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Published in:
Policy & Society

DOI:
[10.1016/j.polsoc.2015.12.005](https://doi.org/10.1016/j.polsoc.2015.12.005)

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Document Version
Publisher's PDF, also known as Version of record

Publication date:
2016

[Link to publication in University of Groningen/UMCG research database](#)

Citation for published version (APA):

Cherednychenko, O. O. (2016). Cooperative or Competitive? Private Regulators and Public Supervisors in the Post-Crisis European Financial Services Landscape. *Policy & Society*, 35(1), 103-114.
<https://doi.org/10.1016/j.polsoc.2015.12.005>

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To cite this article: Olha O. Cherednychenko (2016) Cooperative or competitive? Private regulators and public supervisors in the post-crisis European financial services landscape, *Policy and Society*, 35:1, 103-114, DOI: [10.1016/j.polsoc.2015.12.005](https://doi.org/10.1016/j.polsoc.2015.12.005)

To link to this article: <https://doi.org/10.1016/j.polsoc.2015.12.005>



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Published online: 03 Mar 2017.



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Cooperative or competitive? Private regulators and public supervisors in the post-crisis European financial services landscape[☆]

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Abstract

This article explores the interplay between private regulators and public supervisors within principles-based regulation and meta-regulation in the post-crisis European retail financial services landscape. It shows that the way in which the compliance with such regulatory frameworks is supervised and enforced may determine the type of relationship between private regulators and public supervisors – cooperative or competitive – that prevails at a specific moment in time. While there is evidence of both cooperation and competition between the two in the post-crisis era, a predominantly competitive relationship between private regulators and public watchdogs may severely undermine the practical importance of co-governance arrangements. A significant degree of cooperation between private regulators and public supervisors is key to ensuring their effectiveness. Public supervision and enforcement must therefore be responsive to the peculiarities of co-governance arrangements.

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Keywords: Private regulation; Public supervision; Public enforcement; Co-governance; Cooperation; Competition; Financial services; EU

1. Introduction

Financial services, such as payment, credit, investment, and insurance, have become a critical element of modern European societies. Financial services allow citizens to meet their essential needs, such as having a home or sufficient income after retirement, and to fully participate in society. In mobilising savings and allocating investment, financial services are also highly important for the EU economy. A single market in financial services would act as a catalyst for economic growth and provide lower prices and better quality goods and services for consumers.¹

While initially the European financial industry played a major role in the regulation of financial services across the EU, the last three decades or more have witnessed the rise of public regulation in this area. This trend received a major

[☆] An earlier version of this paper was presented at the workshop ‘The Causes and Consequences of Private Governance: The Changing Roles of State and Private Actors’ held on 6–7 November 2014 at the Mannheim Centre for European Social Research (MZES). I gratefully acknowledge funding for this event by the COST Action IS1309 ‘Innovations in Climate Governance: Sources, Patterns and Effects’ (INOGOV), MZES, and the Lorenz von Stein Foundation.

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¹ See, for example, Economic and Financial Committee (EFC), *Report on Financial Integration*, No. 171, Brussels, 2002.

boost in the aftermath of the global financial crisis that was triggered by the collapse of the subprime mortgage market in the US in 2007.² According to the now prevailing policy stance, the crisis exposed the risks that the lack of public regulation in the financial services field can pose not only to individual consumers but also to the proper functioning of the financial markets and economy at large.³ A frequently mentioned example in this context is widespread irresponsible lending in the largely unregulated US subprime mortgage.

However, it would be misleading to conclude from this that, in the post-crisis era, to use the words of the former French president Nicolas Sarkozy, '[s]elf-regulation as a way of solving all problems is finished.'⁴ Private regulation in the financial services field has not been entirely displaced by public regulation in the post-crisis European financial services landscape.⁵ Contrary to the traditional dichotomy between self-regulation by private actors and command and control regulation by public actors, there is still room for the interplay between the two in governing financial services in a multi-level EU legal order.⁶ The regulatory styles that enable such an interplay include, in particular, principles-based regulation and meta-regulation (or management-based regulation) which are familiar from before the crisis and remain on the agenda in the post-crisis EU.⁷ In fact, the interface between the financial services industry and financial regulators is necessary in the post-crisis era, given that the financial services sector remains a 'decentred' regulatory space⁸ that is characterised, inter alia, by a high degree of complexity, fragmentation of knowledge, resources and capacity for control, as well as unpredictability of actor behaviour.

When co-governing public goods, such as financial services, public and private actors may cooperate or compete with each other.⁹ As will be illustrated in this article, which form of the relationship between the two prevails at a specific moment in time may be considerably influenced by the way in which the compliance of private actors with principles-based regulation or meta-regulation is supervised and enforced by public watchdogs.¹⁰ The interplay between private regulators and public supervisors in the financial services field is particularly interesting in the present context, given the general post-crisis trend towards strengthening public supervision and enforcement in this area across the EU. In particular, with the establishment of a new institutional framework for financial supervision – the European System of Financial Supervision (ESFS), the post-crisis era has witnessed a major move towards a greater Europeanisation and centralisation of public supervision in the financial services field. The ESFS is formed of the three sectoral European Supervisory Authorities (ESAs) – the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) – plus the European Systemic Risk Board (ESRB) and national supervisory authorities. In particular, the ESAs avail themselves of far-reaching powers to govern the financial services industry. This can be illustrated by using the example of ESMA, whose mission is to enhance investor protection and to reinforce stable and well functioning

² On the main characteristics of the global financial crisis, see, for example, J. Tosun, A. Wetzel, & G. Zapryanova, 'The EU in Crisis: Advancing the Debate', *Journal of European Integration* 36 (2014) 195, 196 *et seq.*

³ See, for example, Financial Services Authority (FSA), 'The Turner Review. A Regulatory Response to the Global Financial Crisis', available at: <http://www.fsa.gov.uk>. This view, however, is not shared by all commentators. For the post-crisis defence of free financial markets and self-regulation, see, for example, J. Allison, *The Financial Crisis and the Free Market Cure: Why Pure Capitalism is the World Economy's Only Hope* (New York: McGraw Hill, 2012); E.P. Stringham, *Private Governance: Creating Order in Economic and Social Life* (Oxford: Oxford University Press, 2015).

⁴ "'Laissez-faire" capitalism is finished, says France', *EU Observer*, 26 September 2008, <https://euobserver.com/political/26814>.

⁵ On this is more detail, see O.O. Cherednychenko, 'Public and Private Financial Regulation in the EU: Opposites or Complements?', in N. Dorn (Ed.), *Controlling Capital: Public and Private Regulation of Financial Markets* (London & New York: Routledge, 2016), forthcoming. Cf. M. Moschella & E. Tsingou, 'Regulating Finance after the Crisis: Unveiling the Different Dynamics of the Regulatory Process', *Regulation and Governance* 7 (2013) 407; M. Andenas & I.-H. Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility* (London & New York: Routledge, 2014) 101 ff. See also F. Cafaggi & A. Renda, 'Public and Private Regulation: Mapping the Labyrinth', CEPS Working Document No. 370/October 2012.

⁶ Cf. e.g. F. Cafaggi, 'Private Regulation in European Private Law', in A.S. Hartkamp *et al.*, *Towards a European Civil Code* (Alpena an den Rijn: Kluwer Law International, 2011), 91, 100 *et seq.*

⁷ Cf. J. Black, 'Regulatory Styles and Supervisory Strategies', in N. Moloney *et al.* (Eds.), *The Oxford Handbook of Financial Regulation* (Oxford: Oxford University Press, 2015), 218.

⁸ J. Black, 'Critical Reflections on Regulation', *Australian Journal of Legal Philosophy* 27 (2002) 1; J. Black, 'Mapping the Contours of Contemporary Financial Services Regulation', *Journal of Corporate Law Studies* 2 (2002) 253; J. Black, 'Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation', *Public Law* (spring) (2003) 63.

⁹ See J. Tosun, S. Koos & J. Shore, 'Co-Governing Common Goods: Interaction Patterns of Private and Public Actors', in this Special Issue.

¹⁰ Cf. J. Black, 'The Rise, Fall and Fate of Principles-Based Regulation', in K. Alexander & N. Moloney, *Law Reform & Financial Markets* (Cheltenham: Edward Elgar, 2011) 3, 10.

financial markets in the EU. While its predecessor – the Committee of European Securities Regulators (CESR) – was a network-based advisory body, ESMA's powers reach much further.¹¹ In particular, ESMA is conferred with considerable powers to adopt technical standards implementing the legislative measures of a more general character and to issue 'strong' guidelines and recommendations with which local supervisory authorities and financial institutions are required to 'make every effort to comply'.¹² In addition, ESMA has direct supervisory powers over market actors, including the power temporarily to prohibit or restrict certain financial activities, as specified in relevant EU legislation, and extensive powers to gather information concerning financial supervision practices from local supervisory authorities. In fact, the rise of public supervision over private relationships between financial service providers and their (potential) clients at EU and Member State level has led to the emergence of 'European supervision private law'. This body of rules is made up of contract-related conduct of business rules for financial institutions, which are cast as supervision standards and are further elaborated and enforced by financial regulators.¹³

Against this background, in this article I will explore the interplay between private regulators and public supervisors in the context of post-crisis European *retail* financial services law. How private regulators and public supervisors interact with each other will be discussed with the focus on two forms of public regulation that enable such an interface – principles-based regulation and meta-regulation. The concept of private regulation is thus understood here in a broad sense, encompassing the rules for private actors that are produced and/or enforced not only by such actors themselves alone, but also by private actors in cooperation with public actors, with varying degrees of the latter's involvement.¹⁴ Throughout the analysis, I will use some prominent examples from the Netherlands and the UK to illustrate the interplay between private regulators and public supervisors. I will conclude with some final observations concerning the patterns of such an interplay and the way forward for the co-governance of retail financial services in the EU.

2. Principles-based regulation

Although there is no uniform definition of principles-based regulation, this regulatory strategy is generally associated with open-ended standards. A standard is open-ended when its content is not specified in detail by the legislator. In practice, such standards are further elaborated upon by public and/or private actors. In the EU law context, the involvement of private actors in this process is often referred to as co-regulation. Under co-regulation, EU public regulation typically defines mandatory open norms or minimum standards, while EU and/or national private regulation further specifies or raises them.¹⁵ The involvement of private actors in standard-setting and/or enforcement may be explicitly mandated by the EU public regulation (formal co-regulation),¹⁶ or be (strongly) encouraged,¹⁷ or

¹¹ On these powers of ESMA in more detail, see N. Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (1) Rule Making', *European Business Organization Law Review* 12 (2011) 41; N. Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action', *European Business Organization Law Review* 12 (2011) 177.

¹² How significant these rule-making powers of ESMA and the other two ESAs are has been shown by M. Busuioac, 'Rule-Making by the European Financial Supervisory Authorities: Walking a Tight Rope', *European Law Journal* 19 (2013) 111. See also E. Chiti, 'European Agencies' Rulemaking: Powers, Procedures and Assessment', *European Law Journal* 19 (2013) 93.

¹³ On this development in more detail, see O.O. Cherednychenko, 'Public Supervision over Private Relationships: Towards European Supervision Private Law?', *European Review of Private Law* 22 (2014) 37. See also O.O. Cherednychenko, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law', *European Law Journal* 21 (2015) 500.

¹⁴ Cf. e.g. A. Ogus, 'Rethinking Self-Regulation', *Oxford Journal of Legal Studies* 15 (1995) 97; N. Gunningham & J. Rees, 'Industry Self-Regulation: An Institutional Perspective', *Law & Policy* 19 (1997) 363; D. Sinclair, 'Self-Regulation Versus Command and Control? Beyond False Dichotomies', *Law & Policy* 19 (1997) 529; Cafaggi (2011) 93.

¹⁵ Cf. Cafaggi (2011), 107.

¹⁶ Cf. the definition of 'co-regulation' in Inter-Institutional Agreement on Better Law-Making between European Parliament, Council of the European Union and the Commission of the European Communities, *OJEU* 2003 C 321/1: 'Co-regulation means the mechanism whereby a Community legislative act entrusts the attainment of the objectives defined by the legislative authority to parties which are recognised in the field (such as economic operators, the social partners, non-governmental organisations, or associations). This mechanism may be used on the basis of criteria defined in the legislative act so as to enable the legislation to be adapted to the problems and sectors concerned, to reduce the legislative burden by concentrating on essential aspects and to draw on the experience of the parties concerned.'

¹⁷ The involvement of the European Payments Council (EPC) in the realisation of the Single Euro Payments Area (SEPA) stimulated by the European Central Bank and the European Commission may serve as an example. On this in more detail, see A. Janczuk-Gorywoda, 'Public-Private Hybrid Governance for Electronic Payments in the European Union', *German Law Journal* 13 (2012) 1435.

simply not precluded (informal co-regulation). In any case, private regulation contributes to the attainment of the specific objectives of the EU public regulation. In the UK, for example, where principles-based regulation is as much a supervisory strategy as a rule-making technique, in the aftermath of the crisis the label ‘principles-based’ regulation was replaced with that of ‘outcome-focused’ regulation.¹⁸ The latter suggests a greater focus on the outcomes to be achieved by the supervised financial institutions rather than mere compliance, although in terms of supervisory practice the difference between the two appears to be one of form not substance.¹⁹ In the following, the interplay between private standard-setting and public supervision and enforcement in the context of co-regulation and outcome-focused regulation in the above mentioned sense will be discussed in more detail.

2.1. Private standard-setting

A good illustration of the involvement of private actors in standard-setting within the EU principles-based regulatory framework that implicitly leaves room for co-regulation can be found in the area of consumer credit. The Consumer Credit Directive²⁰ currently in force, which remained intact in the wake of the post-crisis financial reforms, aims at fostering market integration and ensuring a high level of consumer protection in simple unsecured consumer credit transactions. For this purpose, it obliges Member States, inter alia, to ensure that, before the conclusion of the credit agreement, the creditor assesses the consumer’s creditworthiness.²¹ However, this directive does not specify the criteria on which the consumer’s creditworthiness must be assessed or when the consumer can be considered as creditworthy. The open-ended nature of the creditor’s duty to assess the consumer’s creditworthiness laid down in this directive allows Member States considerable leeway in implementing this obligation of EU origin in national laws and does not preclude them from involving private actors in shaping its content. This is despite the fact that the Consumer Credit Directive is a full harmonisation measure that formally precludes Member States from maintaining or introducing in their national laws provisions diverging from those laid down in the directive.²² In practice, therefore, private actors in some Member States have played a significant role in elaborating the concept of consumer creditworthiness in simple consumer credit transactions.

This has been the case, for example, in the Netherlands where the national legislator imposed a general duty on creditors to act as ‘responsible lenders’, so as to prevent consumer overindebtedness; for this purpose, it only obliged creditors to assess whether the consumer is creditworthy before the conclusion of the credit agreement, and to refuse granting credit if this is not the case.²³ The meaning of this open statutory norm as far as the assessment of the consumer’s creditworthiness in simple consumer credit transactions is concerned is mainly fleshed out in the codes of conduct of the three branch organisations: the Code of Conduct of the Netherlands Association of Consumer Finance Companies (*Vereniging van Financieringsondernemingen in Nederland (VFN)*), the Consumer Credit Code of the Dutch Banking Association (*Gedragcode Consumptief Crediet van de Nederlandse Vereniging van Banken (NVB)*), and the Code of Conduct of the Dutch Home Shopping Organisation (*Gedragcode van de Nederlandse Thuiswinkelorganisatie (NTO)*). All three codes of conduct share the same starting point for assessing whether the consumer is creditworthy and the provision of credit is thus justified: upon incurring interest- and repayment-related obligations under the credit agreement, the consumer must still have sufficient means to provide for his or her basic needs and to bear his or her recurring expenses.²⁴ If this is not the case, providing credit would be considered irresponsible.

Private regulation at Member State level could also play a similar, albeit more limited, role under the newly adopted Mortgage Credit Directive.²⁵ This post-crisis EU regulatory measure aims to create a Union-wide mortgage credit

¹⁸ Black (2015) 229 *et seq.*

¹⁹ Cf. J. Black, ‘Paradoxes and Failures: ‘New Governance’ Techniques and the Financial Crisis’, *Modern Law Review* 17 (2012) 1037, 1042.

²⁰ Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC, *OJEU*2008 L 133/66 (Consumer Credit Directive).

²¹ Consumer Credit Directive, art. 8.

²² Consumer Credit Directive, art. 22. On the implication of full harmonisation for private regulation more generally, see Cafaggi (2011) 101 *et seq.*

²³ Financial Supervision Act (*Wet op het financieel toezicht (Wft)*) 2006, art. 4:34.

²⁴ See e.g. the Code of Conduct on Consumer Credit of the Netherlands Banking Association, arts 5 and 6.

²⁵ Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No. 1093/2010, *OJEU*2014 L60/34 (Mortgage Credit Directive).

market with a high level of consumer protection. Like the Consumer Credit Directive, the Mortgage Credit Directive also obliges creditors to assess the consumer's creditworthiness.²⁶ However, in contrast to the former, the latter provides more guidance as to how this should be done. This assessment should be thorough and take into account all necessary and relevant factors which could influence a consumer's ability to meet his or her obligations under the credit agreement over its lifetime.²⁷ Such factors include, on the one hand, future payments under the mortgage credit and other regular expenditure, debts and other financial commitments of the consumer, and, on the other, his or her income, savings, and assets.²⁸ In addition, reasonable allowance should be made for future events, such as reduction in income or increase in the borrowing rate.²⁹ The creditworthiness test cannot rely predominantly on the fact that the value of the property exceeds the amount of the credit or the assumption that the property will increase in value, unless the purpose of the credit agreement is to construct or renovate the property.³⁰ Besides, in contrast to the Consumer Credit Directive, which does not deal with the consequences of the negative outcome of the creditworthiness test, the Mortgage Credit Directive obliges the creditor to refuse granting credit to a consumer in such a case.³¹

While these provisions of the Mortgage Credit Directive reduce the room for manoeuvre for the Member States and private regulators in making responsible lending rules for consumer mortgage credit contracts at national level, they do not altogether preclude co-regulation at national level. All the more so, given that they are subject only to minimum harmonisation, which allows Member States to maintain or introduce more stringent rules.³² Private actors could thus still draw up codes of conduct addressing the issue of responsible lending within the regulatory framework established by the EU legislator in the Mortgage Credit Directive, provided that the national implementing legislation also allows some leeway for such activities.

Another interesting example of principles-based regulation, or its alter ego, outcome-focused regulation, that leaves room for private standard-setting is the Treating Customers Fairly (TCF) initiative adopted by the UK Financial Services Authority (FSA) – the predecessor of the Financial Conduct Authority (FCA).³³ This project was initiated in 2001 based on Principle 6 of the FSA's Handbook of Rules and Guidance requiring firms to 'treat customers fairly'. Even though, as we will see below, in the post-crisis period, the FSA did not exclusively rely on the TCF initiative in pursuing the consumer protection objective, it initiative did not lose its significance and also remains an important element of the current consumer protection agenda of the FCA. Under this initiative, firms are not subject to specific rules implementing the TCF principle, but are required to achieve six retail outcomes:³⁴

'Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances.

Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.

Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.'

²⁶ Mortgage Credit Directive, art. 18(1).

²⁷ Mortgage Credit Directive, art. 18(1) and recital 55.

²⁸ Mortgage Credit Directive, recital 55.

²⁹ Mortgage Credit Directive, recital 55.

³⁰ Mortgage Credit Directive, art. 18(3) and recital 55.

³¹ Mortgage Credit Directive, art. 18(5)(a).

³² Mortgage Credit Directive, recital 7. This in contrast to maximum harmonisation in relation to the provision of pre-contractual information through the European Standardised Information Sheet where Member States have no such room for manoeuvre. On the implication of minimum harmonisation for private regulation more generally, see Cafaggi (2011) 102.

³³ FSA, Treating Customers Fairly after Point of Sale (2001). See also FSA, Treating Customers Fairly – Towards Fair Outcomes for Consumers (2006).

³⁴ FSA, Treating Customers Fairly – Towards Fair Outcomes for Consumers (2006) 3.

The focus on such broadly formulated outcomes rather than rigid rules potentially allows financial institutions considerable leeway in choosing appropriate means to achieve them and developing internal policies to this end.

2.2. Public supervision and enforcement

The involvement of private actors in standard-setting within the EU and/or national principles-based public regulatory framework for financial services allows public actors to address the problem of the regulator/market information-asymmetry and to fine-tune a particular regulatory regime in response to the local circumstances.³⁵ The need for principles-based regulation enabling co-governance of financial services by public and private actors will only deepen as financial markets become ever more complex across the EU. However, as we will see below, the relative importance of private standard-setting within a particular public regulatory framework depends, to a large degree, on the way public and private actors interact with each other. The financial regulators' approach to supervision and enforcement may play a crucial role in this context shaping the type of relationship between the two. A cooperative relationship between financial watchdogs and financial institutions may enhance the significance of and potential for private standard-setting in practice. Conversely, a more competitive relationship between the two may result in conflicting norms and substantially reduce the room for private standard-setting.

To illustrate this point, let us return to the two examples of private standard-setting within the EU and national principles-based regulatory frameworks introduced above. In the first place, it is worth taking a closer look at the approach by the Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten (AFM)*) towards privately produced rules concerning the assessment of the consumer's creditworthiness in simple consumer credit transactions implementing the principle of responsible lending. It is notable that the Dutch financial regulator regards the provisions of the codes of conduct drawn up by the branch organisations with respect to this aspect as minimum norms for responsible lending.³⁶ If a particular lender is not bound by one of the codes of conduct, it may use other norms provided that the latter offer the same or higher level of consumer protection. Consequently, the disregard of the provisions of the codes of conduct by the financial institution when providing credit to consumers may result in the violation of the statutory rules on responsible lending, regardless of whether the institution is formally bound by a particular code of conduct or not. In such a case, the Dutch financial supervisory authority may impose administrative sanctions. In addition, civil courts could follow the norms on responsible lending embodied in the codes of conduct when interpreting and applying general private law concepts, such as the lender's duty of care towards its clients.³⁷ Acting contrary to the relevant code of conduct may thus also lead to the lender's civil liability for the damage suffered by the consumer as a result of irresponsible lending or trigger other private law consequences. In this way, private regulation within the statutory framework can be supported by the public and private enforcement mechanisms provided by the state.

At the same time, as the following case related to consumer mortgage credit shows, public enforcement of the rules produced by private actors based on principles-based regulation may also pose a particular challenge to building a cooperative relationship between financial supervisory authorities and financial institutions. In its decision of 24 September 2010,³⁸ the Netherlands Authority for the Financial Markets imposed an administrative penalty in the amount of € 120.000 on one of the major retail banks operating in the Netherlands – Rabobank – for the breach of Article 115 of the Business Conduct Supervision (Financial Enterprises) Decree 2006 (*Besluit Gedragstoezicht financiële ondernemingen Wft (BGfo)*). This provision, which specifies the statutory principle of responsible lending, obliges creditors to establish and apply criteria for assessing the consumer creditworthiness with a view to preventing consumer overindebtedness. The meaning of this open-ended norm was further specified in the Mortgage Financing Code of Conduct (*Gedragscode Hypothecaire Financieringen (GHF)*) drawn up by the Dutch Banking Association. In

³⁵ Cf. Cafaggi & Renda (2012) 5.

³⁶ See e.g. District Court Rotterdam, 4 May 2011, *JOR* (2011) 228.

³⁷ At present, however, the Dutch civil courts do not always follow public regulation in general and the codes of conduct which specify its content, in particular, when assessing whether granting credit to a particular consumer was justified. This results in legal uncertainty concerning the purport of the duty of responsible lending in private law. On this in more detail, see O.O. Cherednychenko & J.-M. Meindersma, 'Verantwoorde kredietverstrekking aan consumenten in een multilevel governancestelsel', *Tijdschrift voor Consumentenrecht & handelspraktijken* (2014) 181, 186 *et seq.*

³⁸ Available at www.afm.nl.

some cases, this Code of Conduct allowed lenders to deviate from the strict criteria for consumer lending laid down therein, provided they sufficiently motivated their decision given the specific situation of the consumer. Based on the respective provisions of the Code of Conduct and the statistical data, the Rabobank formulated its internal rules for consumer lending. Under these rules, highly educated consumers under the age of 35 who were expected to get the salary increase could be granted a higher amount of credit than was normally allowed. However, in the view of the Netherlands Authority for the Financial Markets, this provision was contrary to Article 115 BGfo as specified in the *authority's own report* concerning the quality of advice and transparency in mortgage lending.³⁹ According to this report, the Rabobank was not allowed to deviate from the normal consumer lending rules based on statistical data; such a deviation was only permitted based on the data relevant for the specific situation of an individual consumer (such as the employer's statement of salary increases). In this way, the Dutch financial supervisory authority deeply interfered with the bank's internal policy concerning the prevention of overindebtedness designed to implement the co-regulatory arrangement. This outcome was reached in the course of public enforcement whereby the administrative agency not only looked into whether the bank complied with the Mortgage Financing Code of Conduct drawn by the industry, but also into whether it acted in accordance with the agency's own guidance.

This case provides a good illustration of the vulnerability of private standard-setting within the public regulatory framework as interpreted and applied by financial supervisory authorities. What is striking about it is that the open norm which was elaborated in the code of conduct produced by the industry under the vigilant eye of the financial supervisory authority was also specified by this authority itself in its formally non-binding guidance. In its enforcement action, therefore, the financial regulator followed its own interpretation of the code of conduct rather than the interpretation given to it by the bank. Obviously, such an approach leads to rivalry between public and private actors and undermines the practical significance of private soft law within the statutory framework. What is more, it does not make it clear how public soft law produced by administrative agencies and private soft law produced by the financial services industry relate to each other, impairing legal certainty.

It is also notable in this context that, in the aftermath of the financial crisis, the role of co-regulation in the area of consumer mortgage credit in the Netherlands has been considerably weakened by the rise of public regulation. The Dutch government largely replaced the provisions on responsible consumer mortgage lending laid down in the Mortgage Financing Code of Conduct with much more prescriptive and protective provisions of the delegated act.⁴⁰ Private regulation in this area enacted within the statutory framework was considered to have failed to provide for a sufficient level of consumer protection against overindebtedness in the post-crisis era.

Not only private but also public regulation, however, faces difficulties in terms of designing an optimal regulatory regime. In particular, overprotective public regulation may not perform well in markets characterised by consumer heterogeneity.⁴¹ A related concern is that highly paternalistic public regulation may backfire against the consumers and thus prove ineffective in practice. Restrictive rules on responsible lending, for example, may prevent consumers from gaining credit from licensed creditors and force them into the arms of shady lenders, who charge much higher interest rates.⁴² In fact, private regulation within the statutory framework may be better equipped to strike the right balance between freedom and protection, particularly if both financial institutions and consumer associations are involved in the process of private rule-making. Therefore, the substitution of private regulation in the financial services field by hard core public regulation and/or public soft law produced by financial watchdogs is not without risk.⁴³

A similar tension between principles-based regulation, on the one hand, and public supervision and enforcement, on the other, can be traced in the context of the above-mentioned TCF initiative adopted by the UK FSA. By launching this outcome-focused project, the FSA wanted financial institutions to focus not on rule-based compliance but on the

³⁹ AFM, *Kwaliteit advies en transparantie bij hypotheek*, 1 November 2007.

⁴⁰ Temporary Mortgage Credit Regulations of 12 December 2012 as amended on 30 October 2013 (*Tijdelijkeregelinghypotheekcrediet*). For instance, as of 1 January 2013 the maximum mortgage credit amount is being gradually reduced to 100 % of the property value by 2018. On this in more detail, see O.O. Cherednychenko, 'Freedom of Contract in the Post-Crisis Era: Quo Vadis?', *European Review of Contract Law* 10 (2014) 390, 414.

⁴¹ Cf. e.g. R.A. Epstein, 'The Neoclassical Economics of Consumer Contracts', *Minnesota Law Review* 92 (2008) 803, 810.

⁴² See e.g. Epstein (2008) 831.

⁴³ See in this context Stringham (2015), ch. 12, with a catchy title 'The Relationship between Public and Private Governance: Does the State Help or Crowd out Good Governance?'.

substantive standards required to achieve fair outcomes for retail customers.⁴⁴ In this way, the FSA aimed to prompt a step-change in the behaviour of the financial services sector towards retail customers at every stage of a ‘product life-cycle’, from product design and marketing through to sale. In addition to monitoring the product cycle, the FSA also developed a ‘TCF culture framework’ to assess the extent to which the financial institutions’ culture was supporting or impairing their ability to achieve the outcomes pursued by the TCF initiative.⁴⁵

In fact, this supervisory strategy was based on a considerable degree of trust in the financial services industry reflected in a largely cooperative relationship between the FSA and the industry in realising statutory objectives. However, in the aftermath of the financial crisis, the FSA’s trust in financial institutions all but disappeared. In particular, the large scale mis-selling of payment protection insurance (PPI)⁴⁶ appeared to suggest that the TCF initiative was not sufficient to prompt a much needed change in the financial institutions’ treatment of retail customers. As a result, the outcome-focused TCF initiative was supplemented by a more intrusive rule-based regulation, such as a ban on commission-driven selling requiring firms to change their business model.⁴⁷ What is more, the FSA’s approach to supervision and enforcement also changed post-crisis. The FSA accompanied the TCF initiative by an intensive approach to enforcement aimed at punishing rather than persuading.⁴⁸ For example, in 2010, Kensington Mortgage Company had been fined £1.225 million for breach of the TCF principle in its mortgage business by poorly treating some customers facing mortgage arrears.⁴⁹ In addition, the FSA increasingly insisted on compensation for customers, which by mid-2014 totalled £12.1 billion. All in all, the focus of the UK financial regulator’s supervisory approach shifted from trusting and cooperating with the financial services sector to pursuing credible deterrence in a more competitive relationship between the two. As a result, the leeway available for financial institutions in determining how to treat customers had become more limited. In light of the findings from organisational psychology discussed in more detail below, however, one may question to what extent outcome-focused regulation can smoothly co-exist with an active enforcement policy aimed at making the financial services industry afraid.

3. Meta-regulation

In addition to principles-based regulation, the interplay between public and private actors is possible within meta-regulation. Meta-regulation, also known as management-based regulation, stimulates modes of self-organisation within financial institutions so as to achieve certain public goals.⁵⁰ This means that rather than regulating prescriptively (by telling the regulated entities precisely what measures to take), public regulation only provides an explicit framework for systems, procedures or controls that must be introduced within financial institutions. While regulators always rely on financial institutions’ internal systems to ensure compliance, as Black puts it, ‘meta-regulation simply raises this practical necessity to a conscious regulatory strategy’.⁵¹ Under this strategy, public regulators are to rely upon the senior management of financial institutions to put in place appropriate systems and oversight mechanisms and to take the necessary measures to ensure that these mechanisms are effective. By establishing their own systems of internal control and management, financial institutions in their turn could contribute to the attainment of the specific regulatory objectives pursued by the EU and/or national public regulation.

⁴⁴ FSA, *Treating Customers Fairly – Progress Report* (2002).

⁴⁵ FSA, *Treating Customers Fairly – Culture* (2007).

⁴⁶ A PPI, or Payment Insurance Policy, is an insurance policy that enables consumers to insure repayment of loans if the borrower dies, becomes ill or disabled, or faces other circumstances preventing him or her from meeting the obligations under the credit agreement. As these financial products were sold on a large scale to vulnerable consumers in combination with credit, many consumers ended up with products that were not in their best interests (e.g., not needed or too expensive).

⁴⁷ See *Conduct of Business Source Book (COBS)*, 2.3.1 (Rule on inducements).

⁴⁸ Cf. Black (2015) 232.

⁴⁹ FSA, Press Release 12 April 2010, FSA/PN/065/2010.

⁵⁰ Cf. e.g. N. Gunnigham, ‘Enforcement and Compliance Strategies’, in R. Baldwin, M. Cave, & M. Lodge (Eds.), *The Oxford Handbook of Regulation* (Oxford: Oxford University Press, 2010), 10, available at: <http://www.oxfordhandbooks.com>; C. Coglianese & E. Mendelson, ‘Meta-Regulation and Self-Regulation’, in R. Baldwin, M. Cave, & M. Lodge (Eds.), *The Oxford Handbook of Regulation* (Oxford: Oxford University Press, 2010), 10, available at: <http://www.oxfordhandbooks.com>; Black (2015) 1045 *et seq.*

⁵¹ Black (2015) 1046.

3.1. Private governance

Meta-regulation has not been entirely rejected by the EU's post-crisis reforms. In fact, in some areas, the post-crisis EU financial services regulation heavily relies on this approach. Thus, for example, the recently adopted Markets in Financial Instruments Directive II (MiFID II)⁵² explicitly lays down a new product governance regime under which product design is to be overseen by senior management with a view to preventing investment firms from developing dangerous investment products. Thus, the MiFID II obliges management bodies of investment firms to define, approve and oversee a policy as to such products in accordance with the firms' risk tolerance and the characteristics and needs of their clients, including carrying out stress testing, where appropriate.⁵³ In particular, investment firms that manufacture investment products for sale to clients should maintain, operate and review a process for the approval of each product or significant adaptations of existing products before they are marketed or distributed to clients.⁵⁴ The product approval process should specify an identified target market of end clients for each product, ensure that all relevant risks to such market are assessed, and that the intended distribution strategy is consistent with it.⁵⁵ ESMA appears ready to play an active role in clarifying the content of these organisational requirements.⁵⁶ At the same time, the latter also leave significant room for financial institutions to shape their governance structures.

Moreover, while some Member States, like Germany, remained cautious about resorting to product governance without explicit prompting by EU harmonization, other Member States, like the Netherlands and the UK, had already introduced robust product governance regimes. In the Netherlands, the financial supervision requirements for financial institutions to have product development and approval processes in place came into force on 1 January 2013.⁵⁷ The new product governance regime aims to prevent mass consumer detriment resulting from defective products and it covers all financial products developed and offered by financial institutions, including investment products. The main rule is that, when developing a particular financial product, financial institutions should have appropriate procedures and regulations in place to ensure that balanced consideration has been given to the interests of the consumers of the financial product and that the financial product is demonstrably the result of this consideration of interests.⁵⁸ In particular, the required internal procedures and regulations within financial institutions should delineate a target group of consumers for the product and to conduct tests to establish that the product performs in a way which does not impair consumers' investment objectives.⁵⁹ In the event that a particular product harms consumer interests, the financial institutions should adjust the product as quickly as possible, or cease to offer it.⁶⁰ A similar product governance regime is also already in place in the UK where it aims to prevent potential consumer detriment before it develops.⁶¹

3.2. Public supervision and enforcement

Such open-textured organisational requirements allow regulated financial institutions to shape their governance structures according to their own needs but in the spirit of the public regulatory regimes, and to engage in self-critical evaluation about their regulatory performance. Here lies the major strength of meta-regulation compared to traditional command and control public regulation. This is confirmed by the findings from organisational psychology, in particular the self-determination theory developed by Deci and Ryan. These authors argue that the optimal human condition is one where individuals develop both a sense of positive motivation and responsibility; the contextual

⁵² Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) (MiFID II).

⁵³ MiFID II, art. 9(3).

⁵⁴ MiFID II, art. 16(3).

⁵⁵ MiFID II, art. 16(3).

⁵⁶ See, for example, ESMA, *Structured Retail Products – Good Practices for Product Governance Arrangements: Opinion*, ESMA/2014/332. See also Joint Position of the European Supervisory Authorities on Manufacturers' Product Oversight & Governance Processes, JC-2013-77.

⁵⁷ Market Conduct Supervision (Financial Institutions) Decree 2006, art. 32.

⁵⁸ Market Conduct Supervision (Financial Institutions) Decree 2006, art. 32(1).

⁵⁹ Market Conduct Supervision (Financial Institutions) Decree 2006, art. 32(2).

⁶⁰ Market Conduct Supervision (Financial Institutions) Decree 2006, art. 32(4).

⁶¹ For an overview of the relevant measures, see FSA, *Product Intervention: Discussion Paper 11/1*, January 2011, 32 *et seq.* For an example of the FSA's approach, see FSA, *Retail Product Development and Governance: Structured Product Review. Finalised Guidance*, March 2012.

factors that lead to this are those that promote autonomy, feelings of competence, and relatedness.⁶² Based on these contextual factors identified by self-determination theory, Rupp and Williams, for example, have argued that when regulation develops in principles-based fashion, with cooperative relationships between regulator and regulated becoming part of the regulatory environment, then regulated entities can be expected to engage more deeply with the values and goals of the particular regulatory instrument than when regulation lays down narrow requirements strictly regulating their behaviour.⁶³

In my view, this may be particularly true for meta-regulation. By encouraging the financial industry to put in place effective modes of self-organisation with a view to realising certain public goals, meta-regulation has the potential to contribute to a cultural re-orientation towards public values within the financial institutions or at least not preclude this much needed change. Without such cultural change, it is highly doubtful whether more prescriptive public regulation aimed at ensuring a high level of consumer protection in financial services will be able to realise this goal.

However, yet again, public supervision and enforcement present a major challenge to building a cooperative relationship between the regulator and the regulated and ensuring the effectiveness of meta-regulation in delivering public value. The MiFID II enables supervision over the product development processes within the firms by national financial supervisory authorities and opens up possibilities for regulatory intervention where these processes are not organised in a manner that promotes the interests of clients and the integrity of the financial market.⁶⁴ It is notable that the MiFID II viewed as a whole primarily aims to strengthen the enforcement of the investor protection rules contained therein through administrative law means by specifying the range of administrative sanctions, including pecuniary penalties, which should be employed for certain types of breach and how the determination as to the appropriate sanction and level of sanction should be made.⁶⁵ In fact, by prescribing punitive administrative sanctions, the MiFID II significantly limits the room for manoeuvre available for national supervisory authorities when enforcing it through administrative law means. Coupled with the emergence of ESMA with its far-reaching supervisory powers, this signifies a tendency towards the growing centralisation of public supervision and enforcement at EU level.

This new trend, however, is not unproblematic when it comes to the administrative enforcement of meta-regulation, in general, and financial product governance, in particular. Given that the product governance regime under the MiFID II is still largely untried and insufficiently specific, it is highly questionable to what extent it actually lends itself to formal enforcement actions with the use of pecuniary penalties and other punitive administrative sanctions as envisaged in the MiFID II. It is notable in this context that national financial supervisory authorities across the EU do not exclusively rely on formal enforcement actions against investment firms but increasingly engage in informal enforcement practices reflecting the idea of cooperation with the industry.⁶⁶

For instance, in the aftermath of the financial crisis, the Netherlands Authority's for the Financial Markets formal enforcement style gave way to more informal forms of intervention into the financial institutions' business. There was a growing perception within this administrative agency that formal infringement actions and punitive sanctions would not always produce desired outcomes in terms of better financial products for consumers.⁶⁷ Particularly in the area of product governance, therefore, the Dutch financial regulator now tends to engage in dialogue with the financial institutions by confronting them with poor product outcomes and allowing them to re-evaluate and adjust their products given not only the customer's interest but also their own self-interest. This approach rejects the idea of the financial supervisory authority imposing its own view on the financial institutions as to what constitutes a good financial product. Instead, it aims to rebuild trust between financial market participants by effecting a cultural change within financial institutions that would ensure that such institutions take the customers' interests seriously when developing financial products.

Moreover, in view of the diversity in enforcement approaches across national financial supervisory authorities in the area of investor protection, as well as that in financial markets and products across the EU, imposing a uniform

⁶² E.L. Deci & R.M. Ryan, *Intrinsic Motivation and Self-Determination in Human Behaviour* (New York: Plenum, 1985).

⁶³ D.E. Rupp & C.A. Williams, 'The Efficacy of Regulation as a Function of Psychological Fit', *Theoretical Inquires in Law* 12 (2011) 581. See also C.A. Williams & J.M. Conley, 'The Social Reform of Banking', *Journal of Corporation Law* 39 (2014) 101.

⁶⁴ The legal basis for such actions is provided by art. 69 of the MiFID II concerning supervisory powers.

⁶⁵ See MiFID II, arts 70–72.

⁶⁶ Y. Svetiev & A. Ottow, 'Financial Supervision in the Interstices between Private and Public Law', *European Review of Contract Law* 10 (2014) 496.

⁶⁷ Svetiev & Ottow (2014) 538.

public enforcement strategy at EU level may seriously jeopardise the realisation of the regulatory objectives pursued by the MiFID II, in particular ensuring a high level of investor protection.⁶⁸ Therefore, it is welcome that ESMA currently recognises the dangers involved in imposing a uniform enforcement strategy at EU level and appears to be reluctant to use its formal powers in order to second-guess the choices made by national financial supervisory authorities with respect to enforcement techniques.⁶⁹

A related problem is how to ensure the effectiveness of meta-regulation, particularly when the latter is in place concurrently with prescriptive command and control regulation. This is the case, for example, under the MiFID II which, in addition to a product governance regime, also comprises a range of product intervention techniques targeted at potentially dangerous investment products themselves. In particular, national financial supervisory authorities are given the power to suspend the marketing or sale of investment products where the investment firm has not developed or applied an effective product approval process as described above.⁷⁰ Moreover, such authorities may also prohibit, suspend or restrict the marketing or sale of investment products in or from its Member State where significant investor protection concerns arise, or a threat is posed to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system within at least one Member State.⁷¹ In addition, ESMA may intervene in national markets by temporarily prohibiting or restricting the marketing or sale of investment products in similar circumstances.⁷² By combining indirect product control through process-based organisational requirements for investment firms with direct product control and product banning powers in serious cases, the post-crisis EU regulation aims to prevent potential consumer detriment resulting from the purchase of dangerous investment products. But can such a combination of regulatory instruments foster a consumer-oriented conduct in accordance with the principles and purposes of public regulation, not the letter? As Andenas and Chiu aptly put it:

‘Bright line rules and prohibitions often entail a compliance mindset that is focused on the boundary between what is compliant and not compliant. But meta-regulation requires the application of a different mindset, that of understanding and willingness to achieve the spirit and purpose of regulatory regimes. Will senior management be able to embrace the requirements of both types of regulatory regimes?’⁷³

In this context, the role of financial regulators in supervising and enforcing compliance with meta-regulation becomes particularly important. However, meta-regulation may not be straightforward to enforce, and financial regulators have accumulated little experience in this area, especially when it comes to product governance arrangements. Thus, there is a risk that regulators will exercise only passive compliance monitoring. As Hopkins and Wilkinson have emphasised, however, the regulator’s job under the meta-regulation approach involves *actively* challenging the regulated entities to demonstrate that their systems really work in practice.⁷⁴

This, in my view, could be done more effectively if there is a clear link between organisational frameworks and the achievement of regulatory outcomes, such as better quality financial products. The Dutch experience – whereby the financial regulator actively supervises not only the product development *processes* but also the resulting *products* – may provide useful insights for EU regulation, where the link between the two is much less straightforward. The Netherlands Authority for the Financial Markets assesses the products from the consumer’s perspective based on the four criteria: (1) cost efficiency (does the product offer value for money?); (2) usefulness (does the product fulfil a

⁶⁸ Svetiev & Ottow (2014) 540.

⁶⁹ Svetiev & Ottow (2014) 540.

⁷⁰ MiFID II, art. 69(2)(t).

⁷¹ Regulation (EU) No. 600/2014 of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No. 648/2012, *OJEU* 2014 L 173/84 (MiFIR), art. 42 and MiFID II, art. 69(2)(s) in conjunction with MiFIR, art. 42.

⁷² MiFIR, art. 40. This power of ESMA relates to the general clause in ESMA’s founding Regulation, which empowers ESMA to temporarily prohibit or restrict certain financial activities in the cases specified in relevant EU legislation or in the case of an emergency situation (Regulation (EU) No. 1095/2010, *OJEU* 2010 L 331/84, art. 9(5)).

⁷³ M. Andenas & I.-H. Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility* (London & New York: Routledge, 2014), 209.

⁷⁴ A. Hopkins & P. Wilkinson, ‘Safety Case Regulation for the Mining Industry’, Working Paper 37, National Research Centre for Occupational Health and Safety Regulation, Australian National University, available at: <http://www.ohs.anu.edu.au>. See also J. Viñals & J. Fiechter, ‘The Making of Good Supervision: Learning to Say “No”’. IMF Staff position note 18 May 2010, 14; F. de Vries, ‘How can Principles-Based Regulation Contribute to Good Supervision?’, in J. Kellermann, J. de Haan & F. de Vries (Eds.), *Financial Supervision in the 21st Century* (Berlin/Heidelberg, 2013), 165, 176 *et seq.*

predefined need of a specific target group of consumers?); (3) safety (does the product do what it is supposed to do in different scenarios and is the outcome acceptable for the target group?); (4) understandability (is the product not needlessly complicated and can the consumer adequately judge its quality and suitability for his needs?).⁷⁵ If the product fails to meet one or more of these criteria, it can be considered to be harmful for consumers, which can trigger enforcement action against the financial institution for failure to comply with the relevant financial supervision requirements.

4. Concluding remarks

The preceding analysis has explored the interplay between private regulators and public supervisors in the post-crisis European retail financial services landscape. It has shown that, despite the rise of public regulation and supervision after the crisis, private regulation has not entirely lost its significance in governing financial services in the EU. The conventional dichotomy between self-regulation by the financial services industry (commonly associated with its freedom) and public regulation produced by the EU and/or national public authorities (commonly associated with control over the financial services industry) fails to capture a number of regulatory options which enable the interface between public and private actors in facing the post-crisis regulatory challenges and which remain open in the post-crisis period. In particular, such options include principles-based regulation and meta-regulation.

In order to achieve breakthroughs in our understanding of the way in which retail financial markets operate and to increase the effectiveness of the post-crisis financial services regulation in realizing its goals, public and private actors need to cooperate with each other. This is particularly true for newly-developing regulatory areas, such as financial product governance. When co-governing financial services, however, public and private actors often not (only) cooperate but (also) compete with each other. Which form of the relationship between the two prevails at a specific moment in time may be considerably influenced by the way in which the compliance of private actors with principles-based regulation or meta-regulation is supervised and enforced by public watchdogs.

In the post-crisis period, there is evidence of both cooperation and competition between private regulators and public supervisors across the EU, in general, and within specific jurisdictions, in particular. In the UK, for example, in the wake of the crisis the supervisor's trust in financial institutions operating in the retail financial market gave way to credible deterrence and the rhetoric of 'be afraid'. In contrast, in the Netherlands, the emphasis in the supervisory approach shifted towards more dialogue and less confrontation with the retail financial services industry.

The problem with a predominantly competitive relationship between private regulators and public watchdogs fed by mutual distrust is that it may severely undermine the practical significance of co-governance arrangements. This may lead, in particular, to the substitution of private soft law by public soft law and only passive compliance monitoring. Therefore, a significant degree of trust and cooperation between private regulators and public supervisors is key to making the co-governance arrangements work in practice.

In order to ensure a cooperative relationship between public and private actors in standard-setting and enforcement, states must become, to use the words of Van Waarden, 'responsive to regulatory initiatives of markets and civil society and vice versa, with responses varying from banning or blocking, to support or even adoption.'⁷⁶ In particular, what is needed are responsive public supervision and enforcement, i.e. supervision and enforcement that would be responsive to the peculiarities of co-governance arrangements, with due regard to such rule of law values as legal certainty and equal treatment.⁷⁷ How such responsive public supervision and enforcement in European retail financial services law can be shaped is an important question for further research.

⁷⁵ See the explanations relating to Market Conduct Supervision (Financial Institutions) Decree 2006, art. 32, provided by the Netherlands Authority for the Financial Markets, available at <http://www.afm.nl/nl/professionals/regelgeving/thema/productontwikkeling/toetskaders.aspx>.

⁷⁶ F. van Waarden, 'The governance of markets: On generating trust in transactions', in D. Levi-Faur (Ed.), *The Oxford Handbook of Governance* (Oxford: Oxford University Press, 2012), 355, 367. The meaning of 'responsive' regulation in this sense is thus different from the one given to it by Ayres and Braithwaite (regulation 'responsive' to the reactions of regulatees). See I. Ayres & J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992).

⁷⁷ Cf. R. Baldwin & J. Black, 'Really Responsive Regulation', *Modern Law Review* 71 (2008) 59.