CFA Society United Kingdom

EFFECTIVE REGULATION

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EFFECTIVE REGULATION

Effective regulation involves the design of policies, rules and laws that are thoroughly supervised and supported by the credible threat of enforcement to produce an intended or expected result. Such results can be investor protection, more efficient capital markets or the reduction of systemic risk, to name but a few.

CFA UK believes that effective regulation is essential for capital markets to function appropriately. History has demonstrated that market discipline alone cannot be reliably imposed by financial market participants. Failure in self regulation makes the regulator the last line of defence for maintaining market integrity and, thereby, trust and confidence. The evidence demonstrates that the regulator is also prone to failure.

CFA UK is concerned that not enough emphasis is being placed on supervision and enforcement. While the design of the regulatory framework matters, the recent regulatory failure was primarily a failure of supervision.

CFA UK calls on regulators to amend their approach by:

1) Enhancing financial capability so that consumers become a more robust source of market discipline on firms. Focusing on the supply side of financial markets alone appears a wasted opportunity.

2) Establishing a regulatory philosophy and approach which acknowledges that we live in a world that can act irrationally and inefficiently for protracted periods. Rather than facing a binary choice between the market mechanism and command and control, the regulatory philosophy should embrace libertarian paternalism (nudge theory).

3) Just as market participants need to be held to account by their shareholders and the regulator, so the regulator should also be held to account.

CFA UK believes effective regulation will strengthen UK's position as a leading global financial centre. By fulfilling the essential role they play in enhancing the quality of market integrity, regulators will be able to further strengthen the UK's position as a leading global financial centre.

EFFECTIVE REGULATION

"If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself." (James Madison)

The subject of regulation usually provokes industry concern about the administrative burden and costs. However, having an effective regulatory environment encourages the capital markets to operate more efficiently. Regulators need to supervise and enforce laws and rules effectively, to ensure that those that are being regulated act in a manner consistent with the spirit as well as the letter of the law. This is important in the financial services industry where the products provided are credence goods[1].

Trust and confidence in our economic system depends on three interdependent sets of governance mechanisms[2] –

1) **Corporate governance** – the internal governance mechanisms within business organizations. According to Broby (2010), sound governance is the building block of both good organizational management and the legal and regulatory landscape.

2) **Financial market agents** – The governance provided by financial market agents which consist of buy-side and sell-side institutions, other providers of capital, auditors, ratings agencies and to some extent the media. For the purposes of this paper we will focus on those that are responsible for allocating capital and pricing risk, with an emphasis on the buy-side. By allocating capital efficiently and pricing risk appropriately, financial firms impose market discipline and contribute to market integrity. Financial firms also need to have effective internal governance mechanisms to enable them to play their dual roles as regards market discipline – both as a provider and as a bearer of market conduct requirements. Events from financial and corporate history demonstrate that financial firms cannot always be relied upon to either impose market discipline or act fully in compliance with the spirit and letter of these requirements. Hence the need for effective regulation will always exist.

3) **Financial regulators** – responsible for ensuring that the financial system operates in a manner to meet the objective of imposing market discipline. Intervention should be prompted when there are threats to market integrity, the prospect of market failure or where trust and confidence is likely to be materially undermined. Intervention should be decisive and a deterrent to others considering inappropriate activity. By ensuring that financial firms are held to account, the regulator can maintain trust and confidence and raise the quality of market integrity. Sadly, regulatory failure can be just as common as market failure and thereby exacerbate systemic governance failure. This raises the question of what effective regulation should look like.

CFA Institute has set out material features of effective regulation with the objective being to seek qualified and fair-minded regulators that oversee markets that can react and evolve in ways that enhance investor interests.

The key elements identified by CFA Institute are as follows -

» Underlying principles for regulation and enforcement that are consistent for similar transactions and activities

» Regulators who possess the requisite experience and in-depth knowledge of capital markets and the roles and activities of market participants

» A market system with sufficient flexibility to respond rapidly to changes

» A central market system with sufficient regional representation to ensure sensitivity to emerging niche markets and small-and-medium-sized businesses

» A system that is cost-effective in terms of fees, compliance costs, and other burdens imposed on registrants, issuers, and investors

» Adequate governance to assure objectivity, appropriate independence, and accountability to the government

Effective regulation is composed of two main elements –

1) Practical policy design
2) Effective supervision with the credible threat of enforcement

[1] Credence goods are goods and services where it is difficult for the consumer to ascertain the value of their purchases. The consumer is relying on the expertise of the provider.
[2] Radia, Sheetal Kumar, "From Corporate Governance to Metagovernance - A Holistic Framework" (May 2007). Available at SSRN: http://ssrn.com/abstract=984647

1) PRACTICAL DESIGN OF REGULATION

"You can't regulate what you don't understand." (John Colley)[3].

As the above quote highlights, practical policies and/or laws are those that are based on a significant understanding of financial services. All too often in the past the regulatory evolution has swung between the extremes of command and control to an excessive reliance on market mechanisms. The weaknesses of both philosophies have been exposed because they rely on the premise that agents act rationally.

Underlying the regulatory approaches of the past was an inordinate focus on the supply side of the industry and too little emphasis was placed on actively making the consumer a powerful source of market discipline on financial firms. Ensuring that the demand side plays an active role in imposing market discipline is integral to any practical design of regulation. Based on the recent discussion paper on Product Intervention from the Financial Services Authority (FSA)[4] , there are welcome signs of philosophical change on this front. However, the European Commission's approach seems to be suffering from a myopic focus on the supply side.

Vital to effective policy design is the recognition that in a world with bounded rational agents and where markets are imperfect and not frictionless, the policy options that are chosen are likely to be a hybrid of command and control and market mechanisms "the invisible hand will be combined with the visible handshake" (Jessop).

In this way, practical regulation can be used to bring about more efficient outcomes. The philosophy of policymaking may need to incorporate what Sunstein[5] and Thaler (2003) term libertarian paternalism or 'nudge theory' as it has become more commonly known. The essence of this approach is that policy design should be based on cost-benefit analysis rather than 'estimates of willingness to pay.' In addition, policy design should incorporate some of the findings from psychology to provide some ex ante indications about when people may not maximize their gains when left to choose for themselves. Nudge sounds like a contradiction in terms, but is based on the recognition that people can make inferior and inconsistent choices because they may:

» Not possess complete information, or may be overwhelmed by too much information.

» Lack high levels of cognitive ability.

» Lack the appropriate level of willpower and self-control.

Nudge theory proposes that paternalism can be used in a manner that enables people to make better choices, but not at the expense of the freedom to choose. An example of Nudge theory at work is the Save More for Tomorrow (SMaRT) programme devised by Thaler and Benartzi that involved the auto-enrolment of employees into workplace pension schemes in the U.S. An initiative based on nudge theory is being implemented in the UK with the National Employment Savings Trust (NEST).

To develop the libertarian paternalism concept for policy design, one should look at the work Camerer et al., termed asymmetric paternalism. They argue that one should adopt policies that aim to assist those agents that are bounded rational while minimizing the costs on rational agents. Such a policy would be based on the formula set out by Camerer et al –

$$(p*B) - [(1-p)*C] - I + \Delta\prod \geq 0$$

Where:

p = proportion of firms that can make beneficial improvements in efficiency.

B = Net benefits to bounded rational agents.

C = Net costs imposed on rational agents by the AP policy.

I = Implementation costs

$\Delta\prod$ = the impact on firms' profits

Integral to using asymmetric paternalism for policy design is the assumption that policymakers will obtain the evidence to make judgments about the proportion of bounded rational agents within the population to be impacted by regulation. Policymakers need to demonstrate how a policy change, especially a material one, will deliver net benefits. In addition, the policymaker will also need to be to be self-aware to deliver the most efficient outcome and minimise 'I'. Where B>0, C = 0 and I is small, AP policies would deliver benefits.

[3]"Board Games," John Rubino, CFA Magazine, May/June 2004, Vol. 15, No. 3: 30-36.
[4]CFA UK response on Product Intervention can be found at https://secure.cfauk.org/assets/2126/CFAUKresponseProductIntervention.pdf
[5]Professor Cass Sunstein is Administrator for the Office of Information and Regulatory Affairs and was nominated to this post by President Obama.

The size of 'I' will depend on the costs imposed by policy design, monitoring and enforcement, capture etc. The poorer the effectiveness of regulation the larger 'I' will be.

The impact on firms' profits will also need to take into the account the desirability of intervention distorting the disparity between firms acting in their clients' interests and those that may be more willing to run regulatory risks.

Following on from the above, other features of practical policy design might include –

» Being evidence-based, so as to ensure that the design of laws, policies and regulations are accountable, consistent, proportionate, targeted and transparent.

» Consistency with, rather than conflicting with, existing laws and policies.

» Sensitivity to gaming. Practical regulation and effective monitoring would also minimise the consequences of gaming (for example regulatory and tax arbitrage or even evasion) on society. These efforts would ensure that costs of gaming would outweigh the benefits for those considering undertaking the activity.

» Dynamism. Governance is a complex system that requires evolution and learning for the policy levers to remain effective in the present and the future.

» An appropriate emphasis on the monitoring of the policy, combined with a credible threat of enforcement.

2) EFFECTIVE MONITORING AND THE CREDIBLE THREAT OF ENFORCEMENT

"We know in retrospect what we missed. We set up the Financial Services Authority (FSA) believing that the problem would come from the failure of an individual institution... so we created a monitoring system which was looking at individual institutions. That was the big mistake. We didn't understand how risk was spread across the system, we didn't understand the entanglements of different institutions with the other and we didn't understand even though we talked about it just how global things were, including a shadow banking system as well as a banking system." (Gordon Brown 2011)

Regulation alone is not sufficient. Even the best designed regulation will be ineffective if it is not credibly supervised and enforced. As La Porta et al suggest "these laws and the quality of their enforcement by regulators and courts are essential elements of corporate governance and finance... in contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well."

On occasion it may be more beneficial to enforce existing laws and regulations rather than to devise new regulatory policies. As La Porta et al state "the strategy for reform is not to create an ideal set of rules and then see how well they can be enforced, but rather to enact the rules that can be enforced within the existing structure."

Integral to any monitoring/supervision is the recognition of the importance of whistleblowing and for the regulator to have the judgement and capability to investigate any allegations. Whistleblowers can provide regulators red flags, although in some cases regulators may not act as decisively as they should and so the whistleblower gets forgotten.

Recent regulatory initiatives in the UK have focused on changing the framework rather than on operational excellence. This was pointed out in CFA UK's response[6] to HM Treasury's updated consultation on "A New Regulatory Framework." CFA UK observes that the frequency with which certain key words appear within HM Treasury's document gives the reader an indication

[11] Radia, Sheetal, "From corporate governance to metagovernance, a holistic framework" (May 2007) available at the Social Scienced Research Network
[12] Coffee Jr., John C., "Understanding Enron: It's About the Gatekeepers, Stupid" (July 30, 2002). Columbia Law & Economics Working Paper No. 207. Available at SSRN: http://ssrn.com/abstract=325240 or DOI: 10.2139/ssrn.325240
[13] "Volatility + Leverage = Dynamite", Howard Marks, CFA , Research Foundation Publications, Insights into the Global Financial Crisis, (December 2009): 76-87.
[14] "The Flaws of Our Financial Memory" (Digest Summary), Joachim Klement, CFA, Journal of Financial Planning, Vol. 23, No. 8 (August 2010): 54-60. Summarised by Natalie Schoon, CFA, CFA Digest, November 2010, Vol. 40, No. 4: 11–12 (doi: 10.2469/dig.v40.n4.16)"

of the scale of the problem; 'regulation' is mentioned 252 times; supervision' 71 times. 'Regulators' are mentioned 589 times; 'supervisors' just 65 times. 'Enforcement' is mentioned in only 38 instances.

One benefit of an effective regulatory environment is a lower cost of capital. The interaction of effective regulation, supervision and enforcement can reduce the cost of equity capital. Hail & Leuz (2005) and Leuz (2006) attempt to understand and analyse the complexity of the influences of legal institutions, securities regulation and the level of integration of a nation's capital markets. Emphasising the inherent caveats, they find some empirical support for the claim that firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms (as enabled by a high quality legal infrastructure) have significantly lower cost of equity capital than those that do not rate as highly on these parameters7. **Table 1** lists the ten nations with the lowest cost of equity capital derived from the sample cited by Hail & Leuz and how they score with respect to the quality of legal infrastructure (LAW), disclosure (DISREQ) and securities regulation (SECREG). The UK is ranked ninth.

Country*	Average cost of equity capital (1992 – 2004)	DISREQ**	SECREG**	LAW**
Japan	6.16%	0.75	0.47	0.9
Taiwan	9.87%	0.75	0.64	0.85
Singapore	10.01%	1	0.84	0.86
Germany	10.05%	0.42	0.21	0.92
United States	10.24%	1	0.97	1
France	10.37%	0.75	0.58	0.9
Canada	10.53%	0.92	0.91	1
Italy	10.61%	0.67	0.46	0.83
United Kingdom	10.64%	0.83	0.73	0.86
Malaysia	10.65%	0.92	0.78	0.68

(Source: Hall & Leuz (2005); Note*: sample size differs with country; **based on indices)

[6]CFA UK response can be viewed on the Advocacy page on its website https://secure.cfauk.org/about/advocacy.html
[7]Department for Business, Innovation and Skills (BIS) Economics Paper No1- BERR's (BIS) role in raising productivity: new evidence ch. 2 http://www.bis.gov.uk/files/file44504.pdf

CALL TO POLICYMAKERS AND STANDARD SETTERS

Financial firms are essential in imposing market discipline. The failure to maintain market discipline consistently can impose significant costs to consumers and the wider economy by undermining trust and confidence in the integrity of markets. Financial and corporate history demonstrates that market failures are frequent and that it is vital to have a regulatory environment that can hold firms to account.

Effective regulation requires the design of practical policies that can bring about the appropriate outcomes from consumers and providers. On the demand side, consumers need to become more capable so that they can impose market discipline on firms. On the supply side, firms need to ensure that they conduct themselves to the highest professional and ethical standards and place their clients' interests first at all times. However, history sadly indicates that in the absence of appropriate supervision supported by the credible threat of enforcement, market integrity will always be at risk and that market failures will occur.

CONCLUSION

UK financial regulators need to work effectively. If regulation is effective, market integrity will be protected and the level of trust will rise. Through effective regulation we can attain market command with robust control mechanisms. By fulfilling the essential role they play in ensuring market integrity, regulators will be able to protect investors and strengthen the UK's position as a leading global financial centre.

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