The Organizational Structure of Financial Market Regulation: Highlights from the Literature

Christine Fay and Nicolas Parent

The structure of securities market regulation in Canada is the focus of much debate among the federal and provincial governments, provincial securities commissions, industry participants, and academics. While the Bank of Canada is not directly involved in this debate, it has an interest in the efficiency of Canada's securities markets. This note reviews some of the issues raised in the academic literature regarding the organizational structure of financial market regulation.

Rapid technological change, the globalization of markets, and the increasing complexity of financial innovations are just a few of the factors that have dramatically altered the global financial environment. Given the magnitude of changes in the financial landscape on both a domestic and global scale, many countries have begun to question whether their current regulatory structures are still appropriate, and some have already implemented major reforms.

Canada's financial services sector underwent rapid changes in the 1980s, which led to a number of reforms.[1] More recently, however, the focus of reform has turned to the regulation of securities and, more generally, financial markets. In the past decade, provincial regulators and others have put forward various initiatives covering not only the development of financial markets, but also the harmonization of securities regulations across different jurisdictions in Canada. More recently, there has been a call for significant restructuring of the current regulatory structure for securities markets to better reflect the changing domestic and international environment. (See Box 4 on page 24.)

With so many complex developments unfolding, it is instructive to step back and ask whether we can gain any insights from a review of the academic literature. This article highlights some of the issues in the literature on regulatory structure that are relevant to the debate surrounding the regulation of securities and financial markets. Although some of the literature presented is broad and encompasses the entire financial sector, our focus is on lessons for the structure of securities market regulation.

This article begins with a discussion of why the institutional structure of regulation matters. Following this, the three main approaches to the structure of regulation are outlined: institutional, functional, and objectives-based. Another aspect of the organizational structure of regulation concerns regulatory competition, which is related to the number of regulators (or agencies) covering a particular area within the financial market. This aspect is addressed through a discussion of the pros and cons of having a measure of regulatory competition instead of a single agency. In the final section, some of the unique issues related to self-regulatory organizations (SROs) are introduced.

Why Does Structure Matter?

Goodhart et al. (1998) state that, above all, regulatory structure has an impact on the overall effectiveness of regulation and supervision because of the expertise, experience, and culture that develop within particular regulatory agencies. Other major considerations when determining the appropriate regulatory structure include effectiveness in handling conflicts, the different costs of structures, and the issue of overlaps (unnecessary duplication) and gaps (aspects of businesses or institutions that may fall through the regulatory net).

1. See Freedman and Goodlet (2002) and Daniel (2002–03).

Structural reform is not an end in itself, however, and does not guarantee more effective regulation. Effectiveness also depends, to a substantial extent, on the skill and judgment of the regulators themselves (McDonald 1996). As well, the structure itself might not be the most critical factor for success. Factors such as the clarity of roles and responsibilities and the sharing of information among agencies may, in practice, be more essential.

Finally, there is no single "perfect" structure for regulation. There can be many different but appropriate structures for the same economy, as well as across countries, and the appropriateness of these structures may change over time, as both the domestic and global financial landscapes evolve.

Alternative Approaches to the Regulation of Financial Services

The literature has identified three broad approaches to regulating financial markets: the institutional approach, the functional approach, and the objectives-based approach. In practice, regulation can also be organized as a combination of these three approaches.

Traditional approaches

The two main organizing principles that have been traditionally used in the structure of regulation are the institutional approach (by type of firm) and the functional approach (by type of activity).[2]

In the institutional approach, regulation covers each individual category of financial intermediary, which has made this approach particularly appropriate when considering prudential issues. Traditionally, each category of institution is assigned to a distinct agency for regulation of its entire range of activities. Since each intermediary has only one regulatory authority as a counterpart, duplication can be avoided, and the costs of regulation can potentially be reduced.

2. The debate on institutional versus functional regulation for financial institutions is an old one in Canada. It was raised with regard to financial institutions in 1976 by the Economic Council of Canada, and by the federal government in its 1985 Green Paper and its 1986 Blue Paper. (See references.)

However, with growing integration and the blurring of distinctions between different types of intermediaries, the obvious risk is that institutions performing similar functions can be regulated differently, which raises the issue of competitive neutrality.

The functional approach, on the other hand, focuses on the business undertaken by firms. Proponents of the functional approach include Macey and O'Hara (1999), Merton and Bodie (1995), and Steil (2001). Macey and O'Hara argue that the functional approach provides three main benefits: it applies the same rules to all intermediaries who perform the same activity; it allows firms to select the precise services they wish to offer; and it best supports the process of financial innovation, because it provides competitors with the maximum amount of flexibility consistent with regulatory objectives. Others argue, however, that the functional approach may lead to excessive specialization of competencies across regulatory agencies, and that the position of an institution as a whole may be obscured.

Goodhart et al. (1998) argue that a strict dichotomy between these two approaches is misleading because the two serve different purposes. In practice, it is the institution that can fail, so the institution itself needs to be regulated for safety and soundness; that is, for prudential reasons. Functional regulation, on the other hand, is concerned with how intermediaries conduct various aspects of their business and how they behave towards customers. For competitive neutrality to be maintained, this type of regulation, known as "conduct-of-business regulation," must apply to particular aspects of business regardless of which type of institution conducts the business. So, while prudential regulation may be conducted by different agencies, conduct-of-business regulation needs to be equitable to all firms.

The objectives-based approach

An approach that has been examined more recently is the objectives-based approach, which is advocated by Taylor (1995, 1996), Goodhart et al. (1998), and Di Giorgio and Di Noia (2001), among others, and has been the organizational approach used for Australia's regulatory system. This approach postulates that all intermediaries and markets be subject to control by more than one authority, each of which is

responsible for one objective of regulation regardless of both the legal form of the intermediaries or of the activities they perform. The aim is to create a structure that reflects the objectives of regulation and, at the same time, promotes those objectives most effectively and efficiently. This approach is "*particularly effective in a highly-integrated market context and in the presence of poli-functional operators, conglomerates and groups operating in a variety of different business sectors.*" (Di Giorgio and Di Noia 2001).

Taylor (1995) provides an example of the objectives-based approach in his proposed twin-peaks model for the financial system (including financial markets) of the United Kingdom. This model consisted of only two regulatory agencies: one responsible for ensuring the soundness of the financial system and one focusing strictly on consumer protection. He argues that this model should have several benefits including eliminating regulatory duplication and overlap, providing for greater clarity in the objectives of regulators, establishing mechanisms for resolving conflicting objectives, and encouraging a regulatory process that is open, transparent, and publicly accountable.

In response to Taylor's twin-peaks model, McDonald (1996) notes that the argument regarding the number of regulators seems to depend on the view that each must have only one objective, but it appears that the concepts of investor protection and systemic risk cannot be so easily separated. Goodhart et al. (1998) claim that Taylor's model is too all-encompassing. In their view, major differences still exist between different types of firms, and although firms have diversified, a dominant core business usually remains. They argue that the risks across business lines are sufficiently different to warrant a differentiated approach to prudential regulation. Instead, Goodhart et al. argue for a larger number of regulatory bodies. They suggest no fewer than six separate agencies: a competition authority, together with five others to cover systemic risk; non-systemic prudential regulation; retail conduct of business; wholesale conduct of business; and financial exchanges.

Briault (1999) notes that the rationale for objectives-based models of regulation is superficially attractive, but it does not resolve inefficiencies, nor the communication and co-operation problems that exist whenever there is more than one regulatory body. He criticizes Taylor's approach in particular, arguing that the distinction between prudential and conduct-of-business regulation is not as neat and simple in practice as the Taylor model might imply. With respect to the structure proposed by Goodhart et al., he notes that it looks very similar to a functional approach, partly because many firms would be subject to regulation by more than one regulator.

The Debate over the Optimal Number of Regulators and Regulatory Competition

Two interesting trends are emerging in the debate over the optimal number of regulators. On the one hand, academics are debating the merits of greater consolidation, and a number of countries have adopted reforms to reduce the number of regulators with responsibilities for financial institutions. An example of this is the United Kingdom's adoption of a single-regulator model for their entire financial system, including securities markets. On the other hand, a body of literature is developing in the United States on the merits of allowing greater competition among jurisdictions in the area of securities market regulation.

A single agency

The single-agency model has typically characterized early stages of financial development, but has re-emerged in developed economies, notably in the United Kingdom.

Goodhart et al. (1998) list several advantages that a single regulator can provide. These include:

- Efficiency gains: economies of scale and scope (synergies), which should lead to reduced regulatory costs (although institutional costs are likely a small part of total regulatory costs). There is also the ability to allocate scarce regulatory resources efficiently and effectively, thus lowering the monitoring costs imposed on firms, since they need to deal with only one agency.
- Greater transparency and accountability, because a simple regulatory structure should be easily understood and recognized by regulated firms and consumers and should make regulators more accountable (if for no other reason than that it is more difficult to pass the buck).

- Better monitoring of diversified firms.
- Possible avoidance of problems such as competitive inequality, inconsistency, duplication, overlaps, and gaps.
- Easier retention and utilization of expertise.

According to the literature, however, some of these benefits may not be achieved in practice. For instance, economies of scale and efficiency gains may not arise because specialist divisions will exist within a single agency, creating potential problems in communication, coordination, and consistency.

The arguments made against a mega-regulator include:

- Too much power and overly bureaucratic (Goodhart et al. 1998).
- Might not have a clear focus on objectives and the rationale of regulation and might not make the necessary differentiation between different types of institutions (Goodhart et al. 1998).
- Incompatibility of objectives and cultural conflicts, stemming from the fact that the needs of sophisticated wholesale market participants and those of retail consumers differ significantly, and the style and techniques appropriate to prudential and conduct-of-business regulation are profoundly different (Taylor 1995).
- Conflicting objectives are better resolved at a political level, because resolution involves judgment about public policy issues (Taylor 1995; Goodhart et al. 1998).
- Potential moral hazard resulting from the public perception that the risk spectrum among financial institutions has disappeared or become blurred (Goodhart et al. 1998).
- If a single regulator adopts an inappropriate regulatory regime, the costs of compliance and the structural costs of regulation could rise even though the pure institutional costs of regulatory agencies might be lower.

Two recent papers have reviewed the experiences of countries that moved towards more integrated regulation. Taylor and Fleming (1999) conclude that after a decade, the three Scandinavian countries that moved to a single-regulator model have achieved efficiency gains and economies of scale, but have made only limited progress on improving coordination of the supervision of conglomerates. Briault (2002) reviews the experience of the U.K. Financial Services Authority (FSA) and finds initial indications to be encouraging, although he notes that it is too early to draw conclusions. For instance, the FSA has benefited from economies of scale and has achieved a valuable degree of integration. Also, in his opinion, the experience of the FSA has demonstrated that, in most cases, there is no conflict between the conduct-of-business and prudential regulatory objectives, since both seek to protect consumers. According to Briault, when conflicts did arise, the FSA struck the right balance within an appropriate framework of objectives and accountability.

Regulatory competition

Some researchers have argued that regulation may not be at optimal levels since it is imposed by an authority and not through a market process. Regulators are often monopolistic, and so information is lost about the type and extent of regulation that consumers demand, and about how much consumers are prepared to pay for regulation. Some therefore believe that regulatory competition may help to define the optimal level of regulation. They also feel that there is merit in having a degree of competition and diversity in regulation so that lessons can be learned from the experience of different approaches (Goodhart et al. 1998).

The debate among academics on the merits of greater competition between regulators of securities markets rests on the “race-to-the-top” versus the “race-to-the-bottom” scenarios.

Those in favour of greater competition point out that competition provides incentives for responsive and innovative regulation, as well as guarding against an excessive regulatory burden. This is the race-to-the-top scenario. Kane (1987), a proponent of competition in the regulation of financial services, also points out that regulatory competition will tend to smooth out “bubbles” of overly severe regulation that would develop in response to intermittent financial services crises and scandals if regulatory barriers to entry were more significant.

Others, however, believe that competition will result in a “race-to-the-bottom” outcome as individual agencies will excessively relax their rules in order to attract greater regulatory clientele.

In a seminal paper, Romano (1998) provides a case for allowing states to compete with the United States federal government in two main areas of securities regulation: registration of securities and a disclosure regime for issuers; and antifraud provisions. In this proposal, an issuer would be able to choose which regime (federal or state) applies to its capital markets activities and then deal only with that jurisdiction, thus effectively creating a market for regulation. According to Romano, this system would produce rules more aligned with the preferences of investors, whose decisions drive the capital market, because no government entity can know better than market participants what regulations are in their interest. Such a system provides an incentive for innovation and, finally, if there are significant differences in the characteristics of firms such that the most suitable regulatory regime differs significantly across firms, then firms and investors can self-select the more appropriate scheme.

Competition in itself will not necessarily reduce international harmonization. In fact, Romano suggests that if diversity is not preferred by issuers and investors, then competition will produce uniform regulatory outcomes without the need for government agreement mandating harmonization. That is, competitive federalism would not necessarily increase differences between regulatory regimes. For example, the most desirable disclosure regimes would likely spread across states.

MacIntosh (2002) argues in favour of a passport system for Canadian securities markets by suggesting that the single-regulator system exhibits all of the problems commonly associated with monopolies. He concurs with Romano that there is no case for a race to the bottom. He concludes that we have had a mutual-reliance system in the closely allied field of corporate law for more than 100 years and argues that securities regulation is not functionally distinguishable from corporate law.

One of the most vocal critics of regulatory competition is Fox (2001). He believes, in particular, that abandoning the current mandatory system of federal securities disclosure in the United States would lead to a race to the bottom and would likely lower U.S. welfare. Fox focuses on the interfirm costs that arise when a disclosed item of information can put an issuer at a disadvantage relative to its competitors. Thus, if issuers were allowed to choose, they would likely select a regime requiring a level of disclosure that is less than socially optimal because the issuer's private costs of disclosure are greater than the social costs of such disclosure.

Coffee (1995) makes a case against regulatory competition by looking at the experience of the Securities and Exchange Commission and the Commodity Futures Trading Commission. He concludes that within the increasingly competitive international environment, gains from competition in domestic regulation are likely to be modest, while costs can be substantial and may have been under-recognized. He agrees that, in theory, regulatory competition could bring benefits, but for these benefits to occur, a number of conditions need to hold. These include the ability of regulated firms to migrate between regulatory agencies at low cost in order to restrain inefficient regulation; the secure delineation of regulatory agencies by clear lines of jurisdiction that they cannot exceed; and the existence of competition between agencies rather than collusion. He finds that in practice many of these conditions are not met and notes that proponents of regulatory competition focus only on benefits that rival regulators can provide to attract clientele.

Self-Regulatory Organizations versus Public Oversight

Self-regulatory organizations are prevalent in many countries, including Canada, and have played an important role in the securities market landscape. As many countries enact reforms however, there is debate as to whether or not SROs should be included (or maintained) in these new regulatory frameworks. The United Kingdom, for example, has eliminated SROs completely in its new regulatory framework. In view of this, it is important to look at the pros and cons of SROs, their role in regulation, and the type of environment to which they are best suited.

In theory, self-regulation works best when participants in a transaction possess approximately equal knowledge, information, and bargaining power. All investors, whether professional or private, have an interest in a fair, appropriately transparent, orderly and efficient market that is free from abuse and misconduct. Professionals have a clear interest in market integrity. For this

reason, a large degree of self-regulation has typically been seen as appropriate for the general regulation of exchanges. It is important, however, for a competition agency to monitor the self-regulation of exchanges for any anticompetitive behaviour.

Aggarwal (2001), and Domowitz and Lee (1998) list several arguments in favour of SROs relative to government agencies. Their arguments include the following:

- SROs linked to the business interests of participants have a more direct and stronger interest in maintaining market integrity than any government agency.
- The presence of market practitioners may enhance the knowledge and experience of the regulatory authority.
- It is easier for a market to police itself, and self-imposed rules are easier to accept.
- SROs may have better resources (government agencies may not have either the financial resources or the human resources necessary to carry out all aspects of their regulatory function).
- Their close proximity to markets enables them to more effectively monitor many types of conduct and activity that lie beyond the reach of the law. And they are more flexible than governments in responding to market needs and creating appropriate rules.

Nevertheless, self-regulation does present some challenges. The most interesting is the conflict arising from the multifunctional roles of SROs: they may regulate markets to their own advantage, thereby acting against the public interest. The conflicts of interest inherent in SROs require regulatory oversight of SRO practices, particularly their governance structures.

Conclusions

From this summary, it is apparent that the literature on the organizational structure of financial markets regulation offers many different points of view on the optimal means of regulation. While it helps to put the current debate surrounding the regulation of securities markets in perspective, the literature does not point to a single "optimal" solution. On the one hand, there is the trend of combining regulatory responsibilities within one or a few regulatory bodies. The theoretical pros and cons of this approach are well known. But research on the practical implications is still in its infancy. Other academics have made a number of strong theoretical arguments with respect to the benefits of greater regulatory competition, but little research has been done on its impact in practice.

Many questions remain unanswered, and economic theory seems to provide limited guidance as to how to organize the complex world of securities regulation. As more data are collected from countries that have implemented reforms, future research and empirical studies should shed more light on these issues.

References

Aggarwal, R. 2001. "Regulatory Infrastructure Covering Financial Markets." In *Brookings-Wharton Papers on Financial Services.* R.E. Litan and R. Herring, eds. Washington D.C.: Brookings Institution Press.

Briault, C. 1999. "The Rationale for a Single National Financial Services Regulator." Financial Services Authority. Occasional Paper Series No. 2 (May).

———. 2002. "Revisiting the Rationale for a Single National Financial Services Regulator." Financial Services Authority. Occasional Paper Series No. 16. (February).

Canada. Department of Finance. 1985. *The Regulation of Canadian Financial Institutions: Proposals for Discussion.* Catalogue F2-63 (April).

———. 1986. *New Directions for the Financial Sector.* Catalogue F2–2.

———. 2003. *It's Time, Research Studies.*

Coffee, J. 1995. "Competition versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation." *The Business Lawyer* 50: 447–84.

Daniel, F. 2002–03. "Recent Changes to Canada's Financial Sector Legislation." *Bank of Canada Review* (Winter): 3–16.

Di Giorgio, G. and C. Di Noia. 2001. "Financial Regulation and Supervision in the Euro Area: A Four-Peak Proposal." Financial Institutions Center Working Paper No. 01–02. The Wharton School Financial Institutions Center, University of Pennsylvania.

Domowitz, I. and R. Lee. 1998. "The Legal Basis for Stock Exchanges: The Classification and Regulation of Automated Trading Systems." Working Paper Series. Pennsylvania State University.

Fox, M.B. 2001. "The Issuer Choice Debate." *Theoretical Inquiries in Law* 2: 563–611.

Freedman, C. and C. Goodlet. 2002. *The Financial Services Sector: An Update on Recent Developments.* Bank of Canada Technical Report No. 91.

Goodhart, C., P. Hartmann, D. Llewellyn, L. Rojas-Suarez, and S. Weisbrod. 1998. *Financial Regulation Why, How and Where Now?* London: Routledge.

Kane, E. 1987. "Competitive Financial Reregulation: An International Perspective." In *Threats to International Financial Stability*, 111–45. R. Portes and A. Swoboda eds. Cambridge: Cambridge University Press.

Macey, J. and M. O'Hara. 1999. "Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective." *Journal of Legal Studies* 28: 17–54.

MacIntosh, J.G. 2002. "The Future of Canadian Securities Regulation." CMI/TSE Symposium on Canadian Securities Regulation. Toronto. <http://www.mgmt.utoronto.ca/cmi/news/MacIntosh.ppt>.

McDonald, O. 1996. "Financial Regulation in Germany and the UK: A Comparison." Financial Markets Group Special Papers: sp82.

Merton, R. and Z. Bodie. 1995. "Financial Infrastructure and Public Policy: A Functional Perspective." Harvard Business School Working Paper No. 95–064.

Romano, R. 1998. "Empowering Investors: A Market Approach to Securities Regulation." *Yale Law Journal* 107: 2359–430.

Steil, B. 2001. "Creating Securities Markets in Developing Countries: A New Approach for the Age of Automated Trading." *International Finance 4*: 257–78.

Taylor, M. 1995. *Twin Peaks: A Regulatory Structure for the New Century.* London: Centre for the Study of Financial Innovation.

———. 1996. *Peak Practice: How to Reform the UK's Regulatory System.* London: Centre for the Study of Financial Innovation.

Taylor, M. and A. Fleming. 1999. "Integrated Financial Supervision, Lessons of Scandinavian Experience." *Finance and Development* 36: 42–45.