Understanding Interorganizational Cooperation: Public-Private Collaboration in Regulating Financial Market Innovation

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Abstract

This paper examines how a collaborative effort between the private and public sectors, called the Derivatives Policy Group (DPG), helped shape current regulation of financial innovation. In 1994 and 1995, this group of six large financial firms developed procedures for risk management, internal controls, and reporting for largely unregulated areas of finance, in cooperation with the United States Securities and Exchange Commission and Commodity Futures Trading Commission. The process succeeded despite strong competition among the firms themselves and incentives for both the public and private sectors to resort to adversarial lobbying and legal challenges. The Derivatives Policy Group was a path-setting event in the development of flexible regulation of financial innovation that is now the norm for related policy making. The case is important in and of itself—the financial markets are a major concern of national and international economic policy—but here we treat it as an instance of a larger class of problems. Organizational science constantly encounters settings that involve numerous participants who compete or have histories of conflicts; who are interdependent, and collectively would gain (and even individually gain long term) by cooperating rather than competing on an issue; who fall under different governance systems; and who try as a group to design rules and principles governing their behavior. Four factors appear repeatedly in the research on the success or failure of such arrangements. These are (1) the initial dispositions toward cooperation, (2) the extant issues and incentives, (3) leadership, and (4) the number and variety of organizations involved. This paper focuses on how these factors shaped the development and consequences of the Derivatives Policy Group, and the general implications of this process for interorganizational cooperation.

Financial engineers have developed new types of instruments allowing market participants to manage risk and speculate in virtually unlimited ways. The innovations’ power and flexibility are economically valuable, but, if mismanaged, they can quickly produce serious losses. Landmark financial catastrophes in the mid-1990s included the failure of Kidder Peabody as an independent firm ($350 million in losses in 1994); Orange County, California ($3.5 billion in losses in 1994 from trades by its financial manager); and Banker’s Trust (lawsuits in 1994 by institutional investors for over $150 million alleging fraud in the trading of financial derivatives) (United States Senate Committee on Banking, Housing, and Urban Affairs 1995, United States House Committee on Banking and Financial Services 1996).

Government regulators have strong incentives to prevent such failures because if investors worry about the reliability of contracts they will withdraw from financial markets, harming the economy. As outsiders, however, regulators have a difficult time supervising complex, rapidly changing financial technology. The controls within financial firms themselves can be more technically sophisticated, but the incentives for maintaining effective internal controls are fragile; supervisors within financial firms must deal with politically powerful “production offices” that see controls as slowing down profitable business (McCaffrey and Hart 1998). Cooperation among public and private supervisors could elevate the attention paid to internal controls on public interest grounds while drawing on the technical expertise of the private sector,
but this requires transcending barriers to collaboration between the sectors.

This paper examines how a collaborative effort between the private and public sectors, called the Derivatives Policy Group (DPG), helped shape current regulation of financial innovation. In 1994 and 1995, this group of six large financial firms developed procedures for risk management, internal controls, and reporting for largely unregulated areas of finance, in cooperation with the United States Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC). The process succeeded despite strong competition among the firms themselves and incentives for both the public and private sectors to resort to adversarial lobbying and legal challenges. The DPG was a path-setting event in the development of flexible regulation of financial innovation that has become a norm for policy making (President’s Working Group on Financial Markets 1999; United States House Committee on Agriculture 2000; United States House Committee on Banking and Financial Services, 2000a, 2000b). As one supervisor with extensive experience in both sectors remarked in an interview with us, "[t]his is a new style of regulation. These things are subtle. The spirit of the DPG has worked its way into the stream of consciousness."

The case is important in and of itself—the financial markets are a major concern of national and international economic policy—but here we treat it as an instance of a larger class of problems. Organizational science constantly encounters settings that involve numerous participants who compete or have histories of conflicts; who are interdependent, and collectively would gain, and even individually gain long term, by cooperating rather than competing on an issue; who fall under different governance systems; and who try as a group to design rules and principles governing their behavior (Ostrom 1990, 1998). Furthermore, the settings encompass organizations from the private, public, and nonprofit sectors, and the difference in perspectives of the two sectors is both one of the advantages of cooperation and one of the challenges to it (Reinicke 1998). Similar examples are seen when economically and socially diverse nations try to reach global environmental agreements (Cooperrider and Dutton 1999, Gray 1999); electronic marketers try collectively to restrain their activities when privacy risks potentially diminish buyers’ confidence in the Internet (United States House Committee on Commerce 1999, United States Federal Trade Commission 2000); and different government agencies try jointly, along with private and nonprofit contractors, to address problems spilling across jurisdictions (Bardach 1998). It has been difficult to institutionalize these cooperative approaches, but the successes are so worthwhile that efforts to make them routine continue.

Four factors appear repeatedly in the research on the success or failure of such arrangements. These are (1) the initial dispositions toward cooperation, (2) the extant issues and incentives, (3) leadership, and (4) the number and variety of organizations involved (McCaffrey et al. 1995). This paper focuses on how these factors shaped the development and consequences of the Derivatives Policy Group, and the general implications of this process for interorganizational cooperation.

The paper is organized as follows. The next section briefly describes the features of financial markets that set the stage for the DPG. We then present a theoretical framework addressing the determinants of interorganizational cooperation. The paper next reviews the methodology used to collect and examine the data presented here, and then uses the theoretical framework to discuss the conditions facilitating the DPG agreement, as well as the difficulties the group could not overcome. The conclusion examines the case’s implications, including the necessity of focusing on the complexity of cooperation’s development, and its persistence or failure.

The Benefits and Problems of Financial Innovation

To put the Derivatives Policy Group in context, it is important to understand some key elements of financial markets. Two basic classes of financial instruments are securities and futures. The traditional notion was that securities, generally equities and bonds, were acquired for investment profits, whereas futures contracts were acquired to transfer risk. In a futures contract, a party agrees to pay a certain price for delivery of a commodity or other asset at a designated point in the future. The two contexts for buying and selling financial instruments are exchanges and the over-the-counter (OTC), or off-exchange, markets. Exchanges physically consolidate trading; they include places like the New York Stock Exchange and American Stock Exchange (for securities), and the Chicago Board of Trade and Chicago Mercantile Exchange (for futures). Concentrating trading makes it easier for buyers, sellers, and dealers to find each other and eases regulatory monitoring of trading. The over-the-counter markets, in contrast, are decentralized networks of buyers, sellers, and dealers, not tied to a particular exchange.

The United States Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) are the main regulators for the securities and futures industries, respectively. The SEC regulates
securities transactions done on exchanges and the over-the-counter market. In contrast, the CFTC requires that futures trading take place on exchanges only, not permitting OTC futures trading. The justification is that centralizing all futures trading on regulated exchanges will minimize what could be especially harmful price manipulation (Seligman 1995).

The Emergence of Over-the-Counter Financial Derivatives. In the 1990s, a largely unregulated over-the-counter market in derivative financial instruments became an important part of the financial markets, challenging federal financial oversight. Financial engineers had created new classes of financial derivatives, or instruments whose values are “derived” from underlying assets like stocks, physical commodities like metals, a stock market index like the Standard and Poor’s 500 Index, or a reference rate like an interest rate. Since the mid-1980s, about two-thirds of futures trading volume on United States exchanges has involved futures in financial instruments (Securities Industry Association 1999). Much of this activity occurred in an over-the-counter derivatives market called the swaps market, which was largely unregulated. Derivatives traded on securities and futures exchanges, and in the regulated over-the-counter market in securities, are standardized and marketed to the general public. Swaps, however, are custom-made agreements between two parties to make periodic payments to each other (or net periodic payments) based on changes in underlying assets, rates, or indices. For example, a party currently paying a fixed interest rate, but preferring a variable rate, effectively can “swap” interest rate payments with another who prefers the fixed rate. By 1994, conventional measures indicated that the volume of activity in OTC derivatives activity exceeded that in exchange-traded derivatives (Securities Industry Association 1999). Neither the Securities and Exchange Commission nor the Commodity Futures Trading Commission had tried to regulate swaps as securities or futures because they were not marketed to the general public and were not traded on regulated exchanges. Some people, however, argued that the new market affected the general public so pervasively that it should not remain beyond regulators’ reach.

The “Regulatory Gap” and the Controversy over Derivatives. The SEC and CFTC require broker-dealer firms to maintain capital reserves so they can protect customers from a firm’s operational default; this capital is not available for profit-making activities. The firms’ exposures to OTC swaps transactions counted in computing their capital requirements, but firms argued that applying the standard capital formulas to swaps resulted in excessively high levels of such “unprofitable” reserves being set aside to meet regulations (U.S. General Accounting Office 1998). Firms thus responded by creating subsidiaries which were largely unregulated to carry out their swaps business. The firms defended the arrangements on the grounds that swaps were not marketed to the general public, and so were beyond the SEC’s and CFTC’s jurisdictions, and that the subsidiaries did not affect regulated operations. But critics cited a “regulatory gap,” arguing that the OTC derivatives market was functionally similar to the securities and futures markets and was growing rapidly, and that the subsidiaries indeed did affect the parent firms.

This controversy escalated in 1994. After the Federal Reserve increased interest rates, both private and public institutional investors lost heavily in transactions in exchange-traded and over-the-counter derivatives sensitive to interest rate movements. Many of these investors, in turn, sued the financial firms involved, and the SEC and CFTC initiated several related enforcement actions (U.S. Senate Committee on Banking, Housing, and Urban Affairs 1995, U.S. House Committee on Banking and Financial Services 1996). In May 1994, the United States General Accounting Office (GAO) issued a study of the derivatives market. The GAO wrote that “the largely unregulated activities of U.S. OTC derivatives dealers that are affiliates of securities and insurance companies have been growing rapidly . . . If one of these large OTC dealers failed, the failure could pose risks to other firms—including federally insured depository institutions—and the financial system as a whole” (1994, pp. 11–12). Legislators then introduced several proposals to tighten regulation of derivatives (Culp and Mackay 1994).

The Derivatives Policy Group’s “Framework for Voluntary Oversight.” Securities firms compete vigorously in the design and marketing of financial products. Collaboration among them, in addition to potentially conflicting with antitrust laws, runs the risk of leaking proprietary information to competitors (Matthews 1994, McCaffrey and Hart 1998). In 1994, however, SEC Chair Arthur Levitt suggested that the securities firms most involved in the marketing of OTC derivatives should collectively “voluntarily” address derivatives legal problems. Five firms accounting for over 90% of the over-the-counter derivatives activity by U.S. securities firms (Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Salomon Brothers), plus CS First Boston, responded by forming the Derivatives Policy Group (DPG), releasing the Framework for Voluntary Oversight in March, 1995 (Derivatives Policy Group 1995). The Framework
covered four components of controls. First, the firms outlined and promised to implement “prudent risk management practices.” Second, the firms said they would give the SEC and Commodity Futures Trading Commission quarterly confidential reports on credit risk exposures from the firms’ OTC derivatives activities. Third, the DPG proposed a framework for estimating market and credit risk exposures and how these might affect a firm’s capital. Fourth, it identified guidelines for managing “counterparty” (that is, trading partner) relationships, particularly what firms should tell their customers and what their customers should expect from them.

Levitt and CFTC Chair Mary Schapiro attended the press conference announcing the Framework. (The SEC was the lead federal agency in the process. Individuals we interviewed said that the smaller CFTC was engaged mainly with other matters.) The DPG’s co-chair, E. Gerald Corrigan of Goldman Sachs, stressed that the Framework’s initiatives were “not recommendations or proposals—they [were] commitments,” and that the SEC and CFTC had the authority to make the firms adhere to them. The other co-chair, John Heimann of Merrill Lynch, added “[W]hen a regulator comes in and shakes his or her finger at us, . . . [w]e don’t tell the regulator, ‘go fly a kite.’ So the authority is there.” Arthur Levitt added, “We have more than enough power to take action,” implying that if firms reneged on the agreement, the SEC and CFTC could retaliate legally in some way (Bureau of National Affairs 1995a, p. 395).

Yet the SEC and CFTC did not clearly have the authority to regulate the over-the-counter derivatives markets; the firms had set up the subsidiaries precisely to avoid such regulation. This situation easily could have resulted in a persistent dispute between the agencies and industry. The SEC and CFTC could have pushed Congress for clear legal authority to regulate OTC derivatives, and might have received it because of fears of further financial “disasters.” The firms, in turn, could have lobbied hard against the disruption of such proposals.

Instead of fighting this battle, the government and industry developed a new collaborative regulatory approach through the Framework. In addition, the success of the DPG created a period in which the SEC and other financial regulators could craft capital and reporting procedures tailored specifically to the OTC derivatives markets. In 1998, the SEC approved the establishment of lightly regulated derivatives subsidiaries, with strong industry support and no significant opposition from other private sector interests (Bureau of National Affairs 1998). Then, following the near-collapse in September 1998 of Long-Term Capital Management (LTCM), 12 large financial firms announced that they would use the DPG model to develop new procedures for risk management cutting across banking and securities firms. The SEC, Treasury, and Federal Reserve supported the effort (Bureau of National Affairs 1999, U.S. House Committee on Banking and Financial Services 1999). In 1999 and 2000, the SEC, CFTC, Federal Reserve, and Treasury Department endorsed policies favoring largely private control (overseen by the government) of the OTC derivatives market, the approach established through the DPG (President’s Working Group on Financial Markets 1999, U.S. House Committee on Agriculture 2000, United States House Committee on Banking and Financial Services 2000a, 2000b). In this paper we consider how this new approach developed.

Methods

This paper uses a case study approach to develop a deeper understanding of the collaborative process used by the DPG. As such, the data collection and analysis focus on both the broader context and background in which the DPG operated and the collaborative process that allowed for six private sector organizations to work together and to cooperate with two government agencies. The research draws on two sources of data: semistructured interviews with individuals involved in the DPG’s origins and implementation; and documents, including Congressional hearings, that describe the DPG’s process and/or the types of financial innovations that the DPG was asked to address.

Interviews

Using a snowball sampling approach, in 1997 and 1998, we requested interviews with 21 individuals involved with the DPG or related organizations, including the DPG’s key organizers, prominent leaders involved in the financial markets, and individuals in the SEC and CFTC. Of these, 20 agreed to be interviewed. (We should note that the one individual who was not available for an interview referred us to the main member of his staff who worked on the DPG.) These interviews included 11 individuals involved directly in the DPG working groups, the SEC, and the CFTC; three individuals from committees of Congress overseeing financial market regulation; one from the United States General Accounting Office; two attorneys not involved directly in the DPG, but with extensive knowledge of the issues in regulating financial innovation; and three from financial industry associations.4 We believe that we were successful in obtaining interviews with several of these individuals primarily because the DPG’s key organizers referred us for the interviews.

As noted above, the interviews were semistructured,
and so the specific interview questions varied somewhat, depending on whether we were interviewing someone directly involved in the process versus someone in a stakeholder organization such as a Congressional committee or the General Accounting Office. Each interview, however, covered the interviewee’s perceptions of the emergence of the DPG; how the person became involved, directly or indirectly, with the Group’s work; their sense of the ways in which the Group operated; the conditions facilitating and inhibiting the DPG’s work; and the impact of the DPG on subsequent regulatory processes. We went down different paths during the course of an interview when an interviewer believed a line of discussion was especially important. We did not ask to tape record the interviews because of the sensitivity of the subject matter. Instead, we asked permission to take detailed notes during the interviews, and permission was always granted. Each of the interviews was attended by at least two of the three authors of this paper. Interviews ranged from 45 to 90 minutes, with most running about an hour. The core interview questions are included in Appendix A.

Documents
The DPG was formed after public and private institutional investors incurred heavy losses in the financial markets in the mid-1990s. Various committees in Congress held hearings, later published, examining the losses and the current systems for regulating financial technology. The Securities and Exchange Commission, Commodity Futures Trading Commission, and General Accounting Office, and the agencies’ executives addressed the subjects frequently through reports, conferences, and speeches, as did their private sector counterparts. A list of the main documents we examined for the research is included in Appendix B.

Data Analysis
As noted in the introduction to this paper, we began with a framework that included four factors that appear repeatedly in studies of collaboration or cooperation—initial dispositions toward cooperation, the extant issues and incentives, leadership, and the number and variety of groups involved. Our primary goal was to explore how each of these factors did or did not play a role in the DPG’s collaborative process, as well as whether there were additional factors influencing the process that were not present in the framework. During the data analysis, the notion of interaction between and among factors emerged vividly, and this became an additional theme in the data analysis.

Data were analyzed in an iterative process. First, both interview notes and documents were reviewed for both evidence and importance of the four factors and other influencing variables. During the second stage, interview notes and documents were again reviewed for evidence of interaction between and among factors.

Factors Affecting Interorganizational Cooperation
Management studies, political science, economics, and sociology focus on a variety of factors facilitating or inhibiting cooperation. Four factors appear repeatedly across these areas, with authors generally emphasizing one or two. These factors include initial dispositions toward cooperation; the extant issues and incentives; leadership; and the number and variety of groups involved in a task. This section reviews each factor, and then considers their relationships.

Initial Dispositions Toward Cooperation
Initial dispositions toward cooperation, shaped by personal experience and institutions, favor or inhibit cooperation. People are more likely to cooperate when they expect their own “nice” behavior to be rewarded with nice behavior by others (Axelrod 1984). At least for a time, they will regard setbacks as temporary aberrations not threatening the relationship. When parties do not trust each other initially, however, they worry about making early gestures necessary to increase trust; thus, individuals favoring cooperation will have a hard time selling it as an approach, and fragile successes can be undermined easily by “I told you they can’t be trusted” reactions (Gulati 1995, McAllister 1995, Ariño and de la Torre 1998).

First-hand dealings with others partly shape these attitudes—we learn who we can or cannot trust from personal experience. Institutionalized practices, however, also make it more likely that these personal experiences favor cooperation. A history of good-faith negotiations, legal safeguards, and/or established monitors of behavior reduce the risks of being cheated, and increase faith in the process (Ostrom 1990, 1998; Williamson 1996). Furthermore, employment practices and social rewards and punishment generally favor those who earn reputations for being “reasonable” or “good people.” Thus, people might come to favor cooperation on the basis of calculated self-interest (Williamson 1996) and/or because they accept it as the appropriate way of doing things (March 1999). Personal experience and institutionalized practices also can inhibit cooperation, as in the case of longstanding adversaries.

Issues and Incentives
Initial dispositions establish a presumption in favor of or against cooperation, but those leanings can change
depending on the extant issues and incentives. Using Anthony Giddens' terms (1984), initial dispositions are an important part of a "structure," while the issues and incentives present occasions for the ongoing "structuring" of relationships. People who favor more extensive cooperation emphasize its "pragmatic necessity" in dealing with tighter economic, technological, and social connections (Daft and Lewin 1993, Gray 1989). Cooperation provides benefits because parties can pool knowledge and complementary strengths; deal with their interdependencies more effectively; combine similar operations and thus take advantage of economies of scale; manage geographically dispersed operations and diverse laws, cultures, and politics; and handle crises more effectively (Powell et al. 1996, Gulati and Singh 1999). Of course, conflicts over values, ambitions, and interests may give people incentives not to cooperate, and even intense cooperation can decay when the forces pulling people together—such as a compelling task or charismatic leader—no longer offset such tensions (Bennis and Biederman 1997).

Leadership

Leadership at all levels of organizations can play an important role in defining the situation for the individuals involved, to the point of getting people to think about the issues and incentives, and even their initial dispositions, in particular ways. Leaders with strong reputations can legitimize certain ways to deal with a problem, and prod or persuade people to act in ways favoring or inhibiting cooperation (Gray 1989, 1996; Weick 1995). Case studies of successful cooperation show leaders actively managing the cooperative process, particularly in its early stages and during trying moments. Studies also show failures of cooperation stemming from leaders acting in narrowly self-interested ways or relishing political battles (Browning et al. 1995, Huxham 1996, Westley and Vredenburg 1997, Weber 1998).

Number and Variety of Groups

The number and variety of groups involved in a task make cooperation more or less likely by affecting group dynamics and the costs of arriving at agreements. Cooperation develops more easily when parties are similar and/or have personal ties, and when the number of parties is small enough that they can reach and enforce agreements at reasonable cost. It is less likely when group size and diversity introduce so many different perspectives and needs that disagreements can overwhelm potential agreements (Parkhe 1993b, Kumar and Nti 1998, Zaheer et al. 1998). Yet, larger numbers and diversity also can facilitate agreements by creating possibilities for bargains among people with different but compatible preferences. Snidal (1995, p. 57) writes, "institutions play an important role in determining the number and character of participants in an issue and thereby mitigate the independent effect of n and actor heterogeneity . . . on institutional performance and cooperation." He concludes that the impact of the number and heterogeneity of participants on collective action depends on the specific types of heterogeneity involved, the nature of the problem, and institutional context.

Relationships Among the Factors

Although most of the studies cited above focus on how any one or two of these four factors affect cooperation, they rarely conclude that the other factors are unimportant. Theoretical models of cooperation suggest that their combinations and interactions are as important as individual effects (Gray 1989, Gray and Wood 1991, Ring and Van de Ven 1994, McCaffrey et al. 1995). After presenting a model of such relationships, Larsson et al. (1998) wrote that empirical studies on cooperation usually omit the majority of their model’s critical variables, noting that this is "not due to any simple-minded neglect, but rather to the staggering empirical complexity" of the processes involved (p. 300); "[I]t is much easier to develop and argue for a multi-dimensional, interactive, dynamic, and contextual framework conceptually than to test it empirically" (p. 301). Similarly, Parkhe (1993a) suggested that concepts of trust, reciprocity, opportunism, and forebearance were the foundation of theories of international joint ventures, but the exigencies of large surveys and industry-level analysis required researchers to focus on more measurable phenomena to the neglect of the core concepts. This paper follows up on their arguments by indicating how initial dispositions toward cooperation, incentives and issues, leadership, and group numbers and variety all were fundamentally important in the Derivatives Policy Group’s process. We also discuss the interactions among these factors because the data analysis suggested clearly that understanding interorganizational cooperation requires understanding how the elements combine in a particular context.

Conditions Facilitating the Derivative Policy Group Agreement

In this section we discuss how the initial dispositions toward cooperation, extant issues and incentives, leadership, and the number and variety of groups involved influenced the Derivative Policy Group’s development. We then consider the case’s general implications.
Initial Dispositions Toward Cooperation

Initial dispositions reflect both structural and individual levels of behavior. Structures channel behavior in particular ways, making it more likely that certain types of personal relationships will form; thus, the system as a whole may tend to encourage or inhibit cooperation, with these tendencies in turn shaping personal interactions (Giddens 1984). Since the 1930s law and policy in the United States have encouraged a sharing of regulation of the financial markets between the public and private sectors (Seligman 1995, McCaffrey and Hart 1998). Shared regulation made public and private cooperation in the Derivatives Policy Group a legitimate option, while the relationships that develop in such a system facilitated the agreement.

Institutionalized Sharing of Regulation. Unlike other areas of regulation, a three-tiered regulatory system combining public and private controls formally governs the securities and futures industries. The SEC and CFTC oversee self-regulatory organizations (SROs) such as the New York Stock Exchange and the National Association of Securities Dealers. The SROs oversee and set rules for the firms that are members of the SROs; the firms comply with the rules because they need access to the markets governed by the SROs. Cooperation is by no means automatic in the system. On any issue some people complain that government agencies are intervening too much, and on several occasions the agencies have forced changes in industry practices after long disputes (Seligman 1995). But the regulatory history in financial markets makes government and industry cooperation a familiar option, if other factors favor it.

Personal Ties and Relationships. A shared regulatory system brings individuals from the public and private sectors into constant contact, and the resulting personal relationships ease communication and negotiation. Many of our interviewees from the private sector had previously worked at the SEC, CFTC, Federal Reserve, or some other financial regulatory agency. One regulator in New York City commented that he “had a history of working with firms in the neighborhood.” E. Gerald Corrigan of Goldman Sachs, a co-chair of the DPG, had been president of the Federal Reserve Bank of New York. John Heimann of Merrill Lynch, the other co-chair, had been the U.S. Comptroller of the Currency; served on the board and been acting chairman of the Federal Deposit Insurance Corporation (FDIC); and was the first chairman of the Federal Financial Institutions Examination Council (FFIEC). When asked why there seemed to be a relatively high level of cooperation between public and private organizations in financial market regulation, one key participant with extensive experience in both sectors observed that

Maybe it’s that in the financial arena, the nature of interaction between the official legal and private types is day by day. You cultivate a familiarity [that is not common]. It’s day by day, hour by hour. It’s also true that the incidence of financial disturbance has been of sufficient frequency and magnitude that it leads to interaction. There’s not a major chief executive [involved in the DPG process] who I didn’t know very well. That matters.

Other interviewees stressed how personal ties facilitated the DPG process. For example, an SEC staff member said that “At the senior level, [we] had to earn the firms’ respect as they had to earn ours . . . Brandon [Becker, the SEC’s Director of Market Regulation, already] had industry-wide respect . . . The interpersonal relationships were important.” Writings on financial market regulation routinely comment on the salience of such ties (Solomon 1995, Underhill 1997). Issues and Incentives

The individuals we interviewed from both sectors described their reasons for going along with the DPG process. Their incentives differed, and required give and take, but they were compatible. The firms wanted to minimize lawsuits related to derivatives, preempt what they felt would be disruptive direct regulation, and demonstrate that a group of firms could deal with a major regulatory problem. The SEC and CFTC wanted to get a tighter grip on the OTC derivatives market without being asked to implement what they thought would be crude legislation, although they were willing to ask for legislation if the industry was uncooperative.

Industry Incentives: Minimizing Legal Problems and Centralized Regulation. In the 1990s, numerous financial firms faced serious losses and lawsuits because their management controls failed. They accordingly had incentives to improve their management controls, regardless of any regulatory pressures. While firms might appreciate strong internal controls in principle, they also want to develop products and complete transactions. Financial firms’ “producers” are politically strong because they bring in the firms’ revenues, and they would rather spend time developing products and completing transactions than instituting controls that slow transactions (McCaffrey and Hart 1998). While the new legal worries certainly gave firms an incentive to improve controls, other factors as well had to strengthen the hands of those inside firms arguing for the improvements.
Minimizing Governmental Regulation of OTC Derivatives. By 1994, those in the industry worried that legislation and rulemaking would reduce their control over the OTC derivatives business. One individual active in the DPG told us

What we needed to do was head off legislation. We needed a code of conduct on the way we treated customers [in derivatives business] and to provide additional information to regulators to head off formal capital adequacy tests. If we provided information on risks, maybe regulators would see that the risk was not unmanageable . . . We had lived through the mid-1980s, when Congress adopted registration of government securities dealers, subjecting them to the same capital requirements. It was harmful to innovation. For the government securities dealers that wasn’t all that painful, because they already had to be regulated. [The marginal effect wasn’t all that great]. Here [in OTC derivatives] it would have been disastrous.

Some individuals saw the DPG as a prototype of a new way of regulating financial markets. In March 1994, Thomas Russo, the chief legal officer of Lehman Brothers and former head of the Division of Market Regulation at the CFTC, outlined a DPG-like arrangement in a speech to the Futures Industry Institute (Russo 1994). He argued that centralized regulation could not cope effectively with evolving financial technology, and urged initiatives by the industry, overseen by the government, to improve reporting and controls.

In contrast to establishing a new commission or new body of law, a Code of Conduct arising from a joint industry and government effort satisfies the goals of the more elaborate and time consuming approaches. It is a “surgical” approach that cuts to the real issue of risk in a way that is practically feasible, flexible, expeditious, and with the goal of promoting U.S. competition in an increasingly complex world financial market . . . The Code approach also has the unique benefit of establishing a process by which government and industry work hand-in-hand to develop the details of the standards, which will ensure that the ultimate particulars are meaningful, workable, and the result of education through cooperation (1994: 19–20).

Another key participant said that, once the process had started,

I said to [SEC Chair Arthur] Levitt that it was important to give us a chance to do this and leave us alone. I think government in general could be a little more sensitive to, open minded to, the extent to which voluntary, non-legislative solutions could be used. . . . We all recognized that this was a golden opportunity to put a marker down. Even in an area as controversial and complex as this, it’s possible for the private sector to step up to the plate and come up with a good solution.

The SEC’s and CFTC’s Stakes in the DPG. Firms had established largely unregulated subsidiaries to deal in OTC derivatives to avoid current capital requirements which they argued were not tailored to OTC derivatives’ nature and therefore tied up excessive amounts of capital in unprofitable reserves (U.S. General Accounting Office 1998). The SEC and CFTC had little legal control over the subsidiaries, but saw the subsidiaries as clearly affecting their regulatory domains. They wanted more information from the subsidiaries than they were receiving in order to keep track of market developments and risks. The agencies also were concerned with how marketing and risk assessment functions overlapped in the subsidiaries, fearing that combining marketing and risk assessment in the same unit in a firm would make it more likely that those selling products (and bringing in revenues) would win internal debates with those responsible for assessing the products’ risks and maintaining internal controls. While the tension is pervasive, usually the firms are thoroughly regulated; here, the subsidiaries were relatively unregulated, and so further removed from the agencies’ reach.

One individual noted that the SEC Chair, Arthur Levitt, “because he is a very pragmatic person, recognized that something had to change here. Maybe he didn’t know how this would play out. However, he sensed that new ground had to be broken.” The agency felt that the threat of legislation was useful, but actually asking for legislation was risky. In related Congressional testimony in 1995, Levitt remarked “I have, since I’ve been at the Commission, studiously tried to avoid asking Congress for anything . . . With all due respect, I don’t know when we’re going to get it or what we’re going to wind up with” (U.S. House Committee on Commerce 1996, p. 138). A principal staff person at the SEC for the project told us that

Rather than seek legislation, which we weren’t sure we could get, we needed more information . . . We had to have better capital/risk evaluation, and have firms deal with the sales practices and fraud issue. We figured that we could get most of what we wanted if we worked with the firms. Then, if necessary, we could seek legislation . . . Legislation may not be what we wanted, because it might be really bad. . . . The way the process worked is that we would say “Here’s what our concerns are, you write up the guidelines.” They would write up guidelines, circulate them, and ask for feedback. If they didn’t produce something, we’d go to Congress. The chance of their getting something useful out was greater than us getting productive legislation.

Incentives Working Against the DPG’s Success. Interviewees noted several incentives working against the DPG. Firms could have pointed out to the Congress and others that none of the prominent failures prompting regulatory pressures (e.g., Orange County or Kidder
Peabody) involved unregulated subsidiaries of financial firms; in each case the SEC, CFTC, Federal Reserve, or Treasury clearly regulated the operations. They could have argued that “one size fits all” rules would hamper what by any reasonable measures was an economically valuable activity, and likely would push the operations to other nations. Some industry participants said that tolerating informal SEC intervention was risky; one commented to us that even with a “voluntary” effort like the DPG, “There’s a danger that firms will be sucked in too much.” Finally, following the election of conservative Republican majorities in Congress in November 1994, the firms could have walked away from the discussions with less fear of new regulatory legislation. Thus, factors beyond incentives were critical in the process.

Leadership

Case studies of successful and unsuccessful cooperation show leaders influencing outcomes by their shaping of perceptions, interventions at key moments, and other conduct. The ways in which individuals in key positions stimulated and advanced the DPG’s development appeared vividly in our interviews and related materials.

The Roles of Arthur Levitt and Thomas Russo. As noted above, Thomas Russo, the former director of Market Regulation at the CFTC, and at the time chief legal officer of Lehman Brothers, described a DPG-like arrangement to the Futures Industry Institute in March of 1994 (Russo 1994). Committees of the Securities Industry Association (SIA) had been working on issues related to derivatives for some time. The committees, however, had serious difficulties producing agreements. In particular, the members did not have the political leverage to get operational departments inside financial firms to cooperate with them. Designing risk assessment procedures required help from firms’ risk assessment departments, and these departments did not consider helping SIA committees to be high priority work.

In instigating the DPG’s formation, SEC Chair Levitt bypassed the SIA committee structure and directly contacted the CEOs of the major securities firms with derivatives subsidiaries. (One interview reported that Levitt contacted Russo shortly after the address at the Futures Industry Institute, and said, “I just read your speech. Let’s do it.”) Contacting the CEOs directly communicated to departments within the firms that they had to take the DPG’s working groups seriously. One individual familiar with the earlier SIA committees told us:

There was a prior relationship with the SIA started after the SEC’s concept release in May of 1993. We put together a derivatives committee for a response in January 1994. Between then and July or August of 1994 there was additional give and take. Levitt felt that the SIA’s committee wasn’t moving fast enough. Then the GAO report came out, and Levitt called up the CEOs. To give the devil his due, he did help people do it sooner rather than later. When the head of the SEC calls up a CEO, it gets attention . . . It’s tough enough to get guys on committees to do work. Once you have CEO involvement it’s easier to pull on people.

Another stated, “The DPG didn’t really change that much, beyond what the SIA committees were doing. But my hat’s off to Levitt. He did mobilize the senior people, and so things couldn’t drift.” The firms sensed that they should take advantage of this “voluntary opportunity” partly in order to stay in the SEC’s good graces. One former SEC official involved in these deliberations pointed out that “the SEC always could have inspected the firms. [The firms] had to ask themselves, ‘Do I want to cross the SEC?’ No one wanted to be the odd man out. So there was good reason to say yes.”

Levitt also acted as a buffer between the DPG process and those pushing for legislation, backing it, at some risk, with the SEC’s prestige (Krause 1996). At the January 1995 hearings, following Orange County’s declaration of bankruptcy, Senator Paul Sarbanes criticized the reluctance of Levitt and certain other regulators to endorse new legislation regulating derivatives, leading to the following exchange.

Senator Sarbanes: Now, my concern in listening to you is this kind of almost sanguine attitude about these things. The GAO in their study and report to us made a number of recommendations, both to the Congress and to the regulators. I assume you have all examined those recommendations carefully. That report would seem to take a more serious view of the situation, in which we find ourselves and the need to address it, than I have heard at the table this morning. How do you explain the gap that apparently exists between that kind of testimony you have been giving us this morning, and these kinds of reports that we are reading about in the press and the GAO report to the Committee?

Mr. Levitt: . . . I think the problem of derivatives is potentially great. Insofar as the securities dealers are concerned, I’ve asked Jerry Corrigan to head a group of the leading securities dealers to study the issue and look at four areas—enhanced risk assessment, management controls, which I think are critically important, capital, and sales practices—to create a template for oversight of securities dealers. Now, we are on the verge of getting that material together and coming up with something we never had before (U.S. Senate Committee on Banking, Housing, and Urban Affairs 1995, pp. 29–30).

Moments later, the following exchange with Senator Barbara Boxer (D-California) occurred after Senator Boxer suggested that securities firms had sold unsuitable investments to Orange County prior to its bankruptcy:
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Senator Boxer: So I would say to Mr. Levitt here, the issue of suitability really comes up. And I understand that the SEC has asked broker-dealers to come up with their own suitability standards. This report was first due in November 1994. Then it was put off until December and it’s been delayed again. Do you know why the firms are delaying issue of the report? Do you know when the report will be coming? What is the latest on that?

Mr. Levitt: They’re not delaying the report.

Senator Boxer: O.K.

Mr. Levitt: As a matter of fact, we set a November deadline for it. This is a group of six firms that Jerry Corrigan heads. And, indeed, I met with them at the end of November as scheduled. They gave us quite a comprehensive report in terms of their overall activities. And we’re talking about risk-assessment reporting, management controls.

Senator Boxer: Well, when is the report coming because it was supposed to be done in November 1994, in my understanding.

Mr. Levitt: But I asked them for additional clarification.

Senator Boxer: O.K.

Mr. Levitt: Particularly in the area of suitability and sales practices. We intend to meet again later this month, and my expectation is that within the next 60 days, we should have a report... Which I am fairly sanguine about at this point. I think we’re making progress (p. 44).

The DPG Co-Chairs: Legitimizing the Group and Managing Its Tensions. As noted earlier, one co-chair of the DPG, E. Gerald Corrigan (Goldman Sachs), had been the president of the Federal Reserve Bank of New York; and the other co-chair, John Heimann (Merrill Lynch), had extensive public experience in banking supervision. Both helped legitimate the DPG in Congress and in the banking industry. (One individual commented that “Corrigan and Heimann were recognized as names.”) Soothing Congress was critical, but so was the signal to the banks. The firms in the Derivatives Policy Group were the main competitors of the United States banks in the OTC derivatives markets. The banks’ derivatives operations already were regulated by the banking agencies; they were aware that the DPG firms were trying to minimize federal regulation of their own operations, and the banks did not want changes seriously upsetting the competitive landscape. One interviewee noted that “With Corrigan and Heimann, you had two former bank regulators saying that broker-dealers are o.k.” Another said that the banks “were kind enough not to jump on the issue. There was some collegiality on their part.”

Corrigan and Heimann also were able to defend external regulators’ perspectives inside the working groups. As reported in one interview, “skittishness on the part of firms—the question of ‘What are we giving up?’” hung over the DPG’s early discussions. “There [was] first some throat clearing—you had to let everyone get off their chest what they’re concerned about, and the comments about the ‘God damn government.’” This person noted that Corrigan and Heimann “had been on both sides of the fence... This type of group must have some people involved that understand the government role. If you understand what the supervisory problems are, it’s easier to deal with both sets of concerns.”

Leadership in the Working Groups. Interviewees repeatedly singled out the DPG’s general counsel, Edward Rosen, an attorney in the law firm of Cleary, Gottlieb, Steen & Hamilton, as keeping the firms together despite internal disagreements. Rosen was a highly regarded figure in securities law, and had previously dealt, in various ways, with each of the firms. He could mediate among them because he was not employed by any of the firms. As one interviewee noted, “It’s critical to have somebody who understood the business, understood the firms, that firms trusted.” We were told that firms would advise him of matters that affected their view of the DPG process that they would not tell their competitors in the group; his knowledge of the multiple views positioned him to negotiate solutions to difficult problems. Many of our interviewees indicated that the process would not have succeeded had Rosen not been able to integrate the conflicting points of view into the final agreement.

The Number and Variety of Groups Involved

Some initial dispositions toward cooperation, incentives, and leadership favored the DPG. Yet those we interviewed said that it likely would have failed if substantially more than six major firms and one lead government agency had been involved; in one participant’s words, “The probability of failure grows in geometric proportion to the group’s size.” An SEC official said, “What made it successful was an agency dealing with a smaller group of firms. We kept the group small. The smaller you can get it, the more likely it will work... If this had been a situation where five government agencies were involved it would not have happened”; and a former SEC official remarked that, “The biggest issue was that you couldn’t get everybody under the tent. If we drew in the banks that would have gotten too big.”

The firms and the government settled on new reporting, risk assessment, and internal control procedures. These agreements were not easy. The problem was crafting procedures that would satisfy the SEC and CFTC, but that also were acceptable to the different firms, which had
different systems. One central coordinator for the DPG said that firms were asking themselves,

> What information was really meaningful?" “How close are my systems to generating information required for these objectives?” “What is the right information to look at?” I don’t think there is a consensus on these issues. The fact is that there is a lot of legitimate disagreement about these issues . . . It was important to not get married to an approach. [We] went back to the drawing board five times. I think that was critical. If we had kept the original structure it would not have succeeded. There was lots of cajoling.

One major issue on which firms could not agree, either within their own group or with the SEC, was on sales practices in derivatives markets. In particular, should firms disclose all major risks of transactions to institutional customers and counterparties (trading partners), or should the customers and counterparties be required to knowledgeably evaluate their own investment decisions? This volatile area of securities law involves judgements about relative responsibilities in complicated transactions between firms and sophisticated institutional investors (McCaffrey and Hart 1998). An attorney in the group observed,

> In some cases there was emotional disagreement, particularly in the area of customer relations. How do you set a standard that doesn’t create legal obligations—not accepting that you’re responsible for people’s decisions and results? The issue is getting to standards that are meaningful but that don’t lead to liability. Here you had a group of lawyers with different levels of concerns and commitment to the process. Some firms wanted it to happen, and others were less concerned and were very sensitive to the issue of liability. Also, the industry would have one view of liability, and regulators would have a different view. So how do you articulate general principles?

The firms settled on a statement that securities firms were not responsible for an institutional investor’s investment decisions unless written agreements specified otherwise, but that firms should communicate this clearly to institutional investors and actively “clarify” any misunderstandings about responsibilities (Derivatives Policy Group 1995, p. 37). The SEC, in contrast, had pushed the DPG to design a generic risk disclosure statement. While the agency accepted the new reporting, risk assessment, and internal control procedures, it never endorsed the DPG’s approach to regulation (U.S. House Committee on Agriculture 2000, United States House Committee on Banking and Financial Services 2000a, 2000b).

**Interactions**

Understanding the interactions among initial dispositions toward cooperation, issues and incentives, leadership, and group size and variety is fundamental to understanding the Derivatives Policy Group’s development. Figure 1 presents a model of relationships among these four factors, proposes specific interactions between the factors, and suggests how they operated in the case. It also suggests that one needs to understand cooperation as a process in which outcomes at one period set the stage for the next (Gray 1989, Ring and Van de Ven 1994). Figure 1 does not try to capture all potential relationships among the four factors; it identifies relationships that we believe are pivotal, based on what we saw in the case and our reading of the theoretical and empirical literatures. In the figure, the four factors appear as boxes. Their interactions appear in the ovals, as a factor moderates the relationship between another factor and collaboration. Five such interactions are identified here.

In general, initial dispositions toward cooperation at Time $T_0$ favor or inhibit cooperation. In the ensuing Time $T_1$, how leaders frame and handle choices, and the extent
issues and incentives, interact with these initial dispositions. Leadership and the issues and incentives also interact with the effects of the number and variety of groups on cooperation. For example, leaders potentially can shape discussions of incentives and issues in ways that allow even potentially contentious groups to coalesce. Thus, the initial dispositions toward cooperation, and the number and variety of groups involved, shape and constrain the possibilities of cooperation, but we have to consider carefully how leadership and extant issues and incentives expand or contract these possibilities. How these relationships develop in one period sets the stage for the next cycle of action in T2. Cooperative success in T1 helps build a foundation for cooperation in T2, but one has to continue to consider the influence of all four factors in subsequent periods.

The advocacy by Thomas Russo, Arthur Levitt, and others (leadership); the laws and norms establishing regulatory conflict or cooperation as legitimate options to deal with OTC derivatives (initial dispositions); the relatively small number of organizations involved in the project (the number and variety of groups); and the joint desire for change without unpredictable legislation (issues and incentives), clearly were key elements of the case. Yet it is striking how often the individuals we interviewed named one of these factors, and then stated that this factor would not have mattered if other factors were not present.

For example, leadership interacted with initial dispositions toward cooperation and incentives. The system of shared regulation had institutionalized both cooperation and confrontation as feasible options to deal with the derivatives issue (initial dispositions). When Thomas Russo advocated a cooperative government-industry initiative to design a new regulatory system for derivatives, and when SEC Chair Arthur Levitt supported the proposal, they cited examples of cooperation in financial markets as precedents (Russo 1994). Yet, Levitt easily could have chosen to assert the SEC’s powers more confrontationally; interviewees noted that Levitt’s cooperative approach differed greatly from that of the previous SEC Chair, Richard Breeden. Thus, the decision reflected how leadership can influence the institutionalized options chosen. Furthermore, the key leaders managed effectively the conflicts within and among the organizations involved. It is important to remember, however, that Levitt, Rosen, and the other parties were successful in this partly because it was easier for them to manage the conflict within the small number and variety of groups than it would have been had the number and variety of groups been larger.
Also, the economics, law, and politics of the situation generated the issues and incentives for those involved, but leaders played key roles in determining which of these were most prominent and how they would come into play in the process. Levitt’s “carrot and stick” approach at the SEC; the mixing by Corrigan and Heimann of the public and private sector perspectives as co-chairs of the DPG; and Edward Rosen’s management of the negotiations among the firms show the impact of leadership on the enactment of issues and incentives.

The interaction of incentives to cooperate with the institutionalized option of cooperation (initial dispositions) was critical. The shared regulatory system in the securities industry made cooperation a feasible option to deal with the derivatives issue, and the public and private sectors had incentives to try to make a cooperative process like the DPG work. In certain other areas of regulation, however, initial dispositions diminish the likelihood of cooperation despite incentives favoring it. For example, even modest reductions in the adversarial nature of rule-making and enforcement in health and safety regulation would bring great benefits, but regulatory structures and traditions in health and safety regulation have inhibited such changes (McCaffrey et al. 1995, Weber 1998). The incentives to cooperate also made it more likely that the existing conflicts among the groups—already limited by the small number and variety of parties involved—could be overcome. Thus, the DPG was very much a product of how the four factors wove together. We will return to this theme in the paper’s conclusion.

Consequences of the Derivatives Policy Group
The outcomes in one period set the stage for the next. As noted earlier, one prominent supervisor commented in an interview that “[t]he spirit of the DPG has worked its way into the stream of consciousness.” In October 1998, the SEC, citing the DPG experience, adopted final rules establishing a flexible approach to regulating derivatives subsidiaries of securities firms (Bureau of National Affairs 1998). Then, in January 1999, 12 large securities firms and banks, including the six firms involved in the DPG (some of which subsequently had merged) formed the “Counterparty Risk Management Policy Group,” modeled after the DPG. The near collapse of Long-Term Capital Management (LTCM) in September 1998 prompted calls for new legislative regulation of such “hedge funds,” or private, largely unregulated investment pools (Lowenstein 2000). During an interview in Washington in November 1998, one senior staff member of a congressional committee told us of a telephone call that morning from a major bank on the possibility of using a DPG-like working group, with government oversight, to deal with the hedge fund issue. The staff member observed that the committee would be willing to consider such a project as an alternative to legislation, depending on how it was carried out. The Counterparty Risk Management Policy Group resulted. Its co-chairs were E. Gerald Corrigan, the former DPG co-chair, and Stephen Thieke of J.P. Morgan; Thomas Russo also was actively involved in the Group’s formation. The SEC, Treasury, and Federal Reserve all endorsed the new initiative (Bureau of National Affairs 1999, U.S. House Committee on Banking and Financial Services 1999). Finally, in 2000 the SEC, CFTC, Federal Reserve, and Treasury Department all endorsed a policy favoring private control, overseen by the government, of the areas of financial innovation originally targeted by the DPG (President’s Working Group on Financial Markets 1999; U.S. House Committee on Agriculture 2000; United States House Committee on Banking and Financial Services 2000a, 2000b).

An important question is whether the cooperative regulatory approach helped the OTC derivatives market develop while reducing its legal and economic hazards. Regulatory agencies’ main challenge is walking a fine line between imposing rules that disregard the industry’s operational needs, and not pushing industry enough to comply with regulatory laws. The advantage of the cooperative approach was that it enhanced the intelligence of the controls, relying heavily, with governmental oversight, on the financial firms’ familiarity with operational details. The risk, however, was that the government could not enforce the controls directly. The subsequent development of the OTC derivatives market does suggest that the cooperative regulatory approach, despite its risks, is working effectively. An article reviewing the OTC derivatives market in the February 2000 Institutional Investor—a publication oriented to end-users—commented that “[t]he swaps market is considered more reliable than government bonds these days . . . In its 20-year life span, the over-the-counter derivatives business has swung between celebrity and ignominy. Lately, it seems, the market has stepped into a dowdier, middle-aged role as a full-fledged corporate finance and investment management workhorse. It sure beats customer lawsuits and Senate hearings” (Clow 2000, p. 91). Regulation, when it is operating effectively, fosters this type of stable growth.

As noted above, a wide variety of industry stakeholders, including end-users who were originally suspicious of the DPG, now support the approach (United States House Committee on Banking and Financial Services, 2000a, 2000b). We believe that the dynamics outlined in Figure 1 help explain this result. The private and public sectors developed a new type of working relationship in the context of the DPG. The project had little margin for
error politically and legally during its implementation. The fact that the agreement was implemented in a good-faith way, and that the parties had experience with how this regulatory relationship would work, justified a similar approach to deal with the hedge fund issue posed by the Long-Term Capital Management in 1998, and to respond more broadly to the growth of over-the-counter derivatives.

The DPG also was part of a move toward more cooperation internationally among financial supervisors. Technological, social, and economic changes have pervasively increased global interdependence. While financial markets have been linked for centuries, the ties today cover more activities more tightly than at any point in the past (Bordo et al. 1999). A government trying to oversee and regulate financial markets internally knows that the firms it is trying to monitor can easily move money across borders in a variety of ways, and so must obtain the assistance of other nations, and global firms, in tracking financial flows. A major failure in one country can quickly spill over into other countries because the webs of international obligations and contracts are so dense (Reinicke 1998).

Accordingly, attempts at cooperation among national financial supervisors have become broader and deeper in the late 1990s. A core function of transnational organizations like the International Organization of Securities Commissions, the Bank for International Settlements, and the Financial Stability Forum is the development of regulatory principles and practices that serve as norms across nations (Porter 2000, Bank for International Settlements 2000, Financial Stability Forum 2000). One key architect of the DPG explicitly saw it as a step in enhancing international cooperation between the public and private sectors, portraying the DPG as the “first floor of a ten-story building.”

You don’t want to show too much of the 10th floor early on, because you don’t want to appear to be a dreamer. . . . But what we need is an international working group. You’ve got to get [New York Federal Reserve Bank Chair] Bill McDonough, and [Arthur] Levitt, and have it co-chaired by the Basle [Bank for International Settlements] people, and involve the International Chamber of Commerce. The membership has to be hand-picked by top regulators. It needs to be much as being a member of a club—you don’t want to be left off, with prestige attached to it. You need about twenty of the largest investment banks. The actual membership should be of the same ilk as at the DPG.

Another respondent also referred to various efforts to try to develop “a DPG-like structure at the international level” (e.g., see Group of Thirty 1997, Russo 1999). We believe that the model outlined in Figure 1 could be used to examine these international developments; certainly the literature on regulatory relationships in international financial markets focuses on such factors. For instance, one central debate in that literature focuses on the extent to which key financial supervisors or representatives of international organizations shape policy (Haas 1992), as opposed to being constrained by the initial dispositions established by distinctive national regulatory structures and traditions (Moravcsik 1998). Another debate asks whether economies are linked so tightly that the extant issues and incentives compel harmonization of international regulatory standards, or whether agreements will become unmanageable or meaningless as the number and variety of nations involved in negotiations increases (Financial Stability Forum 2000, Porter 2000). We cannot discuss these issues in detail here, but we believe—as our interviewees noted—that they involve internationally the same processes one saw within the DPG. Explanation of such international regulation, regardless of its outcomes, will require showing how all of these factors weave together.

**Conclusion**

This paper has examined how initial dispositions toward cooperation, issues and incentives, leadership, and the number and variety of active groups influenced interorganizational cooperation in the regulation of financial innovation. Most of the studies of cooperation cited earlier focus on how one or two of these four affect cooperation, with the other factors as background or residual considerations. Yet, initial dispositions, issues and incentives, leadership, and group size and diversity all affected the DPG in pivotal ways, as did their interactions; we do not see how any of these effects could be downplayed. This complexity presents real challenges for analysis (Larsson et al. 1998, Parkhe 1993a). Literatures that have developed relatively independently—for example, on leadership, bargaining and negotiation, group dynamics, and institutional processes—all need to be brought to bear on the problem.

In the past century, several scholars have urged approaches to research that explicitly recognize the value of linking the worlds of professional practice and organizational studies (Graham 1996, Schön 1994). We find this compelling, as obtaining a feel for how the four factors were linked required us to understand the economic, legal, and political details of derivatives regulation. For example, it would not be possible to understand the DPG’s development and impact without understanding the reasons for the SEC’s ambivalent attitude toward direct control of financial innovation, or the way that institutional investors came to evaluate positively the new approach.
to derivatives regulation. It is critical to understand the worlds of practice as experienced by the parties involved to understand the relationships among the factors that were so central to the developments discussed here.

Appendix A
Interview Questions

Introductory Question: Please describe how you became involved in the DPG.
Follow-up Questions:
- Why did you, or your organization, become involved in the process?

Grand Tour Question: Please describe the beginnings of the DPG.
Follow-up Questions:
- Could you describe the process of pulling people together?

Grand Tour Question: How did the Group organize its work?
Follow-up Questions:
- What were the key factors or events that influenced the process?
- In what ways did the process work well?
- What were the biggest problems that had to be overcome?
- How were they overcome?
- Were there some persistent problems that could not be resolved?

Grand Tour Question: What were the main impacts of the DPG?
Follow-up Questions:
- Are regulators and supervisors approaching regulation differently as a result of the DPG, or in much the same way?

Concluding Remarks: Is there anything else about the DPG process that is important for us to know?

Endnotes

1Actually, while one can read an economic purpose into these different approaches, historical circumstances fundamentally shaped regulatory organization. A large and relatively respectable OTC market in securities existed in the 1930s, and the securities laws covered it beginning in 1938 (Seligman 1995). In contrast, the OTC market in futures historically had a reputation as a collection of dishonest dealers arranging bets on future prices with vulnerable customers. The futures exchanges exploited that reputation in arguing that everyone engaged in futures trading should be legally required to do business in the more easily regulated exchanges; the Federal commodity trading laws, beginning in 1924, did consolidate legal futures trading on exchanges.

2The agencies filed the enforcement actions involving swaps on the grounds that the agreements involved elements of securities or commodities trading, while not claiming general authority to regulate swaps. Some analysts maintain that the agencies overreached in filing the enforcement actions; the courts did not resolve the issue because the cases were settled before they were adjudicated fully (Romano 1996).

3CS First Boston’s primary regulator was the Bank of England. It was involved in the DPG because, like the other firms, it operated an OTC derivatives affiliate in the United States that was not regulated by the SEC, CFTC, or banking regulators like the Federal Reserve.

4We do not identify specific individuals because we promised confidentiality to all interviewees.

5Large banks and securities firms routinely dealt with hedge funds, and frequently had financial stakes in them. In fact, Long-Term Capital Management survived only because a consortium of banks and securities firms, brought together by the Federal Reserve Bank of New York, collectively injected $3.65 billion in capital into the hedge fund (U.S. House Committee on Banking and Financial Services 1998).

References


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