Legal Backgrounder

WLF Washington Legal Foundation

Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 23 No. 28 July 11, 2008

EFFICIENCY AND EFFECTIVENESS IN FINANCIAL REGULATION: OF RULES AND PRINCIPLES

by

Joseph E. Silvia

Financial institutions in both the United States and the United Kingdom play a vital role in capital formation for business growth, investment risk protection, savings and investment, and the overall growth and prosperity of their economies. As the recently issued Treasury *Blueprint for a Modernized Financial Regulatory Structure* notes, a strong financial system, with efficient and effective oversight, is crucial to both Wall Street and Main Street. The current status of the competitive regulatory structure, focusing on rules-based regulation, has developed over many years. The more recent adoption of a single regulator structure by the United Kingdom, focusing more on principles-based regulation, offers us the opportunity to consider the impact of form on substance. How do they compare when we measure the efficiency and effectiveness in monitoring financial markets and regulatory enforcement as a path to ensuring transparency, investor protection and prosperity?

The United States Regulatory System. The U.S. is an example of a single monetary area and a common market, combined with an extremely fragmented financial supervisory landscape and a complex regulatory system based upon federal law, state "blue sky" laws, individual agency regulation, and self-regulatory organizations (SROs) with their own rules. The fact that there are multiple federal, state and industry regulatory authorities results in complex, and often duplicative, regulatory oversight. Furthermore, this fragmented system also creates gaps in regulation and an overall increased regulatory burden for market participants. For example, the U.S. Treasury's *Blueprint* report addresses several inadequacies to consider in the current system: no single entity has all information and authority, jurisdictional disputes among regulators, and duplication.

The effectiveness of U.S. financial regulation depends on a comprehensive regulatory system providing rules for both primary and secondary markets applicable to issuers, underwriters, brokers and investment advisers. The complexity, multiplicity of regulators, and demands of federalism are crucial components to the structure's success. Enforcement actions, also a critical element in U.S. regulation, are the most consistently used tool for defining the scope of regulation in the capital markets. This is evidenced by the fact that over half of the roughly 3,100 Securities and Exchange Commission (SEC) employees are within the enforcement division, supported by an impressive track record for prosecuting corporate scandals.

The U.S. banking industry is regulated primarily at the federal level by the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision; the states also provide supervisory authority. In contrast, securities industry regulation is a combination of federal law, self-regulation, and state law. The SEC oversees the exchanges and the National Association of Securities Dealers, recently merged with the Financial Industry Regulatory Authority (FINRA), administers the federal system for the registration of new

---

Joseph E. Silvia is Chief Policy Counsel to the Washington Legal Foundation.

issues of securities. The exchanges themselves are SROs with powers to issue rules for member firms and listed companies. Additionally, FINRA is an SRO with powers – under the supervision of the SEC – to promulgate rules governing voluntary membership of broker-dealers in the over-the-counter (OTC) markets, such as the NASDAQ.[1] The insurance industry currently has no federal regulator and therefore consists of more than fifty state regulators for institutions offering insurance products.

This regulatory structure creates multiple levels of oversight which may intend to balance interests, protect investors, and create regulatory competition. Often, however, this approach is economically inefficient and wasteful. Regulatory competition for the SEC comes from the Commodity Futures Trading Commission (CFTC), the Department of the Treasury and the Federal Reserve Board. Competition among regulators has its roots in constitutional federalism and involves conflicting philosophies with considerable overlap and inefficient duplication. For instance, some institutions are subject to over 100 regulators. Competition, however, can be beneficial when it creates debate regarding parameters of jurisdiction in regulating financial products and institutions.

The financial regulatory system of the United States is laden with themes of economics, history and politics, making it not only complicated and duplicative, but also very difficult to change. If change is to become useful and efficient, the current regulatory authorities must first grapple with convergence of the regulatory bodies and regulations themselves. As the UK model demonstrates, a shift in the focus of financial regulation toward principles and objectives, as identified in the U.S. Treasury's *Blueprint for a Stronger Regulatory Structure*, is possible, and may create benefits, but how does it compare?

The Single Regulator Model of the United Kingdom. The Financial Services Modernization Act of 2000 created the current principles-based regulatory regime. The resulting single regulator, the Financial Services Authority (FSA), strives for a more efficient organization of oversight, including reducing regulatory compliance costs. London's successful attraction of new capital results largely from FSA's "light touch" regulator approach.

"The single regulator model acts as a three-peak regulatory model by objective, in which the two objectives of microeconomic stability – prudential supervision and investor protection – are assigned to a unique agency while the macroeconomic stability objective is left to the Central Bank."[2] The FSA also has a duty to consider international competitiveness in the UK markets. It focuses on supervision and on-going relationships with authorized firms in the UK, while implementing a risk-based approach whereby regulation is designed to align the FSA's finite resources with addressing the big risks that matter most. Unfortunately, this allows for some violations of securities law and financial crisis to occur; recall the recent nationalization of Northern Rock and the resulting scrutiny of the financial competence of the FSA and British government.

Commentators attribute this approach's adoption to: (1) the existing system was failing to deliver standards of investor protection and supervision that the industry and the public had the right to expect; (2) the two-tier structure of the UK regulatory system, under the Financial Services Act of 1986, was inefficient, confusing, and lacked accountability and a clear allocation of responsibilities; and (3) there was a need for a regulatory structure that would reflect the nature of the markets where the old distinctions between banks, securities firms, and insurance firms had become increasingly blurred.[3]

Use of basic statutory principles, market confidence, public awareness, consumer protection, and reduction in financial crime all encourage and foster good business practices by recognizing firms' duties to

---

[1]Rosa M. Lastra, *The Governance Structure for Financial Regulation and Supervision in Europe*, 10 COLUM. J. EUR. L. 49, 54 (2003).

[2]Giorgio Di Giorgio & Carmine Di Noia, *Panel II: Appropriateness of Regulation at the Federal or State Level: Financial Market Regulation and Supervision: How many Peaks for the Euro Area?*, 28 BROOKLYN J. INT'L L. 463, 485 (2003).

[3]Eilis Ferran, *Do Financial Supermarkets need Super Regulators? Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model*, 28 BROOKLYN J. INT'L L. 257, 271 (2003).

Copyright © 2008 Washington Legal Foundation ISBN 1056 3059

owners and customers. Furthermore, the FSA believes that firms committed to a set of outcome-based principles will be in the best position to judge the details of how best to deliver those outcomes to market.

Unlike the approach adopted by U.S. regulators, the FSA is more concerned with overregulation and the damaging effects it may have on competition and innovation. Rather than bring enforcement action, or engage in regulatory intervention, the Director of Enforcement at the FSA has indicated that market failures "may also be addressed with competition policy or the FSA using its relationship with other market participants to change firms' policies," without breaking out the regulatory rulebook. Thus, the focus within the FSA's regulatory function is on the outcome rather than the prescription of detailed rules. The philosophy is that prevention is better than a cure. It is more desirable to implement pro-active surveillance of likely "hot spots," up-to-date transaction analysis systems, and industry cooperation to ensure a steady flow of information.

The Better Regulatory Framework: A Comparative Analysis. Comparison of the two approaches to financial regulation must involve an analysis of the main components of capital market regulation. First, consideration must be given to prosecution for regulatory violations. Second, there must be an analysis of the costs and benefits associated with each system. Finally, the overall effectiveness and efficiency of each system must be examined in light of the U.S. Treasury's *Blueprint Report.*

When comparing systems, one must factor in the obvious youth of the regulatory structure in the UK. FSA has three challenges in implementing the single-regulator model. First, how should FSA oversight respond to increasingly international financial institutions? Second, how can the FSA become a more principles-based regulator than it already is? Finally, how will the FSA retain its focus as the single financial services regulator in the UK?

This model is also affected by possible incompatibility among different supervisory objectives, which may lead to problems of self-contradiction. A single regulator model is dependent on internal organization because if the areas of competence and specialization are not well-structured and coordinated, the regulatory process collapses.

Ms. Cole, FSA Director of Enforcement, claims that "among several criticisms of the UK's light touch approach to regulation are three that stand out: (1) there is a conspicuous absence of criminal prosecution of securities law violations; (2) the FSA's resources are widely stretched across its expansive jurisdiction; and (3) the FSA's strategic approach to enforcement sends out selective messages to the markets and allows some illicit activity to go unpunished."[4] Proponents of the U.S. regulatory structure indicate, quite correctly, that the regulators, the investors, and even the regulated firms, derive great benefit in the safety and security offered by detailed rules that define the scope of their legal exposure.

FSA's Enforcement's muscle is no match for the sizes and depth of actions brought in the U.S. by the SEC, CFTC, Treasury Department, Justice Department, and a host of other interested federal and state regulators. The FSA devotes just eight percent of its staff to enforcement, while the SEC devotes over half its staff to the enforcement division. This stark contrast exemplifies the inherent cultural differences between the mindset of the U.S. and UK regulatory authorities. Appetite for prosecution in the U.S. has created a reputation based on the knowledge that borderline activity will at least be a subject of investigation by federal financial regulators in cases where criminal prosecution is warranted, not forgetting the SROs and state securities regulators.

On the other side of the Atlantic, the FSA has accepted the knowledge that some illegal activity may go unpunished, but focus will be placed on higher-risk issues in the market. The enforcement division of the FSA has no stand-alone priorities separate from the rest of the organization. Instead, the entire FSA is concentrated on market abuse on the wholesale side and fair treatment of customers on the retail side. Ms. Cole has noted though that the FSA is able to prosecute insider dealing, market abuse, and breaches of the perimeter (people conducting regulated activities without authorization) in criminal courts, while also bringing cases in the civil courts to freeze assets and to restrain unauthorized behavior.

[4]Margaret Cole, Speech, *The UK FSA: Nobody Does it Better*? (Fordham Law School, NY, Oct. 17, 2006).

Associated Costs and Benefits. Examination of a single regulator and a multi-regulator model necessarily hinges on practical considerations of costs and benefits to the regulators, institutions, and individual market participants. Possible overregulation costs more in compliance, and in the U.S., there appears to be a worrisome trend of corporate leaders spending an inordinate amount of time on compliance minutiae rather than innovative growth strategies. Financial policymaking heavyweights Senator Charles Schumer and New York City Mayor Michael Bloomberg are fearful of penalties for market firms, but more importantly, they are weary of personal financial penalties on firm leaders from overzealous regulators. U.S. regulators compete to be the "toughest cop on the street." However, the UK system focuses on collaboration and finding solutions to regulatory problems.

Advocates of the UK model advance the proposition that overregulation is too costly, inefficient, and leads to inevitable exploitation and abuses along regulatory seams.[5] Furthermore, the costs of supervision charged to those regulated and/or to taxpayers decrease while there is less room for "regulatory arbitrage."[6] Senator Schumer and Mayor Bloomberg note that industry experts estimate the gross financial regulatory costs to U.S. companies to be as much as fifteen times higher than in the UK. Increased cost in the U.S. comes with the benefit of increased certainty, but in the UK, the benefit comes with an almost hurdle-free path.

Effectiveness and Efficiency Considerations in the U.S. and UK Models. The goals of each system seem congruent, but the efficiency and effectiveness of each may not be. Scholars advocating the U.S. regulatory system point to the competitive nature of regulation as providing the optimal level of regulatory intrusion upon private business interests and less, more efficient governance. However, the FSA's "light touch," principled approach, has been highly effective. Backed by bold and strategic enforcement action, this approach has been effective in creating a more collaborative and solutions-oriented regulatory system.

Additionally, Senator Schumer and Mayor Bloomberg claim "there is a "regulatory dividend" that London enjoys under the auspices of the FSA which has bolstered London's status to establish itself as the world's leader in mobile capital." The UK system's advantage stems from the economies of scale associated with the FSA's regulatory structure. These economies of scale produce considerably reduced costs and expenses for firms.

Conclusion. Both the UK and the U.S. supervisory authorities maintain similar goals and missions, but implement different initiatives to achieve these goals. Admittedly, each system contains elements of both rules and principles in regulatory oversight; however, the U.S. system offers competition among regulators, engaging in far greater enforcement adding to security and transparency. The UK regulates primarily by principles with a last resort of bringing enforcement actions, however this may create less certainty than with detail

[5]Jerry W. Markham, *Panel I (Part 2): A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOKLYN J. INT'L L..319, 404 (2003).

[6]Giorgio Di Giorgio & Carmine Di Noia, *Panel II: Appropriateness of Regulation at the Federal or State Level: Financial Market Regulation and Supervision: How many Peaks for the Euro Area?*, 28 BROOKLYN J. INT'L L. 463, 479 (2003).

Copyright © 2008 Washington Legal Foundation ISBN 1056 3059