academic literature dedicated to compliance as a function is the relative youth of the concept, even though it is part of recent efforts towards better risk mitigation in organizations. Another is that the function itself is not that keen on the spotlight: compliance officers usually remain backstage, unless they feel an urge for public disclosure or perhaps even whistle-blowing (Katz and Lenglet, 2010), but such cases are very rare and indicate serious internal dysfunctions. Furthermore, the legal definition of the compliance function remains quite loose, even though there have been several attempts at delineating the contours of its responsibilities.

In the UK, the compliance function is considered a 'controlled function' (CF 10) under the Financial Services and Markets Act (2000), meaning its members take an active role in appraisal of the firm in application of the regulations. Similarly, French compliance officers are considered 'relevant persons' holding a 'professional licence' issued by the French market regulator Autorité des Marchés Financiers (AMF) once they have passed a professional examination (AMF, 2011: art. 313–38). Recently, the compliance function went through a calibration period in France, being named and renamed several times. Originally a function dedicated to 'control of investment services' (AMF, 1998), it mutated into a 'deontological' function (AMF, 2003), and is now known as the 'compliance function', translated as *conformité*[2] in French (AMF, 2005). The AMF's *General Regulation* provides the following definition of the compliance function:

> Investment services providers shall establish and maintain an effective compliance function that operates independently and has the following responsibilities: 1° To monitor and, on a regular basis, assess the adequacy and effectiveness of policies, procedures and measures [ensuring their ability to detect 'any risk of non-compliance'], and actions taken to remedy any deficiency in compliance of the investment services provider and the relevant persons […] 2° To advise and assist the relevant persons responsible for investment services so that they comply with the professional obligations of investment services providers. (AMF, 2011: art. 313–2).

In short, the compliance function is responsible for making sure that market operators, other employees and the management abide by the rules in force for their dedicated environment. This is more complicated than it sounds, for market contexts often provide situations that do not directly fit the regulatory texts.

Compliance and organizational ambivalence

Compliance officers are supposed to be independent assessors making sure that rules are disclosed, known and followed; they provide regulatory insight when the rules are unclear, unfamiliar or disregarded. Compliance officers therefore occupy an ambivalent position in the organization: they are hired by the company, and therefore attached to it 'from the inside', but also perform control and reporting duties required by external regulators. Their dual role puts them at the heart of conflicting interests. This ambivalence is typical of what legal scholars have called the 'New Regulatory State', or 'New Governance' (Hutter, 2011): the result of a movement where the State 'is attempting to withdraw as direct agent of command and control and public management, in favour of being an indirect regulator of internal control systems in both public (or formerly public) and private agencies'

(Parker, 2002: 15).[3] Representatives of 'gatekeeping' functions, such as compliance officers or chief privacy officers (Bamberger and Mulligan, 2011), hold an ambivalent position through their two-sided task, and accountability to two different spheres of interest: private on the one hand (relating to the company) and public on the other hand (contributing to regulation of the financial system, in this case). But what do compliance officers do exactly? And how does this ambivalence translate in the course of their daily duties?

The compliance function appears to be heavily determined by the context it is rooted in, for it is ontologically attached to situated practices. However, it is possible to identify at least five different tasks assigned to compliance officers in financial service firms.[4]

(a) First, compliance officers *enact rules within the firm*: They create policies and procedures from their reading and understanding of national or supranational regulations, and implement them. Also, the compliance department is usually in charge of designing an internal code of conduct aimed at describing the firm's activities and explicitly stating the principles of conduct that employees must know and abide by.
(b) The second task of the compliance function is directly linked with this rule-making activity: Compliance officers *train employees* to keep them informed of the regulations constraining their practices. Whenever new regulations relevant to the firm's activities are issued, the compliance department then assesses the need for specific employee training.
(c) The third task of the compliance function is a *monitoring duty*: There are specialized controls requiring compliance officers' physical presence not too far from market operators, for purposes such as managing conflicts of interests. As part of this monitoring activity, compliance officers often play an active role in 'New Approval Committees' involving several representatives of the company (not only from the front office, but also members of support functions such as the middle and back offices, IT, accounting, legal and control functions). These committees meet whenever the company launches a new product or engages in a new activity. Their meetings provide a space for a validation process involving description of financial innovations and firm-wide dissemination of knowledge (Armstrong et al., forthcoming).

Along with these three regulatory activities (rule-making, training and monitoring), two other tasks, much more privately oriented towards the specific interests of the firm, exemplify compliance officers' organizational ambivalence.

(d) The fourth area of compliance officers' recognized expertise is an important one: They *provide operators with advice* in a market dilemma, that is, situations when the operator finds it difficult if not impossible to make sense of the context through his own knowledge and understanding of the rules. Although this part of the compliance function's activity is not widely known or studied by scholars, it accounts for a definitive portion of the function's work, in which compliance performs the hermeneutics of regulations in market contexts (Lenglet, 2008, 2011).

(e) Finally, compliance officers also have a *lobbying* task, actively participating in official discussions of the implementation of rules and regulations at either national or international level. Two main channels are used for this activity: they either take part through a professional association such as the British Bankers Association (BBA) in the UK or the Association des Marchés Financiers (AMAFI) in France, or through their firms' responses to occasional calls for evidence or discussion papers issued by regulatory bodies and various institutions such as the European Commission or the Basel Committee on Banking Supervision.

Compliance officers, like members of many other nascent or young functions, have had a long maturing period, with 'considerable organization-specific path dependency in [their] emerging role' (Power, 2005b: 135, speaking of risk officers). This very brief description of their duties shows, however, that their field of intervention is slightly different from other control function members, such as auditors producing legitimacy (Power, 2003) or risk officers organizing risk management processes (Power, 2005b), even though those tasks are part of their job descriptions. Compliance remains central to the existing agency relationship between private actors and the regulations governing them, which are for the public good, and compliance officers take an active role in the making of regulations: not only as internal enforcers acting on behalf of the public authorities, but also because of their ability to fill in the blanks left by the regulations,[5] in the specific frame of the markets. Because they are in a position to provide 'instant' advice to market operators, and adapt their answers to market temporalities (sometimes constructing solutions within minutes), they are constantly switching between their roles as private and public actors. The blurring between the two roles increases the ambivalence of their status within the organization: as previously noted in studies on risk officers (Power, 2005a) or environmental officers (Rehbinder, 1991), in such functions 'a fundamental tension exists [...] between [their] public meta-regulatory role and their private function as agents of management' (Power, 2005b: 133). Compliance officers are literally 'double agents' acting on two different levels: in the interests of the company that hires them, and in the interests of the market as a public good. This dual agency relationship is best reflected in compliance officers' role as interpreters of regulatory texts, in which they act as internal legislators enacting rules for the company, with a view to ensuring employees and the management act within the legal framework. Like translators able to switch between two languages, compliance officers occupy a position where they must speak the conceptual language of regulations, and the material language of practicalities. This point is now investigated further, bearing in mind the fundamental ambivalence of the compliance function.

Making things explicit: Managing ambivalence to shape ambiguity

Strictly speaking, financial markets develop in such a way that perfect control over them is impossible, for there are always areas where innovation can burgeon unnoticed, the consequence being that operators may move into areas that are left with few or no regulations. And there is absolutely no need to look for structured products or over-the-counter transactions involving elaborate 'bricolage' (Engelen et al., 2010) to find such areas.

Encountering ambiguity while using 'accepted market practices': Liquidity contracts as an example

Liquidity contracts are considered an 'accepted market practice' in France, yet they remain completely unimaginable in countries such as the UK. The practice consists of allowing an issuer to enter into a contract with a market intermediary entitling that intermediary to buy or sell shares in the issuer, with a view to 'regulating' its natural liquidity and the resulting volatility. Liquidity contracts are defined by an AMF decision (AMF, 2008: art. 1, our translation)[6]:

> The liquidity contract defines the conditions under which the investment services provider intervenes on behalf of the issuer, either on the buy-side or the sell-side of the order book, in order to facilitate

> trading liquidity and the regularity of prices of the issuer's securities, or prevent price discrepancies that are not justified by the market trend [...] For each different class of securities, the issuer may use only one investment services provider to ensure the liquidity (*animation*) of the security concerned.

It goes without saying that such contracts are very strictly regulated, monitored on a daily basis by both external market surveillance teams and internal compliance officers, for they could definitely be considered a market-abusive practice. A very strict disclosure regime applies to liquidity contracts, and the intermediaries managing the interventions make decisions to place orders in the book[7] independently of the issuer. Similarly, as this accepted practice can be considered essentially manipulative, the trading rules applicable are very strict: operators managing liquidity contracts must ensure that 'instructions managed by the investment services provider [...] do not create artificial price discrepancies when compared to the market trend' and cannot make the issuer 'hold more than 10% of his own capital' (ibid.: art. 3.a). All in all, the contract supports stock liquidity (hence the word *animation* in French), but at the same time remains within the strict objectives assigned to the intervention.

In 2005, compliance officers in Paris started actively lobbying for other European markets to promote this practice. From certain perspectives, however, a practice where an issuer enters into a legal contract with a market participant to guarantee sufficient liquidity for its financial instruments appears ambiguous. This may be the reason why liquidity contracts are not yet widespread; they have been adopted in very few countries, one being Spain.[8] As the following excerpt from an exchange of emails shows, discrepancies between local regulations in European financial markets can create difficulties for market operators in their relations with different regulatory authorities. This conversation took place between a compliance officer located at the headquarters of a brokerage house in Paris, and a sales manager in its Spanish subsidiary. It dates from the beginning of 2009, just after the Spanish regulator had authorized the practice of liquidity contracts (correspondence quoted verbatim).[9]

Sales: Good morning guys. Let me drop you just a couple of lines regarding an informal chat we had with the regulator [name of the contact] on liquidity contract's trading rules. [...] We pointed out the fact that fostering liquidity on very illiquid stocks, such as [name of a stock] is very difficult if the constraints were to be strictly followed. I think it could even inhibit issuers from signing liquidity contracts […] [Name of the contact] agreed on the fact that, given the sharp decline on traded volumes in these stocks, it is indeed necessary to ease the trading rules, in order to achieve the contract's aims. He said that it is fair to give this little room to those issuers who have decided to sign liquidity contracts […] As you can imagine, he wouldn't send us anything in writing or set any precise limits on how much we can break the rules, it's just a matter of common sense.

Compliance: When you 'chatted' with [name of regulator], were you on a recorded line? And what is the official position of that person? A big chief at [name of the regulatory agency]? I think you have to be very careful with such unofficial conversations, as the regulator can sanction us or even ban us if we do not abide by the rules they just put in place, if we don't have anything to prove our willingness to respect those rules.

Sales: Sure, what I meant is that it was an informal conversation – on a recorded line. [Name of regulator] is not a big chief of [name of the agency], but he was definitely giving not just his own opinion but the [agency's] team in charge of supervising liquidity contracts' opinion (he's part of it). In other occasions he wouldn't give this kind of 'tips' without consulting with his boss, this time it seemed that it's been agreed internally beforehand. […] What I would suggest is to be fully transparent, inform them the day we go beyond the rules (if ever), explain them why and how we did it, etc. All this can strengthen our link with them and may open their eyes in order to soften trading restrictions later in the future. […] Just my opinion though.

Compliance: I really don't know how to deal with [name of regulatory agency] (we don't have the same relations with our French regulator), but I think if you have to do something which you think goes beyond the line they defined, the best is to have the prior consent of your regulator on a recorded line. The subject is too sensitive for you to inform them *a posteriori*.

This excerpt illustrates the material difficulties arising in the course of an ordinary trading day: a financial innovation has just been accepted by the regulator, but there are no past cases yet, and both parties (the regulator and the investment firm) are unwilling to take a public position, even though the regulatory burden may prevent any use of the newly enacted rule. What we see here is *ambiguity* at work: a market context that does not fit the rules, and market participants exchanging ideas, advice and unofficial positions. The specific character of the context, its 'newness' so to speak, makes the rules questionable; yet questioning them remains a risky business, hence the reaction of the compliance officer.

Shaping ambiguity while moralizing practices: The case for IOIs

A further example enhances understanding of how ambiguities develop in financial markets. Even certain very basic practices, such as stating an interest in a financial instrument, may involve conflicting perspectives pertaining to different regulatory regimes. This second example concerns 'Indications of Interest' (IOIs), which are 'messages sent between investment firms to convey information about available trading interest' (CESR, 2010: 6), usually regarded as 'non-firm expressions of trading interest' (FINRA, 2011: 2). The important issue here relates to the status of the information conveyed, and the resulting conflicts of interest: an IOI crystallizes the difference between proprietary (the company's) interests and third party (external clients') interests. Some countries, for example France, disregarded the practice for quite a while: nothing in their regulatory framework explicitly referred to IOIs, although the practice was already part of the market texture. In such countries, regulators apparently take the view that existing legislation on conflicts of interest and market abuse is sufficient to ensure proper regulation of the practice. Other countries, in contrast, for example the US, have been discussing the issue for more than ten years, trying as far as possible to regulate publication of interest through a dedicated financial instrument.[10] This reveals the discrepancies existing between countries, and the questions raised by the international nature of financial investment services firms: how can a firm with foreign subsidiaries manage the issue? More importantly, the IOIs themselves raise profound regulatory questions with regards to the way business is conducted and conflicts of interests are managed. One of the pivotal issues with IOIs is their materiality: are there any underlying positions to prove the materiality of the informational flow communicated by the financial intermediary? And are these expressions of interests linked with a customer (in which case the IOI would be deemed 'natural')? Or have they instead been generated by the investment firm to attract orders? US regulations try to make this distinction clear-cut:

> Although the meaning of the term 'natural' may differ across firms and service providers, a 'natural' IOI is generally considered to refer either to customer interest a firm represents on an agency basis or to proprietary interest that was established to facilitate a customer order or as part of an execution of a customer order on a riskless principal basis.
>
> FINRA (2011: 2)

All these explanations are intended to distinguish between customer-related interests and the firms' own proprietary interests, for obviously the consequences for the nature of the transaction differ accordingly.

Until at least 2009, French regulations did not include any specific guidance framing such practices: market operators were therefore (legally) able to display buying or selling interests apparently materializing an immaterial interest, solely for the purpose of attracting customer flows by publicizing excessive liquidity. Some market participants, however, defending the idea that self-regulation should not be just a shallow concept, decided to define a market practice, as IOIs were beginning to make up a large proportion of intermediaries' marketing efforts in Paris. During a job interview dating back to 2006, the CEO of an investment firm explained that he had decided to ask his compliance officer to build an internal procedure, even though there were no specific obligations in the local regulations:

> I try to hire a compliance officer who shows a capacity to understand the business, I mean I expect him to take initiatives when there are true compliance issues. Not only as an employee hired to check and help as indicated by the regulations, but rather a person who'll be in a position to suggest important changes as regards our practices [...] Take the case of IOIs: well, there are no rules there; our compliance officer addressed the issue and we implemented our own procedure for them. I know it's not a popular procedure with sales traders, but I feel much more on the right track, even though I know some of my competitors will just take advantage of that and continue to bullshit the market.

This CEO shows how far intermediaries can take part in regulation of practices they activate, by unfolding ambiguities rooted in market practices. Contrary to the previous situation (Encountering ambiguity while using 'accepted market practices') where the newness of the rule made it impracticable, clearly here it is the lack of regulation that is the problem: of course, creating a new regulatory burden for the company is not part of the daily routine, and such cases arise only rarely, yet they remain paradigmatic of how regulatory ambiguities are managed by firms in the field.

Promoting different forms of ambiguity? Compliance officers as political actors

The previous two cases (liquidity contracts and IOIs) offer complementary views of the compliance function. It cannot be understood simply as a defensive function, sending symbolic signals to the market about how the firm formally complies with rules and regulations. Whereas the first example underlines how the geographies of financial regulation create ambiguity, revealing the informal perspectives developing between the regulator, the salesperson and the compliance officer, the second example shows how ambiguity is not always sought by market participants. The situations described appear to echo Jacqueline Best's (2005: 3–5) identification of three forms of ambiguity in her analysis of the political economy of international finance: a *technical* form, a *contested* or political form, and an *intersubjective* form of ambiguity. In her writing, Best argues that modes of thinking at work in and around the financial arena do not leave enough room for the development of ambiguity. Building on her distinction between different types of ambiguity, she shows how financial institutions currently tend to have discourses promoting the eradication of such ambiguities: 'whereas the emphasis in the post-war regime was on *managing* ambiguity by *regulating* capital and exchange rate movements, the contemporary reliberalized regime has focused on *eliminating* ambiguity by *deregulating* financial flows' (Best, 2005: 2). She shows instead how important it is to look into ambiguities, and fully accept their role, for 'the process of defining and managing ambiguity is, by its nature, political' (ibid.: 7). The cases presented in this chapter tend to confirm this view, highlighting the political nature of the compliance function.

While Power (2009) makes a strong case against box-ticking approaches in monitoring functions, it must also be acknowledged that some constituents of the 'control family', at least in some organizations, remain less bounded by a narrow understanding of the rule-based approach. Compliance officers may well spend some of their time box-ticking and filing reports demonstrating a conformist approach to compliance.

But reducing them to this role may prevent understanding of how businesses develop, namely in a much more subtle palette of nuances, where the compliance function may either try to draw on the law to establish a defensive, bureaucratic position intended to guarantee nominal compliance, or, on the contrary, promote the invention of new rules in a regulatory desert. In other words, we contend that the formalist approach to the function is necessary (i.e. legitimate) but not sufficient if we are to unfold its intricacies. Not only because there is usually a point where the compliance officer looks at his own interests as an individual, and cannot go too far in an apparent fulfilment of compliance while bending the spirit of the rules (this would be the point where merely conformist compliance clashes with personal ethics), but also because compliance officers are regulatory pathfinders.

Benefiting from their ambivalent position within the organization, compliance officers manage ambiguities arising in the course of business. In making contexts more explicit, they help (in)form situated practices, serving as semiotic 'disambiguators': as such, they cannot be reduced to a defensive mechanism for companies facing a heap of complex regulations. They therefore also embody a positive function, underlining the gaps left by regulatory texts, suggesting new regulations and unfolding the practicalities materializing from their 'explicitation' efforts. Compliance officers are very close in status to regulatory experts, for 'as an interpreter and mediator, the expert spans the otherwise distant worlds of the objective and the subjective. He bridges the gap between guarantees of being in the right (which can be only social), and making the choices that one wants (which can be only personal)' (Bauman, 1991: 199). This metaphysical position is possible because compliance officers benefit from their ambivalent position, which is perfectly appropriate to the ambiguous, finitist nature of rule-following. Offering interpretations of practices and rules in the making, they contribute to the unfolding of the market, acting as a jurisprudential function creating law that both *deploys* and *follows* rules in a setting where the correct interpretation is never clear in advance.[11]

The paragon of ambiguity: The possibilities offered by interpretation of MiFID

A renewed definition of compliance has been reached: while at the beginning of this chapter, compliance appeared as a control function broadly comparable to other monitoring functions, two short examples have shown that the ambivalence it embodies can also be a powerful resource for the management of ambiguity. This section looks into the development of the recently enacted Markets in Financial Instruments Directive (MiFID) in order to explain how this directive, originally intended to create the conditions for deployment of competitive pan-European financial markets, failed to fully achieve its goal, resulting in the creation of layered markets with partially blurred transparency regimes. One reason for this state of affairs now acknowledged by market participants is that some actors managed to interpret the text aggressively to their own benefit and the detriment of others: the specificity of the case lies in the fact that it is the directive itself, together with its promoters (the European Commission) and its readers (including compliance officers) that made such a development possible.

Post-trade transparency intricacies

In the early 2000s, the 1993 Investment Services Directive (ISD) had reached its limits: it was inappropriate for creation of a fully integrated financial market in Europe. The introduction of a common currency further emphasized the fundamental weaknesses of European financial service architecture. Following the Financial Services Action Plan (May 1999), the Lisbon Council (March 2000) mandated a Committee of Wise Men to look into issues related to implementation of a new regulatory framework that could help overcome missed achievements and unaddressed questions. Among the different themes identified at the time, measures relating to public offers, the disclosure of information by corporate issuers and market integrity were all named as points on which the Union needed to do better.[12] Headed by Alexandre Lamfalussy, the Committee published the results of its work in November 2000: one of the expected benefits of market integration was 'intensified competition between financial markets and intermediaries' (EC, 2000b: 4). Central to the argumentation was the fact that market information was at the time heterogeneously disseminated within European countries, under different rules, with a total lack of regulatory homogenization (ibid.: 18). This provided the initial impetus for revision of the European regulatory framework, resulting in issuance of MiFID and a renewed transparency regime.

Following the Committee's recommendations, a new directive was written and adopted by the European Parliament (EC, 2004), drawing on two main principles: enhancement of competition, and protection of financial service consumers. After three years during which members of the Union formally transposed this directive into their local regulations, a new financial space was created on 1 November 2007, and the old 'concentration' rule still in force in some countries was removed. MiFID, in this respect, offered a whole set of new possibilities for the creation of alternative structures: Multilateral Trading Facilities (MTFs), which could be seen as alternative trading systems – platforms supporting transactions and acting as secondary markets; and Systematic Internalizers (SIs), which can be paralleled with market makers, continuously making prices on specific securities. To make sure competition would arise from this new landscape, transparency rules were enacted: *pre-trade* transparency rules on the disclosure of prices and volumes available, and *post-trade* transparency rules on completed transactions taking place on these platforms. Both principles were made very explicit in the implementing directive and regulation issued by the European Commission (EC, 2006a, 2006b); they remain one of the most disputed topics of MiFID, for they deal with the core of the financial market's activity: the shaping and dissemination of information.

Two issues arose rapidly within EU member countries: first, problems of basic transposition, then technical issues resulting from the new requirements. Local regulators began to discuss how they would implement MiFID in their national regulations. In most countries, discussions involving the Parliament (in its legislating capacity), the local banking commission and the local market regulator led to imperfect transposition of the directive. Some institutions were unwilling to lose their own framework and began 'gold plating', that is, decided to transpose the new principles by *adding* new rules to their existing framework rather than *replacing* the old rules, an absurd approach that generated ambiguity. Furthermore, the transposition process took much longer than initially planned: between November 2007 and the early months of 2010, the markets witnessed a slow movement towards MiFID adoption. Needless to say, there were teething problems in the early period; local transposition of European-wide rules was in some instances almost impossible, even though questions raised by the new transparency regime remained critical for orderly development of the markets. The enforcement of MiFID brought about a shift from a situation where investment firms had to report securities transactions under local regulators' rules, towards greater homogenization with a view to enabling competent authorities to monitor participants' activities, thereby ensuring they would act 'fairly and professionally in a manner which promotes the integrity of the market' (CESR, 2007: 2). Deciding where to report transactions soon became the subject of discussions between regulators and participants: in almost every country, the issue was not fully resolved long enough before November 2007.[13]

The problem with transaction reporting under MiFID is its apparent simplicity: the general principle is that transactions made on a regulated market or an MTF should be reported 'to the competent authority either by the investment firm itself, a third party acting on its behalf or by a trade-matching or reporting system approved by the competent authority or by the regulated market or MTF through whose systems the transaction was completed' (EC, 2004: art. 25.5). However, this overarching principle reaches its limits with the deployment of electronic markets: it may be quite difficult to decide 'where' the transaction took place, especially when two or more countries are involved. In such situations, did trading occur in the location of the market, or the country of the firm sending the instruction? And what about the firms' legal status (for instance, should a subsidiary be responsible for reporting its transactions, but not a branch)? And who, ultimately, is the competent authority: the local market regulator, or the regulator monitoring the investment firm? Even a simple trade occurring on the London Stock Exchange can raise critical issues as regards interpretation of the rules, when it is sent by a client of an Italian branch belonging to a French intermediary. Four years after the directive was implemented, these questions have now generally found their answers: yet it took market actors some time to understand the new requirements, and set up systems that would allow some monitoring of transactions.

The situation was made more complex by the fact that MiFID also required disclosure to other participants of (even off-market) transactions in shares admitted to trading on a regulated market, in as close to real time as possible. This ignited debates within firms, usually because the IT development teams needed to know precisely what should be reported, and to whom. Most of the answers were not straightforward, and for a while some companies decided to use the option of third-party reporting of the transaction, as allowed by the directive. Yet such reporters were unable to 'tag' dedicated transactions within the flow of data sent by intermediaries. Conflicting geographies would therefore become invisible, and even though intermediaries could be sure their transactions had been reported, they would not know precisely where, or to whom.[14] Also, the reporting mechanisms were not able to state the name of the reporting firm with the required degree of precision: some transactions would therefore be reported twice (both the buyer and the seller could be reporting), thereby increasing published volumes[15] and making it almost impossible for regulators to track abuses. And so post-trade transparency, which should have been improved and made more homogenous by the European directive, remained a blurred, ambiguous area for several months after the official application of MiFID.

The pre-trade transparency game: Building hybrid systems from creative interpretations

Despite all this confusion, post-trade transparency was not in fact to be the main area of dispute in European financial markets. Pre-trade transparency – that is, disclosures concerning available financial instruments (prices, volumes, numbers of orders, sides of the order book, etc.) – was also the subject of fierce debate, with some market participants seeking to waive the obligations attached to the reporting principles.[16] The case presented next briefly tells the story of one possible interpretation of MiFID requirements regarding the disclosure of pre-trade information, and the concomitant construction of an in-house matching system at an intermediary: compliance officers seeking a path through the twists and turns of regulation are seen playing with definitions and classifications in order to facilitate construction of the matching system. The case shows how some intermediaries, when they had to adopt an interpretation of a complex regulatory text, created a (competitive) advantage while documenting their position.

Following publication of the MiFID implementing directive and regulation in August 2006, intermediaries had all the information necessary to start designing their own trading platforms. A first requirement for the platform creation process was to set up a crossing engine, a system to identify and optimize matching of instructions sent by clients (for instance, the system would try to find opposite orders such as 'buy 10 X @ Y EUR' and 'sell 10 X @ Y EUR', and optimize the number of such possible transactions). Even for intermediaries who did not want to build full market platforms, being able to systematically 'cross' client orders generated significant gains, as the transaction costs were sharply reduced, sometimes even partially rebated to clients (thus becoming a marketing argument). While off-market crossing of orders between two clients had been a well-accepted practice in the financial markets prior to MiFID, the removal of market regulations limiting the practice (a direct consequence of the end of the concentration rule), together with the desire to systematize the process, changed the perspective. Furthermore, developing crossing systems required more than technical IT solutions; careful assessment was also needed for the institutional side of the project, and to ensure acceptance of such systems by local regulators. In investment firms, teams of compliance officers therefore began to produce interpretations intended to support the management's decision-making process. Constructing argumentation was seen as a way to defend the case should a regulator raise questions about the proposed platform structure. Reading a regulatory text such as MiFID remained a tricky task: not only because it introduced a new financial architecture, but also because at the time it contained several uncertainties; hence the use of external experts such as legal advisors (to help in interpretation and bring legitimacy to the project) or compliance colleagues (to remain within the 'benchmark'). Discussions with regulators were also incorporated into the reading process, thereby introducing competition between regulatory areas rather than pure regulatory arbitrage.[17]

One of the pivotal questions raised among market participants was how to classify such hybrid systems: would they belong to the MTF category, in which case the intermediary would need to obtain prior approval from its regulator, as managing such a system was recognized as a financial service; or would they be considered SIs, in which case the intermediary would need to trade on its own account on an 'organized, frequent and systematic basis' (EC, 2004: art. 4.7) outside a regulated market or an MTF? Either situation raised interpretive issues, and implied a different regulatory burden for the intermediary. Many investment firms soon decided that SI status was not particularly attractive, for it implied some exposure in the market (SIs have an obligation to offer prices in stocks for which they are internalizing) and required too much capital.[18] On the other hand, building an MTF seemed almost impossible a task, for it would require the creation of a whole new legal entity, involving setting up procedures, hiring employees (for surveillance obligations at least), not to mention the need for regulatory approval. Certain market participants therefore began to seek creative readings and interpretive options that would generate some conceptual space for a new category of trading systems. In the early months of 2008, a new generation of crossing engines emerged at French brokerage houses, paralleled by active 'dark pools of liquidity' (platforms with no pre-trade transparency) abroad. Neither fitted into the categories proposed by the directive: if the system did nothing more than crossing third-party interests, it could not be seen as an SI (which concerns proprietary transactions); but could it qualify as an MTF? And more importantly, what would the regulators think of these systems?

This situation brought compliance officers to the fore as producers of interpretation, and providers of argumentation. They were helped in their hermeneutic task by the structure of the regulation: MiFID contains an unusual *paratext* (Genette, 1982),[19] a set of recitals that have no legal power (as opposed to the articles constituting the bulk of the directive), but should be used for its interpretation. These recitals, left in the document by the legislator, account for EU member countries' differing views: they help to contextualize some principles, but also describe conflicting views, creating multiple ambiguities. Discussions about the classification of hybrid systems were thus given a wide open door to creative interpretations. If MiFID defines MTFs as 'multilateral system[s], operated by an investment firm or a market operator, which [bring] together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract' (EC, 2004: art. 4.15), how should a platform allowing crossing of third-party interests be classified? On the one hand such a system appears to meet the regulatory requirements, as matching rules are non-discretionary (as expressed in recital no. 6)[20] and fixed in an IT system. But on the other hand, the crossing system does not technically include 'market participants' (only clients), nor does it create prices; furthermore, the intermediary managing the system would still have a duty of 'best execution' (i.e. applying a set of rules agreed between the intermediary and the client). For all of these reasons, some compliance officers argued that the crossing systems did not impair transparency or the quality of market liquidity: building their arguments on the spaces left by the text and its paratext, they had created a new category outside the official categories (MTFs and SIs).

With almost no legal precedents to refer to, and a directive consisting of legally enforceable articles plus a paratext of recitals used as interpretive aids, it was in the end quite tempting for intermediaries to make up their own minds. Based on a reading of the text, contradictory positions could be demonstrated with due argumentation, in a scholastic *disputation* style. The intricacies of transparency led to creation of multiple hybrids that are still populating European markets. Four years after the effective implementation of MiFID, these markets offer a blurred vision where clear identification of roles and capacities sometimes remains impossible, contributing to a decline in the quality of available information. In a public consultation on the revision of MiFID launched in December 2010, the European regulator recognized that 'in order to support the original purpose of efficient and integrated financial markets and to take account of rapid changes in market structure and technological development, a number of unforeseen developments that could affect the smooth and efficient functioning of EU equity markets need to be addressed' (EC, 2010: 7).

Two years after the implementation of MiFID, the AMF issued a three-page 'press backgrounder' (AMF, 2009), in a late reaction to the deployment of crossing engines and dark pools of liquidity all over the marketplace.[21] Such systems scarcely attracted any attention at the time, and had been developing freely in France for at least two years. Although it is quite impossible to assess how far these platforms contributed to the decline in the quality of transparency on the equity markets, long-established marketplaces such as the LSE were not fooled: the LSE, which saw its market share decrease by 33 per cent between September 2008 and September 2009 mostly as the result of competition from both legitimate and ambiguous markets, criticized the latter as detrimental to the initial objective to create a 'level playing field' among market actors (LSE, 2009).

Concluding remarks

The aim of this chapter was to unfold the unnoticed attributes of compliance officers, by describing what they do and raising a few questions linked with their activities. With their pivotal locus in the organization, compliance officers appear as intermediaries holding a nodal position between several interests, private and public, complementary and contradictory. Carrying a distinction between legality and legitimacy, they embody different folds in the organization, structuring the architecture of compliant practices: as such they are mediators linking separate, heterogeneous elements. If we agree with Cooren (2004: 375) that 'organizational activities […] are discursively structured, which means that text in all its forms (written, oral, iconic) can display a form of agency, that is, it can make a difference', then compliance officers play a positive role in organizations, and as such cannot be reduced to their customary simplistic portrayal as box-tickers.

Furthermore, their performance, reflected here in specific representations involving advising market operators and lobbying for the acceptance of contextualized regulatory readings, gives better insight into the interpretive role they play in contemporary financial markets. As active participants in regulatory reading, compliance officers play a definitive role in the development of normative controversies. Their ambivalent position within the organization enables them to produce situated interpretation, a process during which they develop a specific jurisprudence consisting of a type of 'semantic disambiguation'. Working on the ontological ambiguity of regulatory texts intended to constrain market practices, they try to make sense of market contexts while using written or oral language as a tool for categorizing and creating normative spaces for the deployment of (new) practices.

The compliance function is thus seen here with all its attributes, accomplishing part of the ongoing 'discreet' regulation making markets in the mechanistic sense of the term, taking into account certain information at certain specific points in time – shaping ambiguity.

Notes

1. *Oxford English Dictionary* (1989).
2. The terminology remains contested within the industry, as the notion of 'conformity' relates to an idea that is quite different, in French, from the idea of 'deontology' or 'ethics'.
3. This movement has been described as the result of failing command and control approaches towards regulation: 'the experience of command and control shows that it is not reasonable, practical or efficient for external legislature and regulators to be solely responsible for determining how organizations should manage social issues' (Parker, 2002: 29). See also Power (2007: 93–4).
4. The material presented in this chapter was collected during a three-year (2006–9) participant-observation at a pan-European brokerage house located in Paris. Although this makes up the bulk of my empirical material, I also had the chance to attend the AMAFI's regular meetings during this period. The AMAFI, formerly AFEI, is one of the lobbying arms of investment firms in France; it holds regular meetings for market participants, with dedicated workgroups. As a participant at two of these workgroups, I was able to crosscheck the observations presented here (especially those relating to the definition of compliance officers' job description) on many occasions.
5. Whether 'principle-based' or 'rule-based', for texts are always in a need of an interpreter. Debates on the formal expression of regulation strikingly ignore this fact, best expressed in Wittgenstein's *Philosophische Untersuchungen* and a whole branch of analytical philosophy (Wittgenstein, 1953, 2001).
6. Liquidity contracts are different from Liquidity provider agreements signed between a market (such as NYSE Euronext) and brokers acting as market makers.
7. Not surprisingly, the practice is described in the last book of the AMF's *General Regulation*, relating to the definition of market abuse.
8. To date, five countries have accepted the practice: Belgium, France, Italy, Portugal and Spain.
9. Apart from certain changes to protect anonymity, the situations described are confidential and very sensitive. The changes made for this purpose do not affect the reasoning surrounding the argument.
10. For instance, 'Firms have the ability to communicate or advertise proprietary or customer trading interest in the form of IOIs to the marketplace through their own systems or several service providers that disseminate the information to subscribers and/or the marketplace. For example, some service providers allow firms to publicize trading interest in a particular security relating to firm proprietary interest or interest that the firm represents on an agency basis. A firm may choose to disseminate IOIs to inform other market participants that it seeks to, or represents customer trading interest that seeks to, interact with other order flow in the security' (FINRA, 2011: 2).

11. This relates to a comment made by Deleuze about the nature of law: 'It is case law that really creates the law [...] We do not need a Committee of wise men, [...] but rather groups of users. In this, we operate a shift from law to politics' (Deleuze, 1990: 230, our translation).
12. 'The Committee will consider how to achieve a more effective approach towards transposition and implementation, in particular in the following areas of regulation: the listing of enterprises, the public offer of securities and requirements relating to reporting by issuers, the conduct of cross-border financial operations, the day-to-day operation of the regulated markets, the protection of consumers and investors in the provision of investment services, and the integrity of the market' (EC, 2000a).
13. The Italian CONSOB published a legislative decree in November 2007, while the Spanish CNMV did not manage to publish its requirements until July 2008. The Swedish and French regulators published scenarios in October 2007, while the UK FSA, usually known for its rapidity, issued guidance as late as July 2007. For more details, see http://ec.europa.eu/internal_market/securities/isd/mifid_implementation_en.htm, accessed on 11 October 2011.
14. Several interviewees highlighted this point, especially members of the IT department.
15. Sales traders would complain that some participants deliberately take advantage of the situation, while marketing higher volumes in their monthly statistics.
16. Q&As issued by the Commission actually began to list such waivers in 2008.
17. At the time, the UK FSA had a reputation for 'pragmatism', in contrast to the French AMF.
18. As of 1 October 2011, there were only 14 disclosed SIs in all the EU, a figure that should be compared with the number of MTFs (143) and Regulated Markets (93). See http://mifiddatabase.cesr.eu/.
19. Genette (1982: 10, our translation) identifies a relationship between the text *stricto sensu* and its *paratext*: title, subtitle, preface, notes, epigraphs, etc. He explains that the notion of paratext 'shall be understood in an ambiguous, even hypocritical sense, just as is the case with adjectives such as *parafiscal*, or *paramilitary*'. I could not convey the idea any better.
20. The EU (EC, 2004: recital no. 6) states that 'the term "non-discretionary rules" means that these rules leave the investment firm operating an MTF with no discretion as to how interests may interact. The definitions require that interests be brought together in such a way as to result in a contract, meaning that execution takes place under the system's rules or by means of the system's protocols or internal operating procedures.'
21. It should be noted here that this 'backgrounder' does not constitute an official regulation, and if anything adds ambiguity to ambiguity: what indeed, is the underlying intention, and what should be done with these elements of language?

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4
Perpetuating the Regulatory Order in the Credit Rating Industry

Benjamin Taupin

The subprime crisis put the spotlight on the debate over the credit rating agencies (CRAs) system. Questions had already emerged following the cumulative effects of the role played by CRAs in a number of crises involving credit ratings: the Mexican crisis (1994–5), the Asian crisis (1997–8), the default by Argentina (2002) and the corporate bankruptcies of the early 2000s (Enron, Worldcom, Parmalat).[1] But since 2006, rating agencies have been more widely criticized for their role in the subprime financial crisis, particularly for assigning top ratings to mortgage-backed securities and other financial instruments which later turned out to be toxic assets, or for failing to take the measure of the threats hanging over A-rated firms (AIG, Lehman Brothers) shortly before their collapse.

The agencies' repeated shortcomings in their mission of assessing credit default probability have been highlighted, notably by the US Securities and Exchange Commission (SEC) which announced its intention to put an end to rating agencies' self-regulation,[2] but also by the European Union through the CESR (Committee of European Securities Regulators),[3] and a large share of public opinion.[4]

Despite all this adverse attention, there has been no major reconsideration of the rating system or its organization, most strikingly from the regulatory point of view (see chronology in Table 4.1). This raises the following question: what makes the credit rating industry so resistant to challenge and change? I seek to demonstrate in this chapter that the debates over regulation of credit rating, as presented by its stakeholders, are not only failing to challenge the prevailing organization, but are unexpectedly fuelling the existing regulatory order.

I. Huault et al. (eds.), *Finance: The Discreet Regulator*

Table 4.1 Chronology: Events implicating credit rating agencies and regulatory measures between 1994 and 2011

1994	Orange County bankruptcy, the largest municipal bankruptcy in US history that CRAs had failed to predict.
1997	Asian Crisis, CRAs' shortcomings underlined.
2001	Enron bankruptcy, CRAs' shortcomings underlined.
2004	Basel II reasserts the use of private credit ratings for public regulatory purposes.
2006	Credit Rating Agency Reform Act of 2006 'to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry'.[5] Enacted on 29 September.
2007	Subprime Crisis, CRAs' shortcomings underlined.
2008	SEC Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies.
2009	16 September, European Regulation 1060/2009 on credit rating agencies. For the first time, agencies will have to register and be supervised (by the CESR) to operate in the European Union.
2010	Dodd-Frank Wall Street Reform Act, including some improvements to the regulation of CRAs.
2011	Because of budget constraints resulting partly from a Republican House decision, the implementation of Dodd-Frank, in which CRA improvements are minor in any case, could be seriously weakened.
2011	The European Central Bank rejects the idea of creating a credit rating agency. The European Sovereign debt crisis pushes national governments to implement austerity measures recommended by CRAs.

The regulatory paradox of credit rating

The contrast between the series of events that proved CRAs were failing to accomplish their mission, and their flourishing business development, undeniably raises the question of the agencies' resistance to criticism. Paradoxically, the role of credit rating agencies has been reinforced with each rating crisis. After the Penn Central Transportation Company bankruptcy[6] in 1970, the NRSRO regulation granting regulatory power to 'nationally recognized rating organizations' was adopted. As a result of the Orange County bankruptcy[7] in the mid-1990s, the numerous sovereign crises of the late 1990s and the corporate bankruptcies of the early 2000s, the Basel II regulations were adopted reasserting the use of private ratings for regulatory purposes. In regulatory terms, then, each event that could have reasonably been seen as a threat to the agencies ultimately helped to reinforce their role.

The surprising prosperity of the rating business gave the CRAs the kind of power usually reserved for national Authorities, as Thomas L. Friedman noted in his well-known comment comparing the CRAs with a super-power.[8]

The theoretical approach to rating considers that the raters work on behalf of investors, to reduce what the economists call the information asymmetry between the issuer and the buyer of a bond.[9] These raters elaborate and publish a rating designed to reflect the likelihood of recovering an investment – for technical details see Langohr and Langohr (2008). In other words, the rating indicates the risk that a debt may not be repaid on time. According to the CRAs, ratings are opinions, not recommendations to sell or buy a product. This definition has received official recognition: in the United States, credit rating is protected under the first amendment of the constitution ('free speech right'), in the same way as journalism. This status makes the agencies unaccountable for ratings that prove to be inaccurate.

In 1999, one scholar came out against the traditional instrumental view justifying ratings by information asymmetry, arguing that 'ratings are valuable, not because they are accurate and credible, but because they are the key to reducing costs associated with regulation' (Partnoy, 1999: 681). Many regulatory measures had used ratings as benchmarks to measure the value of a security or a firm since the 1929 crisis, but it was not until 1975 that the SEC created NRSRO (Nationally Recognized Statistical Rating Organization) status, for agencies that could be considered reliable and credible for regulatory purposes. The Dodd-Frank Act adopted in 2010 therefore aims to 'review any regulation issued by [the SEC] that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings'.[10]

Rating became a very attractive business at the end of the twentieth century, especially for the three main rating agencies Moody's Investor Services, Standard & Poor's and, to a lesser extent, Fitch Ratings. The period running from the rise in the high-yield market, which fuelled the agencies' revenues and was in turn supported by their ratings, proved very fertile for the CRAs. Moreau (2009) highlights the increase in Moody's return on assets (ROA). Between 1996 and 2008 it was constantly above 25 per cent, with peaks at 55 per cent; yet between 1934 and 1960, the ROA had ranged between 5 per cent and 15 per cent. Other indicators attest to the agencies' extraordinary profitability, despite discontinuity in the data (data for Moody's between 1960 and 1996 are incorporated into the accounts of Dun & Bradstreet). Between 1995 and 2007, Moody's made a profit of 30 to 60 cents, depending on the year, on every dollar earned.

In 1999, Partnoy drew attention to what he called the paradox of credit rating: the remarkable profitability of the agencies in spite of their repeated failures.[11] Taking a slightly different approach, this chapter brings out a regulatory paradox concerning the credit rating industry.

Among the varied range of financial activities, credit rating is at first sight emblematic of an object that is naturalized and uncontested. The way the rating activity is produced and legitimized has remained unchanged since the start of its boom period in the second half of the twentieth century. Neither the regulatory uses nor the economic model of credit rating were reviewed during the period 2000–10. Meanwhile, the other specificity of this field is the seeming recognition by its stakeholders of the limitations of credit rating. The outward appearance suggests strong criticism of credit rating as currently performed and regulated. The regulatory paradox observed can therefore be expressed as follows: although the role of credit rating is highly condemned (by investors, small credit rating agencies, the media, citizens and most politicians), the regulatory order of the credit rating industry remains unchanged.

The aim of this chapter is to solve this paradox from the standpoint of the regulatory perpetuation made possible by the discursive work of all actors in credit rating. Admittedly, this situation could be interpreted as resulting from intense lobbying by certain specific actors such as Moody's and Standard & Poor's. They certainly lobbied hard during the Basel II rounds and continue to do so, while the SEC is currently trying to gather the resources to implement regulation of credit rating. I seek to demonstrate that a much more generalized phenomenon of perpetuation is at work, extending beyond the action of the main rating agencies strategizing to advocate continuation of the regulatory order for their own benefit.

As a consequence of the 'naturalized' aspect of credit rating mentioned previously, little is known about the institutional aspects of rating, although it has been demonstrated that credit rating is a social phenomenon (Sinclair, 2005: 47). Data from the field are unavailable and the lack of information is an intrinsic difficulty for anyone tackling this terrain (Moreau, 2009: 7; White, 2002: 2). Focusing on public controversies provides a way to understand the issue.

Controversies in the rating industry

One outcome of agencies' shortcomings in their mission has been an increase in controversy around the credit rating industry (see Figure 4.1), sparking up a debate confronting different conceptions of the common

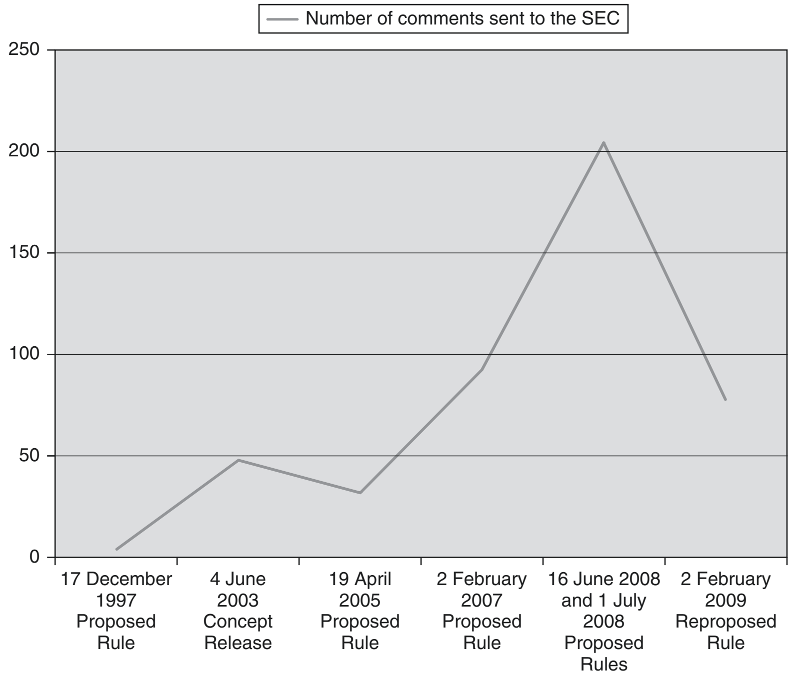

Figure 4.1 2000 to 2010: A debated regulation

good. Since 2007, what could be called a crisis of justification (Boltanski and Thévenot, 2006) has been observed in the field.

I believe that in times of controversy the opinions of credit rating stakeholders clearly reflect their fundamental conception of regulation, as actors find themselves obliged to refer to moral principles to support their arguments. When actors leave the world of routine to face a situation of uncertainty, they question what they are doing. What they initially thought about credit rating is confronted with what is actually happening, which can be different from their representation of rating. For example, the CRAs kept repeating that the processes leading to ratings were independent, but events proved that this was not the case. The emergence of a controversy arouses actors' anxiety and challenges what they perceive as reality. And when actors intervene in the controversy, the cognitive elements underlying their conception of regulation are explicitly brought out: actors refer to higher principles to support or modify the existing order (Boltanski and Thévenot, 2006).

Table 4.2 Main topics in the debate

Topics	Main topics
Barrier to entry and monopoly Use of NRSRO ratings in regulation	**Reliance on NRSRO ratings in regulation**
Conflict of interest Debate on the superiority of the 'investor-paid' or 'issuer-paid' model	**Conflict of Interests**
Notching Rating shopping Unsolicited/shadow ratings	**Other practices that threaten the integrity of rating**

In response to the failings of the CRAs and the rising tide of criticism, the SEC launched a reflection to establish greater oversight of agencies and the rating activity. The resulting Concept Releases and Proposed Rules[12] were submitted for comments from anybody who wished to give their opinion on the subject. These comments address what people conceive as the 'right' regulation to pursue. While arguing their point of view, the individuals are assessing objects and persons and determine what has worth for them in the situation. Moreover, the financial crisis brought out new objects that the actors are mobilizing in their arguments. What attracts their attention, and the way they extract these objects from contingency, reveals part of their cognitive frame with respect to regulation. The various criticisms make for as many challenges to the current conception of regulation:

- Conflicts of interest in the agencies
- The issuer-paid versus investor-paid debate
- The monopolistic nature of the industry
- The lack of accuracy of the ratings, regulatory use of ratings
- The debate over NRSRO status, and practices considered unfair: notching,[13] rating shopping,[14] shadow ratings[15]

Analysis of the commentaries led to identification of seven sub-topics that were raised in the debate. Ultimately, the issue could be encapsulated in three main topics (Table 4.2).

2003 – simple confirmation

Studying the comments made before the crisis is a vitally informative prerequisite for this study of the controversy from 2007 onwards. Compared with the questioning room in which CRAs were apparently placed after the Enron scandal, there were no heated reactions to the Concept Release of 2003 (Gerst and Groven, 2004: 33). Only 50 comments were sent, mainly by the major CRAs, and instead of receiving a grilling, the industry avoided justifying its actions. The actors taking part in the debate simply repeated or reformulated the existing regulatory arrangements; others refused to take part.

The comments received often consist of tautological phrases, closing reality in on itself. The instituted order is visible, but the institution underpinning the order remains partly concealed. The conception of the self-regulated order is simply repeated as it is:

> Ratings issued by the major rating agencies have generally proved to be a reliable source of information for the fixed income markets. The reputational and commercial interests of the agencies provide a strong motivation to maintain the credibility of their ratings.
>
> John M. Ramsay, The Bond Market Association, 2003[16]

Actors also use their discourse to escape the need to justify the existing order: they avoid any form of accountability by diverting attacks launched on the current regulation. Connections that are made are played down, to prevent a rise in generalization that could be contested. 'It does not matter' or 'it's not a problem' are typical phrases supporting this process. The commentators describe the status quo without questioning it, with the consequence that these discourses do not address technical considerations. These pre-crisis comments do not contain the complexity seen later in the analysis of post-2007 comments. Statements of opinion are favoured over actual arguments referring more explicitly to the need to improve the performance of CRAs or foster competition in the industry.

For example, in 2003 when the SEC was planning to regulate rating agencies, it was declared that

> The NRSRO system is designed, appropriately in our view, to assure that recognized organizations possess the competence to develop accurate and reliable ratings and protect against the establishment of rating organizations that would issue inflated ratings in an effort to achieve short-term competitive gain.
>
> Charles D. Brown, Fitch Ratings, 2003[17]

Further in the same statement is the following comment about possible conflicts of interest in the rating business:

> Fitch does not believe that the fact that issuers generally pay the rating agencies' fees creates an actual conflict of interest, i.e., a conflict

> that impairs the objectivity of the rating agencies' judgment about creditworthiness reflected in ratings.
>
> Charles D. Brown, Fitch Ratings, 2003

This attempt to escape any form of accountability is unsurprising in the discourse of the main agencies, as it is clearly in their interest to legitimate their position. However, it is much more disconcerting when it appears in the discourse of other actors, such as investors, who would

Table 4.3 Examples of discourses seeking to preserve the regulatory order in 2003

Actor	**Quotation indicating the actor's desire to escape the debate over regulatory improvement**
Charles D. Brown, Fitch Ratings, 2003	'The NRSRO system is designed, *appropriately* in our view.'
Cheryl Kallem, SIA Capital Committee,[a] 2003[18]	'The Committee believes that such differentiation in the determination of capital charges on the basis of credit ratings is *a concept that has served markets well for over 25 years*.'
Grace Hinchman, Financial Executives International, 2003[19]	'In general we believe that the two factors above [in determining whether a credit rating agency qualifies as an NRSRO], as well as the key components within the operational assessment, *are adequate*.'
Gregory V. Serio, NAIC Rating Agency Working Group, National Association of Insurance Commissioners, 2003[20]	'The four NRSROs have a good deal of influence in the market. […] Considering alternatives to the current system *that has worked well* for state insurance regulators could be costly and complicated.'
John M. Ramsay, The Bond Market Association,[b] 2003	'[A]s a general matter the Association believes that the current system of oversight of credit rating agencies *functions reasonably well*.'

Notes:

[a] The Security Industry Association was an association of firms and people who handle securities. In 2006 it merged with the Bond Market Association to form the Securities Industry and Financial Markets Association.

[b] The Bond Market Association was the international association of the bond market industry. It merged in 2006 with the Securities Industry Association to form the Securities Industry and Financial Markets Association.

be the first to suffer if the CRAs did not carry out their mission with due diligence:

> [T]he Commission should not, in the Association's view, subject NRSROs to additional ongoing examination or oversight, especially with respect to particular rating methodologies, practices or individual rating determinations.
>
> John M. Ramsay, The Bond Market Association, 2003

The SEC is effectively being asked not to interfere in the operation of the industry, because the current state of affairs is claimed to be fair and appropriate to the actors' constructed representation of the 'right' type of regulation (Table 4.3).

Despite the lack of great depth in these statements, the underlying logic can already be more subtly glimpsed. The foundations on which regulation is built are latent at this stage of the period considered: transparency ('a reliable source of information', 'reputational', 'the credibility'), competition ('commercial interests', 'the market') and the performance of ratings ('objectivity', 'functions well').

Since 2007 – the apparent rise in criticism

The reluctance to acknowledge the need to reconsider credit rating regulation observed in 2003 reached a new level from 2007, when the subprime crisis brought CRAs centre stage. New objects fuelled the criticisms and the calls for stricter supervision:

- The inflated ratings supplied by the agencies, sometimes while they were simultaneously rating and advising on structuring of securities.
- The inaccurate ratings assigned to firms that later went bankrupt (AIG, Lehman Brothers).
- The survey conducted by the SEC, released during the summer of 2008,[21] which underlined shortcomings[22] in CRAs' practices.

The shortcomings of credit ratings forced people to test their conception of the regulatory setup against reality, by confronting the material or symbolic objects arranged in situations. Of course, the post-2007 comments are no longer confined to reaffirming in a simple manner the current order. The reality as conveyed by the CRAs has been overwhelmed by new objects mobilized in the debate. I believe these arguments now require scrutiny, as they reveal more keenly the reasoning mobilized in response to new information conveyed by the crisis.

The debate on notching

During what we can call a *crisis of justification* in the credit rating industry, a substantial amount of comments[23] concerned one specific rule[24] proposing to prohibit 'notching' unless a portion (a certain percentage) of the underlying assets has not been rated by the rater. Two opposing views were taken. Some thought efficiency might be adversely affected, since the rule could push agencies to rate products when they had not in fact rated the underlying assets, a practice which could jeopardize the accuracy of the rating. Others thought the proposal might foster competition, because it would prevent the main agencies from strengthening their market power by requiring an issuer to rate every part of a structured asset:

> The 85% threshold allows the largest credit agencies to continue to suppress competition by compelling structured finance products to buy securities that carry their ratings; otherwise they may not be able to obtain a rating. Congress demanded an end to such abusive practices, recognizing that increased competition within the credit ratings market leads to increased responsiveness of the rating agencies to the needs of financial market participants, and to greater accuracy and comprehensiveness of available information. We therefore urge you to modify the exception to the prohibition set out in Proposed Rule 17g-6 by reducing the 85% threshold to no higher than 66% to allow for the increased competition that Congress demanded.
>
> David Lazarus, Capmark Securities Inc., 2007[25]

It is ironic that while all around them the crisis was hitting the economy hard, individuals were debating whether to lower a threshold below which notching should be prohibited. (Should 66 per cent or 85 per cent of the asset be rated by the agency?) This example gives an insight into the way rating stakeholders are able to avoid fundamental criticisms of the practice by focusing attention on minor technical issues. While in appearance the existing order is being shattered by the volume of comments sent to the consultations, those comments concern a technical discussion regarding the acceptable threshold for notching.

The practice of notching is thus addressed by contrasting the need to increase efficiency with the aim to foster competition (as highlighted in figure 4.2). This presentation of the issue diverts criticism away from challenging the regulation and attacking the lack of integrity suggested by such a practice. It also gives rating stakeholders the opportunity to

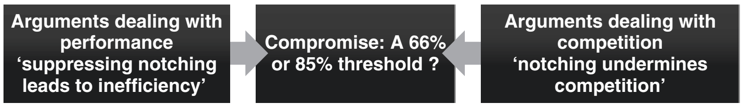

Figure 4.2 Monopolizing the debate with minor issues

reassert the principles on which the order is regulated: the performance of rating is bound up with greater competition.

The debate on NRSRO status

A vast majority of the comments received were against the SEC’s proposed measures to reduce undue reliance on NRSRO ratings (see Baklanova, 2009). I refer to these comments to pursue analysis of the non-accountability defended by the credit rating stakeholders.

In Table 4.4, an investor disagrees with abolishing reference to NRSRO ratings because they ‘provide a clear and discernible threshold below which investments may not be made’.[26] He also considers that ‘replacing it with a subjective standard’ will lower its ‘effectiveness’. Another investor argues against eliminating rating requirements[27] because ‘the market dynamic’ would be affected and this would create ‘greater inconsistency in the credit quality among funds’. Ultimately, ‘confidence in the whole system may dissipate, freezing credit throughout the economy’. As Table 4.4 shows, these actors consider that appropriate regulation is reached through a self-regulated order. Their position can be summarized as follows: reference to NRSRO ratings should not be eliminated because it is efficient and recognized by all; taking such action would destabilize the market.

As stated earlier, Frank Partnoy is a scholar who advocates elimination of references to NRSRO ratings in the regulation. However, he supports this position by reference to the current conception of market-based supervision. In his opinion, information based on market indicators is the best way to assess credit risks (‘it would be appropriate for directors to look to, and rely on, market measures of credit risk, including both the credit spreads’). In other words, even what is effectively the sharpest attack on the regulatory order has a foothold in market-regulated credit rating.

What we have here is a situation in which references to the market, disclosure and efficiency aim not to challenge the relevance of the regulatory measures by contesting their founding principles, but to reinforce the validity of those principles. The purpose of the criticism

Table 4.4 Discourses of perpetuation in the debate on NRSRO status

Actor	Quotation indicating denial of the need to improve supervision with respect to regulatory use of ratings
J. G. Lallande, Invesco Aim Advisors, Inc., July 2008.[28] Invesco Aim Advisors, Inc. is a financial services firm.	'NRSRO ratings, although imperfect at times, provide a clear and discernible threshold below which investments may not be made. By eliminating this threshold and replacing it with a subjective standard – one that may vary from fund to fund – the Commission would be hindering the effectiveness of Rule 2a-7's ability to protect investors.'
Daniel Pedrotty, Office of Investment, AFL-CIO, July 2008.[29] The AFL-CIO (American Federation of Labor and Congress of Industrial Organizations) is the largest federation of workers' unions in the USA.	'It is not an exaggeration to suggest that the elimination of the ratings requirements as contemplated may accomplish the exact opposite of what the Commission intends. The market dynamic that would likely arise with the elimination of a third-party rating requirement is predictable and has been observed time and again in other arenas. […] As a result, there will be greater inconsistency in credit quality among funds. Some investors for a time may not be concerned with or aware of the increased risk that has boosted the return on their investments. In other words, they may assume that the money market funds industry is well regulated. When a fund then inevitably "breaks the buck," confidence in the whole system may dissipate, freezing credit throughout the economy. To avoid this scenario and the significant harm it would do to the "real" economy, it is prudent to maintain the objective ratings requirement.'
Jeffrey T. Brown, Charles Schwab Co., Inc., July 2008.[30] Charles Schwab Co. is an investment and private equity firm.	'Schwab has found that issuers and other market participants are very cognizant of the rule's rating requirements and most issuers and underwriters use the rating requirements as a tool when structuring products intended for money market investment. The fact that the ratings requirement is a necessary condition for investment provides the funds with leverage when issuers and dealers are marketing new securities to the money funds. Schwab believes that removing the references to the ratings would be a disservice to the funds because it would eliminate one of the few means funds have to compel a level of market discipline. Another disadvantage is a potentially wide disparity among funds regarding what constitutes an Eligible Security. Without the objective floor provided by NRSRO ratings requirements, money market funds' investment decisions will be far more subjective, making it more difficult for investors to compare the safety and quality of investments held by one fund versus another.'

(*continued*)

Table 4.4 Continued

Actor	Quotation indicating denial of the need to improve supervision with respect to regulatory use of ratings
Frank Partnoy, July 2008,[31] professor of law.	'My one substantive recommendation to the Commission is that it include in its Final Rules some language indicating that reliance on market-based information and market prices, rather than NRSRO ratings, can be an acceptable – indeed, preferable – method of satisfying obligations to assess the credit quality and risk of particular assets. For example, in directing that money market fund boards of directors look to outside quality determinations, I believe the Commission should highlight in the Final Rules that, in addition to NRSRO ratings, it would be appropriate for directors to look to, and rely on, market measures of credit risk, including both the credit spreads of fixed income instruments and the market prices of credit default swaps.'

is to strengthen the existing logics by removing any interference in self-regulation. The argument is that to achieve greater efficiency, supervision of credit rating must be reinforced by more competition and greater transparency.

The debate on conflicts of interest

By 2009, the CRAs' shortcomings were well known to industry stakeholders. First because late downgradings and inaccurate ratings helped to make financial actors distrustful of financial markets, and second because the mass media reported the CRAs' part in market failures. Above all, the subprime crisis very vigorously revealed the true role played by CRAs when structuring a financial product. In participating in the issuance and creation of a product whose value depends mainly on its rating, the agency occupied a conflicted position. The supposedly objective rating process would appear to be undermined by a conflict of interest. By granting extremely high ratings to poor-quality bonds, the credit rating industry clearly contributed to the financial crisis – and the resulting turmoil then became a systemic crisis that required State intervention to shore up the financial system. President Obama's election appeared to usher in a shift in the status quo: as soon as he took office, the new American President appointed a new Chairman for the SEC, Mary Shapiro, replacing her conservative predecessor Christopher Cox. The establishment of stronger supervision of finance, including the credit rating industry, was therefore expected.

Nonetheless, proposals to mitigate these conflicts still encountered many objections. Bruce Stern's statements on behalf of insurers (see Table 4.5) lamented the fact that trying to prevent CRAs from advising the issuers they are rating would hamper circulation of information on the methodologies used by the agencies – yet insurers need the data provided by the agencies to perform their own evaluations and develop new insurance products. This objection highlights the illegitimacy of such a measure in the eyes of insurers, who see it as inefficient and an obstacle to transparency: integrity should not be achieved by 'impractical' means that undermine efficiency and transparency.

Most actors agree with the current SEC conception of credit rating regulation, represented in the consensus over improving transparency and performance through self-regulation of the market. According to the president of the Canadian agency DBRS, conflicts of interest are inherent to the business of credit rating and while they should be tackled, it is unrealistic to believe they can be eradicated. Therefore, the best way to address these conflicts of interest is through disclosure to the public.

The process identified here is the same as in the debate on NRSRO status: the way the debate is conducted produces criticisms that not only corroborate the validity of the current regulatory situation, but also seek to establish its underlying principles more strongly by removing any unfamiliar element, with the aim of improving transparency and competition in order to enhance the accuracy of ratings. This chapter reveals the resources the actors implement, drawing on their conception of a self-regulated industry to restore harmony at a time of great uncertainty when their beliefs are under serious attack. Disclosing agencies' present and past performance as proposed by the SEC is a way to solve the situation under the current conception of rating regulation, in keeping with credit rating stakeholders' view that the topic of conflict of interest mitigation should be addressed by fostering transparency and competition.

Closely related to the accusations of conflicts of interest is the debate between the *issuer-payer model* and the *investor-payer model,* which was emphasized in the analysed data. The comments of Deven Sharma (see Table 4.5), President of Standard & Poor's, give an insight into how the existing conception of a self-regulated activity can be used to counter the trend towards greater supervision. The right balance can be reached by repeating that 'what is credible is recognized by the market, and therefore it is efficient', or 'what is produced by market laws is credible and therefore efficient'. Nicholas Brown (see Table 4.5) sees the

Table 4.5 Discourses of perpetuation in the debate on conflicts of interest

Actor	Quotation indicating denial of the need to improve supervision with respect to conflicts of interest
Bruce Stern, Association of Financial Guaranty Insurers, 2009.[32]	'The prohibition limiting rating agencies from providing advice on their rating criteria is impractical, and attempts to distinguish between rating criteria and "recommendations". In so doing, the rule inhibits the dialogue necessary to address changing circumstances or new products. The adopting release perceives a conflict when an NRSRO is "rating its own work". If an NRSRO establishes its own rating criteria (as it must do), the NRSRO will inevitably be "rating its own work". AFGI submits that concerns regarding rating integrity should be addressed in a manner that does not inhibit rating transparency. Proposal for Consideration: The rule should be eliminated as impractical.'
Daniel Curry, President, DBRS Inc., 2009,[33] a Canadian credit rating agency founded in 1976.	'Rather than adopting an unrealistic, zero-tolerance policy towards conflicts, DBRS endorses the approach the Commission has followed thus far. Conflicts should be eliminated wherever possible (and some conflicts should be prohibited outright) and the remaining conflicts should be disclosed to the public and managed in a transparent and verifiable fashion. In this regard, DBRS believes that requiring NRSROs to establish and abide by transparent ratings procedures and methodologies; implement and enforce codes of conduct; and publish useful information about the performance of their ratings over time will go a long way to minimizing or eliminating the harmful ramifications of conflicts of interest in the credit rating industry.'
Nicholas Brown, 2009,[34] a private citizen expressing his personal opinion.	'One suggestion to hold them accountable would be to somehow tie agencies' ratings to the credit default swaps pricing. Like maybe the rating firms themselves would actually be required to issue (fully or participating with other parties) the CDSs on the entities they are rating! Since they would be on the hook for paying any default claims on the things they're rating, they would greatly incentivized to rate them accurately so the default insurance that they are selling and backing is priced properly. Instead of just being third-party rate-for-pay machines, they would be more like insurance companies, whose profits are directly tied to their ability to accurately assess risk.'

(*continued*)

Table 4.5 Continued

Actor	Quotation indicating denial of the need to improve supervision with respect to conflicts of interest
Sean Egan, Egan-Jones Ratings Co., 2009,[35] a subscriber-paid credit rating agency.	'I agree with Chairman Shapiro that the compensation is the key to altering behaviour, and, in the ratings industry, the best way to do this is to heighten the awareness levels of who is paying for what. We have a free market system and the government cannot and should not compel the use of one business model over another. However, it is the role of the SEC and other policy makers charged with the responsibility to protect investors to make sure that investors and other users of credit ratings know whether the seller or the buyer is paying for the work product.'
Deven Sharma, 2009,[36] President of Standard & Poor's Ratings Services.	'Every business model has positive and negative aspects and some may work better for certain investors than others. In our judgment, the focus of regulation in this area should be on recognizing the benefits and costs of different models and working to ensure that potential conflicts are effectively disclosed and managed so that market participants can decide which rating firms and business models are appropriate for their needs.'

market as the proper device to *incentivize* the industry. For Brown, to achieve greater accountability, the agencies' revenues should be linked to default indicators provided by the market, such as Credit Default Swaps. Sean Egan, president of a subscriber-payer rating agency, clearly expresses the underlying conception of the regulatory order in credit rating: the market is efficient and creates confidence and confidence makes the market efficient. These positions argue that any individualistic behaviour observed should be addressed in this framework, seeking to improve transparency and foster competition, even though a similar framework actually led to the current situation.

It is thus demonstrated that the comments sent by the various stakeholders in credit rating support a discourse that makes no challenge to the principles of a self-regulated industry on which the credit rating business is founded. All the new objects that appear are converted to fit into the existing principles. Preserving the old order should be understood here as an ongoing process in which repetition of the criticisms of credit rating always produces the same conception of supervision.

Regulatory change is therefore slowed down considerably, if not quite simply brought to a halt by the weight of the controversy.

The findings of the study reported here give an insight into why the statements made in recent governmental commissions, denouncing credit rating as currently carried out, have made little headway into modifying the regulatory order. For instance, in August 2009 the United States Committee on Banking, Housing and Urban Affairs highlighted several shortcomings in CRAs. Mark Froeba, a former employee of Moody's who testified before the Committee, related how the company was pushing for maximum profit from development of structured finance at the expense of ratings quality.[37] Likewise, the United States Senate Permanent Subcommittee on Investigations led by Senator Carl Levin conducted hearings in April 2010 on the CRAs' role in the financial crisis. A report of the hearings was issued on 13 April 2011 titled *Exhibits – Hearing on Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*[38] (United States Senate, 23 April 2010; United States Senate, 13 April 2011). One hundred internal emails from Moody's and S&P were presented to exemplify the various shortcomings of the rating business.[39] Reflecting the disapproving atmosphere that reigned at the hearings, Senator Carl Levin declared, 'I don't think either of these companies has served their shareholders or the nation well.'[40] Last but not least, the American Congress Financial Commission Inquiry of 2 June 2010 chaired by Phil Angelides heard the testimonies of three former employees of Moody's. Scott McCleskey, Eric Kolchinsky and Mark Froeba testified upon oath that Moody's was implicated in wrongdoings.[41] They added that they were punished after expressing opinions contrary to the firm's new corporate strategy, which was effectively to make as much profit as possible from structured finance in the mid-2000s. These testimonies confirmed Mark Froeba's previous declaration condemning Moody's exclusively profit-oriented strategy in the 2000s. The commission's conclusions were issued in a report in January 2011 (The Financial Crisis Inquiry Commission, January 2011).

Contrary to all expectations, these reports were unable to dent the regulatory order for credit rating. Instead, the unpublic-spirited conducts recorded gave credit rating stakeholders leverage to insist on the need for increasing competition and transparency to achieve more responsible action – even though it was precisely this logic that seemed to have led to irresponsible behaviours in the credit rating industry. The documents quoted in the SEC's 2008 report revealing individualistic, greedy behaviours were integrated into the debate through the general logic described earlier. In the Commission's interpretation, the rating agencies faced 'struggles to adapt to the increase in the volume and complexity of the deals'.[42] As the criticisms issued are turned into the current conception favouring assessment of whether CRAs' resources are adequate to manage the volume of business, the SEC concludes as follows:

> Remedial Action: The Staff has recommended that each examined NRSRO *evaluate*, both at this time and on a periodic basis, whether it has *sufficient staff and resources to manage its volume of business* and meet its obligations under the Section 15E of the Exchange Act and the rules applicable to NRSROs.
>
> (emphasis added)

From a public-interest stance, however, arguments based on the resources mobilized to handle the volume of business would be considered worthless. The simple fact of having an adequate amount of resources can never achieve justice if individualism is still rife; or to put it another way, from a civic stance 2000 individualistic credit analysts would not perform a better credit analysis than 200 individualistic credit analysts.

Contributions, limitations and discussion

Justification of the credit rating order

This chapter has sought to explain the paradoxical situation in which the credit rating industry is taking the blame for part of the financial crisis turmoil, but apart from 'a couple of rather small rule changes issued at end 2008',[43] no major regulatory change was actually implemented between 2000 and 2010. In fact, the two sides of the paradox are mutually reinforcing: the debates on the regulatory uses of credit ratings, the accusation of conflicts of interest in the credit rating agencies, and the debate on notching have actually strengthened the fundamental conception of credit rating as a self-regulated activity. What appears as a new and irresistible force for social change in the rating industry actually seems to be a new form of a recurrent historical process in which CRAs, investors, rating users, academics and the SEC all play a substantial role through their discursive work.

Analysing the comments formulated by stakeholders in credit rating, I have shown that the controversy around credit rating prevents any major change in the industry. The way the credit rating stakeholders convert all their criticisms to conform to the pre-existing cognition of the order reinforces the consensus over supervision of the business. The prevailing conception of the regulatory order relies on competition and the role of disclosure to achieve efficiency.

For 2003, I report evidence that the protest against the existing state of affairs was weak. At that time, the stakeholders quite simply refused to question their conception of regulation, pointing instead to the order's presumed ability to respond to the problems encountered by the rating activity. This situation can be related to the *relativization* phenomenon theorized by Boltanski and Thévenot: 'in relativization, the reality test is abandoned in favor of a return to the circumstances' (2006: 339). In other words, such a phenomenon is observed when actors are avoiding any form of justification by diverting the attacks made on the existing consensus.

Following the subprime crisis, as highlighted before a clash arose over the practice of notching, NRSRO status and conflicts of interest: unexpectedly, this led to reinforcement of the existing organization of credit rating in line with the prevailing conception of a self-regulating industry. Analysis of the debate on notching, for example, shows that the complexity of the arguments soared. The way external actors were thus prevented from becoming involved in the debate undoubtedly led to perpetuation of the order. Moreover, the content of the comments produced by the credit rating stakeholders, while outwardly presenting strong objections likely to challenge the status quo, in fact themselves reproduced the existing order. This process can be identified as a *reality test* as defined by Boltanski (2009). It takes place when people are brought to subject their claims to a *reality test* by confronting the material or symbolical objects arranged in situations. Of course, after 2007 the criticism was no longer confined to *relativization*, but was chiefly made up of *reality tests*. Outwardly, the reality as conveyed by the CRAs is being overwhelmed by new events bringing in mobilization of new objects. However, in our case, *the reality tests*, in this particular scenario the discursive work by the stakeholders in credit rating, lend support to credit rating as previously designed.

Limitations

The SEC's Proposed Rules that constitute the basis for the comments are often already focused on its mission of 'fostering accountability, transparency, and competition in the credit rating industry', and this represents a strong bias in this study. However, the actors showed a real freedom of expression that encouraged the approach used in this study: for instance, many comments directly criticize the SEC.

This research focuses on the actors and their ability to create and act freely, albeit constrained by their conception of credit rating's regulatory order. It could be argued that the field should be studied primarily through analysis of domination relationships between credit rating stakeholders, with the focus on the CRAs' attempts to hold onto their privileged situation.[44] But I was surprised by the fact that even as late as 2003, the agencies were not the only actors adopting a discourse perpetuating the status quo, and that later even an apparent difference of opinion eventually led to perpetuation of the industry's regulatory order. This was what inspired me to consider this aspect of the multifaceted nature of the phenomenon.

Perpetuation of the credit rating order as a coexistence of logics

My results are consistent with Sinclair's findings (2009, 2010) which demonstrate that the conflict of interest problem in the credit rating industry should be reconsidered. According to Sinclair, the CRAs' responsibility in the crisis is linked to fundamental dilemmas about the role of rating agencies in the market system, rather than to the 'result of breaking implicit regulative rules about conflict of interest' (Sinclair, 2010: 4). Paying too much attention to this issue would therefore be likely to entail perpetuation of the status quo, as the conflict of interest argument diverts the focus away from important dilemmas faced by the industry.

Some scholars have looked at credit rating as a phenomenon that reveals several conflicting reasonings (MacKenzie, 2011; Ouroussoff, 2010). They notably contrast the industrial logic (the *hard evaluation culture* for MacKenzie, the *rationalist model* for Ouroussoff) with the market logic (the *soft evaluation culture* for MacKenzie, the *competitive model* for Ouroussoff). Our analysis emphasizes the process that ultimately merges conflicting conceptions of credit regulation, although this is only briefly touched on in Ouroussoff's ethnographical field study of rating.[45] In the rating business, competing logics mobilized by the credit rating stakeholders, creating an apparently unstable order, should be considered as co-constructing the order in its stability. Also, the large number of comments identified which were founded on the search for more transparency to preserve the credibility of ratings, is incidentally congruous with the role of 'reputational intermediaries' that Gourevitch (2002) attributes to CRAs. In this field, the perpetual search for greater competition and more objectivity in rating is materialized through a wide-ranging system of dissemination and disclosure built on the pursuit of transparency (Thévenot, 1997: 214).

The current structure of this system historically derives from the Americans' pragmatic response to the need for regulation of credit rating. In 1933 the Glass-Steagall Act called for the existing private credit ratings to be used for regulatory purposes. Coming after the Great Depression, this proposal was conceived as a way to fight the 'banksters' whose ratings might have become regulatory benchmarks, as they were carrying out their own credit analysis (Flandreau, Gaillard and Packer, 2009). Thus local American specificities, such as faith in a competitive and credible market for regulatory purposes, underlay the social construction of the field. Even Franck Partnoy, the academic world's most famous critic of the rating system who has often represented its opponents, would like to see a CRA-free, market-regulated industry using a credit spread system (Partnoy, 2001). The question arises of whether this socially constructed vision of credit rating is compatible with other local specificities – in Europe, for instance, where the decision to create a public rating agency is on the drawing board.

Notes

1. See 'The Credit-Raters: How they work and how they might work better' by Borrus, McNamee and Timmons (2002), available at http://www.businessweek.com/magazine/content/02_14/b3777054.htm (accessed April 20, 2012). See also Langohr and Langohr (2008: 189): 'Enron was rated good credit by S&P and Moody's until four days before its collapse, Worldcom until three months before, and Parmalat until 45 days before.' The agencies' lack of diligence with regard to Enron was also underlined in McLean and Elkind's investigation (McLean and Elkind, 2003).
2. See SEC (July 2008).
3. Now the ESMA (European Securities and Markets Authority), see for example CESR's report on Credit Rating Agencies (2007).
4. See, for example, 'Measuring the Measurers', *The Economist*, 31 May 2007, or 'Berating the Raters' by Charles Gasparino, *Trader Daily*, December 2007.
5. See http://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf, page 1.
6. Credit rating analysts refer to this event to account for the expansion in rating at the end of the twentieth century (Ouroussoff, 2010: 35).
7. For more insight into this fundamental event of credit rating failure, see Partnoy (2003: 118), and Sinclair (2005: 158).
8. 'We live again in a two-superpower world. There is the US and there is Moody's. The US can destroy a country by levelling it with bombs: Moody's can destroy a country by downgrading its bonds': Thomas L. Friedman, 'A Nation's Bond Rating Nowadays is More Important than its Weapons', *The Houston Chronicle*, 23 February 1995, p. A3. It is quoted by Sinclair (2005: 1), Flandreau, Gaillard and Packer (2009: 6) and Partnoy (1999: 620 and 711).
9. For a historical approach to credit rating and the asymmetry of information existing between railway companies and investors during the nineteeth century, see Olegario (2006) or Harold (1938). An overview of credit rating history is also to be proposed by Poon (2012).

10. This review should be effective by 2012, two years after the Act was signed into law. See http://www.sec.gov/rules/proposed/2011/34-64352.pdf.
11. 'Continuing prosperity of credit rating agencies in the face of declining informational value of ratings' (Partnoy, 1999: 622).
12. The Proposed Rules and Concept Release are available at: http://www.sec.gov/divisions/marketreg/ratingagency.htm.
13. The practice 'whereby a credit rating agency issues or threatens to issue a lower credit rating, lowers or threatens to lower an existing credit rating, refuses to issue a credit rating or withdraws a credit rating with respect to a structured financial product unless a portion of the assets underlying the structured product also are rated by the NRSRO'. See http://www.sec.gov/news/speech/2007/spch013107ers.htm.
14. When debt issuers 'shop around' for the best credit rating.
15. A rating given to a bond issue that is not reported to the general public.
16. Full comment is available at http://www.sec.gov/rules/concept/s71203/bondmarket072803.htm.
17. Full comment is available at http://www.sec.gov/rules/concept/s71203/cbrown072803.htm.
18. Full comment is available at http://www.sec.gov/rules/concept/s71203/ckallem072803.htm.
19. Full comment is available at http://www.sec.gov/rules/concept/s71203/fei072503.htm.
20. Full comment is available at http://www.sec.gov/rules/concept/s71203/naic072803.htm.
21. http://www.sec.gov/news/press/2008/2008-135.htm.
22. The SEC's analysis of credit rating analysts' email exchanges before the crisis revealed irresponsible behaviours, particularly with respect to structured finance. See the Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies (http://www.sec.gov/news/studies/2008/craexamination070808.pdf).
23. 'The Commission received far more comments on this provision of the proposed rules than on any other provision. Many commenters expressed strong support for the prohibition; though many of the supporters stated that the 85% exception was too high and should be lowered to at least 66%' (http://www.sec.gov/rules/final/2007/34-55857.pdf, p. 162).
24. Proposed Rule 17g-6(a)(4). The action of notching was eventually prohibited.
25. Full comment is available at http://www.sec.gov/comments/s7-04-07/s70407-11.pdf.
26. J. G. Lallande, Invesco Aim Advisors, Inc., July 2008.
27. Daniel Pedrotty, Office of Investment, AFL-CIO, July 2008.
28. Full comment is available at http://www.sec.gov/comments/s7-19-08/s71908-31.pdf.
29. Full comment is available at http://www.sec.gov/comments/s7-19-08/s71908-37.pdf.
30. Full comment is available at http://www.sec.gov/comments/s7-17-08/s71708-9.pdf.
31. Full comment is available at http://www.sec.gov/comments/s7-19-08/s71908-45.pdf.

32. Full comment is available at http://www.sec.gov/comments/4-579/4579-1.pdf.
33. Full comment is available at http://www.sec.gov/comments/4-579/4579-14.pdf.
34. Full comment is available at http://www.sec.gov/comments/4-579/4579-29.pdf.
35. Full comment is available at http://www.sec.gov/comments/4-579/4579-16.pdf.
36. Full comment is available at http://www.sec.gov/comments/4-579/4579-23.pdf.
37. Testimony by Mark Froeba before the commission, 5 August 2009, available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=89e91cf4-71e2-406d-a416-0e391f4f52b0.
38. http://hsgac.senate.gov/public/_files/Financial_Crisis/042310Exhibits.pdf.
39. The documents mentioned are in fact originally taken from SEC's 2008 report. They shed light on individualistic and greedy behaviours from credit analysts: 'One analyst expressed concern that her firm's model did not capture "half" of the deal's risk, but that "it could be structured by cows and we would rate it". […] In another email, an analytical manager in the same rating agency's CDO group wrote to a senior analytical manager that the rating agencies continue to create an "even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters."' Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies (http://www.sec.gov/news/studies/2008/craexamination070808.pdf).
40. http://www.mcclatchydc.com/2010/04/22/92709/senate-panel-ratings-agencies.html#.
41. Mark Froeba's testimony is available at http://www.fcic.gov/hearings/pdfs/2010-0602-Froeba.pdf. Kolchinsky's testimony is available at http://www.fcic.gov/hearings/pdfs/2010-0602-Kolchinsky.pdf. Full information for that day of the hearing is available at http://www.fcic.gov/hearings/pdfs/ (files with prefix 2010-0602).
42. Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies, page 12.
43. 'And while intense heat has been applied to virtually every other participant in the party, ironically you don't hear much grilling of the rating firms, who are actually the most responsible for the financial sector systemic breakdown (in my opinion). This is the most insane part of all of this … while there were a couple of rather small rule changes issued at end 2008, it's hardly the overhaul that's required to prevent this from happening again': Nicholas Brown, St Peters, Missouri, 'Comments on Re-proposed Rules for Nationally Recognized Statistical Rating Organizations', 16 April 2009, available at http://www.sec.gov/comments/4-579/4579-29.pdf.
44. 'They are, however, engaged in a yearlong lobbying campaign, which has cost them about $2.7 million so far, a record for the rating industry, documents show' (http://huffpostfund.org/stories/2009/12/barney-frank-vs-credit-raters).
45. 'It is at this point, where investors' values meet the consolidating demands of major players, that the two universes work in tandem' (Ouroussoff, 2010: 125).

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Part II
Markets and States: Forms of Joint Regulation

5

Banks as Masters of Debt, Cost Calculators and Risk-Sharing Mediators: A Discreet Regulatory Role Observed in French Public–Private Partnerships

Elise Penalva-Icher, Chrystelle Richard, Anne Jeny-Cazavan and Emmanuel Lazega

External, top-down regulation by public authorities is increasingly being combined with endogenous bottom-up regulation by private actors to produce various forms of 'joint' regulation (Lazega, 2003). The financial sector – banking in particular – plays a central role in this joint regulation. This chapter looks at a case in point, describing the central but discreet role of the banking sector in the construction of a new institutional system combining public procurement and private markets through the promotion of PPPs (public–private partnerships) in France.

Businesses usually try to participate as much as possible in the governance of their own markets. They try to shape their opportunity structures, design their environment and uphold the social mechanisms allowing them to cooperate. At the inter-organizational level, at least two different sociological traditions deal with the issue of market governance, one stressing the formal and often exogenous aspects of this governance, the other the informal and often endogenous character of self-governance. In the first tradition, with its socio-legal outlook, exogenous governance or 'regulation' (Ayres and Braithwaite, 1992; Hawkins, 1984; Hawkins and Thomas, 1984; Shapiro, 1984; Weaver, 1977) is provided by government agencies backed up by courts. The relevant studies focus on questions such as the decision by government agencies whether to prosecute deviant companies. Such decisions are not clear-cut and often result from trade-offs between official inspectors and company managers. This is especially the case when companies are

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facing risks such as large-scale losses or layoffs, and sometimes bankruptcy, should the law be strictly enforced. The second tradition focuses on inter-firm arrangements promoting self-governance benefits for firms in their inter-organizational transactions and more informal conflict resolution mechanisms. Precisely because litigation is costly, firms prefer informal dispute resolution whenever possible, especially when they have long-term continuing relationships (Macaulay, 1963; Raub and Weesie, 2000). In this second tradition the focus is on pressures to conform, exerted by one organization on another. Pressures are based on resource dependencies and reputation (Raub and Weesie, 1993). Each tradition thus focuses on a different kind of actor intervening in governance and incurring the largest share of costs of control: mainly the State and/or companies themselves – the latter sometimes through industry representatives or through selection of contracting partners (Blumberg, 1997). In reality, the two governance systems combine in variable ways. One example is provided by Ayres and Braithwaite (1992) in their analysis of 'responsive self-regulation', which shows the existence of 'enforcement pyramids' that exist between state regulatory agencies and corporate actors. Such pyramids express the possibility, for industry representatives and law enforcers, to escalate from persuasion to warning letters to civil penalties to criminal penalties to licence suspension and revocation. Actors know that such enforcement pyramids exist. They know that each way of enforcing contracts is only one of several, and that an escalation can be deliberately triggered. This is why firms continue to use formal institutional litigation, both as plaintiff and as defendant, despite the costs involved (Cheit and Gersen, 2000; Dunworth and Rogers, 1996; Galanter and Epp, 1992) and why conflicts follow the pyramid transforming informal complaints into court filings and formal judiciary decisions (Felstiner, Abel and Sarat, 1980). Following the idea that the two forms of governance are connected, we explore this connection further. We think it is possible to identify a form of 'joint' governance, a combined regime of endogenous and exogenous regulation. We use the label 'joint' because we argue that the governance mechanism is a combination of self-regulation and exogenous regulation, and in this combination the costs of control are shared. Over the last generation, such joint regulation has emerged in various forms with the increasing financialization of neoliberal capitalism. This chapter presents one example: the emergence of PPP contracts and the system that makes them enforceable.

France's Partnership Contract (Contrat de Partenariat) is a recent legal instrument introduced in 2004[1] to promote new links between public authorities and private partners. It has created a structure for economic relationships between private and public sectors that has yet to be closely observed. These relationships are embedded in a system of heterogeneous actors: public authorities, private industrial companies, banks, lawyers, lobbyists and consulting firms. Studying this system of actors, which supports the emergence and development of the PPP contract, boils down to exploring a new discreet regulation process. The PPP is a legal innovation that fills a technical vacuum but also paves the way for a new type of regulation – a joint regulation bringing public preoccupations and private management together in a New Public Management type approach.

PPPs in France

At the beginning of the millennium, the French government was inspired by the UK's Private Finance Initiative (PFI) experiment to imitate its neighbour and create its own contract for public–private partnership (PPP). Promoters such as Osborne (2000) stress that the growth in the numbers and importance of PPPs is an international phenomenon – in the US they are 'central to national and state-government initiatives to regenerate local urban communities', while within the European Union they are 'an essential mechanism both to combat social exclusion and to enhance local-community development'.

Different arrangements such as the *délégation de service public* already existed in France. But the new Partnership Contract created by the French public authorities was intended to be a flagship initiative to develop a new market with new types of relationships between the public and private sector. What is the spirit of this new kind of Partnership Contract? How are actors seizing this opportunity? And how do they self-organize? These three questions are explored further.

The legislative framework

The legislative framework for the French Partnership Contract derives from the Order of 17 June 2004 and the Law of July 2008, and has been reinforced by the 2009 Recovery Plan. This new contractual instrument can be used for financing, construction, maintenance and operation of public buildings for a minimum of five years and a maximum of 30. Payment of private partners is spread over the term of the contract and linked to achievement of performance objectives. Despite this legal definition, the scope of such partnerships remains difficult to define. It differs from public contracts in its long-term perspective. For example, payment of the investment is spread over time, taking the form of rental payments to the private entity. The establishment of a PPP involves all the phases of a project from financing to construction to maintenance. The main difference between a public contract and a PPP therefore rests on a link with time: overall management of a project is possible, from beginning to end. This involves funding and brings private investors to the forefront.

PPPs can only be used in France when the urgency and/or complexity of the project can be demonstrated (Bergère et al., 2006). The 2008 law introduced a third criterion: the Partnership Contract may be adopted if it is economically more advantageous. This third, economic criterion – otherwise known as 'best value for money' – is becoming the dominant reason for using a PPP. French practices are inspired by the UK's PFIs and the British emphasis on the advantages of PPPs, seen primarily in economic terms (Ball, Heafy and King, 2007; Weil and Biau, 2006). Today, the relevance of France's own new legal instrument – the Partnership Contract – is founded on an economic evaluation criterion, namely the question of project funding, cost and profitability (Campagnac, 1997; Kirat, Marty and Vidal, 2005). In this sense, it represents a learning process for public authorities as regards economic and financial management of a long-term project (Campagnac, 2001).

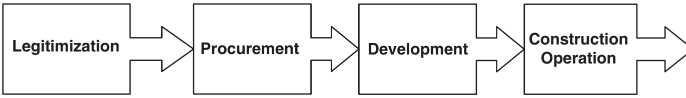
To date (December 2011), the French PPP market consists of 112 signed contracts, including 25 with national government. These contracts are primarily for public buildings in national projects, and for urban equipment (particularly street lighting) in local authority projects.[2] Many more projects are currently being set up. There is clearly a strong desire to develop this type of contract, but the market is seeing a slow start due to the current financial crisis. The State therefore implemented a guarantee fund in 2009 to support such projects and reassure investors.

The PPP negotiation process

The description of the system of actors in PPPs shows that the contracts are complex, but so are the interdependencies between the stakeholders. Various forms of expertise (legal, technical and financial) compete over definition of the terms of the exchange, and PPPs comprise a sequence of temporal phases (legitimation, signing the contract, adjustment, construction and operation).

Negotiation of French PPPs takes place in a sequence of steps, each possessing a certain complexity. Figure 5.1 describes this sequence.

The first phase initially demonstrates the validity of the contract through documents such as the 'functional programme' or the 'prior



Process	Project motivation	Choosing a candidate	Financial package	Construction, operation, maintenance
Agents	Public sector, the MAPPP	Public sector, candidates from the private sector, advisors	Private consortium which will create the Project Company (SPV)	Private group (SPV)
Tools	Provisional Programme, Prior Appraisal, Opinion of the MAPPP	Competitive dialogue	Risk sharing	The contract
Duration	A few months	12 to 18 months	Two to three months	Up to 30 years

Figure 5.1 The sequences of a PPP in France

appraisal'. The public sector is very active, especially through its 'Support Mission' for PPPs (Mission d'Appui aux PPP – MAPPP), which gives an opinion on the projects. However, it does not completely take on the role of the client because other actors, such as legal and other advisors, are very actively involved during definition of its needs. The public sector thus switches from the status of contracting authority to that of 'buyer' (Campagnac, 2009). Other studies (Gilbert, 2002) show how the public authorities can find themselves excluded from the negotiation process in highly complex and risky situations. The following excerpt illustrates how the magnitude and complexity of a PPP project may appear to deprive the authorities of their expertise:

> On the public agents' side, there's a big problem; they don't understand what a consultant is. [...] They don't know what to do or what to expect from consultants. The main added value of consultants is partly to be project manager and partly to support the public authorities; not because they are stupid, quite the reverse, but they have no experience, it's always their first project. The main task of a consultant is to hold the public agent's hand. They do everything, the civil servants do very little. We have to force them to make decisions and tell them that in this instance, we can't make such and such a decision for them.
>
> Interview with a legal advisor

The project then goes into the procurement phase of the contract. The competition between candidates from the private sector is known as the 'competitive dialogue', and can last up to 18 months. This procedure is longer than the more standard tender procedure, and more unwieldy for the private sector candidates. The role of legal consultants and financial and technical advisors becomes crucial at this point. They speak on behalf of the public partner and – in the case of highly specialized problems – may even become omnipresent and lead the negotiation:

> In fact it isn't the public agent who actually speaks at these meetings, it's his three advisors. This is an interesting point. I personally find it interesting to see the public interest from the perspective of the public agent. And unlike what happens in traditional public procurement contracts, we the advisors really are the negotiators. And this negotiation process [competitive dialogue] is not at all carried out the old-fashioned way, in a black box. Candidates have to open the bonnet of their car, dismantle the engine, etc. Everything gets examined. We know the candidate's entire set of margins, the way they structure their prices. It's extremely interesting for the advisors.
>
> Interview with legal advisor

A two-to-three-month period of adjustment and development follows, to allow the successful applicant to finalize the draft project with investors. This phase only involves private actors; the financiers are dominant and impose their conception of risk sharing. Failure of the final adjustment phase can be a significant let-down for public agents: for instance, when a deal agreed with industrialists is not approved by the banks and they have to start all over again. The interviews reveal tensions at this phase, as illustrated by the following comment:

> There's a phase known as the adjustment phase. As soon as the winner is declared and the contract is signed between the public agent and the industrialist, the real lender comes in […] This funding contract [the interviewee's current project] will be the most complicated contract that I've ever seen in my life! Once we win the project, we have to arrange the financing and that's a negotiation phase that is carried out entirely by the private sector; it's all amongst ourselves. The public agent's no longer there. When it gets very complicated, we sometimes have to go back to the client, and argue that we can't do it because of such and such a clause in the contract that is deemed too big a risk by the banker.
>
> Interview with an industrialist

Much remains to be learned about the public/private sector relationships that develop during the execution, construction and continuation of projects in the long run, particularly when banks start withdrawing from the projects by selling them or their debt on secondary markets. However, the projects in this emerging market have not yet progressed far enough to allow us to study these phases at the present time.

The system of actors in PPPs

Once the sequence of PPPs is identified, it is possible to specify the role played by the many actors involved (see Figure 5.2).

It is interesting to note that SMEs – too small to carry the procurement phase and the long competitive dialogue – are de facto ruled out of this type of contract. The same goes for independent architects.

> [PPPs] will marginalize SMEs, because they have neither the technical capacities nor the financial and legal capacities to implement PPPs; this will bring them back to a subcontractor role.
>
> Interview with a banker

> When an ad hoc company is created to run the PPP, the economic strength of the architects isn't big enough for them to take their share of the financial risk.
>
> Interview with a public service agent

The public partner is present during the first stages of the PPP and states the legitimate grounds for the PPP project (with the MAPPP); in that sense, it legitimates it, before selecting a candidate during the lengthy competitive dialogue phase. During these two phases, the public partner must acquire the know-how required for long-term contract management. It must also understand financial reasoning based on risk and return factors. The challenge for a public entity is to successfully transfer these skills from the private sector to the public sector:

> One of the issues would be for […] the administration to be reformed and become efficient. This would require a transfer of skills which I believe will not occur. It should be a criterion!
>
> Interview with a financial advisor

The private partner joins the cast of players during the competitive dialogue; it then participates in the financial arrangements during the adjustment and development phase, and manages the construction,

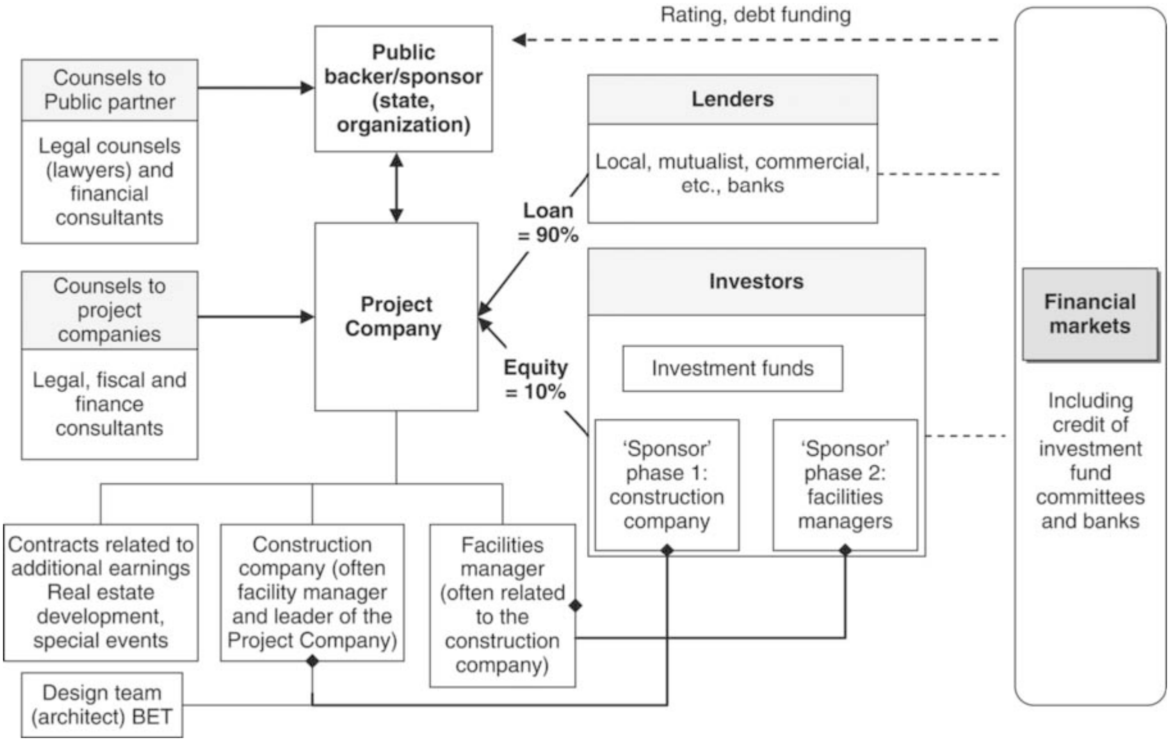


Figure 5.2 The system of PPP actors in France
Source: Deffontaines (2010: 4).

operation and maintenance of the project through a Project Company formed as a Special Purpose Vehicle (SPV). This SPV is responsible for integrating, coordinating and organizing – over a long period of time – the design, construction, operation and maintenance functions, and fund-raising for the PPP. Usually, a construction firm is the commercial agent and leader of the Project Company. Facility managers (maintenance professionals) are generally related to the construction firm.

> On the private partner side, the candidates are groups, consortia and so on. In practice, this company will be created when the contract is signed by the main private agents: the builder, the maintenance agent, possibly an investment fund, a bank. Banks may intervene directly as financier, with an equity contribution through an investment fund. Or they may be involved in the complete assessment of the loan that will be made, and borrowings by the private partners. So it's all very variable; it depends on the projects. There's still the idea of a single private partner, and unified private partner responsibility.
>
> Interview with a ministry attaché

The most striking fact in this system of actors is undoubtedly the role played by agents from the finance world, in particular banking. The public partner, like the private industrial partners, deals with private financial advisors throughout the negotiation. Beyond this advisory role, the bank plays a key lender role. Investment funds are also involved in the loan, but for a much more modest portion of the financial package.

> Today there is a category of actors who are involved in equity funds, which are the investment funds, and these investment funds couldn't care less whether they carry the debt, because in any case, they don't have a balance sheet to consolidate! So the debt ends up with them, but it isn't registered anywhere.
>
> Interview with a financial advisor

The financial and legal advisors who work with the public entity during the prior appraisal phases and the competitive dialogue play an essential role. They provide assistance to the government or local authorities in the partnership contract negotiation and drafting process with the private partner, usually a large company in the construction and public works sector, that is, an entity well versed in the techniques required for such a negotiation, namely risk calculation and evaluation of project profitability. These advisors often come from major international audit firms, but can also be from the banks' advisory services departments. The role of financial advisors is crucial: they act as 'interpreters' between the private and public actors during the screening, prior appraisal and competitive dialogue phases.

> We have an educational mission to explain how each and every actor works ... But above all to explain their behaviour, in other words, everyone's sociological habits. This is important for us as advisors: explaining how the person across the table behaves. It's a strategic choice on both sides.
>
> Interview with a financial advisor

> Then the negotiation begins and the advisor's role is to assist the public agent during the negotiation. More than that, it's not the public agent who speaks; in practice the three advisors are the ones who speak.
>
> Interview with legal advisor

Compared to conventional public contracts, a PPP comes across as a particularly complex deal, understood by the private partners as an investment project. Yet financial theory and practice define any asset or investment project in terms of two criteria: the expected return and associated risk. As the PPP price is constructed, the contract is progressively defined by these two financial criteria (profitability and risk). This typifies the regulatory process in this case: the actors are trying to establish new practices for public services based on another norm related to private financial values, and this explains the centrality of financial techniques in negotiation and evaluation of these complex contracts. It also explains why the French government had to create a new type of contract, rather than using regulation based on the previous *délégation de service public* arrangements. The existing framework could not encompass or drive the intended normative and institutional change.

A qualitative and quantitative study

The aim of this study is to understand the social construction of the French PPP market, especially the promotion of the new 'partnership contract' created in 2004. Qualitative and quantitative empirical work was carried out based on two main kinds of data: firstly, an interview campaign with key actors, and secondly, a network analysis questionnaire.

The interviews were based on an extensive review of the literature: for example, reports, presentation brochures, manuals, websites, newsletters, etc. This preliminary work was necessary to define the boundaries and identify the key players in this new market. It also enabled us to reconstruct the main events in the market since the creation of the partnership contract in 2004. This led us to specify PPP stakeholders in France and identify 94 organizations considered important and influential. Those organizations belong to the categories involved in contract negotiation and performance as presented previously: industrial actors, builders, maintenance agents, consultants, investors and bankers, as well as certain public bodies which play a decisive role in the continuation of PPPs, namely training bodies and lobbyists. Although some of these actors do not sign the Partnership Contract, they make its negotiation possible for public and private partners. The PPP also generates subcontracts for areas such as consulting or training, which must be taken into account in order to understand the joint regulatory process.

Once this exploratory analysis was complete, we conducted 22 semi-directive ethnographic interviews with well-known key players from the inner circles of the PPP world in France (five from the public sector, five from the banking sector, four industrialists, three corporate lawyers, three business consultants and two lobbyists). These interviewees enabled us to size and understand the system of actors behind the PPP market in France, especially the negotiation process leading up to a contract, during which actors meet and try to reach an agreement. Thirty-two additional interviews were also conducted to fine-tune our investigation questionnaire. Lastly, and simultaneously, we attended some professional symposia on PPPs in order to capture something of the informal atmosphere of this small world.

This ethnographic step led to construction of our second quantitative device: a questionnaire aimed at reconstituting the social networks of this milieu. The interviews showed that the PPP milieu is complex and heterogeneous, and we wanted to understand how these actors interacted. Social network analysis is an appropriate method to report on and model such interactions. We decided to identify the discussion, business and advice networks between the actors, as these relationships were necessary resources for promoting and signing PPPs. These social networks could also be the place where new normative practices of contracting between public and private actors are defined (Lazega, 2003).

Proceeding with network analyses required clearly defined system boundaries: in other words a list of members was necessary. We identified them under a two-mode approach, starting with organizations, then finding individuals who represent them (Breiger, 1974; Eloire, Penalva-Icher and Lazega, 2011; Lazega et al., 2007). This provided a list of 100 people (belonging to the 94 organizations previously identified), all members of the French PPP milieu performing the diverse roles cited earlier. The survey and the list were tested during the 32 interviews, when the interviewees were asked for their opinion on some of our quantitative questions about what they thought a PPP should be. They checked, modified, completed and altogether enhanced our nominative list through their personal knowledge of the system. Anyone not previously included in the list but named by two of the 32 interviewees was added to the list. Between September 2009 and April 2010, 88 members of the PPP milieu answered our questionnaire during face-to-face interviews.

The questionnaire began by identifying the sociological profile of members of the list: their role in the actors' system, the organization they worked for, their background before PPPs, how and when they joined the milieu, their career and qualifications, etc. Next, in order to define their possible normative practice, we examined the actors' representations of a PPP contract and what they considered PPP best practices, which form the substance of the regulatory process studied. Lastly, we traced the different relationships and asked the actors to name their contacts using several name generators, accompanied by the nominative list. We chose three kinds of interactions: discussion, business and advice. The discussion network was reconstituted with the question: 'With whom do you have the opportunity to discuss PPPs seriously on a one-to-one basis?' The business network was identified with the question: 'With whom are you currently doing business?' And finally the advice network was established with the question: 'Have you ever sought advice about legal, financial, or technical issues related to PPPs, informally or formally, but free of charge, from a person in this list? If so, could you please tick their name?'

The discussion relationship corresponds to the huge amount of activity generated by the novelty and complexity of the PPP. As a PPP contract requires several forms of expertise, a general form of collaboration is woven based on exchanges through discussion. This relationship is an indicator of the social life in which PPPs are embedded. The business relationship is economic in nature, with a narrower choice of partners. Because the PPP milieu is very competitive and secretive, it refuses to give researchers access to signed contracts or projects in progress. We believe that business network analysis helps trace the reality of the French 'Partnership Contracts' system, and also the cascade of contracts signed downstream. Sometimes the SPV project company is like a shell that hosts the main contract but also hides other relationships within its private circle. The business relationship question was in fact the most sensitive question we asked: a few interviewees refused to answer it. The third relationship is the advice relationship. We chose to exclude 'billed' advice and instead show social advice interactions in which actors trust an epistemic authority with a socially constructed and legitimated reputation, rather than relying on the consulting market that is emerging in the business network. We consider advice relationships highly significant.

Finally, to understand the role of each type of actor in the regulatory process, we cluster the heterogeneous actors into six categories according to the organizations they represent: private companies (n = 16), public authorities (n = 21), lobbyists (n = 8), consultants (n = 15), corporate lawyers (n = 15) and bank representatives (n = 13). The structural position of these categories will help us understand their importance and their influence in the process.

The visible but discreet action of the banks

Our results show how the PPP system of action is relationally structured, and how the banks play a predominant role. Acting as a discreet regulator, banks influence and may even determine the partnership contract's financing rules (i.e. the extent of private debt in the public investment) and measurement rules (i.e. costing of a partnership contract).

The relational structure of the PPP system

This network analysis makes it possible to examine the banks' role in the new system created by the partnership contract, at an individual level. More precisely, we study the impact of bankers, that is, the individuals belonging to a banking company, who at aggregate level represent the banking sector. The position of these individuals can be summarized by centrality measurements, especially 'indegree' centrality scores, that is, the number of choices received in the network (Wasserman and Faust, 1994). Indegree centrality measurement can be interpreted as a measure of prestige. An actor benefiting from a high indegree score often has enviable resources or a good reputation. 'Outdegree' centrality counts the number of relational choices made by an actor, that is, the number of people the actor considers as his or her contacts. This figure could be interpreted as a measure of local knowledge and action in the milieu. A high outdegree score reflects high activity and a good grasp of the environment. It could also show that the individual seeks information through many ties, especially in the case of an advice network. A low outdegree score could indicate that the individual does not know where to seek resources, or does not have access to those resources. Together, indegree and outdegree shape an actor's degree of centrality, which reveals the actor's general level of activity within a network. In addition to these three main centrality measurements, 'betweenness' centrality is an indicator of the capacity to act as an intermediary (a 'broker') between all the other actors in the network.

We begin our network analysis in Table 5.1 by examining individual action in each category of actors, with individual degree measurements at micro-level.

Firstly, the fact that lawyers and consultants are behind banks and lobbyists is surprising. Business lawyers and consultants, with their legal and/or financial expertise, might have been expected to be central in this milieu, but instead have low scores in the business and advice networks. This indicates that they are being sidelined by the new system of action created by the Partnership Contract: legal expertise is apparently not the key competency for a PPP contract. In comparison, bankers play an important role, strongly legitimizing financial expertise as the 'PPP-maker'. Closer examination shows they are not very central in the discussion network (only two bankers in the ten highest indegree scores), but they have established themselves as the leading players on the PPP market in terms of business. For instance, in the business network outdegrees (choices sent), there are two bankers in the ten highest scores and seven in the 20 highest scores. In the advice network, one banker is very prestigious, appearing as the most sought-after advisor of all actors; at the same time, three bankers are in the top ten outdegree scores in the advice network. Last but not least, lobbyists are very visible in this extensive, dense network, registering four of the ten highest indegree scores. The betweenness degree on this line highlights the fact that lobbyists mask bankers' centralities, especially in neutral, widespread relationships such as discussions. The centrality of lobbyists in the PPP system may be explained by their raison d'être itself: their work is to promote PPPs, and discuss with and advise others (cf. their high indegree scores for discussion and advice). Also, extensive advice-seeking is necessary to do their job. Their high centrality scores can thus easily be explained by their organizational role in the PPP system.

Table 5.1 Network activity of key players in the PPP system in France

	Indegree Discussion Network	Outdegree Discussion Network	Indegree Business Network	Outdegree Business Network	Indegree Advice Network	Outdegree Advice Network	Betweenness Discussion Network	Betweenness Business Network	Betweenness Advice Network
Bankers	25.5	**28.9**	**12.2**	**16.8**	6.8	6.0	0.01	**0.01**	0.01
Lawyers	20.3	21.9	8.2	10.3	6.0	3.7	0.01	0.01	0.01
Consultants	17.9	14.9	8.4	6.3	3.8	2.7	0.00	0.00	0.00
Lobbyists	**29.9**	24.5	11.4	11.9	**7.4**	**12.0**	**0.01**	0.01	**0.03**
Public Authority representatives	20.7	20.4	9.0	7.7	4.6	4.9	0.00	0.00	0.00
Private Company members	20.4	22.0	8.4	6.1	4.2	5.4	0.01	0.00	0.01

Some bankers are in a more unusual position; their structural centrality in the business network tells us that they play a key role in the PPP system, as if they were conductors orchestrating this emerging sector. Their outdegree scores in the discussion and business networks show good knowledge of their environment; they are very active and have many contacts. Furthermore, their betweenness centrality in the advice network shows that they are unavoidable 'brokers' of thinking on best practices. In other words, bankers are not only there to finance contracts, they form the relational and normative core of the business structure, able to spread opinions on how to practice PPP in France. To sum up, this structural representation of the different relationships between PPP actors suggests that bankers are the discreet regulators of this milieu alongside the strong, visible influence of lobbyists, who are mostly acting on the bankers' behalf. Although it was created for political ends by the government with activist support from lobbyists, the PPP market can thus be considered economically and normatively dominated by banks.

For a better understanding of the actors' role in these networks, Table 5.2 shows the normalized average indegree score by category, aggregating the links between individuals belonging to the same types of organization. The networks are partitioned and reduced to aggregate links: the resulting inter- and intra-categories are normalized according to the number of individuals in each category. We then compute the choices received to obtain an average indegree score per category rather than per individual. This makes it possible to cross-check the reputation of certain individuals, and understand the role of banks in the PPP milieu. At the meso-level, this measure gives an idea of the level of activity of the different categories of actors in this milieu. This complements the previous individual analyses and shows that as a category, banks are even more central.

Table 5.2 confirms our first analysis: it shows the surprisingly weak position of law firms and, to a lesser extent, consulting agencies, but also the strong action of lobbying agencies (scores of 13.43, 34.83 and 9 for each network respectively). Finally, the role of banks in the PPP process is confirmed: the highest scores in Table 5.2 show that the most cited partner in the business, discussions and advice networks is the bank (scores of 17.23, 39.62 and 9.74). For all three networks, the organizations represented by the most central actors come from the financial sector. This means that at the aggregate level, the banks' interests are overrepresented and dominate the making, but also the regulation, of the PPP process. It appears that although bankers use their relational capital discreetly, without taking centre stage, they are able to self-organize at

Table 5.2 Average indegree score by category of actors in the discussion, business and advice networks of key players in the PPP system in France

	Business network	**Discussion network**	**Advice network**
Private Companies	9.42	22.57	7.21
Public Authorities	7.82	18.6	4.12
Lobbying Agencies	13.43	34.83	9
Consulting Agencies	12.9	25.95	7.7
Law Firms	10	20.65	4.7
Banks	**17.23**	**39.62**	**9.74**

the meso-level in order to dominate the discussion, business and advice networks. In other words, the organizations are very visible; the involvement of the individuals representing them is more discreet.

Analysing the structure of the PPP networks reveals the centrality of the banking actor's role in the PPP process, but this important role is played out in the background and is not immediately obvious. Discreetly but surely, in practice the banks dominate the PPP process. Their structural position helps them define and set the rules. Banks have thus been able to change both the financing rules – that is, the proportion of private debt in the public investment – and the measurement rules, that is, for long-term costing of a partnership contract. This understanding of the banks' regulatory power brings us to grasp not only their consequences for the public investment market, but also the banks' ability to ensure their own interests prevail.

The regulatory power of banks

This first analysis of the PPP network deconstructs a complex, ideological regulatory process in which the banks impose a 'consensus' based on their own definition of risk, cost and the way they are shared. They play a crucial role throughout the contract negotiation, particularly during the adjustment phase.

> I have a maintenance contract that's finalized and all of a sudden there's another team [from the same bank] that tells us, no, the financial advisor is only the financial advisor. They tell us that they are the lenders, they have all the lenders' rights and they remind us that without them, we wouldn't have our funding! And it starts all over again. If you forget any detail, it can be very hard.
>
> Interview with a builder

Thus, banks and other agents from the financial domain (credit institutions, investment funds and financial consultants) economically regulate the partnership contract, a new public management tool that was created for political ends. PPPs raise new questions in a new way concerning the interactions between government and business, the emergence of a 'regulatory' State (Campagnac, 2001) and a new 'joint regulation' (Lazega and Mounier, 2003) of the economy.

Through its dominant position in structural terms, the financial world apparently holds a decisive role: it is able to impose its interests, and therefore its own idea of the PPP contract, notably during the development phase and financial package negotiation. The financial structure of these contracts – generally 10 per cent equity funds and 90 per cent debt instruments – illustrates the predominance of a financial sector that is dictating its own view of risk. The emergence of the economic 'best value for money' criterion also introduces financial investment decision concepts (e.g. NPV – Net Present Value – and IRR – Internal Rate of Return) that are not yet familiar to the public actor. The method for calculating the overall price of a PPP for the community – in other words seeing whether it is a 'good' or 'bad' PPP – depends on the risk-sharing defined by each contract. The underlying risk allocation principle appears to be 'he who knows how to do it shall take the risk'. The first interview extract next highlights the discreetness of regulation; the second shows how this discreetness is controlled through the 'know-how' rule.

Q: Are there rules for risk allocation?

A: There are market standards. That is to say that after a while, having negotiated all these contracts, we know from what can be observed on the market that such risks are transferred or transferable, but there are no written standards, there are practices that are accepted.

Interview with an advisor

Our rule is that each risk should be taken by the person most able to meet those needs.

Interview with an industrialist

This rule raises the question of which authority legitimates expertise. Some actors, such as banks, may refuse to take risks or succeed in influencing the definition of the other actors' field of expertise. The bank (as a lender), by its intermediate position between the investor and the builder, manages to impose its plans. By mediating risk sharing, the banking sector discreetly silences the debate over the legitimacy of PPPs. Structurally, this sector 'owns' the means of estimating what constitutes the cost of a PPP, for itself as well as the community. The public sector, with its long-term view, has projects requiring expertise in building, maintenance, but also financing: that expertise involves a significant economic and financial component, presently held by the banking sector. The regulatory process, which leads to definition of best practices for a PPP, seems to be based on the questions of project costing and the definition, valuation and allocation of risks attached to these long-term projects.

Conclusion

Our initial results show that a new type of public contract is emerging in France, in which public investments financed by PPP contracts are structured by a complex system of actors dominated by banking and finance. These two sectors have come to control PPP contract negotiations, long-term risk allocation and costing intrinsic to these long-term investments. With this financialization of the contract, quality-oriented regulation is being superseded due to domination by the banks' action as a discreet regulator at the core of the contracting process. Financial returns and risk criteria are essential during the prior appraisal, competitive dialogue and adjustment and development stages of a PPP. At each step of the process, banks can intervene as consultants for the public or private partner, as well as lenders or investors. This gives them an influential position in the regulatory process and helps them to promote their own regulatory interests.

Finally, private-public partnerships are long-term contracts and should be studied over the long term accordingly. The banks are undeniably masters of debt, cost calculators and risk-sharing mediators holding a position that currently enables them discreetly to regulate the French Public Contracts milieu, but even they may be unable to shape long-term, global coherent public policies providing a lasting public asset. As Coulson (2005) noted for the British experience: 'That is likely to prove a serious underlying problem for many PFI/PPP partnerships – we do not know what will happen over 25–30 years, but we may surmise that in many cases partners will fall out, either among themselves or with their clients, and it will be very difficult then to deliver the promises that have been made.' The current lack of strong political will at both French and European level regarding the acknowledgement and clear registration of debt makes stakeholders 'sorcerer's apprentices'. The PPP market is built and growing on a foundation of hidden debt, unfortunately heralding a future public finance crisis equivalent to the subprime crisis of 2007.

Notes

1. Order no. 2004-559 of 17 June 2004.
2. Source: www.ppp.bercy.gouv.fr.

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6
Market Information as a Public Good: The Political Economy of the Revision of the Markets in Financial Instruments Directive (MiFID)

Paul Lagneau-Ymonet and Angelo Riva

Introduction

The crisis triggered by the US mortgage market meltdown in summer 2007 initially forced governments with a deep-seated belief in deregulated markets to do what they had repeatedly said they never could or would do again: namely to take stakes in financial institutions, suspend certain transactions deemed to be speculative and manipulate their currencies. Once the emergency was over, they said, they would take measures to put credit institutions and the financial system – currencies, banks and markets – back on a sound footing.

However, the 2009–11 G-20 meetings failed to deliver the Bretton Woods-style accord that some had been calling for, and since then the sovereign debt crisis has damaged national economies, especially in Europe, and a currency war is now looming large. The public authorities – with the exception to some extent of the US and British governments which respectively passed the Dodd-Frank Act (2010) and partially followed the recommendations of the Independent Commission on Banking (2011) to separate proprietary trading, brokerage and investment banking operations from other banking activities – soon abandoned their ambitious plans to exert greater control over financial institutions or regulate market practitioners. On the question of bonuses, it has become very clear that practitioners' 'money-lust' has not been reined in. Amending accounting standards and redefining prudential ratios (to be implemented by 2019) might provide financial institutions with a firmer capital foundation to cope with the risks they incur. The most important focus of these attempts at reform, which it

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must be said are shallow compared to the magnitude of the financial crisis and its economic and political aftermath, should be the actual organization of financial markets, since the risks incurred by financial institutions depend on the markets in which they operate. That is why in Europe, which has the second-largest financial industry after North America, the revision of the Markets in Financial Instruments Directive (MiFID), which came into force on 1 November 2007, is of cardinal importance for those who still claim they want to overhaul financial regulation and bolster the stability of the globalized financial system. The structure of the financial services markets, that is the field of financial intermediation, affects the financial instruments market (Djelic and Lagneau-Ymonet, 2008; Pirrong, 2000, 2002).

How come the EU has shaped the stock exchange industry in such a neoliberal way, reflecting an unwavering faith in the coordinating virtues of competition? How come the European authorities are still promoting an (imperfect) market as the desired form of financial markets, despite the recommendations of even mainstream financial economists? Drawing on socio-economics and financial history, this chapter demonstrates how the revision of MiFID left the 'standards-surveillance-compliance regime' (Wade, 2007) untouched, although it gives the industry the upper hand in regulation of financial activities. On a theoretical level, the revision of MiFID offers an archetype for the critical analysis of 'joint regulation'.

European law-making has been designed to integrate regulated and regulating bodies.[1] In both its formal architecture, which organizes official open consultation on financial issues, and its actual process which offers businesses a large number of lobbying opportunities, EU regulation displays both exogenous and endogenous elements. Moreover, the relative smallness that is a key feature of European Union bureaucracy compared to the number and resources of vested interests forces the Eurocrats and European Parliament members to rely on data, surveys and analyses provided by the industry, individual enterprises and their lobbyists or national governments and their administrative bodies.[2] To drive regulatory change, this institution with its population of supranational political actors not only relies on such information, but strikes up alliances with the information providers to leverage its position, define the agenda and push forward new regulations. Moreover, financial matters have always intertwined public and private interests, and therefore business, administrative and political institutions and actors (under arrangements that vary historically as well as geographically). Last but not least, contemporary finance, and especially the field of financial intermediation, is characterized by its concentration and transnationalization, which force social scientists to relate heterogeneous actors and various levels of jurisdiction.

The ongoing debates on the organization of securities markets

Academic research on the organization of financial intermediation, and especially the stock exchange industry, has flourished over the past 30 years after a relative lack of interest from the end of the Second World War to the mid-1970s. This trend has affected not only financial economics but also history, sociology and anthropology, in other words the social sciences in general (for a review of the literature, see Knorr-Cetina and Preda, forthcoming). The topic was already considered of paramount importance in the late nineteenth century in Europe and the United States, when legal scholars and statisticians, economists and sociologists, social theorists and publicists wrote numerous pieces on the organization of Western stock exchanges (for a famous example, see Weber, 2000 [1894 and 1896]). One common feature of the 'first' and 'second' globalizations is the strong development of financial markets (Rajan and Zingales, 2003).

One of the most disputed principles surrounding the contemporary organization of the stock exchange industry is whether there should be one centralized market, or a competitive market for markets. The European Commission clearly endorses the second option, as its neoliberal stance and anti-trust policy show (Denord and Schwartz, 2010; Jabko, 2006; Mirowski and Plehwe, 2009). But a more detailed analysis of the theoretical framework which underpins European policy reveals detrimental discrepancies between the theory and the praxis. Adopting a process-tracking approach reveals that the current regulatory regime and organizational features of the stock exchange industry in Europe have been much more influenced by power struggles among leading financial centres and their stakeholders (governmental authorities, European, national and local regulators, financial intermediaries and, to a lesser extent, representatives of issuers or investors) than by theoretical welfare maximization. Although the European Commission's initial choice is back on the reform agenda, providing an opportunity to objectify, explain and correct the limits of the model adopted, there is little doubt that its main features will remain untouched.

The competing theoretical frameworks

Mainstream financial theory highlights the characteristics of different organizational models for the stock exchange industry. A first stream in this literature shows the virtues of a stock exchange industry based on one centralized market for each informationally integrated region. According to this view, positive externalities (mainly due to the nature of market liquidity) and economies of scale and scope should lead both investors and issuers to concentrate on a single centralized stock market. Nevertheless, this literature is unable to explain the 'network externalities puzzle' – that is, the continuing existence of various stock exchanges in an informationally integrated region.

Another stream of the literature explains this puzzle through the heterogeneous preferences of both investors and issuers, arguing that it is impossible to conceive a market model able to satisfy both. Market participants have different preferences because of differences in size, resources, skills and temporality, and because of the institutional framework in which they are embedded. Different markets can coexist as long as their models are differentiated enough to satisfy these heterogeneous preferences.

This second approach considers that the coexistence of heterogeneous markets is optimal, provided it allows all actors to join the market that satisfies their respective preferences, while a single market would exclude actors whose preferences do not match its defining features. The dynamics between differentiated exchanges would thus rely more on 'co-opetition' (cooperation and competition) than on strict competition (Brandenburger and Nalebuff, 1998). Consequently, this approach is able to explain the synchronic coexistence between private opaque markets (such as OTC markets) and high-end stock exchanges (regulated and hence more transparent markets), as well as the diachronic coexistence of differentiated but neighbouring exchanges like the Paris Bourse and the London Stock Exchange.

With the rise of large, informed institutional investors (pension and mutual funds, financial intermediaries extensively practising proprietary trading, hedge funds), most of the trading activity has migrated toward OTC-opaque markets. This is now true for derivatives, bonds, and to a lesser extent shares.[3] Those informed investors invest huge amounts of capital in collecting and elaborating information. Trading in transparent venues discloses costly information to market participants and therefore reduces the rents that large, informed investors can extract from the superior information they can collect and process.

Without a legal (even if imperfect) monopoly, it is likely that the bulk of trading activity would migrate to opaque markets.

A third, and much more radical, stream of literature praises full competition among numerous trading venues. According to this view, inter-exchange competition would multiply access points to the financial market and the supply of financial services, enabling an increasing number of investors to join them: the larger number of participants in the market for trade execution would decrease the rents of the incumbents (the traditional exchanges). Competition among these trading venues would thus reduce transaction costs for investors and be beneficial for issuers. It would also foster innovation, mainly in technology: competing exchanges would innovate to offer better (i.e. reliable and faster) services to their (potential) clients in order to consolidate or increase their market share. The normative implication of this third approach is the creation of a 'market for markets' characterized by free entry into the industry for operators of trading venues. Overall, the competition among exchanges should lead to higher liquidity, and therefore a lower cost of capital for issuers; this decrease in the cost of capital would, it is argued, eventually foster economic growth.

To be effective, changes in the competitive regime of the stock exchange industry require three preconditions: dismantling of the regulated markets' national monopolies; demutualization of the exchanges; a switch from face-to-face open outcry trading to electronic trading. Obviously, any national monopoly (de jure or de facto) for regulated exchanges is an obstacle to free competition between trading venues. Consequently, the policy implication of the third normative prescription is the end of the monopolies which have long defined the national (or regional) organization of the stock exchange industry in Europe and the United States (for recent reviews of this issue, see Biais, Glosten and Spatt, 2005; Cassis and Bussière, 2005; Hautcoeur and Riva, 2012; Madhavan, 2000; Majois, 2008 and Ramos, 2003 for a long-run perspective on this topic).

Mutualized exchanges, that is, exchanges which belong to their members, tend to restrict new members' entry in order to maximize the incumbents' rents. This limits the potential liquidity, considered by standard models as an increasing function of the numbers of traders (for the opposite view, see Baker, 1984). Demutualized listed exchanges, on the other hand, belong to investors who have a strong interest in maximizing the number of members in order to maximize the exchange revenues, and hence their dividends (Pirrong, 2002).

Last but not least, the constitution of a market for markets implies a switch from face-to-face open outcry trading to electronic trading.

The open outcry system allows for flexibility and has an advantage in terms of short-term information sharing between market participants (particularly valuable in a crisis). Nevertheless, electronic trading systems have become well established since they can handle (manual or fully automated) huge amounts of orders at decreasing costs. The open outcry system also gives local traders a clear advantage, while electronic order books not only satisfy large institutional investors but make development of remote access through IT connections possible and fair (Ansidei, 2001).

In the early 'Noughties' the EU, showing a preference for the most radical theoretical option (the third stream of literature) and encouraged by the rise of hard-lobbying, internationally operating financial intermediaries and large institutional investors, opted for the creation of a market for markets to unleash competition in the European stock exchange industry. However, robust theoretical models show that competition among demutualized electronic-order-book exchanges can have positive effects if and only if information from all the sources of liquidity (i.e. all trading venues) is consolidated in order to enforce price and time priority rules (Glosten, 1994). This requires ex ante full trading transparency (pre-trade transparency) and post-trade consolidation of market data. Lack of such consolidation instead appears to amplify the negative effects of competition. From the investors' point of view, observation of the full range of outstanding trading possibilities is the only way to negotiate better prices and reduce the chance of being 'skimmed'. From the regulators' point of view, availability of complete pre-trade data is the only way to observe operators' trading strategies, and hence detect market abuses and price manipulations. This is why *full* consolidation of pre-trade data is so crucial for the orderly operation of European financial markets.

In practice, the sequence of competitive regimes seems to obey political-economic reasons rather than any regulator's desire for welfare maximization. The rise of internationally operating financial institutions has pushed the stock exchange industry towards radical liberalization, although the theoretical preconditions for containing the negative impacts of fierce competition among trading venues have not consistently been put in place.

Changes in governance and competition regime

In Europe, the rapid expansion of the Euromarkets that began in the 1960s City of London impacted national financial systems that had been under tight international capital controls and strict banking regulation since the Second World War (Baker and Collins, 2005; Bussière, 2005; Schenck, 1998, 2005). The monetary disorder of the 1970s gave the opportunity or convinced West-European governments to take a neoliberal approach in reorganizing global finance and wage all-out war on inflation (Abdelal, 2007). One of the tactics designed and implemented in the search for non-inflationary financing methods was financial deregulation, which was pursued by successive governments from the late 1970s.[4] Deregulation was supposed to make it easier for companies to raise capital directly and, above all, for governments and public agencies to be financed through a public sector debt market that was liquid and hence attractive to international institutional investors (Feiertag, 2001, 2005; Lordon 1997). Not until the late 1990s and the creation of a 'financial common market' in the wake of European Monetary Union did this movement receive a European impetus (Jabko, 2006; Posner, 2009). These incremental changes (Streeck and Thelen, 2005) not only underpinned the growth of trading in transnational private financial markets; they also spread the associated ideology that markets coordinate their own effective self-regulation.

Large financial institutions which operate internationally have always found it in their interest to claim that opaque, lightly supervised ('self-regulated') financial markets are more efficient because they bring down transaction costs. In fact, these large institutions do so mainly because they can take full advantage of information asymmetries in such markets (as a French stock exchange adage says, 'a position revealed is a position lost'). Leaving aside these material interests and their inbuilt justifications often served by economists (Epstein and Carrick-Hagenbarth, 2010; Lebaron, 2011), it is clear that the rapid growth of financial transactions sparked a radical change in the 'private' nature of the markets where they took place. Financial markets were private insofar as trading information was not readily available to all stakeholders, but they belonged to nobody. Since the deregulation era, the adjective 'private' no longer applies solely to the unavailability of trading information; it describes the organizational features of the financial markets themselves, which have become for-profit trading venues owned by the largest financial intermediaries (Lee, 2010). In terms of legal status, capital ownership and operating philosophy, therefore, they are not so much private as privatized.

This metamorphosis has also affected incumbent (traditional) exchanges (Aggarval, 2002). Long organized on a mutualized basis, they were run as monopolies – particularly in continental Europe – by virtue of their quasi-public dimension (Riva, 2005, 2007; Lagneau-Ymonet and Riva, 2010). Starting with the Big Bang in London in 1986 (Michie, 2009), the main European stock exchanges have demutualized. In addition to adopting privatized status and becoming profit-driven private companies, they went public at the beginning of this century on the same markets they operated. This dual process of corporatization and privatization was supposed to transform exchanges into 'real' companies that could compete fair and square with private transnational trading platforms. Demutualization ought to have made it easier to resolve the problems of governance that mushroomed as international competition, domestic deregulation and technological progress undermined the old market-wide arrangements between intermediaries and exchanges. Intermediaries and market operators often had different strategic goals with regard to pricing, commission sharing, investing and broadening their membership. Conflicts and power struggles between intermediaries were heightened by differences in capital resources, organizational arrangements and geographical origins. In addition, going public was supposed to allow stock exchanges to raise the capital they needed to pay for technology investments (Ansidei, 2001; Ramos, 2003, 2006). In this set-up, competition between demutualized stock exchanges and alternative trading platforms was supposed to generate greater liquidity than mutually owned exchanges, making it possible to build a truly integrated market-based financial system.[5]

This move towards privatized securities markets had been underway for several decades by the time it culminated in November 2007 with the entry into force of MiFID. Stock exchanges morphed from institutions organizing public competition between financial intermediaries into private companies competing with one another and with their main users to provide intermediation services. MiFID replaced the Walrasian market model, based on a Durkheimian institutional arrangement, with a Williamsonian arrangement (Streeck, 2009) intended to usher in a kind of 'market for markets'. The markets thus went from being forums for public competition to privatized players in private competition.

MiFID, *quid prodest?*

To foster competition, the EU not only decided to dismantle stock exchange monopolies but also (at least indirectly) encouraged demutualization to facilitate competition between exchanges and financial intermediaries, namely internationally operating banks and funds, developing alternative trading venues. MiFID promised nothing less than 'an efficient, transparent and integrated trading infrastructure' for Europe.[6]

To achieve this it abolished that last trace of the old monopolies, the concentration rule (in countries where it still existed, such as France) requiring orders (with exceptions[7]) to be executed on a regulated market. This rule not only concentrated liquidity, it organized both strictly egalitarian matching of orders and trade reporting by publicly disclosing the price formation process. MiFID replaced this neoclassical model formalized by Walras, who used it to establish the political legitimacy of markets, with institutionalized competition among regulated markets (the successors of mutually controlled exchanges) and other order execution platforms – multilateral trading facilities (MTFs) and systematic internalizers[8] – without seeking to curb the expansion of existing over-the-counter markets. Competition was supposed to reduce trading costs, which in turn would enhance market liquidity and make it cheaper for issuers to raise capital. Mandatory pre-trade and post-trade reporting requirements that varied according to the type of execution venue were expected to improve price discovery and contribute to market integrity. This transparency would lead to best execution, meaning that customers could be guaranteed the best price, lowest cost and highest probability of execution for their orders. Last but not least, the competitive transparent architecture created by MiFID would foster closer integration in the European financial market, hitherto fragmented because of differences inherited from member states' individual financial histories.

Initial assessments published by organizations such as the Committee of European Securities Regulators (CESR, 2009), the Association Française des Marchés Financiers (AMAFI, 2010) and the CFA Institute (2009) – hardly bastions of anti-capitalism – have pointed up numerous disappointments. First, venues such as dark pools[9] and crossing networks,[10] which are hard to distinguish from over-the-counter systems, proliferated alongside MTFs and internalizers in the regulatory gaps left by the directive. Second, although competition has indeed reduced the fees paid by financial intermediaries that collect or generate market orders, there is no proof that these reductions have been passed through to end-clients, namely institutional investors and, more significantly, retail investors. Some AMAFI members estimate that although execution costs per trade (in other words, fees) have fallen by some 30 per cent, the average cost of carrying out a transaction has risen by 12 per cent (AMAFI, 2010: 15). This is because competition between order execution venues has fragmented liquidity and information, forcing firms to make huge IT investments in order to reconstitute the information so vital to securities trading. Reconstituting and processing widely scattered data is also costly, and as fragmented liquidity has led to a decline in average transaction size (CESR, 2009: 8), large orders have to be split and executed on several trading platforms, thereby multiplying fees and commissions.

Conflicting research findings regarding MiFID's impact on spreads – the difference between the bid and ask price for a security, used as the standard measure of liquidity – doubtless illustrate the difficulty of disentangling the effects of the crisis from those of the directive. Aside from academic wrangling about the most appropriate econometric techniques, these conflicting findings chiefly reflect a lack of hard data to use in tests.[11] This absence of statistical series highlights the main weakness of MiFID: its biggest shortcomings concern trade transparency. The fragmentation of liquidity among competing and increasingly opaque trading venues has not only dispersed the available market data; it has seriously undermined their quality. This disintegration has been only partially offset by the paid-for information available from a handful of financial data vendors. More importantly, these vendors do not supervise or inform the regulator about the transactions whose terms they disseminate to clients. Accordingly, best execution can only be a pipe dream. MiFID did introduce a system – the Transaction Reporting Exchange Mechanism (TREM) – for regulatory authorities to exchange transaction reports. But TREM applies only to completed transactions and, given the way it currently works, regulators find it more or less ineffectual (AMAFI, 2010: 9).

Only major international firms, particularly proprietary traders, have been able to afford major IT investments and thus stay ahead of the game, and they are now leveraging the informational advantages derived from those expenditures. Yet at the level of the financial system, the profits they earn result from the structural equivalent of the insider trading observed – and sometimes punished – at firm level. For other intermediaries (not to mention their clients), the drastic rise in investment and information processing costs outweighs the nominal decline in trading fees. The conflicting research findings on spreads should be seen in the light of the foregoing differences. If a firm can afford the investments needed to scan each and every market, it can gain access to prices beyond the reach of other, less well-off and IT-geared participants. Spread sizes may in fact be negatively correlated with the resources of firms that observe these price differentials. One of MiFID's consequences may be greater concentration in the financial intermediation industry – if that were still possible following the wave of post-crisis mergers – at a time when regulators and public authorities are voicing suspicions about financial institutions that are too big to fail.[12] One way of describing the outrageous profits these behemoths derive from the safety net the community is forced to grant them is, to coin a phrase, 'systematic abuse of a systemic position'.

In the securities intermediation market, the fight to capture trading in the most liquid securities (large caps and standardized derivatives) has intensified. That said, it is noticeable that new entrants are ignoring initial public offerings and the listing of small and mid-caps, which remain the preserve of regulated markets since the resulting profits are slim or non-existent. MTFs often operate at loss, subsidizing clients who send them orders and are also their largest shareholders. These shareholders benefit because they make up for forgone dividends through lower trading fees or even commissions on the orders placed on their MTFs.[13] The major banks have thus achieved their aim, namely to integrate – or, failing this, control – the entire recurring profit stream from intermediation.

To defend themselves, regulated markets are also concentrating on clients that generate the highest trading volumes, even though these clients are also the MTFs' main users or leading shareholders. Some exchanges, weighed down by the costs inherent to their constitutional trading supervision and transparency obligations, are beginning to pass through to issuers the costs that used to be covered by trading fees. They are also acquiring MTFs and developing dark pools, further blurring the boundaries between regulated markets and non-transparent trading platforms.[14] Some of them may even be considering abandoning regulated status at some point. This would free them of the attendant regulatory obligations so they could compete on an even footing with their rivals, who are governed by far less stringent regulations.[15] At least, such is the logic behind this strategy.

The political economy of the MiFID revision

To objectify the political economy of the MiFID revision, this section focuses on the questions in the European Commission's consultation paper which specifically addresses the key features of the European equity markets. More precisely, the selected questions deal with two major issues: post-MiFID developments in market structures (especially the regulatory frontier between OTC transactions and regulated trading venues, be they exchanges, multilateral trading venues, systematic internalizers or crossing networks) and the possible improvements to pre- and post-trade transparencies in EU equity markets.[16]

Table 6.1 The list of analysed respondents

	United Kingdom	France
Public authorities	HM Treasury-FSA	'French authorities'; AMF; Banque de France
Issuers' associations	BCI	AFEP; MEDEF
Investors' associations	CFA	AFII; AFG
Stock exchange	LSE	NYSE-Euronext
MTF	Chi X	None
Intermediaries' associations	AFME; BBA; ICMA	AMAFI; FBF
Dominant players	Citadel, Goldman Sachs	BNPP, SG, BPCE, CA-Cheuvreux

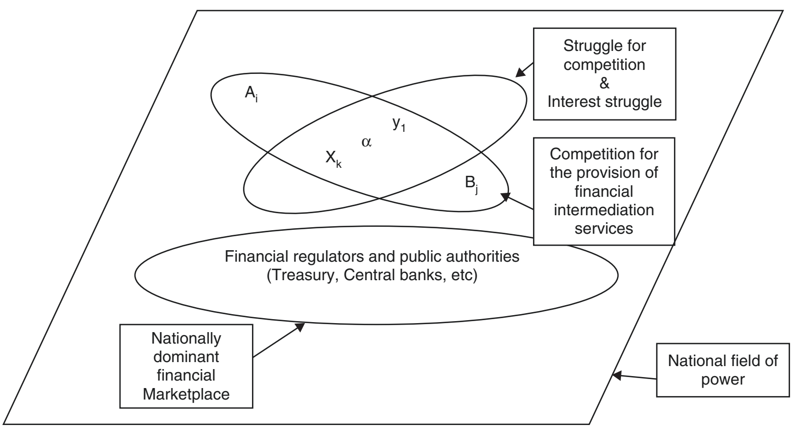

Figure 6.1 The field of financial intermediation
Note: Financial markets, especially the stock exchanges that are their most institutionalized form, are social realms where agents (individuals or businesses) fight to be part of the exchange process and then confront their conflicting interests. According to Max Weber, the empirical price is produced by these two struggles. To pacify these struggles, they are mostly intermediated (Beckert, 2009; Riva, 2009). Ai and Bj are pure intermediaries. They provide their clients xk and yl with brokerage services. They buy and sell on behalf of their clients. They do not buy or sell for themselves, be they individuals or companies. α, in contrast, is a broker-dealer. It buys and sells and makes its profits (in addition to ordinary financial services) through the bid-ask spread. In each country, the nationally dominant financial marketplace (Paris and London for France and England since the nineteenth century) encompasses the stock exchange, the banks, insurance companies, listed companies, regulators and, to a lesser extent, legal firms. Although they are all in competition, they share at least one common interest: growth of financial activities in their marketplace (Ansidei, 2001). The field of power coordinates and stratifies the various national elites (economic, political and administrative, cultural) (Denord, Lagneau-Ymonet and Thine, 2011). Financial intermediaries stand at the shifting junction between the corporate and administrative elites (Lagneau-Ymonet, 2009; Michie, 1999).

To provide an overview of the typical answers collected by the Directorate General for Internal Market and Services, we selected from the more than 4200 comments received by the Commission sent by institutions in the EU's two greatest financial rivals, the United Kingdom and France, according to both the literature on the 'varieties of capitalism' (see Streeck, 2011 for a review) and the financial history literature (Davis and Neal, 2005; Hautcoeur and Riva, 2012). For each country, we examined the position papers submitted by financial authorities and/or regulators, representatives of issuers and investors, stock exchanges and operators of multilateral trading facilities, financial intermediaries' associations, and dominant players in the field of financial intermediation (see Table 6.1). We thus assess the types of answer depending on the positions of these public and private institutions in the field of financial intermediation (see Figure 6.1).

The limits of the regulatee/regulator explanation

To develop a political economic analysis of the MiFID revision, it is absolutely necessary to abandon the stock idea that regulators and regulated institutions polarize debates. This does not mean they do not have specific, and sometimes conflicting, agendas. Nor does it mean simply rejecting the idea that regulation can be 'captured' by regulated entities, which is all the more possible in the case of financial activities given the enormous differences in the resources (money, staff and influence) available to regulators and regulatees.[17] In our view, the capture of regulation is a phenomenon that deserves explanation beyond individual wrongdoings (corruption, conflicts of interests) or strategies (such as revolving door mechanisms). Moreover, the 'capture' view suggests that regulators do not want to be captured, and after three decades of financial deregulation and neoliberal indoctrination, this assumption remains to be proven. We therefore focus on two features of the contemporary political economy of European financial regulation that explain how financial institutions structurally gain the upper hand over their regulators: competition among financial centres, and social division of labour in the field of financial intermediation.

The regulatory consequences of competition among financial centres

Fierce competition between financial centres to attract thriving financial institutions and their wealthy professionals obliges regulators and regulated entities to strike compromises, even before they start lobbying on the European stage.

First, we observe ex ante alignments of national regulators and authorities' expectations with the hierarchy of financial centres. National regulators and authorities of second-rank financial centres (such as France) tend to ask no more than they expect the European commission and parliament is prepared to give. For instance, the French financial markets authority (Autorité des Marchés Financiers or AMF) did not advocate any radical reform of MiFID in its response to the Commission consultation paper, although nationally, the AMF chairman bluntly declared to the speculation inquiry commission set up by the French Parliament: 'We must be clear about this. There will be no true European regulation of markets until the MiFID is revised in depth' (Emmanuelli and Mancel, 2010, our translation). This critical stance was a way to leverage his position by gaining the fear-fuelled support of MPs to pressure the Ministry of Finance to lobby harder at the European Council.[18] The strategy would be to call for a 'level playing field' set with demanding regulatory standards, rather than engage in a race to the bottom. The British authorities, in contrast, stuck to their defence of the City's interests by praising MiFID, demanding 'full quantitative assessment of the cost and benefits' of any regulatory novelty (Treasury and FSA reply 2011: 3).[19] Regulators thus adjust and contain their regulatory constraints according to the competitiveness of their domestic financial centres.

Moreover, financial institutions have vested interests in finding common ground with their local regulators and public authorities. This is the best way for them to obtain public-authority backing in the lobbying power games at the European stage (especially at the level of the Council of the European Union) and it is also a way to prevent future conflicts on the local interpretation, implementation and enforcement of European regulations. This logic of 'joint regulation' does not, however, imply that regulators and regulatees are all square: the former endorse the latter's rationale ('competitiveness above all') to the extent that it will benefit their own jurisdiction, whereas financial institutions, especially large ones, can operate outside their home financial centre, directly and indirectly (through business associations) lobby European institutions and even benefit from the local compromises struck by the stakeholders of other financial centres. This kind of double game is particularly visible in the dominant players of secondary European financial centres which have located some of their most speculative activities in the City of London. To put it simply, they can choose which regulations to operate under, whereas regulators cannot choose to regulate a different financial centre. Therefore, the largest French financial institutions can always count on the 'light-touch' regulation of the British authorities and regulators, even though their 'home' regulators would prefer tougher rules, especially in times of financial crisis.

The City of London Corporation, which represents and defends 'the City', produced its own assessment of MiFID with the help of the consultancy London Economics. Their satisfaction with the directive was crystal clear – 'MiFID achieved financial market integration in secondary equity trading and thus reduced trading costs' (London Economics, 2010: 2). The fact that most of the big players of financial intermediation are concentrated in London explains this positive assessment of a regulation which clearly favours them. In a subsequent position paper which also took into account the perception of MiFID by non-UK-based financial institutions, the City of London Corporation acknowledged concerns with regards to data quality in post-trade information. With the forthcoming MiFID review in mind, France's Finance Minister Christine Lagarde appointed Pierre Fleuriot, president of Crédit Suisse France and a former General Director of the French Stock Exchange Commission to set out the position of the French financial community. Fleuriot's report submitted on 17 February 2010 put more emphasis on technical compromises between conflicting interests than on analysis of the directive's underlying principles. Its main recommendation was to strengthen the woefully inadequate TREM system for consolidating post-trade data; the vital issue of pre-trade information was relegated to second-line status. Consequently, adhering strictly to the recommendations put forward in the 'cautious'[20] The Fleuriot report would amount to reinforcing the existing unequal access to markets and information in the stock exchange industry. This was ultimately equivalent to abandoning the overarching principle, deeply rooted in the history of French stock exchanges (Lagneau-Ymonet and Riva, 2012), that stock market information is a public good and access to it should be, at least, strictly egalitarian. Although inconsistent with the grand aim of 'overhauling financial regulation' which Ms Lagarde specified in her mission statement to Pierre Fleuriot, this move offered the Paris financial centre's main stakeholders the lowest common denominator – a consolidated tape for post-trade transparency – which could successfully be lobbied for at Brussels, Strasbourg and London (AMF reply 2011: 24).

Interestingly enough, these two pre-legislative reports not only echo the relative positions of London and Paris in the international competition among financial centres, they also reveal two different settings for the making of 'joint regulation'. In London, in parallel to the public authorities that collectively defend the City's financial dominance through 'light-touch regulation', an ancient corporation not only represents and promotes the City's interests, but still runs the Square Mile and its municipal infrastructures through its elected members. In France, the landscape is less united and structured, even though the remains of French dirigisme can still be used by the private sector (Schmidt, 1996): as we have seen, a former senior civil servant turned CEO of a non-EU bank was appointed by the Finance Minister to draft a consensus report and express the French voice on the revision of MiFID.

The social division of labour in the field of financial intermediation

Over the past four decades, financial analysts, asset managers, traders and investment bankers have certainly gained power over firm managers (Aglietta and Rebérioux, 2004; Davis, 2009). But talk of the supremacy of the investors' rationale should not be misunderstood. It does not mean that the final principals in the financial system – individual investors, pensioners, issuers – are eventually better off. What the investors' rationale actually means is the asymmetrical distribution of material and symbolical resources, to the benefit of financial institutions and among financial intermediaries. For instance, the main stakeholders' assessments of MiFID replicate their positions in the social division of labour in the field of financial intermediation. This constitutes the second dimension of our political economic analysis of European financial regulation.

Financial intermediaries are all the more inclined to praise MiFID and call for only minor revisions since they are large financial institutions predominantly operating on their own behalf or on behalf of professional investors. They are the greatest beneficiaries of MiFID, and strongly oppose any regulatory move that may undermine the profits they make from darker and more opaque equity trading in Europe. This position is openly defended by UK industry associations like the AFME (Association for Financial Markets in Europe) and the BBA (the British Bankers Association). The London-based AFME, which represents major global financial institutions (investment banks and the investment branches of the largest universal banks) operating in and from the City,[21] stated that 'proposed policy changes are disproportionate to the regulatory issues described and will therefore have an overall negative economic effect' (AFME reply 2011: 3), while the BBA went even further and warned against 'significant deleterious effects' (BBA reply 2011: 3). While occasionally acknowledging opportunities for some 'targeted amendments' (BBA reply 2011: 3), they stick to their positions, with arguments based on 'user choice' and 'flexibility' leading to 'welfare maximization' and 'efficiency of financial markets'. In their view, such goals can only be reached through unfettered competition and lenient regulation.

The UK industry associations continuously stress that 'it is vital that these [regulatory improvements] are proportionate to the actual problems identified, are based on robust and thorough impact assessments that demonstrably support any new legislative requirements, and do not impinge inappropriately on user choice, innovation or competition' (AFME reply 2011: 2; see also BBA reply 2011: 3). The evidence the UK associations call for is often impossible to provide, first because of lack of data and second because it is based on metrics and concepts that, by construction, show an improvement in market quality.[22]

This strategic positioning is obvious in the debate on transparency and the consolidation of market information. Concerning pre-trade transparency, these associations insisted at the very least that it should not be prioritized, and generally warned against a 'complex and (likely) contentious' issue (AFME reply 2011: 58; BBA reply 2011: 35). In their view, 'a number of services exist to provide a high level of pre-trade transparency' through Bloomberg, Markit and other data vendors. Concerning the post-trade consolidated tape, they were more inclined to acceptance, even though the AFME would prefer to let market players propose a market-driven solution (rather than regulation by a public authority or even an industry body). On these issues, the positions of dominant players such as Goldman Sachs or Citadel were in line with the AFME and BBA.

The three French industry bodies which represent the banking sector (Fédération française des banques or FBF) and the financial intermediaries (Association française des marchés financiers or AMAFI, and Association Française de Gestion or AFG) took a much more critical approach. Since they not only represent investment banking professionals but also universal banks, smaller brokers and asset managers which mainly operate locally and on behalf of their clients, they supported the competition created on monopolistic exchanges by MiFID through SIs or MTFs, but highlighted the general deterioration of market quality and organization, especially for small and medium-sized intermediaries. 'Indeed the directive itself has brought about asymmetries, not the economic crisis which, although it has made the markets much more volatile, has not affected their efficiency in terms of liquidity or resilience' (FBF reply 2011: 3). The AMAFI was even more critical: 'The Commission's consultation paper is an exercise in contradiction. After a self-satisfied introductory section explaining that MiFID has met all its objectives, it sets out 147 questions over 83 pages, which to all intents and purposes revisit virtually all the points that make up the directives' (AMAFI reply 2011: 13). The AFG has always stressed the negative consequences of having fragmented markets dominated by low-latency funds or proprietary traders (AFG reply 2011: 3). Nonetheless, pre-trade transparency is not presented as a priority. Both the FBF and AMAFI consider that transparency should be preceded by the consolidation of clearing and settlement services in Europe. Although pre-trade transparency would be necessary to reinstall the formal equality between trading parties that pre-existed MiFID and help detect market abuses, these professional associations do not strongly support it. Contrary to the homogeneous AFME, the AMAFI, AFG and, to a lesser extent, FBF have broader and more diverse memberships which force them to defend a less coherent, much less categorical position, despite general criticism of MiFID.

In line with our analysis based on the social division of labour in the field of financial intermediation, the most vocal critics of MiFID are found among the representatives of issuers, that is listed companies. The Association française des enterprises privées (AFEP) delivered the most critical assessment of MiFID, basically calling for mandatory pre- and post-trade consolidation of market data for shares and all standardized financial instruments (AFEP reply 2011: 3, 28–9). They repeatedly referred to the US NBBO rule that requires intermediaries to guarantee to their clients that orders are executed at the best price across competing trading venues. In contrast, the CBI (Confederation of British Industry), adopting a macroeconomic rather than a non-financial firm-oriented perspective, repeated the mantras of the financial institutions most heavily involved in trading activities: increase market liquidity, maintain flexibility and user choice (CBI reply 2011).

Stock exchanges and MTFs all express a desire to improve post-trade transparency through the creation of a consolidated tape – but this apparent consensus masks strong disagreements. The London Stock Exchange, which is under greater pressure than NYSE-Euronext and has longer experience of a competitive market for markets, gave the impression it would be willing to align regulation of exchanges on the softer rules that apply to MTFs, whereas its pan-European rival tried to gain the support of public authorities and regulators by emphasizing the relations between market infrastructures and the prevention of systemic risks. Both incumbent exchanges, however, strongly opposed any pre-trade consolidation of market data. Even Chi-X, their rival MTF, formally stated that such a solution ‘should not be disregarded’ (Chi-X reply 2011: 37). The oldest exchanges made no calls for consolidation of pre-trade information, partly because they did not want to be criticized as ‘monopolists’ and partly because they considered that it could not be obtained from the Commission for nothing.

In such a context, consolidation of post-trade transparency was seen as the lowest common denominator between market participants, including issuers and investors as well as regulators.

The forgotten lessons of financial history

According to most EU technocrats and the most influential stakeholders in the revision process, private or public, the only possible future outcome remains the privatization of trades and trading platforms, argued to be the best and only way of generating the liquidity the economy needs. Yet financial history has shown that strict market regulation and trade reporting are not contradictory to thriving financial markets. Three decisive lessons can be drawn from the past: capitalism and market economy are not the same thing; strict complementarity between OTC and on-exchange trades matters; stock exchanges used to be regulating institutions rather than temples for speculators.

Capitalism and market economy are not the same thing

Since the 1960s surge in cross-border financial transactions executed outside incumbent exchanges, private non-transparent markets have steadily gained ascendancy over public financial exchanges. Fernand Braudel has brilliantly shown how the tensions between the two systems are actually inherent to the development of any national economy (Braudel, 1979, 1988). The dominance of private markets over public markets may even be seen as a relevant indicator of economic financialization and the pre-eminence of the main financial practitioners.

In this perspective, financialization is not only the actual supremacy of investors’ chrematistic interests over any other stakeholders’ views. It should also be interpreted, at the most general level, as the contemporary ascendancy of capitalism over the market economy. And since Minsky (1975, 1982) and Kindleberger (1986), we know that when capitalism dominates a market economy, financial markets as a whole suffer from ‘over-trading’ and the next crisis is about to materialize. While the biggest financial institutions certainly benefit from this imbalance, over-trading jeopardizes the stability of the financial system to the detriment of all financial agents and, more seriously, of society as a whole.

Complementarity matters

A strictly complementary dual system composed of OTC markets (confined to block trading between professionals) and public regulated markets can contribute to satisfactory and orderly development of financial activities. The history of the French financial markets reveals as much, and more besides. For instance, the landmark period of France's financial expansion that began in the mid-nineteenth century under the Second Empire and lasted until the 1930s coincided with a clear dual market structure. Stock exchange members (*agents de change*) subject to close ministerial oversight operated on the *parquet*, offering guaranteed low transaction costs, reliable trade execution and publication of the official list; while the *coulisse*, an unregulated parallel market, provided a handful of wealthy traders with greater opportunities for speculation but with much higher risk (Hautcoeur, Rezaee and Riva, 2010; Hautcoeur and Riva, 2007, 2012; Lagneau-Ymonet and Riva, 2011).

In Italy a similar separation existed between the stock exchanges of Milan and Genoa. During the Giolittian Era (1892–1914) the financial markets developed promisingly around the Milanese bourse, comparable to Paris' *parquet*, and the Genoan exchange, similar to the *coulisse*. Genoa's domination over Milan explains the severity of the 1907 stock market crisis, while the charter act passed in 1913 imposed the Milanese model on all Italy's stock exchanges, curtailing financial activities for an extended period in Italy (Riva, 2005, 2007). The Italian experience shows that proper linkage between the OTC and official markets is not only necessary; it is also hard to find.[23]

Exchanges as regulating institutions rather than temples for speculators

In nineteenth century France, the development of the Paris *bourse*, by far the biggest French stock exchange, and the formation of the Compagnie des Agents de Change de Paris cannot be separated from the official stockbrokers' aim to protect themselves against the risks involved in speculation, especially legally contested forward operations with no actual delivery of securities (Lagneau-Ymonet and Riva, 2011). This was anything but a free choice. It was the result of the contested interactions and power struggles between stockbrokers and government. By refusing to legalize forward operations until 1885, the public authorities transferred the default and counterparty risks to the *Compagnie des Agents de Change,* which was held fully responsible for the orderly operation of the stock exchange. The government's position forced the stockbrokers to trade prudently, since individuals were at risk of losing fortune and social standing, and groups were at risk of losing the foundations of their revenues and social position: their monopoly on trading in securities they listed. It was only after a century of constant, clear allegiance to the interests of successive governments that the stockbrokers were granted legal recognition for forward operations. This allegiance was possible because the stockbrokers shaped the organization of the market and built up their social cohesion for that very purpose.

The organization of the official Paris stock exchange was designed to create a transparent, relatively stable and safe market. Transparency reduced (without completely eliminating) problems of information asymmetry and facilitated strictly fair comparison of supply and demand. Also, the strict rules of the exchange were intended to reduce market risks by containing the 'money-lust' of intermediaries and their investors. Last but not least, the guarantee provided by the intermediaries (through their unlimited personal liability and a common fund created in 1818) for all operations on the official market meant that users would not lose a centime in the event of default by the stockbroker. This enabled the stockbrokers to legitimate their operations by showing the reliability of their organization in critical times (Hautcoeur and Riva, 2012; Riva and White, 2011). Selection of candidates from an increasingly higher, homogeneous social milieu, and incorporation by the stockbrokers of the social dispositions appropriate to the corporative order produced group cohesion which, in turn, contributed to the social stability of the market (Lagneau-Ymonet, 2009; Riva and White, 2011). Preda rightly argues that 'throughout the nineteenth century, the consolidation of stockbrokers as a status group went hand in hand with the consolidation of the stock exchange as an institution' (Preda, 2009: 75). This brief overview of the history of the corporative organization of official stockbrokers in France reveals that self-regulation only works if it is balanced by a discipline deeply rooted in the market operators' *habitus*. The time of the official stockbrokers and their old boys' system may have passed, but in France and elsewhere in Europe, strictly conditional self-regulation with strict discipline demonstrated over the long run remains a powerful regulating idea today.

Conclusion

These historical examples should serve as reminders that orderly development of financial activities hinges on the fit between strictly regulated exchanges and over-the-counter trades. They may not provide a miracle solution for balancing the two types of organization, but they do remind us that when the public authorities fail to restrain the self-interested preference for more opaque and less strictly regulated trading venues shown by the largest market participants (institutional investors as well as large intermediaries) the next crisis is about to materialize. For this reason the ongoing convergence towards increasingly privatized trading systems should be refused outright.

The MiFID review could have been an opportunity to re-establish regulated markets as the linchpin of Europe's stock market architecture. It would not have harmed economic development to give regulated markets a general interest mission at the European level similar to their long-standing mission at national level: centralize, consolidate and publicize both post and pre-trade information, as a public good (see box next). This would not have been enough to eliminate crashes and bubbles altogether, but it would have made them less likely and mitigated their harmful effects. Above all, it could have been a step towards reasserting the public dimension of financial markets in market economies, and consequently restoring the balance of power between public and private actors in the making of European financial (joint-)regulation.

A different 'mainstream' reform was conceivable

Regulated market status could have been coupled with a general interest mission. In this approach each regulated market would have received, consolidated, supervised and re-disseminated relevant market data (price displays, tradable quantities and order types) from trading venues that handle the securities of its listed companies; the same information would have been sent to the regulator.[24] As things stand, regulated markets are best able to perform these functions because they have the necessary knowledge, resources, skilled staff and information systems. Multiple listing of the same stock on several regulated markets has not developed to such an extent as to rule out some form of cooperation between them.[25]

Regulated markets could thus be linked to other trading platforms in Europe by an IT network incorporating information about trading in their listees' securities, while intermediaries would be free to execute orders as they see fit. The advantage of this architecture, similar to the system in place in the United States,[26] is that best execution would not come down merely to identifying the best price. Market participants could take into account cost differentials arising from the fees charged by different platforms, and the fragmentation of Europe's post-trade services.[27] Ideally this system would lay the foundation for construction of a unified clearing and settlement system to be shared at European level, and would not only reduce costs but help the European System of Central Banks supervise systemic risk more effectively. Accordingly, this renovated architecture of European financial markets would provide all market participants with all relevant information, thereby reducing the information rent earned by the biggest practitioners. It would also facilitate trading supervision, especially the detection of market abuse. The availability of this information, as well as its effects on the competitive playing field and on regulators' duties, would be valuable externalities. Consequently, the financing of technological infrastructures and the compensation of surveillance personnel could be based on pooled costs, which would be divided up among all trading systems based on the ratio of their trading volumes to the volume of securities admitted to listing on each regulated market.

Defining centralized stock market information as a public good is not only possible, it would also be coherent. This is because the gathering, supervision and dissemination of market data is consistent with the definition of a 'service of general interest' as enshrined in European regulation, given that these activities 'touch on the central question of the role public authorities play in a market economy, in ensuring, on the one hand, the smooth functioning of the market and compliance with the rules of the game by all actors and, on the other hand, safeguarding the general interest, in particular the satisfaction of citizens' essential needs and the preservation of public goods where the market fails'.[28] While it falls to the public authorities to determine what is or is not a service of general interest, such services can certainly be provided by undertakings using different constitutional arrangements.[29] Such a proposal would not have challenged the diversity of market operators, nor would it have distorted competition. Cost pooling – an option compatible with prevailing legislation – would actually have restored the sacrosanct 'level playing field' that MiFID has skewed by placing the cost burden of providing transparency and stringent trading supervision on traditional exchanges only. Moreover, trading supervision – whatever the order execution method – would have been made easier by concentrating and providing access to all available information about trades in securities listed on Europe's stock exchanges. This would have helped restore the ties, loosened by privatization, between regulators and regulated markets, both at EU level and in each European financial centre.

Notes

1. http://ec.europa.eu/governance/better_regulation/index_en.htm.
2. http://www.corporateeurope.org/sites/default/files/publications/CEOlobbylow.pdf.
3. For up-to-date metrics on the topic, go to http://fragmentation.fidessa.com/. In September 2011, the trading fragmentation for the largest French listed company, Total, was as follows: regulated market and MTF 23.94 per cent (including NYSE-Euronext Paris, accounting for 12.73 per cent), OTC transactions 73.9 per cent, Internalizers and dark pools 2.16 per cent.
4. For the United Kingdom, see Moran (1991); for France, see Lagneau-Ymonet (2009); for Germany, Lütz (2000).
5. As it happens, economic efficiency and performance do not appear to result automatically from demutualization, according to recent empirical studies (Morsy and Rwegasira, 2010; Serifsoy, 2008).
6. Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council directives 85/611/EEC and 93/6/EEC and European Parliament and Council Directive 2000/12/EC (2003/C 71 E/07) – COM (2002) 625 final – 2000/0269(COD), OJEC, 25 March 2003.
7. Investors could still ask for their trades, especially large-size orders, to be executed outside a regulated market over the counter.
8. MTFs can be operated by an investment services provider or a regulated market operator. The securities of companies listed on regulated markets can be traded on MTFs under less stringent oversight and trade reporting requirements. Internalizers are banks that match their clients' orders against their own inventory without presenting orders on a market.
9. Dark pools are MTFs that take advantage of pre-trade transparency waivers under MiFID and exemptions granted by national regulators. At the name suggests, dark pool trading is non-transparent.
10. Crossing networks are systems put in place by banks to match orders automatically, with no reporting requirements.
11. The Federation of European Stock Exchanges (FESE) has reported an increase in spreads post-MiFID (FESE, 2009: 7). CESR stresses that regulated markets have seen an increase in spreads on the most actively traded shares since end 2007, and notes that many intermediaries have come to the same conclusion. Regarding the effect of the crisis, even the collapse of the Lehman Brothers does not appear to have heightened the widening of spreads on the London Stock Exchange, a trend that has continued regularly since MiFID came into force (CESR, 2009: 18–19). Further, a CFA Institute study of 44 European stocks in the Dow Jones Stoxx 50 index shows that their spreads have been extremely volatile but there is no meaningful correlation between the degree of fragmentation and spread movements (CFA Institute, 2009). However, the same study points to a particularly steep decline in spreads in the UK (CFA Institute, 2009: 41), whereas the LSE complains that the opposite is true.
12. Some 200 intermediaries operate at the European level. The ten largest firms, all of which are British or American (considering that most of Deutsche Bank's trading activity is handled by its London-based teams) generate approximately three quarters of all transactions (AMAFI, 2010: 14).

13. Many alternative trading facilities have introduced a pricing system that rewards order senders that provide liquidity and charges those that absorb it. In the United States, this rationale has resulted in charging for insider trading: with a flash order, a market participant pays an extra commission to the trading platform to see the order several milliseconds before its competitors.
14. Moreover, MTFs create single liquidity pools by combining their dark pools and their order book. To employ a metaphor, watering down an espresso makes the water less transparent and the coffee less tasty. Likewise, if transparent transactions are mixed with opaque transactions, they themselves will become opaque.
15. This strategic stance is based on the questionable idea that regulated market status engenders costs but no benefits for the operator(s) of such markets. But to promote their interests to public authorities and regulators against those of other trading platforms, the operators could argue that their status is also a valuable resource, notably in terms of reputation. The fact remains that the potency of that resource diminishes as regulated market operators themselves open opaque trading platforms.
16. European Commission, *Public Consultation. Review of the Markets in Financial Instruments Directive*, 8 December 2010. Issues related to the trading of derivatives are addressed by Isabelle Huault and Helène Rainelli-Weiss in this volume.
17. For instance the DG Internal Market is staffed by 461 people, and over 4200 comments were received for the MiFID revision.
18. In a meeting with a member of the staff of Finance Minister Christine Lagarde (February 2010), we received confirmation that French authorities and regulators downplayed their demands in order to avoid regulatory battles and find common ground for reform with the City.
19. The replies to the consultation paper issued by the Commission on MIFiD are classified as follows: (INSITUTION-reply 2011: XY). All the documents are available at https://circabc.europa.eu/faces/jsp/extension/wai/navigation/container.jsp.
20. Mathieu Rosemain, 'Le "prudent" rapport sur la MiFID est bien accueilli par la place', *Les Echos*, 19–20 February 2010.
21. www.afme.eu. The AFME was formed in 2009 when the London Investment Banking Association merged with the European arm of the Securities Industries and Financial Markets Association. At the time of writing, the chair (Fall 2011) was Gaël de Boissard, co-Head of Global Securities at Credit Suisse.
22. For example, the AFME defines a liquid market as a market where 'there are sufficient buyers and sellers at all times such that transactions are rapidly concluded with minimum price impact' (AFME reply 2011: 3). Under this definition, the MiFID effect can only be assessed as positive (the higher the number of platforms, the higher the number of potential players; the more fragmented and opaque the markets, the lower the price impact of an order). Nevertheless, not all potential participants can access all the markets, and nothing is said about the actual cost of trading in such a messy environment.
23. In the United States, most fixed-income business moved from the New York Stock Exchange to the OTC market in the 1940s under the influence of large institutional investors, which dominated this type of trading. Yet higher

trading costs and lesser transparency prompted smaller issuers and investors to stick with the Big Board (Biais and Green, 2007).

24. While the dual 'exchange/OTC' structure is constant throughout history, it can have a detrimental effect – as we have seen – if it abolishes the distinction between these two separate, contrasting types of market. The revised directive should therefore disallow dark pools and crossing networks. One way of curbing the expansion of over-the-counter trading would be to design Basel-style ratios that calculate OTC trading volumes as a percentage of volumes traded on regulated markets. The ratios would be binding and modulated according to the status and balance sheet components of the financial institution. Moreover, banking supervisors could use the TREM system – overhauled and extended to OTC markets – to oversee compliance with the ratios. Non-compliance would be punished by suspending the institution's banking licence.
25. At present, regulated markets compete indirectly with each other when they develop opaque platforms to trade the securities of companies listed on other regulated markets (AMAFI, 2010: 7).
26. In the United States an electronic system technically comparable to the system outlined here already links financial exchanges, which are legally required to reroute orders to the market displaying the best price. The system exists only because the clearing and settlement system has been unified in a mutually owned structure.
27. Because of differences in fees and clearing and settlement costs, an order executed at the best obtainable price may not always be the cheapest outcome for the end investor. For professional investors, this situation is compounded by speed-of-execution issues.
28. http://europa.eu/legislation_summaries/competition/state_aid/l23013_en.htm.
29. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions of 12 May 2004 titled 'White Paper on Services of General Interest', Brussels, 12 May 2004 – COM (2004) 374 final; Lee (2010).

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7

Finance in Public Service: Discreet Joint Regulation as Institutional Capture at the Paris Commercial Court

Emmanuel Lazega and Lise Mounier

Introduction

Businesses of all kinds are usually very keen to participate in regulation of their own sector. One way of contributing to regulatory activity is to exercise influence in the State institutions set up to solve conflicts between businesses and discipline entrepreneurs. This can lead to institutional capture, which we redefine at the institutional (not individual) level as an extreme form of joint regulation. This chapter describes and illustrates one of the ways the financial industry effectively runs a State institution through analysis of the operations of a judicial institution, the Paris Commercial Court. This is France's main first-level commercial court, and its judges are lay volunteer judges, that is, business people elected by their business community through their local chamber of commerce. The court functions as an institution of discreet joint regulation of markets, hearing commercial litigation and bankruptcy cases. It is a contested terrain, the object of broader conflicts played out outside the court buildings. We focus on how this court handles bankruptcy proceedings, observing the composition of chambers, the judges' networks, and the normative choices made by bankers when dealing with insolvency and recovery plans. The results illustrate the financial industry's domination of this institution, and its epistemic, normative and regulatory influence. This exposure of the connections between discreet joint regulation, the dual role of finance, and institutional capture more generally shows it is time to re-examine the inner organizational, structural and normative workings of economic and legal institutions, from the perspective of protecting the public interest in regulation of capitalist economies where the private/public sector boundaries are increasingly blurred.

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Redefining institutional capture in the social control of markets

Businesses are usually very keen to participate in the governance and regulation of their markets. This chapter looks at an extreme example of collective organization to that end: capturing and effectively running a judicial institution, namely the French commercial courts, a four and a half century-old institution. France has a long tradition of the State sharing its judicial power with the local business community. As early as 1563, corporations successfully negotiated what could be considered a 'joint regulation' agreement with the public authorities, instituting a form of shared government for markets. This agreement created special courts for commercial affairs presided over by lay, volunteer judges, that is, elected members of the business community who are not paid for the job. French commercial courts are truly judicial, first-level courts. They solve conflicts between businesses or between businesses and consumers (commercial litigation). They also exercise a form of discipline on market exit by handling bankruptcy cases. Their capture has resulted from a complex historical and institutional process. The focus here is on the dimension of this process that is brought to light by social network analysis.

One definition of institutional capture is 'the efforts of firms to shape the laws, policies, and regulation of the State to their own advantage by providing illicit private gains to public officials' (Hellman and Kaufmann, 2001). We suggest that this definition is over-focused on individuals. We believe that the definition of the process of institutional capture should be broadened to encompass corporatist efforts to design or redesign institutions, influence decision-making in rule enforcement and secure collective gains for interest groups in those institutions. These factors extend collective actors' capacity to reap invisible advantages. A court can thus be considered 'captured' when interest groups are successful in using their influence to benefit systematically from its decisions.

The French commercial court system as an institution represents a form of joint governance, or a combined regime of endogenous and exogenous conflict resolution in markets. The term 'joint' applies because in practice, governance is often a combination of self-regulation and exogenous regulation, and in this combination the costs of control are shared. The joint element in 'joint governance' can be defined as the coexistence of several sources of constraint, both external and internal, restricting the actors in charge of solving conflicts and enforcing rules (Ayres and Braithwaite, 1992; Dunworth and Rogers, 1996; Hawkins and Thomas, 1984). Seeing joint governance in these terms follows both an organizational and a broadly conceived structural approach to economic institutions (Favereau and Lazega, 2002; Lazega, 2009; Lazega and Mounier, 2002; Reynaud, 1989).

Courts are undeniably a locus of joint governance. They are not static institutions making atemporal, purely rational decisions (Heydebrand and Seron, 1990; Wheeler, Mann and Sarat, 1988). They are a contested terrain, the prizes or objects of broader economic competition and conflicts that occur outside the courts (Flemming, 1998). This is particularly true of courts where the judges are business people elected by their local business community. Attempts from outside the court to influence what goes on in court come from various angles. Flemming (1998) lists five such angles: external stakeholders can try to influence jurisdiction (the range of disputes over which the court has authority), positions (actors formally authorized to participate in the disposition of cases), resources (the capacity to influence the decisions of other actors), discretion (the range of choices available to actors) and procedures (rules governing courtroom processes). The parties involved in this contest may not be directly concerned by all the conflicts dealt with by the court, but they may have indirect material or symbolic interests in the court's rulings, and thus attempt to influence what goes on there.

Flemming's categorizations focus attention on specific processes of influence. We study the two processes concerning positions and resources (to borrow Flemming's vocabulary), and the relationship between the forms of influence they represent. This involves examining who is allowed to become a judge, and what kind of resources are made available to them when they sit in judgement, and when they participate in governance of firms through solving conflicts between businesses.

Collective actors involved in conflicts on the markets, such as companies, whole industries (in class actions, for example) or even State administrations, may have strong incentives to influence the appointment of judges and the resources available to those judges. The more litigious the sector the stronger the incentives to share the costs of conflict resolution. Such collective actors are usually considered as external actors. A concern for long-term protection of their interests provides the incentive to influence the court's decisions. They may do this by helping selected members of their own community to become judges. The stronger their incentives, the greater their desire for representation among the judges. Once in a position to solve conflicts between parties, these judges have combined incentives to influence the court's decisions: they represent the law and are supposed to be strictly impartial; but they may also represent, and therefore may seek to protect the interests of, the organizations that supported their becoming a judge in the first place.

Influencing who becomes a judge and what resources are available to judges can be a very strong, although indirect, way of influencing court case outcomes. Joint deliberation by a bench of judges is a mainstay of French legal institutions. Such deliberation – whether formal or informal – relies heavily on knowledge management by the court. This brings us to the second process (from Flemming's list mentioned earlier) through which influence on joint governance is exercised in such institutions. One way to influence judges' behaviour is to try and set the premises underlying their decisions, by attempting to control the information available to them while sitting in judgement. Judges from a given sector of the economy may act like 'judicial entrepreneurs' (McIntosh and Cates, 1997), attempting to keep particular legal definitions alive, or promote ideas, customs, rules and interests that are commonplace in their sector but not in others. Influence over the premises of decisions can be assumed to affect the probability of winning a case, even though this 'framing control' by players is almost invisible to outside observers.

The law and the courts are aware that various actors in the court's environment will engage in such influence attempts. Anticipating that the court will be targeted in this way, the legal system lays down rules concerning conflicts of interests for judges: when they are too closely linked to one of the parties – for example, when they are to sit in judgement on a potential or actual competitor, they must step down from the case; if they do not and the conflict of interests is discovered, they will be removed from the case by their hierarchy. However, a structural approach to joint governance raises the issue of how far such procedural attempts succeed in neutralizing external influences (Lazega, 1994), especially when the judges are elected volunteers. To summarize, given the incentives identified earlier, influence on judges can be expected to take the form of intensive efforts by interested sectors to shape the court, especially through selecting the judges and promoting normative choices that provide overall support for their interests.

This chapter analyses the operations of a judicial institution, the Paris Commercial Court, France's main first-level commercial court. This court is staffed by lay judges, business people elected by their business community through the local chamber of commerce, and handles commercial litigation and bankruptcies. As stated before courts are not static institutions making atemporal, purely rational decisions. They are a contested terrain, the object of broader conflicts that are played out outside the courts. Through a study of the operations of this court with observation of the composition of chambers and qualitative interviews with judges, we examine some characteristics of this type of institutional capture, particularly the normative choices made by bankers judging bankruptcy cases. The results illustrate the normative and regulatory influence of the financial industry, showing a need to re-examine the inner workings of economic and legal institutions from the perspective of protecting the public interest in regulation of capitalist economies where the private/public sector boundaries are blurred.

Consular commercial courts as institutions of joint regulation

French commercial courts, also known in French terminology as 'consular courts' (*tribunaux consulaires*), are staffed by 'consular judges' (*juges consulaires*). An explanation of the term *consulaire* is in order. The *consulat* was a mode of urban government practised in the Middle Ages in the southern part of the Kingdom of France by cities with a right to self-administration and self-defence. 'Consulatus' derives from 'consul', meaning 'council'. The word referred to a community's ability to deliberate together in an assembly likewise called the *consulat*. Urban communities governed by a *consulat* could call themselves cities. All had markets and many had fairs. In a 'consular regime' the community was self-governed by way of consuls, who varied in number and qualifications. Merchants organized into socially distinct guilds occupied an important place in this regime. On the basis of the *lex mercatoria*, they managed to negotiate with the State a kind of joint regulation of their business activities within the consular framework: local self-regulation was to be founded on the State's sanctioning power. The State, given its own as yet embryonic administration, may paradoxically have seen this co-optation by local merchants as a means of further extending its central control over the country. A major component of this 'consular regime' is the *tribunal de commerce* or commercial court, whose content evolved over time.

Each consular judge acts as both an individual judge and a representative (presumably with no explicit mandate) of the business community. Consular judges are unpaid volunteers elected for terms of two or four years (up to a maximum of 14 years) through their local Chamber of Commerce. The two economic institutions (Court and Chamber of Commerce) support each other financially and politically, and maintain close ties. Judges are elected after a complex procedure (Falconi et al., 2005) that begins with individually obtaining the support and approval of a professional association (e.g. the French Banking Association or the French Hotel Industry Association). The electoral body is composed of current commercial court judges, and representatives of employers' associations (some of whom supported the candidates in the first place). A small administrative unit of the Chamber of Commerce searches for new candidates, interviews and selects them, and draws up a single list of candidates (exactly as many as the number of seats to fill), that is then put to the vote of the electoral body for formal rubberstamping. Consular judges have thus co-opted each other for centuries, in a way no section of a democratic government is usually allowed to self-perpetuate.

In this institutional arrangement, the State, industries and companies, and the individual judges share the costs of exercising social control of business. The court sits one day a week to enforce law and customs among the judges' peers. Decisions made by the court can be challenged, as in any other court, before the Court of Appeal, whose judges are not business people, but highly trained professional magistrates. There are at least two categories of unpaid volunteer consular judges in the system: firstly, retired business people looking for social status, an interesting occupation and social integration; and secondly, younger professionals – bankers, lawyers, consultants – looking for experience, status and social contacts, sometimes on behalf of their employer (who continues to pay their salary while they are serving as a judge at the Court). If the individual judge is young enough, appointment to the court can help build a useful network of contacts (as explicitly stated in the brochures designed to attract new judges to the job) and pave the way to future positions in economic institutions such as the Chamber of Commerce itself, the Conseil Economique et Social (a powerful advisory board to the Prime Minister), and other honours dispensed by the State apparatus. For younger professionals, being a judge at the Paris Commercial Court has traditionally been considered a 'chore' rewarded in later years with seats on prestigious committees in France's economic institutions. Various types of lucrative contracts and missions to 'preventively' advise companies may also be awarded to former judges at the discretion of the current President of the Commercial Court. Consular judges can also become arbitrators in lucrative arbitration courts once they have served the maximum 14 years in the public court.

The consular judges see several justifications for this joint governance system. First, it is a cheaper and faster form of justice than a system with career judges. Business bears more of the costs of its own regulation, backlogs are much smaller and waiting time is shorter than in traditional High Courts. For example, there is no case law at this level of the court system. Second, career judges – who are civil servants – have often been considered inexperienced in business and unable to understand the trials and tribulations of private companies, or to monitor the behaviour of company directors satisfactorily, particularly in the insolvency and bankruptcy minefields (Carruthers and Halliday, 1998). Third, business law often ignores the idiosyncratic norms and customs (called *usages* in French commercial courts) that derive from traditional subcultures marking whole sectors of industry (Macaulay, 1963; Swedberg, 1993). Consular judges argue that efficient conflict resolution cannot ignore these bodies of rules and conventions that shape business practice differently in each sector. Since they are supposed to be experienced business people, Commercial Court judges are considered specialists in their field, which means they are more knowledgeable than career civil servants about these customs and able to adapt them more quickly to unstable or changing business environments; this puts the judges in a better position to foster regulatory innovations either as experts in their field consulted by Parliament, or as members of think tanks.

In this consular court system, the judges' predicament has always lain in the difficulty of representing both general and particularistic interests. When they are elected from the business community, they can be considered as representatives of the State as well as their community. They may claim they are not 'representatives' with a clear mandate from the industry that helped them become a judge, but members of that industry, and sometimes fellow judges, still expect them to speak on behalf of the industry and its customs. The public has always suspected that patronage appointments lead to politicized elections of judges, who then fail to detach themselves from their virtual 'constituency', that is, the industry that endorsed their nomination. Especially in small towns, litigants' confidence in the commercial court's impartiality is often impaired. They fear that the court could be controlled by competitors. The institution, however, assumes that its judges will be entirely independent despite the proximity between regulator and regulatee.

Over-representation of the financial industry among judges at the Paris Commercial Court

A six-year field study was conducted at the Paris Commercial Court,[1] which is one of the four large commercial courts in the Paris region.

It comprises 21 general and specialized chambers (for matters such as bankruptcy, unfair competition, company law, European law, international law, multimedia and new technologies) which handle around 12 per cent of all commercial litigation in France, including large and complex cases not heard by the arbitration courts. There are around 150 judges each year. Socio-demographic examination of the judges shows that their average age is 59, 87 per cent are men and 38 per cent are retired. Positions occupied (or formerly occupied) by judges in their industry include CEOs (25 per cent), vice-presidents and top executives of all kinds. Among the younger judges, there are more professionals such as in-house lawyers, accountants and consultants. They mostly work for large business groups or medium-sized companies, but the judges prefer to remain discreet about their employers and professional ties. Most judges are highly educated graduates of France's most prestigious higher education establishments: administrative institutions such as ENA and Polytechnique, business schools, law schools and elite engineering schools (known as the *noblesse d'Etat*, literally the State nobility).[2]

The Paris Commercial Court is complex in its organizational operation. Without going into too much detail, several kinds of professionals work there together: consular judges, clerks, business lawyers, prosecuting magistrates, bailiffs, experts of all kinds, professional liquidators and/or administrators (for companies on the brink of bankruptcy that can perhaps be saved). Judges are allocated across the large number of general and specialist chambers. The basic distinction in terms of specializations is between bankruptcy and litigation, which are governed by different procedural rules. But the litigation bench is then subdivided into several specialized areas as mentioned previously. Each chamber has a president who reports to the overall president of the court. In each chamber, cases are heard by a bench of three or sometimes five judges together, who issue their decision after listening to both parties, as in any other judicial court.

According to the justification of this system of joint governance, the elected judges should represent as many sectors of the local economy as possible, especially in large commercial courts such as Paris. At the time of the study, a wide range of economic sectors was indeed represented (the judges' current or former sectors of employment). In complex cases, intelligence about a sector could thus be supplied to the court by judges from that sector. However, some industries or companies invest more than others in 'judicial entrepreneurship' and bear a larger share of the costs of control, because it is in their interest to do so.

Theoretically, all employers' associations can put candidates forward for the annual elections of consular judges (10 per cent of seats are up for election each year), but in practice some rarely do, and some do so much more regularly than others. In 2000, 29 per cent of the judges came from the financial industry. Forty-four consular judges, mostly with a legal background, were current or former employees of the financial industry, which puts several candidates up for election each year.[3] The financial industry is clearly over-represented, in absolute and relative terms, at the Paris Commercial Court. It accounts for around 5 per cent of the working population in Paris, where service industries are over-represented compared to the rest of France. The financial services industry's share of the total value added to the French economy was an average annual 5.3 per cent at the time of the study.[4]

The financial industry is traditionally very litigious (Cheit and Gersen, 2000). The list of cases heard in France, as probably in most countries, is dominated by contract disputes and debt collection issues. For obvious reasons, a sizeable portion of these cases involve the financial industry, which therefore has a strong incentive to invest in judicial entrepreneurship – for example, to ensure damage limitation in cases involving high levels of credit. Banks and financial institutions are often creditors themselves and since they stand to lose enormous amounts, they invest in penetrating the commercial courts and keeping the number of consular judges from their ranks high. With the high amounts of resources at stake in commercial litigation and bankruptcy, the financial industry is willing to play for influence over the rules. It has an interest in trying to shape the court and impose its own norms and practices over those of other industries.

The priorities of the financial sector (such as preserving high asset value and high sensitivity to the impact of corporate bankruptcies on the economy) can thus be defended in both the litigation and the bankruptcy chambers. One of the likely influence processes in joint governance is detectable in the selection of judges themselves (the 'positional' effect in Flemming's vocabulary). Small employers' associations lack the necessary clout to lobby effectively, and the resources to share the costs of control. Not all sectors of the business community can participate equally actively in the contests and attempts to shape the court from outside. Each industry's potential influence in the fight over this kind of contested terrain depends on the resources available to promote candidates for the jobs of consular judge – and those resources are not comparable between the financial industry and less well-organized sectors such as retail.

The following example illustrates the financial sector's interest in assuming a larger-than-average share of the costs of control of the French business world. In 1985, France's socialist government changed the bankruptcy laws to give priority to fighting unemployment. The changes made were obviously consistent with the interests of employees rather than creditors. The new law required judges to rule on whether the companies in question could survive if they were better managed (Guéroult, Lamotte and du Marais, 1993). If the judges decided that a company – and its jobs – could be saved, they were to appoint an administrator (trustee) to take over its management. If they decided it could not be saved, they were to order its liquidation. Banks and financial institutions were often creditors in these cases and ran the risk of losing enormous sums as soon as the new law was passed. For nine years, the French financial sector lobbied politicians to change the law.[5] A defeat in Parliament seems to have driven the sector to switch strategies, and try instead to increase the number of 'its' judges making insolvency-related decisions. In 2006, 21 years after the bankruptcy law's enactment, the financial sector finally secured an amendment in its favour.

As will be shown further,[6] bankers are also the big winners in the struggle for epistemic domination in the commercial court. Our previous results (Lazega and Mounier, 2003a and 2003b, forthcoming; Lazega, Lemercier and Mounier, 2006) expose the informal and indirect influence of bankers with a law degree over their fellow consular judges. A judge's sector of origin has a significant effect on his or her centrality in the judges' advice network. Bankers are over-represented at this court, and bankers with a law degree are so central in the judges' advice network that they exercise strong indirect influence through premise-setting in its decision-making. For example, bankers are mostly non-punitive (Lazega and Mounier, 2009; Lazega, Mounier and Tubaro, 2011; Lazega et al., 2011): they are less keen on awarding 'punitive' damages to plaintiffs in unfair competition cases, mainly because punitive damages can reach enormous amounts; and in many cases the companies with the deepest pockets, able to pay such amounts, are financial firms. Epistemic domination helps bankers impose their discourse, rhetoric and criteria in discretionary decision-making over time.

Money talks

What are the implications of this institutional capture for decision-making in the field of bankruptcy? Scholarly work (Brunet, 2008, 2009) and qualitative interviews with the judges about their preferences with respect to bankruptcy proceedings and possible recovery plans for insolvent companies show variations in discourses and representations regarding sale or continuation of businesses in difficulty that differentiate bankers from other judges and explain their influence over their peers. Analysis of the discourses on bankruptcy, liquidation or recovery plans for insolvent businesses highlights a tendency among consular judges to think of themselves as good people doing the dirty work (in Hughes' sense, 1962) of capitalism. This discourse analysis also clearly identifies three groups of magistrates expressing very different conceptions of the role of 'consular justice', how business should work and how actors should promote their regulatory interests.

The first group of judges gives very serious consideration to the social consequences of bankruptcy decisions, particularly as regards employee salaries and the fate of the entrepreneurs who own the companies. These judges always favour a continuation plan when it will save jobs, as they consider job protection (including management jobs) the primary objective of any recovery plan. A positive representation of entrepreneurs, especially in industry, presents them as the true creators of wealth and innovators in the economy. The company as a complex entity (encompassing social, human, economic and other dimensions) must be protected against financiers who care only about profits. From this perspective, the commercial court is there to protect the industrial innovator by promoting continuation of the business and safeguarding the company, perceived as a source of economic life, and its most committed members, the business owner/manager and the employees. The judges who take this stand – mostly former entrepreneurs from the building, industrial and services sectors – are highly critical of their colleagues who care only about the corporate accounts and debt reimbursement. Judges interested only in the financial aspects of a company are considered as 'gravediggers' of business, incapable of understanding the true economic value of employees and business people. This and their narrow financial logic are considered responsible for the negative image of consular justice in bankruptcy cases.

A second group of consular judges with radically different ideas clearly favours business sale plans, in other words selling off the company to an external purchaser, considering this more viable than continuation plans. Transferring the firm to a new owner brings in new cash and creates a salutary shock for the ailing company because it makes radical reorganization of the business easier. Preserving the social dimension and protecting employees is not the main aim, as it soon leads to failure of the recovery plan followed by liquidation.

Priority is instead given to creditors, who are considered the true developers of economic activity. The creditors are themselves companies and may be affected by their clients' difficulties, possibly to the extent of being pushed into bankruptcy themselves if debtors default on their loans, which in turn creates further layoffs. These judges consider that companies have a lifecycle beginning with birth (formation) and ending with death (bankruptcy and liquidation). Death is thus 'a fact of life' in business. Judges are merely acknowledging this and must not intervene to help companies in difficulty, as that would compromise the general operation of the market. Judges must only act to protect the interests of creditors and their capacity to keep re-injecting capital into new investments, thus driving the dynamics of the economy. This perspective is promoted by a sizeable minority of lay judges from both the financial and industrial sectors. They strongly criticize their colleagues' preference for continuation plans, which in their opinion constitute a practically destructive interference in the natural processes of the economy. The vast majority of them are in favour of selling off the ailing company, so that the market is self-regulating through competition. From this explicitly neoliberal perspective, death of the losers is part of the natural economic cycle; consular judges should not 'feed the zombies' and artificially sustain obsolete companies. Safeguarding jobs by extending the company's existence makes things worse in the long run. These judges are critical of the bankruptcy law enacted by the Left in 1985 (which considers employees as the company's primary creditors) and partly upheld by subsequent conservative governments, but also of what they consider their colleagues' sentimentality with respect to protection of jobs. They see bankruptcy as a purely financial problem: the choice of selling or continuing the business must result from purely financial reasoning, with survival at all costs not an option. The markets and competition will ensure the survival of the fittest through innovation. Favouring sell-offs is thus considered by this group of judges a realistic position that potentially avoids even worse human consequences. The social dimension of the problem must be dealt with outside the market economy:

> I think that a continuation plan must have two potentially contradictory objectives. The first is that there must be at least some chance of the company recovering; it's not worth pushing for a continuation plan if the company will be back at the court six months later. So the judge must put on his businessman's hat and ask: 'Can they make it? Do they have a reasonable chance?' And the second, which matters

> a lot to me, is: 'Will they not disturb the social order?' Social order for me is the whole of competition. That is: by letting a company survive with lower, easier requirements than its competitors … if a company has difficulties, we must kill it off. There are no sick companies. In the jungle, I'm only half-joking, there are no sick animals. The sick animals are all dead. There is no problem with sick animals. Of course, the problem is that this creates social problems. The true problem is social, but that can't be solved in the markets.
>
> Judge 1

> As a banker I can tell you that bankruptcy is a phase in the life of companies. Companies are created; they live and die just like human beings. For financial analysis, the death of a company is the natural fate of the economic body. The question is how to prevent there being too many bankruptcies. Personnel problems need to be treated separately, through occupational retraining.
>
> Judge 2

Protecting a company against competition is thus considered equivalent to giving it a licence not to innovate. It will stagnate with the status quo:

> There's something very frustrating here: I think we live in a society that has completely seized up. There's no attempt to be imaginative. French society is not creative enough. If a company wants to produce textiles, fine. But there will be competition. Sometimes business people know it will be hard, but they don't realize what that means. What it means is that you shouldn't start a business if you don't realize what it means. We lack imagination and creativity; we live in a society of entitlements. I think the true problem is that we believe we're protected whatever happens. We perpetuate rights that we consider absolutely unquestionable, whatever they are, whatever the environment.
>
> Judge 3

A third group of judges – the largest – is torn between these two positions and seeks pragmatic compromises tailored to the specificities of each recovery. These judges want to take all factors into account and find a solution that balances the interests of all stakeholders (owners, management, employees, creditors). They are of the opinion that such a solution is always possible. From this perspective, a judge must favour neither continuation nor sale, nor must he side ideologically with business owners or employees. Laying off personnel and cancelling debt are measures that must be part of the consular judges' toolkit because they are part of the hard reality of business and markets, even if they are problematic for the judges' personal ethics. Sale to an external purchaser can also create tension, because it may sideline the founder of the company whom the magistrates would like to support. Coming from the world of business themselves, many lay judges identify with entrepreneurs in difficulty, and would like to help them:

> Our big role is in bankruptcies. First of all, it's a very diverse and interesting universe: you meet lots of different kinds of people: judges, trustees, companies, bankers, financial backers, etc. And then the idea is not to sanction, but be firm with poor managers and help out good ones. When you see good businessmen in insolvency proceedings because of bad luck, because of the economy, because of a thousand reasons not of their own making, I like to help them get over this crisis and get back into business if possible.
>
> Judge 4

> I tend to favour the owners of SMEs. I spend my time trying to save them or help them out, and that's not the attitude taken by someone with a finance background. Even if matters are sometimes riskier in a continuation plan I tend to try, even when financially, a sale plan looks better. Because the owner of an SME, it's like he's the father of the company, it's his life, that's the long and short of it! If he wants to fight back and if he wants to carry on, I won't sell it off to someone else.
>
> Judge 5

We also noticed that the hesitancy generated by the coexistence of strongly held conflicting convictions is fuelled by internal critiques within the court. For example, one former banker agreed with the critiques of positions taken by judges from her own sector, considering her professional past in banking was a handicap in bankruptcy cases, and contributed to the negative image of the institution. In her opinion, bankers spontaneously favour repayment of debt, and should therefore refuse to handle bankruptcy cases:

> As a professional banker, I'd rather not do bankruptcy work because I'm afraid that my way of working will catch up with me: look

> at the figures and profits, regardless of the human drama behind the figures.
>
> Judge 6

In some discourses, the group of judges who systematically side with creditors is blamed for creating antagonism in the commercial court between entrepreneurs from all sectors of the economy and top executives from banking and finance:

> Bankers and entrepreneurs don't behave the same way, we don't have the same experiences, we haven't lived the same lives. When you've been through all the anxieties of a small business owner, you're more sensitive to the value of continuation than top executives from large companies who never get to know those difficulties. I think that's the big divide: between the people who know what it means to be the boss of their own company, and the rest.
>
> Judge 7

Some judges from the worlds of industry, commerce and services would even like to help failing entrepreneurs prevent takeover by purely financial buyers, who are often disliked. Other judges, we were surprised to realize through our interviews, simply prefer to keep out of bankruptcy work altogether,[7] with arguments such as the following:

> I don't do bankruptcy work because liquidating a company means laying off 15 people and I'm not made to be a liquidator or gravedigger. Quite the contrary, I'm interested in helping out a bit. In my working life, I've always been in charge of development. I develop, I don't bury. I'm interested in creation, not destruction!
>
> Judge 8

The conceptions of business and the role of consular justice with respect to bankruptcy expressed by the three groups of judges can be considered political. They should be related to the economic and political context at the time of the study: nationally famous French companies (such as SNCM, Tati, Moulinex) were filing for bankruptcy, the commercial courts were frequently in the news and the judges felt obliged to frame their discourse so as to respond to the critiques levelled against them. But these conceptions persist beyond the historical context in which they were recorded.

In sum, members of the third and largest group of judges claim to hesitate and steer a pragmatic course somewhere between the positions of the first two groups. They often also think they should not let themselves be guided solely by their own personal preferences, but seek advice from colleagues so as to find and support the solution that is most likely to succeed. In the following section we look at two characteristics of the court that can be considered sociological indicators of institutional capture as an extreme form of joint regulation in specialized institutions. We show that in a situation of uncertainty, the majority of consular judges turn to members of the second group of judges, and thus consult with colleagues who tend to put the interests of creditors first. We then show that bankers tend to be over-represented not only in the court as a whole, but also in its bankruptcy chambers. This indicates that bankers not only make more decisions about bankruptcies than non-bankers, but also dominate the court by advising their colleagues. Given their preference for protection of creditors (since banks are the main creditors in the economy), we can infer from these analyses that any advice provided to colleagues is also likely to favour creditors.

Bankers' epistemic domination in the court

We now look at whether or not judges from the over-represented financial industry are in a position to exercise invisible influence on other judges by providing them with resources such as information and advice. We measure this influence by looking at centrality in the advice network between all the court's judges. We assume that advice interactions between judges are equivalent to interactions setting the premises underlying judicial decisions, especially since bankers – particularly bankers with a law degree – may be sought out for advice because they have more legal knowledge than other lay judges. Patterns of advice-seeking in the court show who is prepared to listen to whom when framing and defining problems at hand in the judicial decision-making process. The advice network between judges can thus be considered as a bridge between structure and decision-making, and an indicator of the bankers' ability to be the main force behind this institution by building its 'epistemic community' (Lazega, 1992). Examining how judges transfer and exchange advice helps measure the capacity of an industry to set the premises of such decisions by looking at the centrality of its representatives in the advice network between all the judges, and then at the determinants of that centrality.

Data on advice-seeking between judges was collected in 2000, 2002 and 2005 using the following name generator:

> Here is a list of all your colleagues at this court, including the President and Vice-Presidents of the Court, the Presidents of the Chambers, the judges, and the 'wise men'. Using this list, please tick the names of colleagues whom you have asked for advice on a complex case in the last two years, or with whom you have had basic discussions, other than formal deliberations, in order to hear a different point of view on a case.

Thanks to the very high response rate, we were able to define the complete advice network (excluding formal deliberations) between the Paris commercial court judges, measuring it three times as a longitudinal dataset, and thus tracking each judge's centrality in this network over time.

As is generally the case in advice networks (Krackhardt, 1990), an informal pecking order or status hierarchy emerges among judges. In order to examine the relationship between bankers and centrality, we included these attributes and several other characteristics of the judges in a regression model predicting centrality in the judges' advice network. In addition to the main variables representing the judges' sector of origin (financial industry background, combined here with holding a law degree), a series of control variables were added to the model. Seniority, measured by the number of years an individual has served as a judge, can be understood as 'experience' and helps a judge wield influence independently of the sector of origin. Another consideration is that the other commercial court judges may not be the only source of advice and influence. Being well-connected and open to the business community can attract colleagues who need economic advice. The same is true of being well-connected and open to professional judges in other courts (especially the Court of Appeal, whose judges are career judges): such external ties can attract colleagues who need legal advice. It may also be true of being well-connected and open to the Public Prosecution office, although monitoring and influence by the Ministry are not always welcome in commercial courts. Being economically active (as opposed to retired) may also have an effect on centrality in the advice network: retired judges may have more time and be more available to discuss issues at length than working judges. Belonging to the State elite (the *noblesse d'Etat* explained earlier) means having connections in high places, with the potential for authority and influence among fellow consular judges. Table 7.1 presents the analysis controlling for these effects.

The results expose the informal, indirect influence of bankers with a law degree over their fellow consular judges. A judge's sector of origin has a significant effect on being central in all three models, particularly when that judge hails from the banking industry and holds a law degree. Figure 7.1 represents the high position of bankers with a law degree in the pecking order of the court. Bankers are over-represented at the Paris commercial court, and among them bankers with a law degree exercise strong indirect influence in the organization through premise-setting.

Controlling for the other variables, active involvement in the social life of the court has an unstable effect (significant in one model only) on centrality in the advice network, and thus on the capacity to set the premises of other judges' decisions. In order to exercise such indirect influence, judges must also be greatly involved in the court and its social life, have and use connections outside the court buildings, and consult with professional judges. In addition to being socially active in the court and being a banker with a law degree, being a senior judge and seeking advice from other sources (the business community and

Table 7.1 Bankers with a law degree as most central advisors in the network of voluntary lay judges at the Paris Commercial Court in 2000, 2002 and 2005

	2000		**2002**		**2005**	
	Parameters	**S. E.**	**Parameters**	**S. E.**	**Parameters**	**S. E.**
Intercept	–3.54	1.02	–1.11	1.65	1.08	1.61
Seniority	0.67	0.08	0.80	0.12	0.72	0.13
'Noblesse d'Etat'	1.13	0.90	3.04	1.42	1.67	1.57
Economically (vs retired)	–0.61	0.63	0.12	0.92	–0.26	1.02
Bankers with a law degree	1.33	0.71	2.93	1.09	3.14	1.32
Participation in social functions	2.36	0.92	0.23	1.30	1.80	1.31
Seeks advice:						
–from business sector	1.61	0.62	0.05	0.92	–1.43	1.14
–from career judges (CoA)	4.49	1.42	5.09	1.93	2.56	1.85
–from public prosecutor	–1.72	0.63	–1.70	1.12	–0.25	1.22

Linear regression model measuring the effect of lay judges' characteristics on their indegree centrality in the advice network in the court.

professional judges) are also good predictors of potential influence in the Paris commercial court. A consular judge's reputation can be built inside the small microcosm of the court by investing in relations with other judges from the same or different courts. Seeking advice from the Public Prosecutor (the State's direct representative in the Paris Commercial Court) is significant and negative in 2000 (under a socialist government): the more contact judges have with the Public Prosecution office and its representatives, the less they are sought out for advice by their peers. In sum, the more socially active a judge is within the court, the more open to discussions with the business community and the legal environment – but less open to discussions with official representatives of the State – the more influence he or she has at the court.

Finally, bankers' influence, particularly when they have a law degree, has effects on decision-making. For example, bankers are mostly non-punitive (Lazega et al., 2009, 2011; Lazega, Mounier and Tubaro, 2011): they are less keen on awarding 'punitive' damages to plaintiffs in unfair competition cases. In bankruptcy cases, bankers' influence does indeed have an effect on decision-making. If we now focus on bankers' involvement in bankruptcy chambers and their propensity to handle bankruptcies in a way that whenever possible favour sale as opposed to continuation of the business, Figure 7.2 represents the composition of the four chambers dealing with bankruptcies at the Paris commercial court in 2000.

The proportion of bankers among the judges in the three bankruptcy chambers is respectively 3/7 and 5/12 for the first two, with one banker belonging to both, and 4/7 for the third chamber. These proportions reflect a strong presence in chambers where bankers have a vested interest, as banks are the main creditors in the economy and their representatives are exposed to serious conflicts of interests when they make decisions concerning company liquidation and priorities of claims on assets (by workers, creditors including banks, clients, suppliers or subcontractors). The most striking proportion is in the fourth chamber, which handles 'Opposition to orders of the bankruptcy judge'. This chamber is equivalent to a small internal appeals court for parties unhappy with decisions made by the judge handling their bankruptcy (*juge commissaire*), and five of its seven judges are bankers. Over-representation of bankers thus reaches a peak in the chamber hearing appeals against decisions made by the bankruptcy court, raising clear conflict of interest issues.

This very high proportion reflects an involvement that can only be interpreted as a form of damage control by the banking industry. Judges from the financial sector are clearly potential levers of influence for their industry. In addition, they are the only group who can dominate

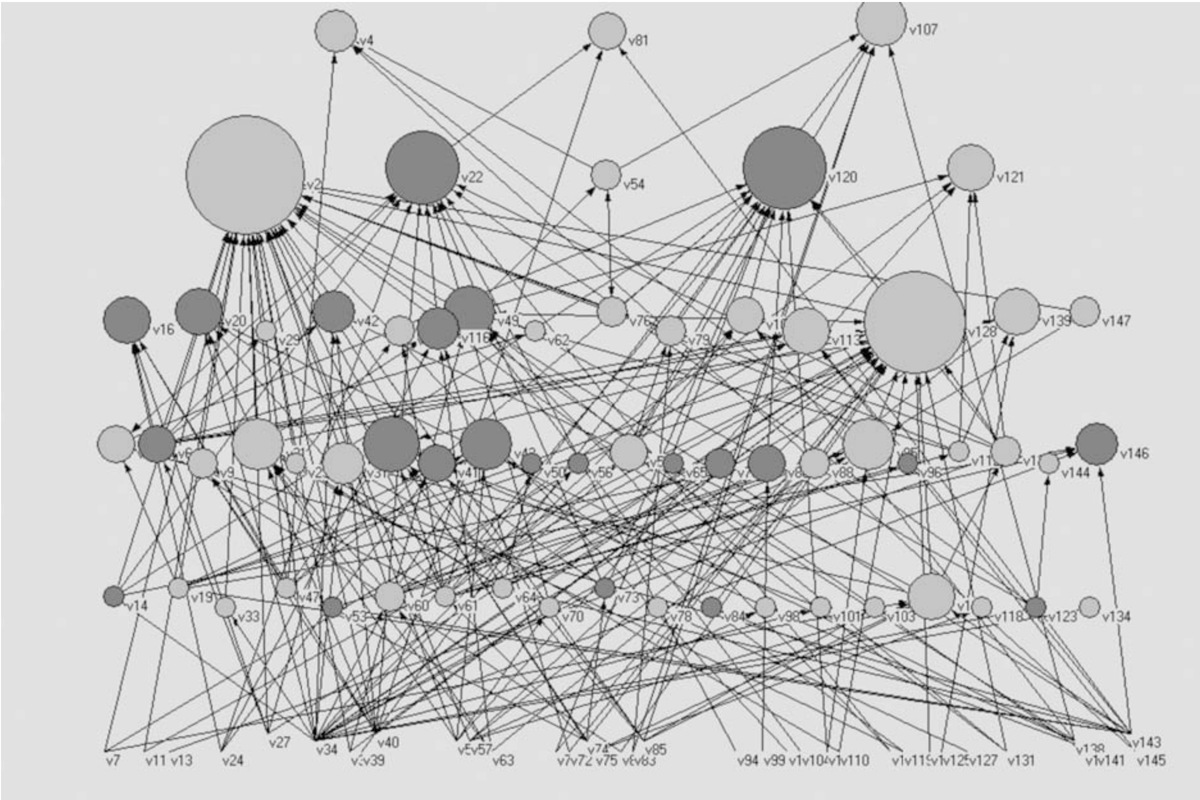

Figure 7.1 Visualization of bankers' position at the top of the pecking order among lay voluntary judges at the Paris Commercial Court

Note: This figure was obtained by focusing on the intersection of the advice networks measured in 2000 and 2002; the informal hierarchy shown here is obtained by taking out all cycles in the network. Bankers are represented in dark grey, non-bankers in light grey.

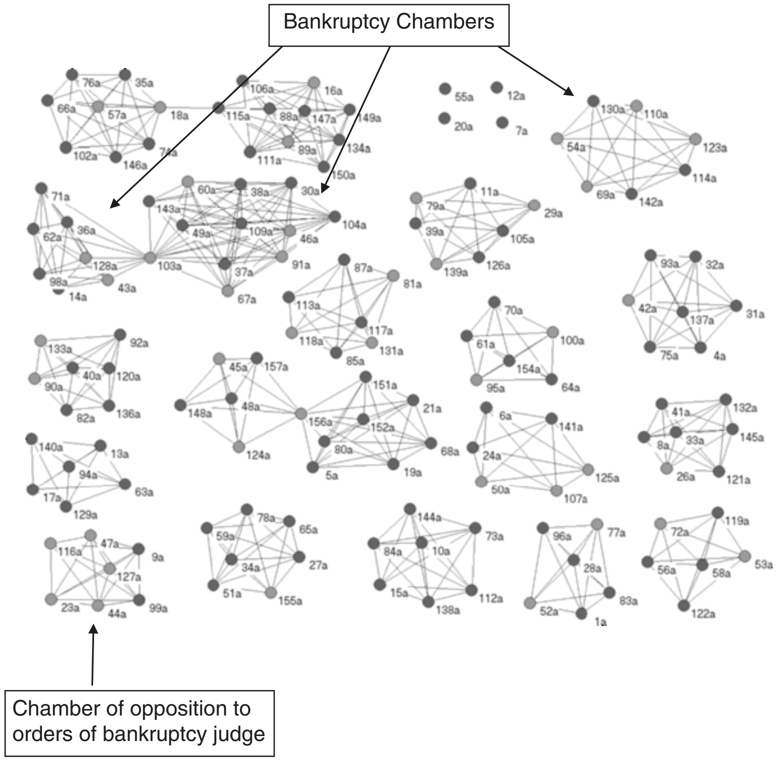

Figure 7.2 Composition of Chambers at the Paris Commercial Court (2000) and conflicts of interest
Note: Bankers are represented grey, non-bankers in black.

such an institution. Their dominant position results from their multiple forms of status – including knowledge of the law, centrality in the advice network, and intermediarity in joint regulation and 'shared' government of markets more generally – which increases their capacity, in a 'consular regime' (Lazega, 2011; Lazega and Mounier, 2011) to convince colleagues hesitating between a purely financial logic and a more industrial logic that sees a company as a collective creator of value.

Discreet joint regulation, the dual role of finance and institutional capture

Given the increasingly porous boundaries between the private sector and public institutions in advanced capitalist societies, institutional capture in the form of joint regulation has become a policy issue even in areas usually considered closer to the core functions of the State, such as education, healthcare, family, security and science. Private economic actors in these market areas spend time and resources trying to structure their environment, improve their opportunity structure and manage the governance mechanisms that constrain them. These efforts are often built into the operations of economic institutions, especially institutions representing joint regulation.

This chapter shows how organizational and network analyses can efficiently measure a level of institutional capture that is usually difficult to observe in complex joint regulation by State and private actors (Lazega, 2003, 2009). As our case study illustrates, State captors can be representatives of the oldest incumbents rather than new market entrants as in Stark and Bruszt (1998) or Hellman, Jones and Kaufmann (2000). Redefining institutional capture in this organizational and structural way as an extreme form of joint regulation focuses on corporatist efforts to design or redesign institutions, influence decision-making in rule enforcement and achieve collective gains for interest groups in these institutions. These factors add to collective actors' capacity to reap invisible benefits. A court can thus be captured inasmuch as interest groups are successful in using their influence to benefit overall from its decisions, even if not all rulings are in their favour.

Re-examining the institutional frameworks of market governance using organizational and network analyses can shed light on the mechanisms that facilitate institutional capture. In our case study, a complex system of cooperation between the State, local Chambers of commerce and voluntary (and militant) citizens produces commercial courts that offer a specific example of joint regulation with specific ways of sharing the costs of social control of markets. In particular, we focus on regulatory influence and the financial sector's special role in this process: when business becomes collectively organized to connect to the public sector, the dual nature (both economic and political) of this financial sector and its regulatory role and combined normative and epistemic influences can be brought to light. In our case study, the importance of the financial industry is measured not only by the number of judges it places on the bankruptcy bench of a judicial institution, but also by the centrality of its representatives in that institution's advice network. This epistemic influence at the conception and implementation phases of market regulation provides a level of remote control over the institution that is difficult to grasp and measure without knowledge of internal organizational operation, normative struggles and social networks. This approach brings to light the mechanics of the dual role of banking and finance, and the structural position of bankers and financiers as heavyweight intermediaries between business and the State.

As joint regulation increases, so does – in our view – the danger of widespread institutional capture by business running public institutions. This study suggests that public policymakers could benefit more systematically from organizational and structural studies of joint public-private regulatory arrangements by looking at such institutions through this lens. We suggest that this approach to the ways private and corporate actors defend and promote their regulatory interests – whether through the official political process or through the less accountable selection of private norms, even in public institutions – can be used in the future to rethink the notion of conflict of interests (Lazega, 1994, 2001; Montebourg and Colcombet, 1998), a dimension of the relational embeddedness of economic action that has been relatively neglected in both the scientific and policy literature. Social and organizational network analysis can be very effective in detecting situations of conflicts of interests and institutional (not necessarily personal) corruption. It can be an efficient method of measuring the level of capture or independence of public office in such complex situations – provided capture is redefined as a collective process, not simply an illicit individual benefit.

Notes

1. The response rate reached an average 90 per cent in each phase of the study. In an initial exploratory phase in 1999, we collected socio-demographic information about the judges, ethnographic information and observations on the operations of the court. During the second phase, in 2000, we interviewed all the judges face to face about various issues of interest to the presidency of the court, and included a name generator about advice-seeking in the questionnaire. The third phase, in 2002, consisted of interviewing all the judges about their motivations, careers and values, and added a second measure of the advice network among the judges. The fourth and final phase in 2005 was used to collect systematic materials on the judges' judicial reasoning (using vignettes and real-life court cases), and develop a third measurement of their advice network. This chapter is based on part of our qualitative data, particularly the organizational analysis and interviews with judges about their normative choices.
2. More details about this institution are provided in Lazega and Mounier, 2003a/b/c, 2010.
3. For example, 21 were elected as candidates of the Association française de banque and five as candidates of the Association française de sociétés financières. Of the financial companies that were the employers of sitting judges (at the Paris Chamber of Commerce alone), BNP-Paribas supplied seven

judges, Suez four, Société Générale four, Crédit Lyonnais four and Crédit Commercial de France four.
4. Source: Institut national de la statistique et des études économiques, Comptabilité nationale, 2001 (www.insee/fr/indicateur/cnat annu/tableaux/t1201254.htm).
5. On the position of the Conférence Générale des Tribunaux de Commerce on the law of 1985, see Rey (2001), to be read from the distanced perspective of Commons (1924). A recent President of the Paris Commercial court from the banking world, she had a decisive impact in shaping France's new bankruptcy and business insolvency prevention bill (2007) – just as the President of the Paris Commercial Court wrote the French Code of Commerce in 1807.
6. See also Lazega et al. (2011).
7. Lay consular judges are also torn between celebrating the regulatory function of their institution and accepting the negative consequences of bankruptcy work for their public image. Some see the cost of handling bankruptcies, in terms of self-image, as higher than the benefit of being a voluntary lay consular judge, and this explains why they do not wish to sit in bankruptcy chambers. Some of their colleagues are highly critical of this attitude of malaise and withdrawal.

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Part III
The Process of Rule Production

8
How Finance Regulates Trade Union Involvement in French SRI

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Corporate social responsibility is a somewhat elusive concept. It corresponds to a number of different local contexts and a variety of organizational structures. The resulting vagueness and diversity of definitions of CSR has been the object of several studies (Aguilera and Jackson, 2003; Louche and Lydenberg, 2006; Matten and Moon, 2008), but is also an issue for the major interested parties in CSR, usually called stakeholders, as opposed to shareholders. CSR is also linked to the financial sector through Socially Responsible Investment (SRI), another concept with a range of meanings, from adding ethical criteria to investment motivations to searching for a new kind of social or environmental performance. Use of the term 'socially responsible' must therefore reach beyond the positive aura surrounding this type of initiative in order to understand how practices are defined, and their potentially complex implications for the actors involved. The 'green' aspect of sustainable development is frequently foregrounded to the detriment of its social dimension. CSR is most easily explained in environmental terms, and its social aspects tend to escape the attention of journalists and the general public. There is a need for certain actors to show that it is not solely an environmental matter, and that it affects them as much as other stakeholders who have greater media visibility in topics concerning the future of the planet. Finance is one of these actors, and it has chosen the angle of SRI performance (Allouche and Laroche, 2005; Gond, 2001) to increase its legitimacy on this subject. But this financial focus on SRI was not a foregone conclusion; it is the result of discreet regulation by the financial sector in a context that could have been influenced by several types of actor. This chapter examines the way SRI is defined in France, through the action of three specific players becoming actors on

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this new market, namely the State, finance and trade unions, and shows how finance is successfully imposing its view.

The State is a key factor in understanding regulation of SRI in France. It has promulgated several laws to favour this emerging market, but those laws are 'empty shells' to be filled with local practices, and thus provide a frame for discreet regulation. The unions are also getting to grips with SRI. The new laws stipulate 'employee savings plans' as one of the routes to implement SRI in France. Because it concerns employees, this area offers trade unions more leverage than environmental bodies, but has the disadvantage of being embedded in the financial sector. Furthermore, employee savings plans have become the main outlet for the new and still small French SRI market. What is at stake here is the creation of pension funds in a country with no experience to date of this kind of economic set-up. In this legislative context we examine the way the three actors – State, finance and trade unions – are trying to shape SRI and the finance sector's success at discreet regulation. As laws are necessary but not sufficient, the strategy adopted by the trade unions to enter the market is based on the creation of a recognized 'quality label' for employee savings plans. A label of this kind represents a specific form of interaction between finance and trade unions, and the nature, effects and limits of the label and the consequences for the definition of SRI are examined through analysis of this interaction. As a major client of SRI in France, trade unions are becoming acculturated to a definition of social responsibility that is influenced by finance.

This chapter examines the issue of regulation, a standard sociological question, from a theoretical standpoint. SRI is not a case of control regulation, but a specific case of discreet regulation where one actor 'pulls strings' to influence the game rules through relational resources. Although this regulation takes place between interdependent entrepreneurs who need one another to establish acceptance of SRI and its practices (Déjean, Gond and Leca, 2004; Holm, 1995; Maguire, Hardy and Lawrence, 2004; Zucker, 1987), the rules of the market not only rely on competition between those actors, but also operate through a large number of relational networks (Lazega and Mounier, 2002; White, 2002). Ultimately, finance is succeeding in discreetly imposing its view on SRI, using the unions' strategy and giving them incentives to enter the market provided they comply with the financial approach.

The first section (When employee savings meets SRI) focuses on the role of the State through the promotion of employee savings plans and the associated laws. It examines the changes in France over the past ten years in employee savings plans and their close links with SRI. Several laws have been passed to support the creation of employee savings plans, and these laws clearly favour socially responsible arrangements. The second section (How should SRI be interpreted?) explains why the concept of SRI still needs to be interpreted, and details the various practices that can be related to it. SRI may have originated in American ethical investments, but in France it covers a number of sometimes overlapping practices. The third section (Relational interaction and social network analysis) details the methodological approach used and describes how the network analysis was conducted, while the fourth (Union action: Quality label) analyses the unions' attempt to position themselves in the legislative context through introduction of a quality label, and shows how this attempt is being discreetly taken over by finance. The fifth section (Effects and limits: How finance regulates the unions' efforts) discusses the effects and limits of the trade unions' strategy, bringing out the discreet regulation process operated by the financial sector.

When employee savings meets SRI

Since the publication of the Ballingand de Foucauld Report in France in 2000,[1] many laws have been promulgated to encourage employee savings plans. These laws have sometimes led in contradictory directions, especially when they hesitated between treating employee savings plans as a form of pension plan, or releasing employees' savings early in order to encourage immediate household consumption in times of deep economic difficulty. The sheer proliferation of laws complicates the legal context of employee savings plans.

Despite the hesitations, a clear trend is emerging: since 2001 the legislative arsenal of employee savings plans has been closely linked with socially responsible investment (SRI) (Déjean, 2010). This 'socially responsible' element must be considered in the light of the strong political desire to support this new form of savings. It is as if ethical criteria were being proposed to compensate for the fact that long-standing collective social agreements were being called into question.

Two types of law exist in France in relation to CSR and SRI. The first concerns corporate communication: for instance, the 'NRE' law on the new economic regulations, which makes social and environmental reporting compulsory for companies. The second type of law creates preferred investors for SRI, and the 2001 and 2003 laws on employee savings plans fall into this category. These investors are France's closest approximation to pension funds.

The 'Fabius Law' of 2001 on employee savings plans (named after the then French minister of the economy, Laurent Fabius) gave SRI a role in connection with employee savings plans. This law requires any employee savings plan investing in accordance with social and environmental considerations to report on those investments. Article 21 reads:

> The regulations spell out, *if applicable* [our emphasis], the social, environmental and ethical considerations that must be taken into account by the asset management company when purchasing or selling shares, as well as in exercising the rights it enjoys. The fund's annual report shall contain an account of how they have been applied, according to the conditions prescribed by the Commission des Opérations de Bourse [the Stock exchange regulatory body].

Article 23 of the Fabius Law also encourages shareholder activism, through the exercise of voting rights conferred by share ownership. When the vote involves the company's social or environmental behaviour, shareholder activism enters the domain of SRI.

The Fabius Law creates a two-way link, designating employee savings plans as a special opening for SRI, and SRI as an appropriate channel for development of employee savings plans. Employee savings plans can be an opportunity to express social and/or environmental considerations as they affect investment. The fact that this type of saving derives from wages, and is therefore collectively negotiated, should offer fertile ground for SRI. Conversely, the extra-financial nature of SRI should contribute to an increase in employee savings plans.

Further legislative proposals followed. In 2003, the national pension reform turned voluntary employee savings plans (PPESVRs[2]) into collective pension plans (PERCOs[3]), which do not release savings until the point of retirement and must invest between 5 per cent and 10 per cent of their funds in ethical savings. In 2006, the law on the development of employee profit sharing and shareholding added to these provisions. Finally, since 2008 all company-based employee saving plans have been obliged to invest part of their assets in ethical stocks or community interests.

At this point, it is important to note a distinction between SRI and ethical savings. Unlike ethical savings, SRI is not obligatory for employee savings plans. Once the extra-financial management policy has been decided upon, the Fabius Law requires communication of that decision and the way it is applied. This Law develops SRI on the basis of a voluntary 'disclosure' principle in the same way as the NRE Law is based on 'reporting'. Importantly, the Fabius Law never provides a precise definition of SRI or how it should be put into practice: this is left to the actors involved in SRI, who try to impose the definition that most closely fits their own approach. SRI employee savings is a typical case of regulation (Lazega and Mounier, 2002; Reynaud, 1989): the state enacts a rule that must be interpreted by local actors who are interested parties and have the resources to read it differently.

How should SRI be interpreted?

Similar to the example of employee savings plans, there is considerable confusion around the definition of socially responsible investment. SRI is a new concept still being formulated, and in its efforts to achieve standardization it also suffers from its relationship with CSR and sustainable development, which both remain rather vague concepts 20 years, after they first emerged (Allouche, Huault and Schmidt, 2004; Brunel, 2004; Campbell, 2006; Capron and Quairel-Lanoizelée, 2007). This vagueness is more than a methodological problem; it is a finding in its own right and must be interpreted. These concepts are the subject of a struggle for standardization. The main difficulty in seeking a definition of SRI is that several practices meet the criteria; another difficulty lies in the confusion between ethical and responsible investment. This confusion is even greater in the case of employee savings plans. The only legal requirement is to have a community investment fund in every plan, while other SRI initiatives remain voluntary.

SRI can be defined by various practices, each of which relates to a specific national context. The first comes from the early American ethical funds, and consists of a refusal to invest in certain shares: for example, those issued by the arms trade. These shares are connected with activities that do not meet moral criteria, whether religious, civil or ethical. A second practice always selects particular shares, but by positive rather than negative criteria; best corporate practices are rewarded according to their environmental and social impact. Applied to specific business sectors, this practice is termed 'best-in-class', and is claimed to be the most widespread practice in French SRI. In France, for example, nobody would dispute that it is difficult to judge a bank and petrochemical company in the same way. In a third approach observed in the United Kingdom and the Netherlands, where pension funds are much more common than in France, there is greater emphasis on shareholder activism. Rather than selecting shares, the fund manager takes a close interest in the corporate management of the businesses in her portfolio.

She expresses her opinion, positive or negative (possibly even criticizing and sanctioning top management) at the company's annual general meeting, or by maintaining links with corporate management teams. Finally, yet another practice concerns what the French call 'solidarity or community investing', which is not quite SRI to the extent that it does not involve applying socially responsible criteria to the management of shareholdings. Instead, a donation is made, either through investing in a socially beneficial project with no profit motive, or by giving part of the fund's profits to a charity.

In reality, this typology is little help in grasping the true nature of SRI, because even though best-in-class is said to be the dominant practice in France, funds frequently combine different practices. All may describe forms of responsible investment, but it is difficult to derive a firm definition from them. Furthermore, while ethical, community and responsible investment can theoretically be separated, in practice they are intermingled in the funds. The legal requirement to have between 5 per cent and 10 per cent of community investments in employee savings plans helps to perpetuate this confusion between community investment and a socially responsible management policy in the strictest sense (e.g. a best-in-class approach). Even when 10 per cent of the fund is invested in solidarity shares, the fund manager is under no obligation to apply socially responsible management criteria to the rest of the fund, which may then pursue a high-risk strategy. The 10 per cent becomes a kind of ethical accreditation.

Relational interaction and social network analysis

The results presented here are drawn from qualitative and quantitative research carried out in the SRI market between 2003 and 2007. In order to capture interactions where specific actors tried to become SRI entrepreneurs, we used a two-stage methodology taking a sociological perspective. The first stage comprised an ethnographic study of French SRI using three methodological tools: first, documentary analysis; second, a series of interviews with trade unionists and managers of employee savings plans; and third, an 18-month period of participative observation in an SRI lobbying organization. The organization observed covered a heterogeneous range of actors from the world of SRI, including financial institutions and trade unions. As part of this process we were able to attend workshops and meetings where SRI definitions were discussed.

The second stage was influenced by one of the results of the ethnographic study. The world of French SRI consists of around a hundred people who meet, talk and exchange views frequently at both professional and social events. This social interaction relates to a definition of CSR that is still being established. People need to interact to gather information about companies' social and environmental behaviour, but also to reduce uncertainty around the meaning of social responsibility. The aim of the second stage of our investigation was to grasp this relational embeddedness. We collected quantitative data through a questionnaire oriented towards network analysis, and conducted face-to-face interviews with 85 members of that market. During the interviews those 85 individuals answered our questionnaire, providing personal details and their definition of SRI. Of the 85 interviewees, 78 agreed to name their contacts, described as 'co-work contacts', in the French SRI milieu. Social network analysis is a very powerful methodology to trace interactions in the SRI market and their effects on the definition of social responsibility. It is used here to capture the complexity of interactions between financial institutions and trade unions.

Union action: Quality label

We now examine the trade unions' chosen positioning in relation to employee savings plans, in order to understand how this choice was made under pressure from finance as a discreet regulator. After the Fabius Law was passed, the unions quickly set up an inter-union employee savings committee, the Comité Intersyndical de l'Epargne Salariale (CIES) intended to give a formal quality label to employee savings products. The formation of this committee was announced in 2002 by four of France's main unions (CGT, CFDT, CFE-CGC and CFTC). FO, the fifth major French union, does not participate in this committee since it remains opposed to employee savings plans. FO is thus the only major French union that has decided to contest what it considers the ambiguity of this form of savings. The other organizations have adopted a more pragmatic position. The CIES takes the view that given the promotion they have enjoyed since 2000, employee savings plans have become an inevitable fact of life that must be embraced rather than challenged if they are to be controlled.

The CIES has an unusual structure, resulting from its inter-organizational make-up. It consists of eight trade union representatives (two members from each union) and its aim is to safeguard employees' savings, while at the same time trying to emphasize the differences between earnings, savings and pensions. From the outset, the CIES has been interested in giving an ethical dimension to employee savings, in keeping with trade union values. Its label is intended to serve as a guide for future employee savers; but over and above the information it provides for employees, it should act as a qualification system in the world of employee savings plans and SRI (Karpik, 2007). The CIES has no resources of its own to award this label; it has neither a budget nor its own premises, and depends on its members' contributions. Its name and logo, on the other hand, are registered trademarks. The label is awarded following a call for applications from fund managers that sets out the quality criteria for employee savings plans as laid down by the unions. SRI is among the first of these criteria.

The CIES' call for applications is to date one of the few formal documents to define SRI in France, and one of the few texts that can be consulted for a concrete grasp of SRI funds' selection practices. Fund managers determine their own SRI management style, and as shown earlier, while management 'families' exist (exclusion, best-in-class, shareholder activism and community investment), in reality it is difficult to penetrate the 'black box' of a manager's selection philosophy. That philosophy is what marks her out from her competitors. One of the criteria for the CIES label is that employees should represent a majority on the fund's supervisory board. The CIES also takes into account the fund management policy and its community investments, continuing the confusion between community investments and socially responsible funds. The CIES' socially responsible criteria are thus explicit, and seem clearly anchored in the trade union tradition of safeguarding workers' interests.

When the applications are being considered, trade unionists are entitled to attend managers' meetings. The application process is in fact an opportunity for the CIES to promote its own concept of the socially responsible. In the process it enjoys the status of a representative of the end users, the employees. It is also one of the few organized institutional investors in France, a country that does not have pension funds as such, and is thus a channel for the unions' contribution to define the socially responsible. The CIES offers a contextualized definition of SRI through the socially constructed mechanism (spatially situated and a vector of interactions) that is the call for applications. The unions' main resource in the struggle to define SRI is that they already have an agreed understanding of what is meant by socially responsible. A major concern for employment is clearly visible in the definition of the CIES' social responsibility criteria. This more socially oriented aspect is characteristic of the French model of SRI, which lays less emphasis on the environment than its German neighbour, for instance. In the eyes of the CIES, management is socially responsible:

> in the sense that the confederations signing it are agreed on these terms: business activity that creates jobs or encourages local development and businesses whose aim is to improve their social and environmental practice.[4]

This definition reflects the basic idea of employment as a value. The criterion of a fund's 'value for money' is also fundamental in the eyes of the CIES, which considers that the employee's interest takes precedence and socially responsible criteria must not lead to higher management costs.[5] This is an indication of a new definition that is becoming more financial because it is embedded in the manager's fiduciary responsibility towards the employee as saver.

The CIES' first quality label campaign, conducted in February 2002, awarded the label to three of the 33 applications received. The low number of labels awarded is explained by the 'trial run' nature of this initial campaign, whose beneficiaries included large management companies that already had a foothold in the SRI or employee savings plan markets. A second campaign therefore followed very soon, in May and June 2002, and the label was awarded to four other groups of funds. By 2010, after five calls for applications, 13 groups of funds, representing around €2.7 billion of assets and 1.4 million employees in 52,000 companies, held the label. This represents 5.2 per cent of the total employee savings plan market and 62 per cent of SRI employee savings plans.[6]

The first two campaigns, conducted in quick succession, demonstrate the learning process involved in the application procedure. Trade union representatives had thorough discussions about the application process (including its form) with the fund managers they met. These relational interactions are central to understanding how finance influenced the action of trade union organizations. Through this interaction, unionists gained knowledge of the financial operations involved, and revised their selection criteria. Fund managers also benefited from their contact with the unions, defining socially responsible criteria and establishing contacts with trade unions to collect information about companies. This face-to-face interaction was a fundamental element of a two-way learning phase, involving lengthy meetings between CIES members and fund managers. These interactions continue today through the CIES' work at meetings of the funds' monitoring and audit committees, which offer an opportunity to strengthen the links built up during the application campaigns. Social relationships are also developed at more general meetings, such as the CIES' frequent participation in conferences on SRI. The qualification process thus has an effect on the fund, but also on the trade unionists who are brought into contact with the world of finance. Financial mechanisms influence the trade unions' perspectives, and the action of trade unions can be reassessed from the perspective of discreet regulation operated by finance through those interactions.

Effects and limits: How finance regulates the unions' efforts

Employee savings plans as vectors of openings for SRI, a sector that is still getting off the ground

The efforts of French trade unions in the SRI world have not been in vain. The first effect of SRI's rise alongside employee savings plans is that SRI needs the income provided by employee savings. The converse is also true: employee savings plans are using SRI and its ethical criteria to spread. A study by Novethic published in 2006[7] shows that the SRI market totalled €8.8 billion, thanks partly to employee savings plans. But SRI appeared to represent only 2 per cent of the total assets held in employee savings plans. It is easy to understand why the SRI market, which has struggled to get off the ground since it was created, is concentrating on this type of savings; they provide an important training-ground for its development. This dynamic continued in 2009, when 13 per cent of employee savings plans were invested in SRI.[8]

The development of the SRI market owes much to employee savings plans, then, but also to the trade unions, which offer it one of its few institutional openings. The CIES was quick to include a potentially beneficial effect on SRI growth among its aims (after the overriding aim of protecting employee savings). It even describes employee savings plans as a 'strike force' for SRI and as such tries to influence corporate social and environmental behaviour. But over and above the statistics, it is important to question the real power relations in this milieu. The CIES label process may well have succeeded in bringing trade unions into the world of finance, but it does not follow that the unions have been found a major role or been welcomed in without having to leave a certain number of demands at the door. We now discuss the trade unions' resources, the possibilities of updating those resources, and the image of SRI to which they adhere in this milieu where regulation is the crucial issue. The principal constraint on union action is that in order to be active in this milieu, they must to some extent subscribe to a financial view of SRI.

The complexity of interactions between trade unions and finance

The CIES label application procedure brought financiers and trade unionists together in a concrete example of a 'relational judgment device' (Karpik, 1996). The application process is specific: the drawing up of terms of reference and the managers' responses are matters of interest when different assumptions and ways of thinking are in confrontation. Given its economic potential, this confrontation has tended more towards consensus than conflict. The label system has advantages for both parties, being experienced and interpreted as a 'win-win' strategy from which both camps can draw a form of legitimacy. The fund benefits from the value of the label, which is recognized for its social impact; and the trade unions gain entrance to the financial world as experts on social issues. It remains to be seen whether effective, fair communication truly exists between the two parties.

Learning appears to take place in both directions during the application process. Given the great uncertainty around the definition of SRI, CIES members learn about finance, and fund managers about the trade union world. The members of the CIES approached during our research were not financiers. They admitted in the course of our ethnographic research that the first round of applications was a 'test run', which served mainly to acculturate them to the world of finance. That learning process particularly explains the very small number of labels awarded in the first campaign: the aim was not primarily to award labels, but to gain positioning in the milieu.

The unions have a resource that is important to the information-hungry world of SRI. Their expertise on social (that is to say labour-related) aspects of business and industry is crucial for analysis of responsible corporate initiatives, which are the lifeblood of SRI. As the employees' representatives, unions possess extra-financial information about companies of a kind that is not yet institutionalized in the same way as traditional financial information. This form of information does not flow along well-worn channels, and has to be verified by extra-financial analysts who do not yet have established standards for their work. The unions' knowledge of companies' social and work conditions is therefore a valuable asset and a basis to make themselves heard or claim expertise. Their role as representatives of employees' interests is thus enhanced. The unions are able to provide SRI fund managers with better-quality information than the data that extra-financial agency analysts collect with their closed questionnaires. Other non-CIES unionists are also active in the SRI debate.

The outcomes of labelling, which concern both the products and the actors associated with the label, have not gone unnoticed in the uncertain SRI market, and the success of the CIES label has led to rival initiatives. Novethic, a sustainable development research centre owned by a French public bank, has launched its own annual label campaign for SRI funds. Signs of this competition can be seen in the latest annual report of the CIES:

> We draw attention to a divergence from the position of Novethic […]. In 2009, this body approached the CIES with a view to presenting the launch of its SRI label for FCPs [Fonds commun de placement, a type of mutual funds], which should not, therefore, involve employee savings plans. The opposite was the case in 2010, when that body's new terms of reference were published. A meeting held this summer enabled the parties to explain their positions frankly and to renew their dialogue.[9]

Another indication of the desire to be positioned as recognized actors in the world of SRI, in competition with the extra-financial ratings agencies, is found in the CIES label application criteria. Extra-financial ratings agencies are the actors who truly introduced SRI in France. The first CIES label criterion relates to socially responsible management and the associated extra-financial information. This management must be based on data provided by not one but two extra-financial ratings agencies. The data must also be re-examined in-house, by an internal analyst employed by the management company. This curtails the power of extra-financial ratings agencies and gives more weight to financial actors' expertise. Union action has therefore significantly boosted recruitment of in-house extra-financial data analysts by management companies in the SRI market. The unions have brought about a situation in which the definition of extra-financial analysis is not the exclusive prerogative of extra-financial rating agencies, whose legitimacy may sometimes be questioned. See, for example, the many questions raised by the capital structure and audit activity of Vigeo, a leading French extra-financial rating agency.[10]

Analysis of SRI social networks reveals the pattern of exchange and competition created by these interactions. The competition between the unions and other information providers is noticeable in this co-work network. 'External' extra-financial analysts are defined by contrast to internal (in-house) extra-financial analysts, who work in a financial firm with an asset manager. In-house analysts belong to the financial sector, while external analysts are the people who introduced SRI to France; their job is to produce extra-financial information for asset managers (Gond and Leca, 2004). The co-work network matrix in Table 8.2 shows how the unions have several collaborative links with finance. This matrix is prepared by an organizational partition followed by shrinking to bring out the inter- and intra-relationships between individuals, presented according to the organization they work for. Links are normalized according to the numbers of senders and receivers in each group (see Table 8.1). For instance, external analysts have 14.4 outgoing co-work links with union members; union members have 16.4 incoming links from internal analysts. Figure 8.1 is a representation of the matrix presented in Table 8.2.

The diagonal of Table 8.2 is instructive: it shows cooperation between homogenous actors. The links between trade union members show that this group of actors is the closest-knit group in the SRI market, more united than the external analysts with whom they are competing. The strategy of creating the CIES established a common position for unions in the SRI milieu. True, the unions are not central to SRI; this is reflected in their peripheral role in creating, managing or promoting funds.

Table 8.1 Distribution of actors between organizations

	Number	%
External analysts	18	23
Internal analysts	15	19
Asset managers	21	27
NGO-Journalists	13	17
Trade union members*	11	14
Total	78	100

Note: *The CIES (eight members) and three other union members who are active in SRI milieu.

Table 8.2 Partition of the co-work network

	External analysts	NGO-Journalists	Internal analysts	Trade union members	Asset managers
External analysts	32.1	24.3	30.0	14.4	18.0
NGO-Journalists	27.0	16.6	10.3	15.4	10.1
Internal analysts	36.7	17.4	45.8	16.4	25.4
Trade union members	25.2	18.1	9.7	50.4	16.0
Asset managers	29.4	16.5	25.7	18.7	19.3

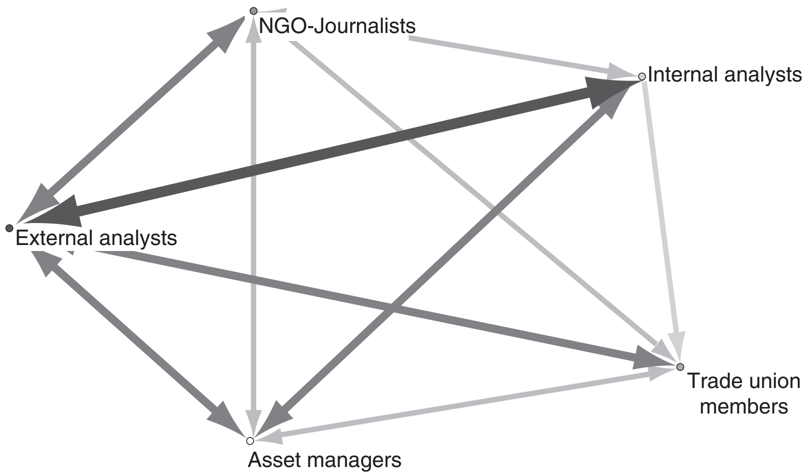

Figure 8.1 Partition of co-work links by organization

They are also more traditionally linked to actors foreign to finance (see outdegrees, that is, outgoing links: 18.1 with NGO-journalists and 25.2 with external analysts). Yet their indegree (incoming link) centrality is highest with financial actors (18.7 with asset managers and 16.4 with internal analysts) who are looking for co-work contacts. This can be interpreted as reflecting an unexpected partnership between two dissimilar actors, unions and finance. Finance sends out links to bring union members closer. But creating such links may be a way for the financial sector to become an arbiter in this milieu. It also makes the unions dependent on finance for their role in the SRI market, and this is why developing outgoing links is shrewd. It enables finance, first, to establish some independence from the external analysts who undertake the extra-financial assessments needed for SRI processes and have long-standing involvement in the market's construction; and, second, to establish a degree of dependence for the unions, which would not have enough centrality for influence in this market without the links received from the financial sector. This risk of dependence has a regulatory impact, as it requires union members to convert to a financial vision of SRI, and promotion of shareholder activism in particular.

The unions and shareholder activism: Financial conversion

One of the criteria for awarding the CIES label is that funds should systematically exercise their voting rights at the relevant AGM. Over the years, this criterion has become increasingly important for obtaining the label, revealing the influence of finance. The CIES requires employee representatives to be in the majority on supervisory boards, and also checks that voting rights are exercised. The manager must submit her voting intentions for discussion by the CIES monitoring committee. These factors reveal that the SRI vision of trade unions is increasingly shaped by shareholder activism, and the importance of the voting policy indicates the potential regulatory influence of finance in SRI. Shareholder activism is at the cutting edge of SRI and best reflects the most financial view of responsible investments, being at the forefront of SRI practice concerning not only fund management but also corporate governance. Through shareholder activism, finance enters the corporate decision-making and management process. It introduces financial techniques and opinions into the economic, social and environmental behaviour of firms, not only their fund management.

For many advocates of SRI, the future lies with shareholder activism as practised in the United Kingdom, where it does not concentrate on portfolio management but addresses corporate management directly. In France, however, the legal arrangements for shareholders to exercise their voting rights are in practice extremely complex. By claiming to represent employees who then become shareholders (through the employee savings plan), the unions are becoming defenders of shareholder activism. Whose interest prevails – the employee's or the shareholder's? There is ambivalence here. It seems that before putting forward their definition of the socially responsible, the unions are made to embrace a financial view of SRI through the links received from financial actors. To have a say in SRI, they must see it in terms of financial practices. This explains the presence of technical vocabulary from the management field in the CIES reports. Lastly, the sudden arrival of pension plans and their funding through employee savings plans poses a certain number of problems and constraints for union action. This brings us back to the issue of creating 'French-style pension funds'.

Discussion and conclusion

Trade union participation in the world of SRI would be a fool's game if employee savings plans turned out to be a means of introducing funded pension schemes. This clearly appears to be the major risk for socially responsible employee savings.

One of the arguments used by opponents of SRI in pensions is that 'responsible' management is not the safest management policy. It does not offer employee shareholders a guaranteed maximum return. Because SRI takes into account criteria other than financial performance, it may not fulfil its obligation to protect their monetary interests. In the course of our research we heard more arguments in favour of SRI than against. Dissenting views on such topics are rarely heard in France. In conversation with French actors in SRI, the question of the conflict between SRI and fiduciary responsibility is quickly put aside, while in other countries with different legislation on pension funds, it is considered a serious concern. This is caused by a semantic slippage, due to the issues at stake in pensions, and the involvement of the unions, which conflates employees' interests and shareholders' interests.

In addition to the development of ethical investment and SRI, the 2003 pension reform has had another important consequence in France: it validates the transfer of employee savings plans into the domain of savings-based pensions, by setting aside the amount deposited in a PERCO collective pension plan until the employee retires. This arrangement presents a major difficulty for the unions in that it blurs the boundary between employee savings and savings-based pensions, and the CIES is therefore very circumspect about this type of savings plan and the status such plans should be given. Its label was only awarded to employee savings plans, not pension funds. The existence of the PERCO handicaps the committee in its action because it highlights the instrumentalization of ethical criteria for the introduction of pension funds in France. At the time of our research (2003–6), the CIES was going through a phase of reflection: it was well aware of the problems posed by the existence of the PERCO, but had not taken a firm position. In 2008, however, PERCO plans were allowed to join the label application system. The CIES explicitly required managers to demonstrate originality in their management of the PERCO, in order to reduce the long-term risks for employees as far as possible. This requirement has been considered not fully satisfied and reflection on the question is apparently still ongoing. The confusion between employee savings and pensions is thus clearly existent and identified, but labelling employee savings plans as socially responsible could tend to mask this confusion, especially in the PERCO context.

Over and above the problems posed by the PERCO, the members of the CIES and trade unions more generally are promoting socially responsible management in other bodies in which trade unions are present and influential. One of France's public sector pension funds (RFAP) requires all its funds to be managed in a socially responsible way, while the French National Pension Fund (FRR) and other supplemental pension funds (ARRCO-AGIRC) apply this requirement to only some of their funds. The FRR is under a legal obligation to invest responsibly, but here again, it sets its own criteria for its socially responsible sections. Its definition of SRI is based on a regulatory process similar to that of the CIES: the State creates a framework but leaves it up to the financial actor to fill that framework with practices. The FRR is also committed to an active voting policy, in accordance with the principles of shareholder activism.

There is surely good reason to doubt the effectiveness of the pressure exerted by SRI on corporate practices (Rémond, 2009). Nevertheless, the specific association of employee savings plans and SRI, which brings employees' interests within the ambit of the shareholder, must be questioned. The work of the CIES has provided the SRI market with a definition of the socially responsible, and its label has influenced the product as much as individuals. But while it has opened up a new mode of trade union action in a social space distinct from the corporate space, it also has clear boundaries drawn by finance's discreet regulation. As the CIES' reservations about the PERCO increase, involvement in this financial world means accepting the idea that some portion of pensions should be funded, even if it is only a (non-compulsory) complementary portion. Although the CIES defends unfunded pensions, this type of plan is a step towards funding. This also explains the refusal by the fifth major French union (FO) to participate in the CIES. Clearly, discreet regulation not only concerns the inner circles of finance, but also has things to say on more general and social topics. Finance is using the action of trade unions as a platform to implement an enlargement strategy to extend its scope.

On the other hand, the CIES label gives the unions a greater presence in a financial world from which they have traditionally been excluded. The SRI market is unique in that it brings together around the same table managers, trade unionists, representatives of NGOs and even members of religious orders. The role of the CIES in defining socially responsible criteria is now recognized. The unions can pride themselves on having exerted an influence on the SRI market and definition of its criteria, as well as an influence in the domain of supplemental pension plans, with the decisions by the RAFP and the ARRCO-ARGIC to invest in a socially responsible way. This influence shows that the unions can still occupy an important position in a more financialized, less industrial capitalism, even if maintaining this position comes at a price, namely acculturation to the financial aspect of our contemporary economies.

Notes

1. A report titled *L'épargne salariale au cœur du contrat social* (Employee savings at the heart of the social contract), commissioned by France's Prime Minister Lionel Jospin in the midst of the stock options scandal (cf. Lechevalier, 2001 for an analytical presentation of the report in the context of shareholder capitalism).
2. Plan partenarial d'épargne salariale volontaire pour la retraite.
3. Plan d'épargne pour la retraite collectif.
4. Source: *L'épargne salariale au service des salariés. Principes d'une démarche intersyndicale*, CFDT, CFE-CGC, CFTC, CGT, Paris, 29 January 2002.
5. The question of the cost of fund management was one of the specific questions raised by the committee's work.
6. Source: 'Troisième rapport d'activité du CIES', December 2010, http://www.ci-es.fr.
7. Source: http://www.novethic.fr/novethic/site/article/index.jsp?id=100550.
8. Source: *Le marché français en 2009*, Novethic.
9. Source: 'Troisième Rapport d'activité du CIES', December 2010.
10. See, for instance, Marc Michaux, 'Notat contre Ferone, le duel des noteuses', *L'Express*, 1 March 2004, http://lexpansion.lexpress.fr/economie/le-duel-des-noteuses_21939.html.

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9

Legitimizing an Ambiguous Financial Innovation: The Case of Exchange-Traded Funds in France

Laurent Deville and Mohamed Oubenal

Introduction

The capacity of financial engineers to develop new products is apparently limitless. After a very fertile period from the mid-1960s to the mid-1980s that saw development of a huge number of innovations,[1] including the advent of index futures and options, Miller (1986) argued that this extraordinary age had finally come to an end. As shown by Tufano (2003) in his review of financial innovation, the next 30 years were about to prove him wrong. New forms of financial products appeared regularly in the form of simple or exotic derivatives, and equity-like products trading on exchanges or in OTC markets. Tufano defines financial innovation as 'the act of creating and then popularizing new financial instruments as well as new financial technologies, institutions and markets'. It is thus not only a matter of inventing products paying new types of cash flow, the way products spread is also of importance.

Exchange-Traded Funds (ETFs) are a typical example of such innovations. This new type of index fund started trading in the US in the 1990s. Like index funds, ETFs aim to replicate the performance of a benchmark index as closely as possible. However, contrary to conventional mutual funds, ETFs are listed on a stock exchange and trade intra-daily. These products thus combine the characteristics of both funds and regular stocks. Their innovation lies in the trading structure put in place to allow efficient trading of funds on a continuous basis. Like conventional index funds, ETFs find their roots in the Modern Portfolio Management theories of Markowitz (1952) and Sharpe (1964) stating the superiority of full, simple portfolio diversification over active management.

I. Huault et al. (eds.), *Finance: The Discreet Regulator*

In just a few years, thanks to their innovative organizational structure ETFs became a serious alternative to traditional non-traded index funds. In Europe, European stock exchange executives monitoring developments on the US financial markets decided they should start trading ETFs, which had already captured a significant part of the asset growth in index funds. Despite tension in the asset management industry, ETFs grew steadily and almost silently during the 2000s until they had become the centre of the regulation agencies' attention by the turn of 2011. Once an innovative instrument extolled for its many virtues in the financial press, ETFs had come to be seen as dangerous and highly risky securities in the space of a few months.

This chapter studies the way the market for ETFs was created and promoted in France from 2000 onwards. Like any other kind of innovation, financial innovation is costly and risky, and several regulatory and institutional challenges had to be tackled before ETFs eventually became popular in Europe. In France, once the decision to create an ETF segment was taken, Euronext had to convince both the regulator and the asset management industry of the relevance of this new instrument. To do so, they relied on a promotional discourse that can be considered ambiguous in the sense that it focused on just a few characteristics representing a simplistic view of ETFs. Starting from a very simple, passive structure, ETFs have slowly evolved into a highly ambiguous security with sometimes paradoxical active features. In this market, the task of convincing parties to accept a new instrument concerns more than the regulator and encompasses market practices themselves, requiring tight social control, with the promotion of ETFs central to the structuring of the market. Issuers' collective efforts to spread promotional arguments during conferences successfully convinced investors that the ETF had been adopted by their community. This cooperation between rival issuers was an important factor in legitimizing ETFs in the eyes of investors.

This chapter presents findings drawn from a longitudinal qualitative study of the French ETF industry, from its inception in 2001 to 2011. The core empirical material consists of a set of semi-structured interviews with actors involved in the creation, development and operation of the ETF market. Our dataset includes a total of 57 interviews conducted between March 2009 and May 2010.[2] All the interviewees had devoted at least part of their principal activity specifically to ETFs: they include members of the French financial regulator (AMF), the Euronext Paris stock exchange, ETF issuers, brokers, market makers, journalists, conference organizers, academic experts and institutional investors. The interviews covered many aspects of the ETF market, from the reasons behind its creation and development to the associated promotional activity and the relationships between actors. The aim was to obtain detailed understanding of the processes at work on this market. We also attended conferences where ETFs were promoted to either institutional or retail investors. During these events, we observed the relationships at play between some of our interviewees. We listened to the promotional discourse targeting institutional investors and talked with some of them about the way they perceive ETFs. As a secondary source of data, we analysed articles on ETFs published in the French financial press from 2000 to 2009.

The results of the study provide empirical evidence of the way ETF promoters were the driving force behind development of the market, exercising social control with relative discretion. The next section, 'The nature of ETFs', describes the nature of ETFs in general and the way they have evolved in France, with a focus on their ambiguities. The third section, 'Lobbying to launch the French ETF market', shows how promoters of ETFs convinced the industry of the value of this innovation, and negotiated rules with the regulator. The fourth section, 'A collective promotional effort to legitimize ETFs', then investigates cooperation between competing issuers dealing with the ambiguities of the product to achieve its legitimization. The final section, 'Facing the legitimacy crisis: Where the cooperative promotion in the ETFs market shows its limits', concludes by discussing the consequences of ETF market growth for the promoters' ability to continue unobtrusively exercising social control.

The nature of ETFs

Passive management is a strategy consisting of 'holding' the equity market as a whole rather than trying to outperform it, regardless of market conditions. Although this is now recognized as a sensible investment strategy, passive management initially encountered considerable hostility from the investment industry before it became the benchmark for all investment strategies (MacKenzie, 2006). Even though most studies show that most active funds do not outperform the market consistently in the long run, and cannot do so on average since active investors clearly play a negative sum game (French, 2008), active management still attracts considerable amounts of money. The idea that investors should simply hold the market instead of selecting potentially profitable stocks derives from the results of Markowitz (1952) and Sharpe (1964). According to Modern Portfolio Theory, every investor should hold a combination of the market portfolio and the risk-free rate. Equity index funds should thus prove the most logical and efficient building block for the equity component of investors' portfolios.

Index funds are the practical translation of these theories into actual investment products. They offer investors a share in a portfolio that is managed so as to replicate the performance of a given index as closely as possible. This replication is generally achieved by holding the index component stocks in the right proportion. Index funds began to sell to retail investors in the 1970s, and diversification has been made more widely accessible through the development of financial products such as conventional index mutual funds and certificates of deposit or index futures contracts, the most recent of which is the ETF. As passive investment strategies grew in popularity, the development of a suitable instrument allowing index components to be negotiated in a single trade became increasingly attractive. Stock exchanges had a particular interest in these instruments which, contrary to conventional index mutual funds sold directly to investors, are traded on a stock exchange.

ETFs were introduced on US and Canadian exchanges in the early 1990s. The earliest ETFs can be seen as stock indices sold like equities on an exchange. An ETF takes the form of a fund that is managed to accurately track the performance of a given benchmark. Shares in the fund trade on stock exchanges and can be bought or sold on a continuous basis, like ordinary stocks. After a few years of relatively moderate growth, the ETF market saw a real boom in March 1999 with the launch of the Nasdaq-100 Index Tracking Stock, popularly known as Cubes or Qubes in reference to its initial ticker, QQQ. Over the years, new ETFs were progressively introduced and became an alternative to traditional non-traded index mutual funds. The major innovation in an ETF is its specific trading process, intended to allow continuous trading while avoiding the significant premiums and discounts[3] that are generally observed in fund trading.

ETFs use a specific dual trading system: they trade on the stock market on a continuous basis, but are open-ended in the sense that new units can be created and existing shares redeemed directly from the fund. This in-kind creation and redemption process is available to institutional investors only, generally in large blocks of shares. The market for ETFs is thus based on two coexisting trading venues: a primary market open to institutional investors for the creation and redemption of ETF shares in blocks directly to/from the fund, and a secondary market – the stock exchange – where ETF shares trade almost like ordinary stocks, with no limit on order size.

ETFs are generally described as financial products that offer almost all the possible benefits – they are practical, cheap, transparent and liquid – while remaining extremely simple to use. They allow continuous trading, in a single trade, of whole basket portfolios, which can number hundreds of different stocks for the broader indices like the S&P 500 or the Russel 2000. They appear cheap in the sense that the management fees charged by the fund are typically much lower than for comparable mutual funds. They are transparent with respect to the strategy followed (passive investment) and disclosure (the fund size and holdings must be regularly reported to the market). Finally, they are expected to be liquid, as the existence of designated liquidity providers is mandatory for trading. They are committed to offering liquidity through small spreads.

The picture painted of ETFs by their promoters mainly focuses on a few aspects considered the most important to explain the product and distinguish it from traditional mutual funds, swaps and futures. In practice, the true characteristics of ETFs are much more diverse and complicated than those presented in the press, or in the brochures and prospectuses distributed by issuers and stock exchanges.

Liquidity is a big issue for investors. The first key benefit of ETFs advanced by issuers is that they trade on stock exchanges. This means it is possible to trade these funds on a continuous basis all day long in a process close to that applied to ordinary stocks.[4] The problem with ETFs is that it is hard to measure their real liquidity because they trade both on exchange and Over The Counter (off exchange directly between counterparties); and in Europe, information concerning OTC trades is not necessarily fully disclosed.

> In Euronext figures, you don't have the OTC order flow. A simple rule would be to multiply the transactions in the order book by five to get the OTC volume. It's not always accurate, but roughly 80 per cent of trades are OTC. This is because we don't report trades. If you want to, it will be costly. When you call Euronext to tell them that you traded a given amount of shares at a given price, when you give them that information, they shouldn't charge you for that, but they do.
>
> An ETF broker

The liquidity proxies that can be inferred from market data do not therefore necessarily reflect the liquidity for an investor trading large amounts of ETFs. Promoters argue that the liquidity of an ETF is the liquidity of the index, thanks to the creation/redemption system, but no clear figures or statistics are presented to support this discourse. This measurement issue is even more complicated for ETFs trading on several exchanges and alternative trading venues. Such cross listings are very common for Europe's major ETFs, which may present different levels of liquidity on different stock exchanges.

ETFs are presented as extremely transparent products: it is hard to find a brochure or a website dedicated to ETFs that does not mention the word 'transparency'. It is true that unlike other non-traded funds, information on ETFs' value and the number of outstanding shares must be reported to the exchange and made public. Also, the 'creation basket' must be published every day, with the implicit meaning that if an investor can create shares by delivering the basket, then the fund should hold those stocks. In fact, funds need not hold the shares forming the index to achieve replication. This topic became a real issue with the collapse of the Lehman Brothers. The holdings of the fund are important in the event it or its issuer fails, in which case investors will receive the assets that are actually held. For full (or physical) replication ETFs, this clearly should not be a problem since the fund manager holds most, if not all, of the stocks composing the index, and the most liquid stocks in general. However, full replication ETFs often lend shares to improve their returns, and the collateral they receive in return may diverge significantly from the fund index composition. For swap-based ETFs, the basket held by issuers does not match the index; it is the equity swap that provides the index return, in exchange for the fund return. It has become clear that some ETFs on European indices were heavily invested in Japanese shares, raising doubts as to the value of the funds in the event of a failure.

> What you should know is that when you buy an ETF, if it's a synthetic replication fund, the things that you bought are very different from what you really have in the fund. [...] So if you think you have the CAC 40 and DAX you can find yourself [in the event of failure of the issuer or the fund] with something that has nothing to do with them.
>
> An asset manager

Another issue concerns the transparency of the index itself.

> It's true that, in the index offering, some indices are less transparent than others. Proprietary indices have appeared in Europe as a joint venture between the ETF issuer and the index provider. Some issuers launched their own indices, and that helped to confuse matters. Initially, for each ETF we wanted one index, one issuer and one

> exchange, but yes, it's getting more complicated. That's because the offering is becoming more and more broad and diversified.
>
> Head of an ETF issuer

One last major ambiguity of ETFs lies in their paradoxical active/passive properties. ETFs were created as an answer to the diversification problem as solved in Modern Portfolio Theory, to be used as a passive investment tool. The innovation in ETF with respect to other index-like securities is the possibility of intraday trading. Clearly this is not essential for long-term investors, yet this 'active' feature is nonetheless put forward by promoters listing the strategies possible with ETFs. Most of these, like the core-satellite strategy,[5] are supposed to be easier to implement with ETFs. This strategy has seen extensions into dynamic core-satellite investing (Amenc, Malaise and Martellini, 2004) in the context of ETFs. The tradability of ETFs ensures that the required mechanical adjustments are feasible with acceptable levels of costs and liquidity risk. This move forward towards active use of ETFs can also be seen in the development of leveraged and inverse ETFs that offer twice or even three times an index performance, or the inverse of an index performance.

Before Euronext could introduce ETFs in France, its executives had two major reluctant parties to convince: the regulator and the industry itself. Paradoxically, ETFs' history on US markets, their apparent simplicity and their ambiguities raised many hurdles. The asset management industry viewed them as a serious competitor to existing funds, both passive and active. Although the ETF was not a totally unknown quantity, the regulator, typically concerned by any financial innovation, was wary of its ambiguities.

Lobbying to launch the French ETF market

In the late 1990s, after a few years of moderate growth, it became clear that the organizational form of ETFs was to become central to mutual fund trading. Although conventional index mutual funds and ETFs now coexist (Agapova, 2011), some professionals at the time presented ETFs as the future norm for the trading of funds. European stock exchanges eventually took note of the ETF's success and decided to launch similar products.

> At the time, I started watching other exchanges to bring in good ideas. I was part of a team working in business intelligence and

> strategic marketing. We identified ETFs as successful products. At the time, there was the Spider and the Cube in the US. So we noticed that these products had grown significantly and we presumed we could launch them in Europe.
>
> A former member of Euronext's European marketing team

ETFs finally came to Europe in 2000 with the openings of the XTF- and extraMARK-specific market segments at the Deutsche Börse and London Stock Exchange respectively. A few months later, in January 2001, Euronext opened NextTrack, a market segment dedicated to the trading of ETFs.

In France, the idea of ETFs faced strong opposition in the asset management industry, as was soon reflected in the AFG.[6] Both passive and active managers viewed this innovation as a serious competitor. ETFs promised a high degree of index tracking at low cost, along with intraday tradability. In France, index funds existed in the form of *SICAV indicielles* which were sold directly by banks' retail networks, with significant entry fees and commissions that would disappear with ETFs:

> ETFs did not enhance the sales departments' P&L at banks' retail networks due to their lower fees.
>
> Investor 1

> The retail bank network was strongly against this product since they already sold index funds that brought them higher margins.
>
> Head of ETF issuer 1

The active management sector had a low opinion of the promotion effort for ETFs, and has always feared the endless debate about their real performance:

> Asset managers saw this type of product as aggressive competitors to active management.
>
> Paris Stock Exchange – A former Executive 1

NextTrack, the segment of Euronext dedicated to ETFs, was to be launched in January 2001 but ETFs still had to be found to list. Although Euronext ultimately decides which ETFs would be listed on NextTrack, they needed providers to apply for listing. Any collective investment funds would be considered, but Euronext explicitly stated that it 'may reject an application for admission to trading on NextTrack if the applicable conditions are not met or if Euronext believes that admission would not be in the interests of NextTrack or investors'. (NextTrack – Admission to trading document, 2000). Given the AFG's strong opposition to ETFs, the executives of Euronext Paris needed to find a way to lead the management industry into the market. Along with the standard arguments that Euronext would accompany the market, Euronext launched a first call for proposals for the creation of ETFs on the CAC 40 index, offering to grant an exclusive fixed-term licence. The prospect of exclusive rights to ETFs on the leading local blue-chip index brought the following reaction from many AFG members:

> Everybody said: s***, if Société Générale, or BNP, or Crédit Agricole [major French investment banks], etc. is launching something and we don't, then it doesn't look good for us!
>
> Paris Stock Exchange – A former Executive 1

As a result, Euronext received a number of proposals, mainly from the major French investment banks or their subsidiaries. It was thus possible to refute AFG's claims that ETFs were of no interest (Euronext finally selected Lyxor Asset Management, a subsidiary of Société Générale).

The regulator was mainly concerned about the price at which ETFs would trade on the stock exchange. An ETF has two prices: the Net Asset Value (NAV) per share in the fund, and the market price of these same shares. The first is the value per share of the stocks effectively held by the fund, computed at the end of each trading day, while the second depends on supply and demand for the ETF's shares on the stock exchange. It is well documented that significant premiums or discounts with respect to the fund's listed value[7] are generally associated with the trading of funds, even under normal market conditions:

> One of the difficulties we faced and had to solve was regulation. We had discussions with the COB [Commission des Opérations de Bourse, the former French equivalent of the SEC] on what could be done so that the stock exchange price would not depart too far from the fund's value. The regulator was concerned about the possibility of an excessive difference between the two values.
>
> Paris Stock Exchange – A former Executive 2

ETFs had faced this problem at their inception in the US. The answer lies in the innovative organizational structure developed so as to allow continuous trading while avoiding these deviations. ETFs use a dual trading system that explicitly organizes arbitrage between the managed fund and the shares that trade on the exchange. As noted earlier, ETF shares trade on the exchange almost like ordinary stocks, with no limit on order size.[8] However, it is possible for some institutional investors to apply for creation or redemption of ETF shares, in large blocks, directly to/from the fund: they can deposit the stock basket underlying the index with the fund trustee and receive shares in return (and conversely). The possibility of 'in-kind' creation and redemption helps market makers absorb the liquidity shocks that might occur on the secondary market, either by redeeming outstanding shares or creating new shares directly from the fund. This process also ensures that differences between the share price and the fund's Net Asset Value (NAV) are not too large. If it did grow too large, authorized participants would arbitrage any sizeable difference between the ETF and the underlying index component stocks.

The structure developed in NextTrack and other European exchanges closely resembles the system set up in the AMEX for SPDRs, but the French regulator required more guarantees and imposed specific trading halts. French laws stipulate that Index Funds must trade at a price that does not deviate from their NAV by more than 1.5 per cent. One problem is that although the market price can change throughout the trading day, the NAV is not continuously known with precision. Alain Dubois, chairman of Lyxor, negotiated with the regulator alongside Euronext:

> We [Euronext] have lobbied the AMF [French regulator] a lot to demonstrate that this product [ETFs] will evolve; and the regulatory frame has to be improved. [...] When we selected Société Générale, Alain Dubois [Chairman of Lyxor] helped a lot in changing the regulations.
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> Euronext had made good progress and then Alain Dubois [Chairman of Lyxor] intervened in the second half of the year 2000 to accelerate discussions on the regulations that needed changing to make continuous quotation of funds possible.
>
> Head of the ETF issuer 1

It was decided that an indicative Net Asset Value (iNAV) would be calculated throughout the trading day. This iNAV is based on the previous day's end-of-trading Net Asset Value (calculated and provided by the issuer), and updated regularly to reflect intraday variations in the underlying index. This solution does not prevent investors from trading shares at a different price from the value of the asset held by the fund, unless this difference becomes greater than 1.5 per cent, at which point trading is halted. However, it ensures that investors are able to trade with full knowledge of the value of premiums or discounts over the trading day. This compromise has been regularly but discreetly called into question by the industry arguing that the rules applying to ETFs trading in London were less restrictive.

ETF promoters in France faced reluctance within the asset management industry and had to bargain with the regulator to adapt regulations in order to launch ETFs. Once they had succeeded in creating the market, they still had to legitimize the product, and this was achieved through a collective promotional effort targeting investors.

A collective promotional effort to legitimize ETFs

Once the case for an ETF market in France had been won, promoters of the instrument had to convince customers of the instrument's virtues. The promotional campaign headed jointly by Euronext and Lyxor targeted all categories of investors. They encouraged publication of articles in newspapers for different readerships and held numerous roadshows. More than 50 articles on ETFs appeared in 2001 in the French economic newspapers *Les Echos* and *La Tribune*, a figure that has never been matched since. Despite these commercial efforts, ETFs were not successful with all categories of investors. While half of individual investors never used ETFs because they did not understand them,[9] assets under management grew steadily and the OTC market was active. The OTC market, more flexible and ultimately cheaper in commissions, was the institutional investors' preferred trading venue. Cooperation between issuers was the first step in their promotional activity. They all focused their offer and discourses on institutional investors.

This cooperation was necessary for the ETF market to develop. Cooperation between competitors involves social control and a capacity on the part of the actors to restrain themselves, at least temporarily, from differentiation (Lazega, 2009). This happens when actors start considering the temporal dimension of their relationships: in other words, when they understand that it is in each one's long-term interest to join forces with others. This is visible when companies decide to formally cooperate in alliances. In the case of ETFs, Axa Investment Manager and BNP Asset Manager created a common trademark EasyETF to distribute the new products. They had a common marketing team for a while, but this alliance failed and EasyETF is now managed solely by BNP, which bought Axa's shares back. The issuer Source, on the other hand, illustrates a successful formal partnership. In 2009 five banks (Goldman Sachs, Morgan Stanley, J. P. Morgan, Nomura and Bank of America-Merrill Lynch) decided to formally pool their resources in order to launch an ETF issuer and collectively promote the trademark Source. This joint venture became one of the major issuers of sector ETFs in Europe. But cooperation is rarely set out in writing in a formal contract-like partnership. Generally, companies in one or more sectors have informal rules for collaboration, consisting of sharing information and building a social niche or community (Lazega and Mounier, 2002). Four principal mechanisms are at work for this social control and cooperation to operate in the French ETF industry: a collective memory, prospects of future collaboration, the existence of a third-party facilitator and the definition of a common enemy.

First, in the social milieu of ETF issuers, rule-breakers are remembered for many years. For instance, many executives at Lyxor have never forgotten the 'All ETFs are not equal' campaign by iShares in 2007–8, which emphasized the differences between full and synthetic replication. The collective memory can lead to distrust or condemnation of a market actor; but it can also engender recognition and esteem for players who respect the rules, or participated in the French launch of ETFs and are still part of this small world.

Second, a shift from fierce competition to formal cooperation brought about by the reorganization of the banking sector with alliances, mergers and acquisitions became possible, especially after the financial crisis. It is also more than likely that issuers will hire executives who previously worked for a competitor. Market actors consider these possibilities whenever they are thinking of breaching an implicit rule, bearing in mind that they could be hired by another ETF issuer and work with competitors reinforces the tendency to keep relations cordial and respect the social rules. This is confirmed by the fact that outsiders are less likely to respect the rules: in the early days of the market Lyxor was against traditional active management, iShares criticized synthetic replication when they first moved into the French market and Deutsche Bank-x trackers initially had an aggressive commercial policy.

Third, third parties with well-established reputations may provide support for cooperation between different competitors, and contribute to compliance with implicit rules. In the case of ETFs, event organizers who were well-respected in the financial community succeeded in bringing competing issuers together at conferences, and asked them to avoid differentiation for a range of reasons.

Fourth, when they define their position by opposition to other groups or a leading company, market actors are eager to respect social rules and develop cooperation. ETF promoters were aware that investors might choose more standard products than ETFs. Asset managers and issuers promoting alternative products were considered the main competitors on the emerging ETF market. This led ETF issuers to consider themselves as a community of interest, with a shared aim of increasing their volumes and trades against other active and passive products. The existence of common enemies endowed with extensive resources was a decisive factor in bringing ETF issuers to overcome the traditional rivalry between their parent banks. They were convinced that joining forces, at least for promotion, was crucial if they were to convince investors to choose the new ETFs rather than well-established financial products.

Having identified the four mechanisms that make social discipline possible, it is now important to define the levels on which cooperation happens. Analysis of the data and ethnographic observation of the social milieu of ETFs bring out two different levels of cooperation between competing issuers: the construction of a common field, and the dissemination of a common discourse. The first level involves creation of spaces where cooperation is possible. This can be achieved through constant press coverage of ETFs in economic newspapers, and more especially putting ETFs on the agenda of important financial conferences. Access to this kind of arena improves discussion and observation between competitors. The second level involves downplaying differences and emphasizing similarities in the content of the discourse itself. Thus, the issuers' 'communication strategy focuses on education and does not highlight the know-how of one issuer compared to the others' (*L'Agefi*, 2003, our translation). During the long period between 2001 and 2007, for instance, issuers never raised the question in the press of the differences between the replication methods they were using to build ETFs, focusing instead on the description of ETFs, the positive market trends in France and around the world and so on. They also used the usual arguments for ETFs in their discourse: that they are simple, transparent, liquid and cheap.

Conferences are places where cooperation occurs and dissemination of a collective promotional discourse is observed. These events advance our understanding of the ongoing process of legitimizing ETFs for investors. We were able to collect data about conferences during our attendance at three Edhec Institutional Days (2008, 2009 and 2010), the French institutional management Forum ('Gi Forum') of 2010 and two round tables held by the *Agefi* (a French financial magazine), one devoted to ETFs and the other to Asset Management. One of the characteristics of these promotional conferences is that they are very 'exclusive clubs'. Not only do their titles indicate that they are specifically intended for institutional investors with complex issues, but they also set up barriers intended to discourage any other kind of participant. For instance, unlike individual investors' conferences which are free, these events are extremely expensive: registration costs more than €1000 for the Edhec conferences and the Gi Forum, and around €700 for Agefi events. The second key characteristic is the symbolic choice of venue. Agefi, for instance, used the Palais Brogniart, home to the Paris Stock Exchange pit before the shift to electronic quotations; and the Edhec conferences were held in the impressive CNIT building in La Défense business district. The underlying message is the business we are promoting (ETFs in these examples) is thriving even in times of crisis.

Including workshops on ETFs in conferences on Asset Management or Institutional Management normalizes them, indicating that they can easily replace other standard financial products. Thanks to the huge monetary effort made by many issuers, ETFs occupy an important place in conference schedules. Without the issuers' collective effort it would be difficult to have a full day dedicated to ETFs at the Edhec Institutional Days (a two-day event of plenary sessions and workshops), or a round table discussion on the development of ETFs in the Agefi and Gi Forum conferences. The visibility of financial products such as ETFs at these events normalizes them and legitimizes them in the eyes of institutional investors. It also offers issuers an opportunity to meet and talk in a single location for a defined period of time. This builds collective identity against competing products that ETFs could replace.

At the Edhec and Gi Forum conferences, exhibition stands are available for a charge. All ETF issuers take up this opportunity to raise the profile of their products, and thereby ETFs in general. This is important because any visitor to the conference will notice one or more colourful stands publicizing the five major banks issuing ETFs. Visibility is guaranteed through some very eye-catching stand design: Amundi ETF, for example, has been known to use orange posters and two orange-clad hostesses circulating and distributing flyers.

The promotional discourse observed during the conferences on ETFs focuses on the qualities of being 'simple, transparent, liquid and cheap'. Despite their market rivalry, issuers are all agreed on the benefits of ETFs. Each one, however, seeks to emphasize one particular aspect over the rest. Amundi, for instance, launched a 'cheaper' campaign while iShares stressed the transparency of its full-replication ETFs. We observed that in their presentations and talks, issuers repeatedly stress the same words in respect of ETFs: simplicity, transparency, liquidity and low management fees. This tacit consensus leads to legitimization of ETFs, but to give the issuers' arguments more credibility, some event organizers also invite academics (as in the case of Edhec Institutional Days) or 'independent' actors such as investors, index providers or Euronext. Even the titles of round tables and discussion sessions are chosen to reflect different uses of ETFs, indicating that they can be used in different investment strategies. One workshop at the 2009 Edhec Institutional Days, for instance, was titled 'Optimal Risk Management with ETFs'. Another important factor is the regularity of conferences on ETFs. Edhec Institutional Days have been held every year since 2008 after an initial event in 2006, while the *Agefi* has held an annual conference on ETFs since 2008, and includes a round table on issues related to the ETF market in its annual conference on Asset Management. The regularity of these events anchors the promotional discourse in the mind of investors and enhances the legitimacy of ETFs.

These conferences have various media partners that provide coverage in financial magazines targeting institutional and professional investors. For example, two special issues on institutional management are published by *Option Finance* and *Agefi* in the week of the Edhec Institutional Days. Many press articles dealing with ETFs are published because the subject occupies a large share of the conference schedule. In such articles, executives of different issuers are interviewed to present their products, and their views on a number of topics related to the impact of the financial crisis on index management or assessment of the liquidity of ETFs. This spreads the discourse on the advantages of ETFs (simple, transparent, liquid and cheap) to a wider audience than conference participants alone.

There is also a mirror effect that enhances the legitimacy of ETFs in the eyes of investors. When a major institutional investor is part of a panel of speakers, many investors or listeners will be interested in his arguments, analysis and practices. The asset managers of small funds need to know about institutional investors' interest in an asset class such as ETFs because such large investors, for example Agirc-Arco or AG2R La Mondiale (French pension funds) trade such large volumes that they can impact market prices. But each investor can also consider his discourse as representing all investors', and start developing mimetic attitudes. This is a way to spread the use of ETFs among investors. Various channels such as the media or surveys can provide investors with a 'mirror image' of their community's supposed practices and opinions regarding ETFs. Promoters sometimes have the ability to reproduce their legitimizing discourse on ETFs in these channels, to disseminate it among the community of investors.

The media can be useful in creating a mirror effect. Press coverage of conferences includes quotes from interviews conducted with selected investors, who explain how they implement investment strategies with ETFs, and give their views on these financial products with a focus on the arguments used by promoters. When readers notice that these views are shared by different investors, they begin to develop the idea that the investors' community has adopted ETFs, and associate them with the same four advantages of simplicity, transparency, liquidity and low management fees. We call this the 'mirror effect' because each investor reading quotes from a peer considers them as the practice of the whole community of investors, and therefore his own.

Market studies or surveys can also have a mirror effect. Generally, these devices are used to study a sample of the population in order to define its needs, its satisfaction with the product and its expectations. In the Edhec survey on ETFs sponsored by iShares (in 2006 and 2008) or Amundi (in 2009 and 2010), the sample is not representative of the population of institutional and professional investors, but the data is presented in such a way as to suggest that it is a close reflection of investors' practices and views regarding ETFs. The authors of the survey insist on the geographic diversity and types of professional investors as evidence of the representativeness of the sample:

> 1.2. A sample allowing for a representative view
>
> Subtitle in the methodology section – Edhec survey of 2006

> Taken together, we believe that this regional diversity and fair balance of asset management professionals make the survey largely representative of European ETF investors.
>
> In the Edhec survey of 2009 and 2010

Moreover, Edhec researchers are well aware that the mirror effect exists and can influence investors:

> All the surveys are widely read by investors because they want to know what financial products their colleagues are using. They want to monitor the market.
>
> An officer from Edhec

These surveys will influence investors in a way that legitimizes ETFs because of their content. Each annual survey report contains the main arguments promoted by ETF issuers. The authors of the 2009 and 2010 reports argue that 'ETFs are perceived to have an edge over other products in terms of liquidity, transparency, and cost' (Amenc et al., 2009: 17; Goltz, Grigoriu and Tang, 2010: 21). Yet the questions are oriented in such a way that good forecasts are bound to emerge. For instance, the authors 'ask those surveyed to identify the area in which they predict the greatest increase in the use of ETFs' (Amenc et al., 2009: 66; Goltz, Grigoriu and Tang, 2010: 79), and when some survey results do not fit their expectations, such as the low use of ETFs as satellites during the year 2008, the authors lament the fact that 'institutional investors do not take fully the advantages of ETFs' (Amenc et al., 2008: 12).

Facing the legitimacy crisis: Where the cooperative promotion in the ETFs market shows its limits

Exchange-Traded Funds are generally described as being simple, transparent, liquid and cheap. The reality behind these instruments is more complex: some of them are based on complex indices, their architecture is hard to understand, their liquidity is hard to measure and the development of new generations of ETFs such as active, leveraged or inverse ETFs[10] brings diversifiable risks back into the passive management industry. Promoters had to clarify the ambiguities behind these arguments to convince the French regulator and asset management industry to launch these products. As competitors of well-established passive and active products, ETFs had to fight to impose their existence, initially through lobbying by Euronext and Lyxor. First, they succeeded in changing the views of both the AMF (French regulator) and the AFG (French investment management association) regarding ETFs. Then, promoters had to convince investors to invest in ETFs. Cooperation between rival issuers was important to downplay differences that would have revealed the ambiguity of their promotional discourse. The legitimization of ETFs was achieved through collective participation in conferences and a focus on four principal arguments: simplicity, transparency, liquidity and low management fees.

Things changed after the financial crisis and the bankruptcy of the Lehman Brothers. Investors revised their opinions in view of the possibility that large banks can default. In addition, the ambiguity issue became visible as many funds were facing serious problems due to the near collapse of American International Group (AIG). These funds were Exchange-Traded Notes which, unlike ETFs, were not regulated by UCITS[11] directives, but were issued by a company called ETF Securities. The subsequent confusion between these two types of security, which do not share the same organizational structure, was long lasting even in the financial press. The flash crash of 6 May 2011 on the US market, when the Dow Jones lost 600 points in few minutes, revealed the illiquidity of ETFs in this kind of situation. Almost 68 per cent of the trades cancelled that day were ETFs. The Securities and Exchange Commission criticized the risks of synthetic replication and banned the sale of leveraged ETFs to individual investors; and in Europe, English institutions criticized the development of swap-based ETFs. The chairman of the UK's Investment Management Association considered that 'many of them [swap-based ETFs] are not transparent, do not disclose what's going on under the bonnet, and they may have embedded counterparty risk, not just to the bank issuing the product, but also to third parties', adding, 'I've also seen some of the marketing materials used by synthetic ETF providers, and it's not made particularly clear how they work'. An executive from the UK's Financial Services Authority clearly stated that they would 'indeed be pushing proposals through the ESMA [European Securities and Markets Authority] process that the rules should be tightened, particularly when it comes to synthetic ETFs, which are our principal focus'.

Three institutions published reports in April 2011 warning of the risks related to Exchange-Traded Funds. The International Monetary Fund (IMF), the Financial Stability Board (FSB) and an economist from the Bank for International Settlements (BIS) all emphasize the counterparty risk inherent to using the synthetic replication method or the risk of lending securities for full replication. These reports highlight the potential low liquidity problem for ETFs during a crash or when they replicate low-liquidity assets. They also suggest considering the risks of leveraged and inverse ETFs, especially for retail investors. The wording used contrasts with the promoters' arguments. For instance, the FSB argues that some innovation in the ETF market has brought complexity and opacity, contradicting the view that ETFs are simple and transparent. The IMF warns about the risk of illiquidity under stressed conditions, or in the case of illiquid emergent markets, in contrast to the issuers' reassuring discourse on the liquidity of ETFs. Statements from these reports are beginning to be quoted in financial magazines and newspapers, linking ETFs with words such as complexity, risks, opacity and low liquidity, and the debate has been introduced into conferences. This has resulted in de-legitimization of ETFs in the asset management industry and financial press.

This legitimacy crisis mainly raises the question of the time needed for the regulators to assess the problems associated with development of the ETF markets. As shown by their absence from the first version of the EU MiFID directive, the regulators have long considered ETFs a marginal asset. The paradox is that ETFs in fact stand at the meeting point between many other asset classes, including stocks, index mutual funds, index derivatives and total return swaps. The explanation for regulators' blindness to ETFs' potential for destabilizing may lie in the relative silence of the asset management industry. Once ETFs were introduced, the industry remained comparatively discreet outside the world of finance, concentrating on institutional investors and imposing strict social control. Traditionally more inclined to protect the interests of retail investors, the regulator limited its action to monitoring prospectuses and put up little resistance to the soft campaigning to relax trading rules on the Paris Stock Exchange. Following the metaphor used by Lépinay (2007) to describe the development of capital-guaranteed products, ETFs were acting as parasites and the combination of success – and the associated destabilizing properties – and a financial crisis cast too bright a light on them. Once under the open sky, a parasite is forced to evolve.

For an effective response to these criticisms by international institutions, issuers were forced to move a step further in cooperation. They were supposed to have a collective lobbying campaign, but this was not easy when issuers' interests were too different. When Lyxor and Deutsche Bank-x trackers proposed the creation of a European lobby involving all issuers to promote ETFs, iShares refused.[12] Even the head of the European Fund and Asset Management Association (EFAMA) suggested speaking with one voice, but the chairman of the UK's Investment Management Association responded: 'It's difficult to get a single, united voice for investment managers. Each firm has a different view of the world, for a start. Then some are independent, while others are owned by banks and insurance companies.' (Amery, 2011) Two clusters are currently emerging. The first comprises issuers working with their investment banks: Lyxor, Deutsche Bank-x trackers and Source. The second cluster covers issuers using full replication, with market leader iShares as the main promoter.

The discreet legitimization of a financial instrument is not an irreversible process. At any time, an event such as the financial crisis or serious divergences may emphasize the controversies between issuers. The ambiguities of the four arguments used by the promoters of ETFs are revealed by the international institutions' reports, and it may take the industry, now divided into two clusters, some time to re-legitimize ETFs.

Notes

1. In his analysis of past and future financial innovation, Miller (1986) gives the following, non-exhaustive, list of new products: 'negotiable CDs, Eurodollar accounts, Eurobonds, sushi bonds, floating-rate bonds, puttable bonds, zero coupon bonds, stripped bonds, options, financial futures, options on futures, options on indexes, money market funds, cash management accounts, income warrants, collateralized mortgages, home equity loans, currency swaps, floor-ceiling swaps, exchangeable bonds'.
2. Interviews lasted from 27 minutes to one hour and 36 minutes, and were conducted by the authors of this chapter. Mohamed Oubenal personally attended all interviews. Most interviews were recorded.
3. A fund is said to trade at a premium (respectively at a discount) when its market price is lower (respectively higher) than the value of the assets owned by the fund.
4. The market continuously reports the price investors can expect for an immediate trade (buy or sell) of a given product for a given number of shares. The difference between the lowest selling price and the highest buying price is called the bid-ask spread. These transaction costs should be taken into account when assessing the total costs borne by investors trading ETFs. Spread is often used as a proxy for the liquidity of financial instruments. For large orders, it is necessary to estimate the impact on the market.
5. The implementation of a core-satellite strategy means part of the wealth is invested in a 'core', generally a passive index fund, and the remainder in possibly different 'satellites' selected so as to outperform the market. With ETFs, the core and the satellites may, for example, consist respectively of a broadly diversified ETF and sector ETFs.
6. Association Française de la Gestion Financière. The AFG is the French Asset Management Association that represents and promotes the interests of the French asset management industry. Most of its members are management and open-ended investment companies, with the most important French investment banks or their subsidiaries represented on the board of directors.
7. A fund is said to trade at a discount (respectively at a premium) when its market value is lower (respectively higher) than its NAV.
8. One important difference compared to stocks is that admission to trading is generally conditional on the existence of competing market makers, even in pure order book markets.
9. TLB survey (*Les Echos*, 2005).
10. As competition intensified between issuers and exchanges, the process for listing ever more original ETFs sped up and active ETFs were created in Europe. Although the words 'active' and 'ETF' do not fit together very well, some issuers built new indices based on strategies and listed ETFs providing leveraged or inverse performance. ETFs providing an exposure to a multiple of an index performance or the inverse of an index performance are among the most commonly traded.
11. UCITS are Undertakings for Collective Investment in Transferable Securities. These are concerned by a set of European Directives that regulate funds and allow them to operate in EU.
12. See the press article titled 'ETF Issuers do not Agree on the Creation of a Common Lobby', in *L'Agefi*, 31 May 2011.

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10

Constructing the Market for Credit Derivatives: How Major Investment Banks Handle Ambiguities

Isabelle Huault and Hélène Rainelli-Weiss

Introduction

What relationship is there between the highly modern financial market for credit derivatives and the auction sale of a prized Kansas dairy cow? Although both involve some form of economic behaviour, the old-fashioned, if not exotic, ritual of auctions seems to be at odds with the style of transactions on one of the most modern and sophisticated derivatives markets. However, appearances can sometimes be deceptive.

Created around 1997, the credit derivatives market can be considered as an extension of other successful innovative financial markets, the first of which being the Chicago Board Options Exchange (CBOE). Enhanced by the valuation model proposed by Black and Scholes (1972), Chicago's options market rapidly spread around the globe.[1] Building on this success, financial engineers soon realized the use they could make of the breakthrough and began to explore the potentialities of the new technology. Identifying the price variation of primary financial assets with 'risk', they proposed to create a different kind of 'derivatives', in other words financial products whose value can be related to the price of a given underlying asset through complex *à la* Black and Scholes mathematical models. Credit derivatives result from an extension of this logic, in which the underlying asset is replaced by the amount of credit risk borne by a debt.[2] This market has since been expanding at a fast pace to an estimated amount outstanding in December 2006 of $28,838 billion.

Yet, while the options market and its mathematical apparatus served as theoretical smelter for the invention of credit derivatives, the contrast between the empirical realities on the option and credit derivatives markets is sharp. Options are highly standardized contracts traded

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worldwide on organized exchanges that provide transparent and instantaneous access to prices through automatic quotation systems. On the other hand, credit derivatives are traded on an over-the-counter basis involving mainly private actors who conclude deals at non-transparent prices. In other words, while options markets appear highly standardized, liquid and transparent, the credit derivatives market remains irregular, opaque and concentrated.

How can a single theoretical apparatus produce so dissimilar empirical realities? And how can one explain the specific features observed in the market structure of credit derivatives?

We show in this chapter that economic sociology can help to answer these questions. Focusing on the particular attributes of the credit derivatives themselves, we demonstrate that the absence of a simple relationship to a traded underlying asset makes these financial products truly specific, with numerous implications.

First, while the event triggering the exercise of options is clearly defined (the stock price goes above or below the exercise price), this is far from being the case as regards credit derivatives. Related to this question comes the problem of defining exactly what a credit derivative actually is. While options technology pre-existed the actual launching of the options market in Chicago (MacKenzie and Millo, 2003), credit derivatives appeared as a brand new concept. Questions were then raised as to whether they should be considered as financial products or as insurance contracts, to which they bear some resemblance. Numerous issues depend on the answer to this question, such as who would be allowed to participate in the market and under what kind of regulation. The absence of any straightforward link to an underlying asset finally poses extremely intricate questions as regards the pricing of credit derivatives. The fact that stocks underlying options are traded on the market is crucial in the valuation formula proposed by Black and Scholes. The extension of Black and Scholes theory to credit derivatives is indeed far from being straightforward. Overall, the specificity of credit derivatives casts a doubt on the notion that they can, like options, be used to manage 'risk', in the sense financiers grant to the word. Following Knight (1921), one traditionally defines 'risk' as a type of uncertainty that can be measured using probabilities, whereas 'uncertainty' refers to future events on which no probability can reasonably be carried out. While risk in the Knightian sense seems acceptable as a description of the price variations of traded assets, the variation of the credit risk borne by a given debt might have more to do with 'uncertainty', than with 'risk'.[3]

Consequently, many ambiguities surround credit derivatives, which leads us back to the example of the Kansas dairy cow.

In his penetrating analysis of auction markets, Smith (1989) shows that many objects traded on auctions involve ambiguities of different kinds. When the goods at stake cannot be easily related to a standard market, or when ownership, allocation of goods and proper classification (Lounsbury and Crumley, 2007) remain problematic, uncertainty prevails on the value of the goods to be exchanged. In such cases, Smith argues, the specific auction structure must be analysed as the result of a social process by which actors collectively attempt to resolve ambiguities. He explains the variation in type of auctions using the variations in the type of ambiguities the actors have to face.

Building on this analysis, and despite the apparent remoteness between some auction markets and modern derivatives trading, we propose to investigate the structure of the credit derivatives market by focusing on the many ambiguities faced by the actors on the market. We argue that this perspective allows a renewed understanding of the empirical contrasts observed on some derivatives markets. It is this need to solve ambiguity issues collectively (issues which differ from one market to another) that produces various cognitive and political communities that engage in a range of social processes shaping markets differently.

Conducting an in-depth qualitative study beginning with the origin of the market for credit derivatives through to the end of 2004, we propose an explanation as to why this market so greatly differs from the ideal vision of financial markets, with its atomistic and equal investors, anonymously exchanging on the basis of widely transparent prices. We show that credit derivatives pose complex definitional and valuation issues. Our contribution is to demonstrate how, while the rhetorical justification of the innovation requires the involvement of as many actors as possible, the social processes required to handle ambiguities engenders concentration and opacity.

The remainder of this chapter is divided into four parts. Using the main results of the social studies of finance, the first part focuses on the concept of the social construction of value on financial markets. The second part presents the research method, a longitudinal qualitative study over the period of 1996–2004, taken from interviews with the principal actors of the market and of an analysis of secondary data. The third part consists of a study of the development of the market for credit derivatives, and of market shaping as an answer to ambiguities. The fourth, and last, part draws the principal conclusions of the research.

The social construction of value on financial markets

Financial markets are traditionally seen as the place where value is unequivocally set by the realization of Walrasian neoclassical economy. On securities exchanges, atomistic investors act as pure price takers, making their decisions on the basis of equilibrium prices. Economic sociology, however, challenges the view that value is unproblematic on financial markets and proposes to see it as the result of complex social constructions well worth exploring.

Kregel (1995) observes that Walras and Marshall modelled their divergent price theories on two real-world institutions: the Paris Bourse for Walras and the London Stock Exchange for Marshall. The diverse organization of the two stock exchanges might explain the dissimilarity in the theories and raises the question of the evolution towards an optimal market organization. Conducting a historical analysis of the evolution of the New York and London stock exchanges, Kregel (1995) concludes that, although facing similar problems of external competition, the two stock exchanges produced responses which have led to different organizational forms showing no sign of convergence towards a uniform structure. Even in the purest case of application of neoclassical economy, the pricing process thus appears to result from a specific social organization, whose universality remains surprisingly limited.

Using NYSE, American Stock Exchange and NASDAQ data, Zuckerman (1999) demonstrates the necessity to understand the precise social process of analysts' coverage to account for the market prices of public American firms in the stock market over the years 1985–94. He shows that stock prices in this period were significantly discounted for firms which did not succeed in getting coverage by the securities analysts specializing in their industry. Similarly, Zuckerman (2004) explores the impact of a stock's position in the industry-based classification that analysts use on the market. Evidencing the fact that stocks that are difficult to classify exhibit more trading volume and higher volatility, he provides explanations related to the difficulty that investors of these stocks had in interpreting ambiguous economic information and converging on a common evaluation. The classificatory system can thus be seen as an imperfect functionalist social solution to market participants' uncertainty, and its impact on market prices as an unintended consequence. Focusing on arbitrage trading, Beunza, Hardie and MacKenzie (2006) conducted an in-depth study of the social processes involved in these specific investment strategies. They illustrate the importance of trust and information exchange as well as the informal norms of conduct involved in the process, and show the efforts arbitrageurs must expend in order to convince others (investment bank managers, for example) of the correctness of their theories. In arbitrage strategies, price clearly appears as the product of complex and specific material and social interactions. Other works focus on the social processes involved in the slow adoption of Black and Scholes' valuation model on the options market created in Chicago in 1973 (MacKenzie and Millo, 2003; Smith, 2007). They show that acceptation of the model required time, the use of some scientific rhetoric (the model was highly mathematical and its promoters emphasized its modernity) and specific market conditions which financially favoured its early adopters. The Black and Scholes model was finally incorporated into technical mechanisms, thus creating the very phenomena it described (Callon, 1998; MacKenzie, 2004, 2006).

All these contributions of economic sociology provide in-depth analyses of the social construction of value on financial markets and suggest the existence of interrelations between market organization and the social processes required to achieve pricing. In this context, they also indicate that progress makes mastering the specific technicalities of various markets a necessity if one is to conduct fine-tuned investigations of the precise social construction of various market structures (Whitley, 2006; Zelizer, 1994).

We suggest using the insights provided by economic sociology on the social construction of financial markets in order to study a new, and quantitatively particularly successful market, the market for credit derivatives. Observing that this market bears strikingly little empirical resemblance with the options market, the research question we start from is thus the following: how could the theoretical apparatus developed by Black and Scholes (1972) produce such dissimilar market structures?

We propose to look for an answer to this question by studying the social construction of value that is observable on the market for credit derivatives. We argue that the starting point of the analysis is found by taking full account of the most striking difference between options on stocks and credit derivatives; this difference lying in the absence of a direct or simple link with any underlying asset in the case of credit derivatives.

We posit that this presents a certain number of practical problems for the actors of the market. A first series of questions are related to definitional issues. As noted by MacKenzie and Millo (2003), the CBOE developed on the basis of a small ad hoc existing market. Therefore, the definition of an option was widely agreed upon from the start. Definitional issues are more problematic in the case of credit derivatives given the absence of any simple link with a quoted underlying asset. The triggering event, which decides whether an option on a stock will be exercised, is the passage of the stock price above or below a given exercise price. In the case of credit derivatives, the identification of the triggering event is more problematic. Another kind of definitional problem lies in the legal qualification issue. Options had a legal status when they began to be traded on the CBOE. The situation is different for credit derivatives which could be considered either as financial products or as insurance contracts with which they bear some similarities (de Goede, 2004). The consequences of having one definition prevail over the other (Zelizer, 1979) are significant for various categories of actors, making the alleviation of this ambiguity a crucial point for the development of the market.

A second series of difficulties is related to valuation problems. Strikingly, the performative role played by the Black and Scholes model in framing the options markets has no equivalent as regards credit derivatives. Overcoming the absence of any direct link with a traded underlying asset proves extremely difficult given the core role played by this issue in Black and Scholes' theory. No reference model has succeeded in becoming established and the price of exchanged contracts result from non-transparent interactions between private actors which, given the concentration of the markets, are not numerous. Various actors complain about prices not being widely observable, especially for the more customized transactions, and even when they are (in the case of more standardized contracts), they are not highly reliable, as liquidity remains doubtful.

We propose to study the way in which actors in the credit derivatives market have confronted definitional and valuation issues (Smith, 2007) stemming from the very peculiar design of the product. By so doing, we extend Smith's (1989) vision of auctions as inherently social processes for resolving definitional ambiguities to a more modern and sophisticated financial market. In particular, we show that the social response of actors to the ambiguities faced actually explain the shape of the market as it now stands.

Methodology

This article is based on a longitudinal qualitative study of the emerging activity of credit derivatives from the mid-1990s to 2004. Our aim is to contribute to the understanding of the development and functioning of this financial market.

Sources of data

Our approach focuses on how French actors took part in the development of the market. Among the 75 financial institutions surveyed by FitchRatings in 2006[4] as actors playing a major role in the credit derivatives market worldwide, three French banks (BNP Paribas, Société Générale and Calyon) consistently rank between tenth and 22nd positions from 2002 to 2005. French banks are acknowledged in FitchRatings' special report (2006) to be 'the biggest players in the European Credit Derivatives market'. Moreover, the type of study conducted in this chapter requires a refined analysis of the institutional context, which is difficult to achieve on a global basis. French actors offer an interesting standpoint from which to understand the structuring of the European Credit Derivative Market.

Although it covers a ten-year period of development of the market, our interviews were conducted during one year and are based on a retrospective analysis. This methodology has its disadvantages (MacKenzie and Millo, 2003: 112). Unlike studies that use participant or direct observation (Abolafia, 1996; Jacobides, 2005), there is a risk of ex post rationalization or memory bias in retrospective interviews. However, we drew upon numerous other sources of data (secondary sources such as documents, archival materials and professional press articles) allowing us to gain an in-depth knowledge of this field. The opportunity to compare and contrast the different positions of diverse actors in order to obtain a triangulated cross-section provided a certain degree of control over results by widening the range of data sources.

Informants

The central activity for data collection was individual interviews. As in MacKenzie and Millo (2003) and MacKenzie (1990), interviewing was necessary because neither financial/trade press sources nor archival sources were sufficient in addressing our research questions. Various categories of actors were interviewed between 2004 and 2005: traders and market practitioners in banks, regulators and experts in Paris and in London. The actors interviewed were members of la Commission Bancaire (the Banking Commission), la Commission de Contrôle des Assurances (the Insurance Control Commission), l'Autorité de Régulation des Marchés Financiers (the Financial Market Regulating Authority, the SEC equivalent), the ISDA,[5] and various banks (Société Générale, BNP Paribas, Exane Asset Management, Fortis Banque). Financial market experts, legal experts and economists were also interviewed. A total of 35 interviews were conducted: eight with the regulators, fourteen with traders from investment banks, four with mutual and hedge funds, three with insurance companies, two with members of ISDA and four with experts. Interviews were semi-structured and focused upon the most important actors in the market, the analysis of their activities and their relationship with regulatory and normalization institutions. The five main question areas were

- What was the origin of the market?
- What type of resistance did the banks meet in developing this new market?
- What were the main crises and events in this market?
- What are the relationships between the actors?
- What are the main operating routines in this market?

Interviews lasted one and a half to three hours and were taped and transcribed. All the interviews involved the two researchers of this study.

Secondary sources

Many categories of archival information were consulted. We reviewed the studies of the Banking Commission in France, FitchRatings publications, Bank of England publications, Bank of International Settlements and documents from ISDA. These materials confirmed the chronology of events, gave details not available from interviews and provided textual accounts of debates and discussions.

Secondary sources also included a review of press articles. The criteria of specialization of the journals in the domain of financial information were used for selection. Three French professional sources were chosen: *La Tribune*, *L'Agefi* and the journal *Banque* (*Banque Magazine*, *Banque et Droit*, *Banque et Marché*). These reviews are those that are mainly read by the French professionals of financial markets. The articles were chosen from the study period 1996–2004. It was 1996, the year from which the French media started to publish articles on credit derivatives. In total, 199 articles made up our database, beginning with research on the term 'credit derivative'. Through these documents, we were able to reconstitute events.

Data analysis

Following Miles and Huberman (1994) and Yin (1989), we arranged the data into a chronological account in order to produce a 'facts database'. We then tried to capture the 'justificatory accounts' of different actors (Greenwood and Suddaby, 2006: 32) engaged in the development of this market.

One of the authors, a finance specialist, conducted an analysis of these accounts, first identifying sentences and words commonly used by actors to justify their activity and to explain the growth of the market. For example, references to *risk management*, *diversification of risks* but also to *size*, *volume of exchanges* and *market liquidity* were made very frequently by banks. We identified an initial set of narratives, reviewed them carefully and interpreted the data using what we knew about the subject based on documents, press articles and interviews (Berg, 2004; Greenwood and Suddaby, 2006: 32). We were then able to analyse the way actors handled ambiguities. We focused on five main themes. The first three refer to definitional problems: (1) economic justification of the market, that is, the efforts to show that credit derivatives are an instrument of risk management, (2) lobbying dynamics, that is, the efforts made by banks to promote the product, especially through legal qualification and (3) normalization and valorization processes, that is, the will of the actors to give credit derivatives a recognizable framework and valorization devices. The following two themes refer to the constitution of communities on this market: (4) heterogeneity of cultural and technical equipment of actors, that is, the absence of a common cognitive framework for the actors of the market, and (5) conflicts of interests, that is, the tensions and political conflicts between actors.

We used then other data sources, to verify the categories and, in particular, professional press articles. These data were collected after we had found the emerging themes from interviews, documents and reports. From the 199 articles analysed, we created a dictionary for the entire corpus using computer-assisted textual analysis software (SPAD-T). We obtained 8854 words, which were organized into a dictionary of 73 words. It was then possible to verify the main actors of the market and their specific vocabulary. Based on this analysis, we observed that only certain types of questions are more particularly put forward by certain types of actors.

Case analysis

The development of the credit derivatives market is presented first. We then go on to analyse the market-shaping process that results from the different ambiguities the actors must handle.

History and development

The first credit derivatives appeared in the early 1990s in the United States. Derivatives are typically financial instruments which are related to a risk, require little or no initial investments and may not be settled.

While for interest rate swaps, the risk resides in the movements of interest rates, and for commodity derivatives in commodity price, credit derivatives would be written on the general credit risk of a reference entity. This risk would be materialized by the occurrence of certain events, called *credit events*, which include bankruptcy, failure to pay, restructuring etc. In practice, the innovation resides in isolating the credit risk from a loan in order to be able to trade it on the market. In this way, the creditor (purchaser of the protection) can transfer the associated credit risk to another party (the vendor of the protection) while still retaining the debt on his or her balance sheet. Typically, the protection buyer will pay a certain premium to the protection seller, receiving compensation in the case where a credit event occurs. Theoretically, credit derivatives are also innovative for another reason. While they result from an extension of the standard derivative technology, they do not rely straightforwardly on a traded underlying asset.

The principal actors in this market are large investment banks, insurance companies and mutual fund companies.[6] Market information is based on estimates or surveys among participants and these estimates differ greatly. While investment banks primarily act as protection buyers to hedge their own exposure, the development of the market also allows them to sell protection according to their anticipations of the credit risk of various reference entities. Insurance companies and mutual funds are typically protection sellers, using credit derivatives as an instrument of diversification, which they hope would generate interesting returns.

Other significant actors are regulators, who play an important role on the market. In France, they are organized in distinct bodies for insurance companies (Commission de Contrôle des Assurances), for banks (Commission Bancaire) and for management companies (Autorité des Marchés Financiers or AMF). The national regulators are also organized into international authorities, as part of the Joint Forum created in 1999.

Finally, the particular role played by the ISDA in the promotion and the development of the market should be noted. This global trade association representing leading participants in the over-the-counter (OTC) derivatives markets has over 650 member institutions worldwide. As we shall see, its role in the development of new OTC markets is crucial[7] and mainly revolves around documentation and promotion of new products.

While the appearance of the first true credit derivative is difficult to trace back, 1997 can be chosen as the starting point for the development of the market, at least in Europe. That year, J. P. Morgan proposed a reference model to price and handle credit derivatives, the CreditMetrics model. In England, the ISDA had credit derivatives legally acknowledged as financial instruments, which launched the process of market development. Its ensuing growth was extremely rapid. From outstanding loans of $180 billion in 1997, the notional amounts on which the derivative products are written, reached a record volume of $28,838 billion in 2006, according to the Bank of International Settlements statistics.

It must be noted that despite the great number of potential actors, the market remains extremely concentrated. A survey carried out on a sample of 27 companies in 2004 by the Banking Commission, the Insurance Controlling Commission and the Financial Market Authority helped to reveal the structure of the market as well as the concentration on the French market.

One figure in itself reveals the high concentration of the global market for credit derivatives. Six main banks alone continue to realize 50 per cent of worldwide transactions. According to Fitch Ratings, the top ten counterparts in the world (all banks) represent 86 per cent of the sold and bought volume totals.[8]

How can this concentration be explained? The next section proposes to look for an answer in the specific social processes observable on the credit derivatives market.

Market structuring as an answer to ambiguities

Although credit derivatives were designed within the paradigm of the financial theory of risk, they entail a number of difficulties that were largely overlooked by their creators. For example, they were far from being well-defined from the start. Diffusion was hampered by definitional issues and contractual uncertainties. Transparency appeared questionable as the first deals were made on a private basis within a circle involving but a few investment banks. It thus soon became apparent that the market for credit derivatives did not naturally match the theoretical description used to justify its creation, and that convergence could only be obtained through commitment and efforts on the part of the product promoters. These efforts can best be understood as attempts to deal with the multiple and fundamental ambiguities confronted by the various market actors. Two main problems remained: definitional issues needed to be solved and product diffusion enhanced.

Problems of definition

One of the peculiarities of the credit derivatives financial innovation is that the very definition of the product was at the beginning (and to a certain extent still is) problematic. Definitional ambiguities had to be removed at three different levels.

The first is that of legal qualification. The specificity of credit risk – a risk materialized, not by the price variation of an underlying asset but by the arrival of a specific event – could lead one to consider credit derivatives as a kind of insurance contract. For banks, which were the promoters of the product, it was incumbent to combat this vision for two reasons. Insurance contracts could only be treated by insurance companies in most European countries and therefore could not be treated by banking actors. In addition, the qualification of credit derivatives in financial products would allow mutual funds, especially hedge funds, to access these products. This was seen as necessary for the development of a market which, in order to exist, needs sellers as well as buyers of protection.

Promoters of credit derivatives chose to approach this issue by gathering within ISDA. In June 1997, the ISDA succeeded in obtaining the legal decision they wanted from Robin Potts QC,[9] mainly that credit default swaps were not insurance contracts but financial products. This was unanimously acknowledged as one of the great successes of the organization; what was at stake was of primordial importance.

> This point is essential as a bank cannot sell insurance. Without this 'Potts' opinion', there would have been no market at all. This clarification was essential. The question of the qualification of the product had quickly been posed by the Financial Law Panel of the Bank of England [the regulator at that time].
>
> A representative of the ISDA

The intensity of the debate around the legal qualification of credit derivatives was also illustrated in France when, in 1999, a law thesis was devoted to the question (Gauvin, 1999). Later, in 2003, A. Gauvin maintained that credit derivatives could come under the gaming and gambling laws. Gauvin noted the way in which both French and British legal systems adopted legal qualification for financial products, and attributed the result to the victory of economic matters over purely legal thinking:

> The strength of financial stakes which [derivative products] represent is such that their being put into question in a given financial place or a particular country could have harmful consequences for the banking industry and local finance.

In France, the debate on the legal qualification of credit derivatives had also become focused on the possibility for mutual fund companies (OPCVM) to use credit derivatives. This access of mutual funds, of critical importance to promoters of the product, was validated by a decree on 10 December 2002 after four years of discussions and consultations. It expressively authorized mutual funds to sign credit derivatives as over-the-counter contracts. The ambiguity on legal qualification thus appeared to have been the first issue that needed solving. While several potential responses to the problem could have been envisaged, the prevailing solution was the one promoted by the community of investment banks, collectively acting to lobby the regulator. This social process is seen by promoters of the market as having yielded efficient results.

> Our lobbying achieved its goal: credit derivatives are no longer qualified as credit operations and no longer come under the banking monopoly. The legal qualification debate has been resolved.
>
> A trader

However, it is highly likely that non-bank actors noticed whose victory it actually was. From the beginning, and continuing through to the resolution of the legal qualification issue, credit derivatives were taken in hand by a specific cognitive and political community, that of banks as opposed to other actors of the market.

A second definitional ambiguity arose from the lack of standardization which prevailed when the market was created. Over-the-counter markets cannot develop without precise definitions of how the products will work in practice. Contractual risk, if too high will hamper the take-off of any financial innovation. As regards credit derivatives, those who decided to take this problem into their own hands were obviously the promoters of the market, and again they choose to handle it using the far-reaching experience that ISDA had developed over the years on other OTC markets. The process of standardization, however, was neither simple nor brief. During the development of the market, generally as a result of legal disagreements, the ISDA was forced to change its standards and norms several times.

> The pragmatic approach of the ISDA must be praised: every crisis, incident or dispute is an opportunity to reconsider and to improve the documentation. The ISDA has demonstrated its great flexibility and its ability to adapt to events.
>
> A legal expert

> Certain crises and disputes, such as the Conseco, RealTrack, Parmalat and LTCM affairs and the crisis in Argentina, meant we had to re-examine the documentation. The ISDA has worked very hard to clarify things – in particular those which concern the credit event that trigger credit derivative payments, as we have examples of cases in the U.S. where credit derivatives payments were unduly asked – without the default being acknowledged by the two parties.
>
> An ISDA representative

This long-lasting process resulted in the *2002 ISDA Master Agreement* becoming the standard form governing future transactions. On 10 February 2003, the ISDA again renewed its documentation relating to credit derivatives by publishing new definitions in the *2003 ISDA Credit Derivatives Definitions*.

> The first market problem was the absence of formalization of frameworks and definitions. It was therefore urgent to put ISDA documentation in place. ISDA norms represent a common language.
>
> A trader

A third, and last, definitional issue of the credit derivatives market, which proved especially intricate, was that of pricing. Regarding this question, a discrepancy materialized between what the theory predicted and what could be done in practice. The financial theory of risk used by credit derivatives designers assumes that credit risk can be assimilated to a typical financial risk. As a result, credit derivatives are theoretically to be valued using the conventional mathematical models. However, setting a tariff on credit risk which materializes through credit events, is practically very difficult. The failure of the CreditMetrics model, publicized on 2 April 1997 by J. P. Morgan, demonstrates this problem. 'The first portfolio model destined for the management of credit risk'[10] was supposed to facilitate understanding and use of the new credit risk management instruments. This ambitious project failed and CreditMetrics never played the unifying role that J. P. Morgan had dreamed of. Banks continued to resort to various internal models, implicitly acknowledging the failure of their attempt to clarify the valorization ambiguity inherent in credit derivatives.[11]

> There are worries about mispricing as there are no good pricing models. Prudence is essential in a context where one is frightened of the

> weakening of the financial system worldwide. The technique is quite simple when the underlying asset is unique and when it is quoted on an Exchange, but otherwise we don't have adequate instruments.
>
> A regulator

Although the ISDA fought particularly to obtain recognition of internal evaluation models[12] by the regulators of the Basel 2 framework, the combat ended in defeat. It led, however, to renewed efforts in Basel 3.

> Within the framework of a working group preparing Basel 3, the ISDA will produce a study showing the growing convergence of models which increasingly achieve the same results. Concerning the model selected by Basel 2, the ISDA is not in a position to react.
>
> A representative of the ISDA

As things stand at present, the absence of a consensus regarding pricing method, most likely weakens banks' capacity to rally the other actors of the market around the idea that credit derivatives are beneficial to all. This leads us to the second broad category of uncertainty that actors of the credit derivatives markets had to face.

Who is to benefit from the market?

The rhetorical justification for the creation of credit derivatives relies on the general assertion of the financial theory of risk, according to which the marketization of new risks is inherently advantageous. It is supposed to be beneficial to all financial actors, and more generally to the financial and economic system as a whole. The case of credit derivatives, however, shows that in reality, ambiguities might remain as to who is to benefit from the development of the market. The interest of the product for the banks promoting it was obvious. First, since 1988 and the Cooke ratio[13] implementation, international regulation had made it obligatory for banks to cover the risk of their assets with sufficient capital. This lessens the profitability for their shareholders, which induced banks to transfer part of their risk to markets, making so-called risk management a strategic activity. In addition, credit derivatives also offered them the more traditional advantages of financial innovations. It might be sold to new customers with comfortable margins, as the product was new, complex and, at least to begin with, not offered by all competitors. While promoters have thus a conspicuous interest in diffusing the innovation to sellers, as well as buyers of protection, and in sharing the risk as much as possible, other actors tended to suspect the innovation to be potentially detrimental to all but its promoters. The promoters, therefore, were led to provide varied responses to alleviate suspicion.

One category of customers was particularly resistant to the effort of promoters. Insurers tended to suspect American banks of having created the market in the first place in order to transfer their bad risks to European insurance companies, who would be at a disadvantage through the asymmetry of information.

> Bankers have often overcharged insurers who were not aware of the size of the risk because they didn't have enough technical knowledge.
>
> A regulator

This circumspect attitude, which seemed to have originated from a few unfortunate affairs dating from the early days of the market involving reinsurers and insurers,[14] led them to almost completely leave the credit derivatives market which had become quite illegitimate within the insurance industry.

> The insurance companies do not see any real interest in this market. They have the impression that the market is not very liquid, has not reached maturity and they are not very enthusiastic. Insurance companies are not promoters of credit derivatives.
>
> A regulator

> These products are somewhat diabolized by insurance companies. They are not put to the forefront in financial communication. Insurance companies are afraid that their stock exchange price will fall if they communicate about using credit derivatives; there is considerable mistrust. It must be said that the heart of the job of insurance companies is to provide people with the rates they promised.
>
> A regulator

In the pursuit of their own interests, banks were also confronted with the regulators. Regulatory capital had indeed been defined in order to meet the regulators' concern about systemic risk. Regulators were thus bound to be cautious in the face of credit derivatives and convincing them was not an easy task, all the less so as their concerns were built on the potential opportunism on the part of credit derivatives sellers.

> Obviously, the problem is the trader who sells nuclear waste, and then once the bloke is irradiated he finds the trader has already taken off with his bonus in his pocket.
>
> A trader

> We no longer know where the risk is with credit derivatives. The asymmetry of information between vendor and buyer is considerable. Some buyers do not even know what they are holding in their hands.
>
> A regulator

> The risk of asymmetries of information is real as the bank retains a higher degree of information than its correspondent. The buyers do not really have the same means at their disposition as vendors of risk. [...] [T]he question is: are we not again going to transfer risks towards households and businesses? [...] In a period of prosperity, they [credit derivatives] boost performance, which attracts subscribers. Only there have been examples of unfortunate experiences in certain European countries [e.g. in Italy with Parmalat shares and individual investors turned to the banks for explanations] [...] The Italian example is not reassuring from this point of view.
>
> A regulator

Promoters of the product did not remain inactive in the face of suspicion. They engaged in various endeavours to alleviate the ambiguity as to who was to benefit from the market and to reassure other actors regarding potential opportunism of their part.

First, an analysis of the specialized press permits quantitative evaluation of the effort made by banks to convince potential clients. Between 1996 and 2004, 77 per cent of the articles written by professional financiers, publishing as experts in the specialized press, were devoted to the presentation of credit derivatives as instruments of excellent risk management performance with 35 per cent of the articles coming explicitly from banks. The advantages of credit derivatives for potential clients were put forward in terms of diversification and profitability.

In a discussion, when one of his colleagues stated that the market starting point was built on the desire of large investment banks to respond to the tightening of international banking regulations in 1998, a representative of the ISDA stated:

> I am not sure that this was the starting point. […] The market existed before […] Another reason for the birth of the market was the relative blockage of the interbanking market. Banks played on a market of concentrated swaps and the counterparty risks were great. Credit derivatives appeared as an instrument of risk diversification […] It was also one way of offering certain clients higher returns by proposing tailor-made products.
>
> An ISDA representative

Other affirmative voices supported the same view:

> What is important is to create new products for investors. We are always looking for new kinds of assets. It is a question of diversification.
>
> A trader

Second, banks got actively involved in collaborative actions to enhance market liquidity and, as a consequence, price transparency. They resorted to two main actions.

In 2002, some banks joined together to produce standard product indices. The construction of indices is common practice in financial markets and it was hoped that credit risk indices would improve price transparency by giving clear signals to the market on the credit risk market price. The idea was to use the relative standardization of the leading product – the Credit Default Swap (CDS) – in order to create a basket of CDS' dealt worldwide, and to furnish an average price of the operation which could be referred to at any moment. Two of the main promoters, J. P. Morgan and Morgan Stanley were the first to independently launch two indices constructed from the CDS market in 2002. In 2003, these two indices joined together and created the TRAC-X index, whereas another group of banks (which included Deutsche Bank, ABN AMRO, then Citigroup and Société Générale) launched, in competition, an index called iBOXX. In April 2004, the two competing indices joined up again. What we observe is thus an interbank alliance, created to tackle the perceived ambiguity on the reliability of market prices.

Enhancing perceived transparency was also attempted through the organization of the market in two distinct market segments, with the first participating in the liquidity of the second. The first segment is one of standardized products, where the aim is to develop and maintain transparency and liquidity. CDS represent the majority of that segment, which investment banks include in what they call flow markets.

> Market techniques have been standardized. The ISDA has declared what options are possible. We chose termly dates in order to have more liquidity.
>
> A trader

As the development of this standardized segment impairs margins, investment banks also continue to develop a second market segment, consisting of structured products, otherwise known as tailor-made. The liquidity of the less profitable flow segment, if sufficient, is expected to warrant the applicability of the traditional financial theory of risk to credit risk by providing an observable market price for risk. Practically, despite the efforts to produce market prices that could serve as quotes (which are transmitted to all banks through means fine-tuned by Lombard, BNP in the form of a Reuters page, or by J. P. Morgan in the form of a Bloomberg function) doubt remains on the reliability of the obtained data.

> It's an over-the-counter market, more or less liquid. The sales argument here is one of liquidity but it's wishful thinking.
>
> A regulator

Third, banks engaged in lobbying actions towards the regulators. National regulators were targeted first.

> At the beginning, it was a question of credit establishments wanting credit derivatives market instruments legally recognized. Banks laid siege on supervisors to obtain a reduction in capital charges off their balance sheet [...]. To begin with the approach was not coordinated internationally. There were informal discussions but each country chose its own way of dealing.
>
> A representative of the Commission Bancaire

At the international level, banks again chose to pull their weight against the regulators within the ISDA. The ISDA had very significant means at its disposition:

> At a global level the ISDA has colossal clout, they pay lawyers worldwide, all the profession joins, and they lobby the regulators.
>
> A trader

At the organization level, the construction of demand, and the alleviation of suspicion on the part of other actors required huge investments of technical and human resources. Most of the actions taken emanated from the small number of sufficiently large and powerful investment banks. In this respect, the Société Générale appeared as a particularly well-equipped actor among French banks, whereas J. P. Morgan represented the precursor in the promotion of the worldwide credit derivatives market. Thanks to their technical and human resources, these two banks had at their disposition a particularly vast capacity for promotion – according them a key role in this market.

> The Société Générale is a very powerful actor which does a lot of lobbying. The doctrine of the Fédération des Banques Françaises comes from the Société Générale lobby. They impose their way of seeing things on everyone and some – mostly competitors – complain about this fact.
>
> A legal expert

> The Société Générale has battalions of legal experts just like the American banks, a large number of legal Ph.D.s, who are really very good. Not only do they master the product technically but they are well organized.
>
> A legal expert

> There has been an effort of systematic promotion by J. P. Morgan. They have been consistent in their efforts, putting huge resources into manpower and technology. They very quickly became rapid in dealing with these products.
>
> A trader

All these resources seemed necessary to both convince potential clients and to socially construct the demand for credit derivatives. Significantly, promoters of the product see cognitive issues as central to the process and sometimes as their main restriction.

> It has to be said that it is a market of 'nerds' who have years of study behind them, who are engineers. They find it interesting because it's complicated and that credit derivatives are more engaging than interest rate derivatives.
>
> A trader

> Very few people really understand what credit derivatives really are [...] To establish a legitimacy of the market, we lobbied, did demonstrations to explain how it worked to clients, we organized conferences within the *Agefi* framework – a formidable lobbying mechanism. We also published articles in the *Agefi* and in *Banque et Droit*. We did everything, in terms of clients – especially mutual fund companies.
>
> A trader

> It was primarily a question of discussing with clients, of education, of demystifying or popularizing complicated documentation.
>
> A trader

Bankers complained about the way insurance companies regarded credit derivatives, seeing them as hardly concerned by the ISDA process and just as satisfied to apply their usual regulations. They explained the long-lasting tendency of insurers to consider credit derivatives as rather 'heretical' by emphasizing cultural determinants. They also complained about the cultural apprehension of the regulator:

> This is a new activity, very technical, conceptually disconcerting. One has to justify oneself frequently to the regulators and each others' positions are often restricting when one considers the complexity of the product.
>
> A trader

> The regulator does not understand the product very well; he doesn't say it's not allowed but he doesn't say it is allowed either.
>
> A legal expert

> The regulator's power to bring prejudice is quite strong. The regulatory environment can be considered as an obstacle, which slows business down. The biggest obstacle, in any case, is the cultural apprehension of many people who spend a disproportionate amount of time in controlling credit derivatives.
>
> A trader

What our analysis shows, however, is that at the heart of the diffusion issue is the unresolved question of who is going to benefit from the innovation. As long as it is not handled collectively by the different categories of actors, but taken in charge by a given category of them, this category is likely to be perceived by others as a political community defending its own interest. The refusal by the Spanish authorities to allow mutual funds in Spain to subscribe to credit derivatives is an example of the limited trust granted by regulators to investment banks in general. Similarly, in France, the AMF gave authorization very prudently. Only 20 mutual fund companies out of the 520 operating in Paris have so far received authorization.

To summarize, while the vision borne by the financial theory of risk is that any innovation of interest should be readily adopted by various categories of actors of the market, the empirical realities of the market for credit derivatives appears fundamentally different. Diffusion meets several obstacles, which requires collaborative commitment and endeavour from promoters of the product. The amount of the resources needed brings the most powerful of them to take the lead and act as main drivers of the entire process. The actual structure of the market with its definitions, standards, indices and segments can be seen as the functionalist result of their endeavours. Moreover, the analysis we led evidences the political nature of the ambiguities at stake. The fact that these ambiguities are dealt with by the main investment banks acting, as what is perceived by other actors of the market, as a specific cognitive and political community provides an explanation for the relatively high concentration of the market.

Discussion

In 1993, in a speech which has since often been quoted, Charles Sanford Jr, the CEO of Bankers Trust, put forward his vision of the financial market in 2020. Traditional finance would be replaced by 'particle' finance creating progress of the same nature as that brought about by quantum physics and molecular biology. In dividing up classical financial assets (a loan note, for instance) into risk particles (interest rate risk on the one hand, credit risk on the other), this new finance would permit us to 'create order from apparent disorder', and 'the amount of unwanted risk borne by individuals, institutions and the system as a whole' would be reduced in size. Even though credit derivatives were just emerging, and even though this wish for new finance seemed to him to be a distant aim at the moment of his speech, Charles Sanford Jr named credit derivatives as the pioneers of this new way of envisioning finance and the economy.

In this chapter, we have evidenced the discrepancy between this ideal vision and the empirical reality of the market for credit derivatives.

We have proposed to explain this gap, by taking into full account the specific features of the product. While credit derivatives result from an extension of the financial theory of risk developed on the basis of the Black and Scholes model, they fundamentally differ from options in that they bear no simple link with a traded underlying asset. Promoters of the product, by sticking to their theoretical apparatus, largely overlook the implications of this specificity. We demonstrate that many dimensions they take for granted are, in fact, rendered ambiguous by the very design of the product. Credit derivatives are not easily defined, categorized, legally qualified or valorized. They pose questions regarding who should be allowed to participate in the market and how ownership is transferred. They induce doubts concerning who will eventually benefit from the development of the market.

Facing these practical difficulties, a specific category of actors has had to collectively organize and decide on the means by which these questions can be handled. The most interested and well-equipped promoters of the market take the lead and jointly commit to a standardization and normalization processes. They carry on collaborative actions to impose their 'calculative device' (Callon and Muniesa, 2005) to promote market liquidity and to alleviate suspicions from other actors. In so doing, they construct a cognitive and political community, taking the role of creator of the rules of the game (Fligstein, 2001). These dynamics cannot be expected to favour the adhesion of other actors who feel technically handicapped and uncertain about potential opportunism of the small group of active promoters. Hence, the ambiguities posed by credit derivatives are solved by social processes which eventually shape the market in such a way that opacity and concentration are practically unavoidable. Remember that the theoretical rationalization of promoters of the product relies on the identification of credit risk to a classical market risk, which implicitly assumes atomistic, numerous and anonymous actors exchanging on the basis of highly transparent prices produced by a pure supply and demand mechanism. Ultimately then, what we observe is a sharp contradiction between the empirical reality and the rhetorical justification of credit derivatives as financial innovation.

This Chapter contributes to the understanding of financial markets in several ways.

First, our study builds on Smith (1989) by acknowledging the crucial role played by uncertainty on the market for credit derivatives. Showing how ambiguities materialize through time, we provide a historical perspective in which the market appears as a functionalist work-in-progress solution to definitional and valorization uncertainties, as opposed to a given device assumed to manage well-defined risks. In this perspective, the conception of markets as definitional practices (Smith, 2007) fits the market for credit derivatives extremely well. However, in contrast with Smith's (1989) description of auction markets, the structure of credit derivative trading cannot be accounted for by recognition of cognitive ambiguities only. Ambiguities of a political nature must be added to the analysis. The manner in which these two types of ambiguities are handled by those who have the greatest interest in the development of the market, and the most resources to devote to the cause, is central in explaining the actual structure of the market, its concentration and lack of transparency. Although often overlooked or denied by the most active market promoters, this political dimension is recognized by other actors.

Second, this chapter emphasizes the role played by academic knowledge in the structuring of modern financial markets (Whitley, 1986). Credit derivatives would not have seen the light were it not for the conceptual and computational matrix provided by Black and Scholes (1972) and their followers. In that perspective, the entire process of market promotion evidenced in this chapter could be described as an attempt to perform the theory (Callon, 1998; MacKenzie and Millo, 2003). Although the definition of performativity is currently strongly debated (MacKenzie, 2006; MacKenzie, Muniesa and Siu, 2007), efforts of market promoters to make the credit derivatives market more like its depiction by the financial theory of risk[15] (index creation, segment organization of the market, promotion of transparency and liquidity) seem to fit quite well with the empirical reality we observed.

Yet, in contradiction with other works (MacKenzie and Millo, 2003), what we evidence here is the relative failure of such an attempt. Our work provides some insight into the causes of this. When the setting surrounding a financial product is too distanced from the ideal assumptions of the financial theory of risk, it might prove extremely difficult for the market promoters to transform actors' perceptions from 'uncertainties' into 'risks'. Whatever the significance of the resources devoted (Fligstein, 2001), the power of large financial institutions seems to find a very serious limitation here. This suggests that there may be a limit to the extension of the financial theory to the objectification (LiPuma and Lee, 2005) and marketization of new risks. It can be expected that attempts at having CAT-bonds, risks of attack or rights to pollute exchanged in financial markets to be hampered if actors feel that uncertainties are too real for them to be considered under a crude risk perspective, or if market promoters fail to push the market towards an acceptable approximation of the theoretical assumptions. According to Beck (1990: 61), risks might be seen as 'the interminable needs sought by economists', because needs that are open to interpretation can be proliferated endlessly (Beck, 1992, 2006). In this chapter, we show that the interpretation provided by the financial theory of risk might have more limited applicability than is generally acknowledged.

Finally, this chapter demonstrates the role played by private actors in the regulating and normalizing processes. Their lobbying capacity is a key issue in trying to ensure that the strongest actors' interests prevail. General interest defence on sophisticated over-the-counter markets thus remains a question. Are the regulators in a position to guarantee the preservation of the common good? Who is responsible in times of crisis (Sassen, 2005)? Observation of the social processes apparent in the credit derivatives market gives some relevance to the issue of the re-politicization of financial risks (de Goede, 2004), as the recent subprime turmoil that occurred after we conducted this study emphasizes.

Notes

This chapter is drawn from 'Market Shaping as an Answer to Ambiguities. The Case of Credit Derivatives' by Isabelle Huault and Hélène Rainelli. Originally published in *Organization Studies*, May, 2009, 30(5). Reprinted with permission.

1. BIS, Statistics on derivatives, September 2007.
2. Although some credit derivatives are written on corporate or sovereign bonds, those underlying assets serve only as a reference. Their price variations are not directly linked to the credit event that will trigger the exercise of the credit derivative. Other credit derivatives are written on several reference entities.
3. For a historical account of the notion of risk and probabilities, see Reith (1999).
4. FitchRatings, Special report, Global Credit derivatives Survey, September 2006.
5. International Swaps and Derivatives Association: the ISDA is a global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rates, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985 and numbers over 650 member institutions from 44 countries on six continents. Its board is primarily composed of banks. For a comprehensive study of the role of ISDA on international financial markets, see Morgan (2008).
6. See Deutche Bank Research, Current issues, June 2004, Credit derivatives, effects on the stability of financial markets.
7. See also Morgan (2008).
8. Fitch Ratings, Special report, Global Credit derivatives Survey, September 2006.

9. Robin Potts' employer is the London-based international law firm Allen & Overy, which shares a common address in London with the ISDA European Office, One Bishops Square, London E1 6AD.
10. J. P. Morgan Chase 2001 Annual Report.
11. This difficulty could perhaps be related to the notion that Maki (1992) termed isolation. Isolation refers to the high level of abstraction of the theoretical models used in contexts that require many more details to be adequately described or fully understood. (Whitley, 2008)
12. In other terms, the doctrine of the ISDA is that it should be the banks themselves who define the method of calculating the risk represented by their activities in derivative products. Regulators remain reticent when faced with the use of internal models. The key reason for disagreement is the absence, in the case of credit derivatives, of an independent liquid and transparent market for credit risk.
13. The Cooke ratio is also known as the Capital adequacy ratio. It is the limit on the risk-weighted credit exposure allowed to each financial institution depending on its capital base. From 2005, it was progressively replaced by the McDonough ratios.
14. The insurance and reinsurance actors have been the largest recipients of credit risk transferred from other sectors. Some regulators have expressed worries about the (re)insurance sector's growing exposure to cross-sector credit risk transfers. These worries also extended to the commercial rating agencies and other market watchers. This sparked some responses from the reinsurance industry. For example, on November 2001, the French reinsurance group SCOR had discontinued its credit derivative insurance activities. It had increased loss provisions by €30 million to €131 million in the third quarter of 2002 and it had taken an estimated 2.5 years for the exposure to run off.
15. Barnesian performativity in MacKenzie's sense.

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