Regulation of Financial Markets: A Focused Approach*

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A new approach and a new mind-set are needed for the regulation of financial markets. Under our existing trajectory, regulation will become inefficient, unwieldy, and too costly as it attempts to deal with an ever–more complex financial system. Regulators ought to focus on what needs to be regulated, not simply on expanding regulatory oversight. Implicit in this mind-set is the idea that not everything must be regulated. A focused approach to regulation would separate what is regulated from what is not. Examples of how regulation can be more narrowly focused are given for banking, for securities markets, and for futures markets (JEL G18, G28, G38).

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I. Introduction

The world wide web, the cash less society, the cell phone. These are just some of the changes that are affecting our daily lives and our financial systems. Trading of financial instruments is increasingly automated and increasingly independent of geography. One half of Schwab's brokerage business comes to it electronically. New issues of stocks can easily be marketed over the web. Financial innovation and what has been called *particle finance*[1] provide new financial instruments

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1. See Charles S. Sanford, Financial Markets in 2020, paper given at the Federal

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and contracts to meet every customer need. Derivatives can create a virtual portfolio like the virtual reality of computer games. Globalization of markets is a by-product of the new communications technology and relative political stability. As a matter of technology and communication, it is as easy to trade a security from Finland or Thailand as from New York; only law and regulation make it difficult. These developments pose major problems for financial regulators. Regulation arose in a simpler time when financial transactions were carried out face to face on an exchange floor or in a banker's office, when trading was localized, and when the variety of financial instruments was small. Today, the task of regulators is much more difficult. Trading takes place in cyberspace, and the variety of financial instruments is limitless. In this high-tech environment, how should regulators cope?

Regulators could try to apply the existing regulatory scheme to expanding and more complex financial markets, an approach akin to the proverbial Dutch boy with his thumb in the dike. Maintaining old dikes and plugging holes as necessary is likely to be difficult, costly, and to end in failure. The Dutch boy did save Holland, but that was a fairy tale. In real life, I doubt just plugging holes in an outmoded regulatory system will work.

A second approach is to make good decisions on what should be enclosed by dikes and what should not. Divert some of the water to flow freely, unencumbered by the dam, while focusing energies in regulating the remainder. The freely flowing water can create power. At the same time, fewer Dutch boys will be required to contain the remaining water and to maintain the smaller dike.

A new approach and a new regulatory mind-set are needed. Regulators ought to focus on what needs to be regulated, not simply on expanding regulatory oversight. Implicit in this mind-set is the idea that not everything must be regulated. A focused approach to regulation would separate what is regulated from what is not. In those cases where regulated and unregulated markets perform similar functions, investors, bank depositors, issuers of securities, and financial firms would be able to choose in which to trade. Market participants could play in the still waters of regulated financial markets or ride the free1–flowing waters where regulation is absent. While the free flowing water is more dangerous, many market participants will develop watercraft that can

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withstand any potential turbulence (by using insurance, hedging, and the like). Also the free-flowing water is likely to be more fun! Others, less knowledgeable or less adventuresome, will choose the still, dammed up waters.

II. Basis of Financial Regulation

Regulation of financial markets rests on the tenet that it protects the public interest by (1) protecting investors and (2) guarding against systemic risk. (This is in contrast to Stigler's (1971) proposition that regulation serves the interests of those regulated. But let us assume that regulation is in fact intended to serve the public interest.)

On the investor protection side, regulation is justified on the ground that investors are uninformed and unskilled. Not only should investors have full information about the security in order to make an informed decision, but because an increasing number of investors are judged incapable of making informed decisions, the SEC and the CFTC today also require brokers to judge the suitability of an investment. We have moved from a free market economy of *caveat emptor* to an economy of *caveat vendor*, as Miller (1997, p. 24) recently put it, that imposes the responsibility on the seller. Suitability may be a reasonable requirement where a fiduciary relationship has been formally established, but it is less clear that suitability should apply to arm's- length sales of financial products, particularly when they are to corporations and financial institutions. Why should a broker-dealer be responsible for judging the suitability of a financial product for a large corporation like Procter and Gamble or a large governmental entity such as Orange County?

I imagine you know my answer. There should be limits to regulation. The focused approach to regulation would limit investor protection to designated markets and securities. Trading in other markets and securities would be at the investor's risk.

A second basis for financial regulation is systemic risk; namely, that the failure of one financial institution will cause a run on other institutions and precipitate system–wide failure. Systemic risk is an externality because the system wide effects are not costs for the firm that fails. Every liberal economist knows that externalities have to be corrected by regulation. The problem is that almost every aspect of financial markets, if not daily living itself, involves systemic risk. For example, defaulting on my home loan has potential systemic effects –

the bank might fail, which might cause other banks to fail, and so forth. Clearly there must be limits on the applicability of this rationale for regulation.

A focused approach to regulation would emphasize those aspects of a market that clearly pose systemic risks and would leave unregulated those aspects that are not central to confidence in the financial system and for which the free market can provide its own protection.

A new approach is needed. Under our existing trajectory, regulation will become inefficient, unwieldy, and too costly as it attempts to deal with an ever–more complex financial system. Financial institutions will be required to justify their actions in terms of suitability, risk, and other criteria. Government officials will have to become involved in the details of business decisions to understand if an institution's actions were suitable and within the bounds of allowable risk. That a new approach is needed becomes clear when one examines current regulatory issues in the banking area, the securities area, and the futures area.

III. Bank Regulation

The linchpin of bank regulation is deposit insurance. Deposit insurance prevents runs on banks because depositors know they can get their money even if the bank fails, and as a consequence, the integrity of the payments system is maintained. However, deposit insurance introduces well-known moral hazard problems: banks take more risk and depositors lose the incentive to monitor banks' risk taking. The regulatory response is to substitute government monitoring for private monitoring. Regulators inspect banks and establish capital requirements that reduce the risk of bank failure to an acceptable level.

Insured deposits are only a small fraction of the assets of the major banks, but capital requirements and bank inspection apply to the much larger bank. If bank inspection and setting capital requirements were easy, this all-encompassing regulatory oversight would be no problem.[2] But establishing the *correct* capital requirements is a difficult task. It is technically difficult; it is conceptually difficult; it is managerially difficult. To do a good job, regulators would have to become managers.

2. Ball and Stoll (1998) compare regulation of different financial institutions and examine the complications of the new world of high-tech finance.

Regulators have now also realized these difficulties and have agreed to let banks use their own internal models to calculate *value-at-risk* and thus the amount of needed capital. That action does not solve the problem because the regulator has to check the model.[3]

In summary, regulation is costly in several ways. First is it tends to require more capital than the optimal capital. Second, the cost of oversight and inspection is great. To properly regulate a modern complex bank, the bank examiner must be as sophisticated and must have as much information as the bank manager. Third, government regulation reduces incentives for monitoring by the private sector, which would be more efficient.

The solution is a focused approach to regulation. Focus on the objective of regulation; namely, to protect insured deposits and thereby maintain confidence in the banking system. The focused approach to bank regulation was proposed exactly 50 years ago by Henry Simons (1948) and has been referred to as the narrow bank approach. Under Simons' approach, the bank would be required to maintain specific 100% collateral against insured deposits. Operationally, this could be accomplished with a separate subsidiary for the insured deposits. Uninsured deposits and the rest of the bank would not have the same protection. It would be up to the market to decide what kind of collateral stands behind uninsured deposits just as is now the case in uninsured money funds. Depositors could choose insured accounts or uninsured accounts, just as they do today.

A corollary of the focused approach is that the *too big to fail* doctrine must be abandoned. The uninsured segment of the bank must be allowed to fail. Depositors and lenders to the larger bank will then have the incentive to monitor the institution. Regulators could help by requiring more adequate disclosure and more complete accounting.[4]

IV. SEC Regulation

The Securities and Exchange Commission (SEC) regulates the issuance of securities under the Securities Act of 1933 and it regulates broker-

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3. In practice, because the regulator is uncertain about the model, the model capital requirement is multiplied by three "to be on the safe side."

4. The Federal Reserve Bank of Minneapolis has recently proposed steps in the direction of elimination TBTF.

dealers and the trading of outstanding securities under the Securities and Exchange Act of 1934. Three regulatory issues dealing with the scope of SEC regulation have been in the news recently. One deals with capital requirements; a second deals with the initial offerings; and a third deals with the trading of micro-cap stocks.

A. SEC Capital Regulation

As is true of banks, broker-dealer regulation includes a heavy dose of capital regulation. But the SEC is still in the dark ages. Its capital requirements are established on an asset-by-asset basis, not on a portfolio basis, with inadequate recognition of the benefits of diversification. Such an approach may do for a simple broker who acts as an agent for customers wishing to trade stocks and bonds, but it is inadequate for a sophisticated investment bank with large positions in financial instruments, many of which did not exist when the capital regulations were written. Under SEC capital requirements, swaps, for example, are considered unsecured loans that are subject to 100% capital requirement (calculated on their nominal value). Furthermore, because of the SEC's asset by asset approach, there is no offset for hedges. Under this regulation, it is prohibitive for SEC registered broker-dealers to do a derivatives business, and firms have had to establish subsidiaries outside of SEC jurisdiction. (This is possible if the subsidiary does business only in financial instruments which the SEC does not consider to be securities, i.e., swaps, or because the subsidiary is off shore.)

In December, 1997, the SEC, concerned that there was something they did not regulate, proposed to bring these heretofore-unregulated subsidiaries under a modified (and for the moment, voluntary) regulation sometimes termed "broker-dealer-lite." The modified regulations would be available for OTC-derivative subsidiaries that deal only with large institutional counter-parties. The thought that such subsidiaries need not be regulated at all apparently did not occur to the SEC. The broker-lite proposal has also produced a return salvo from the CFTC, which thinks that maybe it should be regulating these derivatives subsidiaries.

The SEC has succumbed to the belief that everything should be regulated, even if only lightly. An alternative would be to regulate not at all the activities that are not central to the SEC's mission. The central mission of capital regulation is to protect individual accounts insured by the Securities Investor Protection Corporation (SIPC). The focused approach to SEC capital regulation would parallel the narrow bank approach. Require the portion of the broker dealer holding insured customer accounts to have solid collateral and to be transparent. The remainder of the broker dealer would be unregulated or subject to broker-dealer *lite* regulation. Firewalls between the regulated segment and other segments would be established.

B. Offshore Website Offerings

Securities offered for sale in the U.S. are subject to registration with the SEC under the 1993 Act. What about securities offered outside the U.S. over a web site located outside the U.S. but easily accessible from the U.S.? The SEC recently provided an "interpretation" of when such web offerings would be subject to registration. Web offerings are U.S. offerings when they are targeted to persons in the U.S.. To avoid U.S. registration, the web site is required to post disclaimers and to take actions to ensure that no sales are made to U.S. citizens. The interpretation thus imposes requirements on foreign issuers in jurisdictions outside the U.S.[5] The interpretation leaves unclear the liability of an offeror who sold securities to a U.S. citizen who evaded the law by claiming to be a foreigner.

The SEC is in the difficult position of trying to seal off the U.S. from the flood of foreign offerings, over the web or otherwise. Aside from the fact that this looks a lot like putting a thumb in the dike, why is it so important to prevent an American from buying an unregistered security? An alternative approach would be to declare that the offering is not registered, and let investors participate if they wish. This procedure has been implemented, in part, for accredited investors who are allowed to purchase offerings of securities that do not meet the full SEC registration requirement. It will not be a disaster to permit all investors the same right. Would it not be easier to have two categories of new issues, registered and non-registered? The SEC would focus on the registered issues. The other issues would receive a financial health warning that they are not registered. A web offering could be registered or not; the issuer could choose.

The response from regulators to such a proposal will be that individuals cannot intelligently decide between registered and

5. The interpretation imposes even stricter standards on U.S. companies that offer unregistered securities offshore than it does on foreign companies that offer offshore.

unregistered issues, that it is the obligation of the SEC to protect investors, whether they want the protection or not. Ultimately the resolution of this issue depends on how much responsibility should be given to individual investors and how much protection they want. If investors want the protection of regulated offerings, they will participate only in the regulated market and the unregulated market will dry up. The market can decide if there is a market for unregulated issues.

C. Microcap Stocks

Microcap stocks are *very* small companies that appear and disappear on a moment's notice. They are quoted on the *pink sheets* and traded *by appointment* with a market maker. In response to abuses in the trading of microcap stocks, the SEC has recently proposed new obligations for market makers in such stocks. These obligations require the market maker to read and understand the financial statements of the company in which they make a market. On the one hand, this seems innocuous. Why should market makers not be familiar with the stocks they quote? On the other hand, this is a clear set-up for a legal suit by the first investor who buys a microcap that subsequently tanks. The SEC gives comfort to investors unwilling to accept responsibility for their own actions who would now have a basis for suing a market maker in the event of a loss. The result is likely to be that microcap stocks will not be quoted at all. Would it not be simpler to inform investors that trading of microcaps is done at their own risks? Microcaps that provide the necessary information and register with the SEC would be traded in regulated markets. Those that do not would be quoted in the pink sheets, without warranty and with a disclaimer that they are not registered.

In summary, a focused approach to SEC regulation would set up a separate subsidiary for insured customer business which would be subject to capital requirements and other regulations and would leave the rest of the broker unregulated or subject to lighter regulation. A focused approach would divide new issues into those meeting registration requirements and those not. Issuers could choose whether to meet requirements, and investors could decide whether they wanted to play in the regulated or unregulated new-issue market. A focused approach would also separate certain secondary markets from SEC regulation, leaving it to companies to decide whether they wish their securities to trade in a regulated or unregulated secondary market.

V. CFTC Regulation

Consider now the third area of regulation derivatives and the Commodity Futures Trading Commission (CFTC). Financial derivatives introduced in the late 1970s and early 1980s upset a previously staid regulatory world in which the Commodity Exchange Authority (CEA), the CFTC's predecessor, regulated agricultural commodities, the SEC regulated securities and securities firms, and the banking agencies regulated banks. With the CEA Act of 1974, the backwater of agricultural commodity regulation suddenly became the CFTC responsible for *all* futures contracts, a playing field that, in principle, involved every type of financial contract, including the major financial innovations of the last 20 years. The Act did not define futures, but gave the CFTC *exclusive* jurisdiction over them and required them to be traded on an organized futures exchange. At the last minute, the Treasury, spotting the CFTC's broad mandate, inserted an amendment which excluded futures on currencies and government securities from CFTC jurisdiction.

The CEA Act of 1974 turned out to be a recipe for legal uncertainty, to put it mildly.[6] It generated a turf battle between the SEC and CFTC and the banking authorities and left in legal limbo the OTC derivatives market. If implemented, the CFTC's authority could easily kill off a host of new products. The three elements of the authority are (1) exclusive jurisdiction over futures, (2) a potentially broad definition of futures, and (3) the requirement that futures be traded only on approved exchanges. If the CFTC were to designate an OTC swap contract as a futures contract (which it is), the CFTC would have exclusive jurisdiction, and the product would be illegal unless it were traded on an approved exchange. The CFTC's authority is the opposite of focused regulation because it so broad. The CFTC's potentially broad mandate was limited under the chairmanship of Wendy Gramm, who used exemptive authority given by the 1992 Futures Trading Practices Act to exempt swaps and hybrids from CFTC jurisdiction.

The move to clarify and narrow CFTC jurisdiction has, however, been reversed in recent years in a series of interventionist actions. For example, in the Bankers Trust - Gibson case, the CFTC promulgated the interesting notion that Bankers Trust was a commodity advisor, despite

6. Gramm and Gay (1994) document the legal uncertainty present in futures regulation.

the fact that the security in the case was a swap which was exempt from CFTC regulation. According to the CFTC, Bankers Trust had fiduciary obligations as a commodity advisor, which it violated. In the Metallgesellschaft (MG) case, the CFTC ruled that MG had entered into illegal futures and options contracts. Illegality is based on the judgment that MG had entered into futures options contracts with its customers. Since they were entered into outside an exchange, the contracts were illegal. In May of this year, the CFTC issued a concept release questioning whether the CFTC's jurisdiction over OTC derivatives markets was sufficient. The release has caused nail biting among securities firms and banks and has even shaken up the likes of Alan Greenspan and Bob Rubin, who fear that their turfs will be invaded by the CFTC. We certainly do not need more regulatory uncertainty.

A focused approach to futures regulation would increase the clarity and certainty of what today is a murky and uncertain regulatory sea. The principle is simple. Congress should specify what derivatives markets really need to be regulated and what do not. A reasonable approach would be for the CFTC to regulate futures trading on organized futures exchanges and to leave unregulated other futures trading such as that in the OTC market. The Treasury Amendment could be applied to all futures. The Treasury amendment reads so as to exclude "transactions in foreign currency, ..., government securities, or mortgages..., unless such transactions involve the sale thereof for future delivery conducted on a board of trade." Such an approach would not be unreasonable for all items. A modification might be to allow markets to choose to be regulated by the CFTC or another regulator. Under this approach, the CFTC's exclusive jurisdiction over futures would be removed because certain contracts recognized to be futures contracts would be traded off organized exchanges.

VI. Alternative Regulatory Approaches

How does a focused approach to regulation fit in with other regulatory frameworks such as the institutional approach, the functional approach, and the competitive approach?

Financial regulation in the U.S. and probably around the world evolved as an institutional approach. Banks, brokers, and insurance companies have each been separately regulated even as the overlap of their businesses has increased. The benefits of the institutional approach are that the regulators come to understand the industry they regulate. Alan Greenspan has often argued that the Federal Reserve requires authority to examine the largest banks so that it can be current on how banks work and how monetary policy affects them. The drawback is that regulators become captives of the industry.

The functional approach to regulation organizes regulation by economic function of the financial product or by regulatory function. A good example of this approach is a proposal by the Chicago Mercantile Exchange for a restructuring of financial regulation.[7] The functional approach is said to be more efficient and to reduce jurisdictional overlap. The drawback is that it is difficult to implement as it requires major changes in jurisdiction.

The competitive approach to regulation calls for non-exclusive regulation, which gives investors and financial firms alternatives. Insofar as the institutional approach leads to overlapping jurisdictions, it is a competitive approach. For example, there is competition between the SEC and CFTC. Recently Roberta Romano (1998) has proposed a system of competitive state regulation for a few components of federal securities law (registration of securities and corporate disclosure). A firm could choose whether to be regulated by a federal regulator or a particular state. The proposal requires reciprocity among the legal jurisdictions so that once the firm chooses a regulator, that regulator's authority is recognized in all jurisdictions. The benefits of the competitive approach are that firms would be able to choose their regulator, thereby creating a market for regulation. (The flight of many investment advisory firms offshore and the use of exemptions from regulation, such as the accredited investor exemption, indicate the burdens of some existing regulation and the benefits of alternatives.[8]) Romano's proposal would also translate nicely into the international arena.[9]

The focused approach I espouse is consistent with any of the

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7. See Fleischman (1995).

8. Alan Greenspan (1997) made the same point: "Migration of activity from government-regulated to privately-regulated markets sends a signal to government regulators that many transactors believe the costs of regulation exceed the benefits.".

9. Roger Koppl pointed out to me that Adam Smith had noted with approval the existence of competition among different British courts. Smith noted that "...each court endeavoured, by superior dispatch and impartiality, to draw to itself as many causes as it could." (*Wealth of Nations*, Book V, Ch. 1, Part II.)

frameworks I have just discussed, but it fits in best with the competitive approach because it gives market participants choices not only among regulators but also between regulated and unregulated activities. The focused approach simplifies regulation, and it recognizes that not everything need be regulated. The problem today is less how to regulate than how much to regulate. The focused approach emphasizes the need to specify clearly what ought to be regulated and what not.

VII. Conclusion

As financial markets continue to go global, attempts to impose a single regulatory framework are likely to fail. As a practical matter, world wide functional regulation is not feasible. We are likely to continue to see institutional regulation along with competition among different legal jurisdictions around the world. The task for regulators is not to form one massive world-wide regulatory cartel but rather to enter into reciprocity agreements under which regulation by any one of many legal jurisdictions will be acceptable. In sum, the regulatory system should be institutional, competitive, and, above all, focused.

In this more complex and more competitive environment, focusing regulation on those aspects of the markets that really need it will make life easier not only for firms and investors but also for the regulators. Let us put dams only where they are needed and are cost–effective and let the remaining water run freely.

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