Principles for Ethical and Effective Financial Market Regulation

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The 2008 financial crisis is an obvious example of a poorly functioning financial sector—but not because financial markets were deregulated in the 1990s. In fact, the primary causes of the 2008 crisis were excessive government regulation, over-involvement, and poor monetary policy. Financial firms funded too much unsustainable activity largely because of the rules and regulations they faced, as well as the widespread expectation that the federal government would step in to mitigate private losses.

The dominant narrative of that time—that financial market deregulation, including the supposed 1999 repeal of the Glass–Steagall Act, caused the 2008 crash—is dead wrong. The Glass–Steagall Act was not repealed in 1999,[1] and at no point during the 20th century was there a substantial reduction in the scale or scope of U.S. financial regulations: In fact, the sheer number of financial regulations steadily *increased* after 1999.[2]

For decades, policymakers have appealed to the seemingly special nature of financial firms to heavily regulate them, often in the name of preventing turmoil from spreading to the rest of the economy. Increasingly, financial regulations have focused on risk management conducted by regulatory agencies rather than on disclosure and fraud prevention.

This approach has failed miserably. The U.S. has had 15 banking crises since 1837, a total that ranks among the highest of developed countries.[3] Among severe economic contractions in six developed nations from 1870 to 1933, banking crises occurred *only* in the U.S.[4]

More recently, the U.S. is one of only three developed countries with at least two banking crises between 1970 and 2010.[5]

As federal interventions, such as central banking, deposit insurance, and loan guarantees, have become more widespread internationally, banking crises have occurred more frequently.[6]

Risks of Misguided Regulation

The high level of misguided regulation is the source of most financial market problems. More intrusive, complex regulation favoring large incumbent firms is not the solution. Even very recent equity market disturbances, such as the controversy surrounding the short-selling of *GameStop* stock, cannot be legitimately blamed on the failure of the free market.[7]

Industry Concentration. The ever-increasing regulatory burden imposed by the banking agencies,[8] the Securities and Exchange Commission (SEC),[9] the Financial Industry Regulatory Authority (FINRA),[10] the Treasury Department's Financial Crimes Enforcement Network (FinCEN),[11] and other federal and state[12] regulators has led to a relentless decline in the number and profitability of small broker-dealers and banks and to increasing concentration in the financial sector. The regulatory costs and regulatory risks are such that small broker-dealers—and banks—have difficulty competing and remaining profitable.[13]

Regulatory costs do not increase linearly with size. There are massive regulatory-induced barriers to entry and economies of scale that adversely impact small businesses, entrepreneurship, innovation, and competition.[14]

System-Wide Uniformity. It is long past the time for the U.S. to move to a less prescriptive regulatory system, one that is based on fraud deterrence and disclosure and in which private actors—not taxpayers—absorb the losses from unwarranted risks. Such an approach would reduce the system-wide risk uniformity that was so problematic during the 2008 crisis and would also reduce the regulatory burden on smaller upstart financial institutions, increasing their competitiveness and reducing concentration in the industry.

Financial enterprises are the arteries through which money from one sector of the economy flows into others.[15] Smoothly functioning financial markets result in a more productive and innovative society with more goods and services, more employment opportunities, and higher incomes. They make it easier and less costly to raise the capital necessary for launching or operating a business, to borrow money for buying or building a home, and to invest in ideas that improve productivity and increase wealth.

These companies are not so exceptional, however, that they require rules and regulations to replace the judgment of owners, employees, and investors with those of government bureaucrats. Indeed, financial markets are still markets. The same economic principles that apply to other segments of the economy apply to the financial sector. Across all sectors of the economy, excessive government regulation prevents firms from best serving the needs of their customers and, therefore, society.

Financial firms do have certain distinct characteristics because of the tasks that they perform, but the same is true of companies in all sectors of the economy. The distinct characteristics of any private-sector industry (or individual company) should not dictate the extent to which government officials regulate and direct decision-making. Federal officials have no special knowledge regarding the best way to serve banking customers or investors. In fact, there is strong reason to believe that centralized government decision-making is inferior to decentralized private decision-making by those closer to the situation—and with a personal stake in the outcome of the decision.[16]

Seven Core Principles of Financial Regulation

History has already demonstrated that a federally micro-managed financial system does a good job of protecting incumbent firms—to the detriment of the typical American worker and investor. A new market-based approach, one founded on the following seven principles, would be far superior to the current regulatory framework. It would expand economic opportunities and help more people achieve financial security.

1. Market discipline is a better regulator of financial risk than government regulation. Rather than forcing banks to adhere to arbitrary capital standards set by regulatory fiat, policymakers should introduce more market discipline—the process by which customers and investors make financial decisions based on their views of acceptable risk levels—into the financial system. Ultimately, this process will enable market participants to set their own capital rules based on the ability to tolerate risk. While allowing market participants to determine the appropriate capital levels fails to guarantee a stable banking system and macroeconomy, evidence clearly shows that allowing regulators to set statutory capital requirements fails as well. Both theory and evidence suggest that the financial system will perform better when financial firms face more market discipline.[17]

2. Government should promote well-functioning capital markets by deterring and punishing fraud and by fostering reasonable, scaled disclosure of information material to investors' financial choices. The core purpose of securities market regulation is deterring and punishing fraud and fostering reasonable, scaled disclosure of information that is material to investors' financial choices. Fraud is the misrepresentation of material facts or the misleading omission of material facts for the purpose of inducing another to act, or to refrain from action, in reliance upon the misrepresentation or omission.

Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital, and the maintenance of a robust, public, and liquid secondary market for securities. The reasons for this are: (1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer; (2) information disclosure promotes better allocation of scarce capital resources and has other positive externalities; (3) the cost of capital may decline because investors will demand a lower risk premium; (4) disclosure makes it easier for shareholders to monitor management; and (5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.

The baseline for measuring the benefits of mandatory disclosure is not zero disclosure. Firms would disclose considerable information even in the absence of legally mandated disclosure. It is, generally, in their interest to do so. Firms conducting private placements today make substantial disclosures notwithstanding the general absence of a legal mandate to do so. The reason is straightforward: In the absence of meaningful disclosure about the business and a commitment (contractual or otherwise) to provide continuing disclosure, few would invest in the business—and those that did would demand substantial compensation for undertaking the risk of investing in a business with inadequate disclosure. Voluntary disclosure allows firms to reduce their cost of capital and they would, therefore, disclose information even in the absence of a legal mandate to do so.

Mandatory disclosure laws often impose substantial costs. These costs do not increase linearly with company size. Offering costs are larger as a percentage of the amount raised for small offerings. These costs, therefore, have a disproportionate adverse impact on small firms. Moreover, the benefits of mandated disclosure are also less for small firms because the number of investors and amount of capital at risk is less. Since the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs.[18]

Moreover, mandates for corporate governance or requirements for the disclosure of information that is not material to the financial performance of the firm, including politically motivated Environmental Social Governance disclosure, is not warranted.[19]

3. The government should remain neutral with respect to Americans' financial choices. The federal government should not interfere with the financial choices of market participants, including consumers, investors, and uninsured financial firms. Regulators should also refrain from crafting rules that provide financial incentives for certain types of capital investments over others. Regulators should, on the other hand, focus on protecting individuals and firms from fraud and violations of contractual rights, as well as creating the institutional framework for a vibrant capital market.

It is not a proper function of government to protect people from making poor business or investment decisions or from bad luck. Private markets do a better job of allocating capital than the government, and government regulators do not have better investment judgment than private citizens investing their own money. Public–private partnerships designed to shape financial markets, such as government-sponsored enterprises, abuse this principle.

In practice, they misalign incentives and create rent-seeking opportunities, often leading to economic turmoil. Even offering incentives for one type of investment through tax incentives violates this principle and diverts capital from more productive uses. *All* regulations directed at restricting investor choice and substituting regulators' investment judgment for that of investors should be discarded.

4. The cost of financial firm failures should be borne by equity holders, creditors, and managers—not by taxpayers. Financial firms should be permitted to fail, just as other firms are. Government should not "save" participants from failure. Doing so impedes the ability of markets to direct resources to their highest and best use. In fact, the socialization of the risk of loss via government backing increases the willingness to take unwarranted risk, reduces (rather than enhances) stability, increases concentration in the financial industry, rewards politically connected actors, and imposes an unfair burden on customers and taxpayers. Even conveying special status on large financial firms, such as through a systemically important designation, inevitably impedes the functioning of markets and leads to government bailouts that socialize private losses.

5. Speculation and risk-taking allow markets to operate. Interference by regulators attempting to mitigate risk-taking hinders the effective operation of markets, even when regulators favor investments in "real economic interests" versus "purely speculative"

investments. Recent regulations aimed at quelling excessive speculation in derivatives markets, for instance, have created a system that concentrates (previously decentralized) risks in a small number of specialized clearing firms.[20]

Federal regulators have no special insight into which financial risks are connected to so-called *legitimate* economic interests—the term is subjective and, therefore, allows regulators to substitute their judgment for those investors risking their own money.

6. The government should preserve citizens' right to use whichever forms of money they choose. Policymakers rarely think about improving the quality of money with the same competitive market forces that improve other goods and services. These forces push entrepreneurs to innovate and improve products to satisfy customers, and they expose weaknesses and inefficiencies in existing products, thus improving people's lives. Economists generally acknowledge that private competitive markets produce such benefits, but many view money as an exception that should be provided by the government. Yet the government's actual record of monetary stewardship is poor, thus showing the importance of preserving citizens' ability to use whichever forms of money or other digital assets that they choose. Nothing can provide as powerful a check on the government's ability to diminish the quality of money as allowing competitive private markets to provide it. Suppressing such competition only deprives citizens of beneficial innovations in the means of payments.

7. To promote competition, entrepreneurship, and innovation, regulations should be clear, relatively simple, and straight-forward, and the administrative burden on capital market participants should be moderate. The current high degree of complexity and a high regulatory burden helps incumbent firms and harms innovation, entrepreneurship, and small businesses. It makes U.S. capital markets less efficient, harms productivity and wages, and reduces investor choice.

Conclusion

The dominant narrative remains that financial market deregulation caused the 2008 financial crisis—but that account is dead wrong. To the contrary, the government's extremely active role in directing financial markets, along with its promises to absorb the losses of private risk-takers, brought about the crash. For decades, policymakers have appealed to the seemingly special nature of financial firms to heavily regulate them, often in the name of preventing turmoil from spreading to the rest of the economy. Even though this approach has failed miserably, financial regulations have increasingly focused on risk management conducted by regulatory agencies rather than on disclosure and fraud prevention.

Even if the 2010 Dodd–Frank Act, Congress' response to the 2008 crisis, were repealed in its entirety, the highly flawed regulatory structure that weakened financial markets and contributed mightily to the crash would remain. A new market-based approach to financial regulation—one founded on the seven principles described in this *Backgrounder*—would be far superior to the current framework.

A regulatory approach based on these ideas would focus on fraud deterrence and material disclosure. It would foster a market in which private actors—not taxpayers—absorb the losses from unwarranted risks. This much-improved framework would reduce the regulatory burden on smaller upstart financial institutions, increasing their competitiveness and reducing concentration in the industry, ultimately leading to more economic opportunities and financial security for Americans.

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