Explaining Financial Regulation

Eric J. Pan  
Benjamin N. Cardozo School of Law  
New York, New York  
epan@yu.edu

Presentation to the Department of Risk Management and Insurance  
J. Mack Robinson College of Business  
Georgia State University  

September 10, 2010

What is Financial Regulation?

• Regulation of persons  
  – depositors, borrowers, lenders, investors, issuers,  
    investment advisers, brokers, analysts, underwriters,  
    traders, exchanges, market information providers and  
    clearinghouses
• Regulation of conduct  
  – Regulation of the provision of sale and provision of  
    products and services (business conduct and consumer  
    protection)  
  – Regulation of financial institutions (prudential regulation)  
  – Regulation of trading markets and financial intermediaries  
  – Systemic risk regulation
Tasks of the Regulator

- Content (what is the best rule?)
- Compliance (how to ensure compliance with the rule?)
- Enforcement (how to stop and punish rulebreakers?)

Four Basic Regulatory Strategies

- Rulemaking
- Supervision
- Certification
- Enforcement
### Command Strategies vs. Market Strategies

<table>
<thead>
<tr>
<th>Rulemaking</th>
<th>Command Strategies</th>
<th>Market Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supervision</td>
<td>Rules</td>
<td>Principles</td>
</tr>
<tr>
<td></td>
<td>Prudential supervision</td>
<td>Self-regulation</td>
</tr>
<tr>
<td>Certification</td>
<td>Investigation and evaluation; Licensing; Approvals and authorizations</td>
<td>Disclosure</td>
</tr>
<tr>
<td>Enforcement</td>
<td>Public enforcement</td>
<td>Gatekeepers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Private rights of action</td>
</tr>
</tbody>
</table>
Reason for Preferences

- Repetition of events
- Nature of market developments
- Diversity of players
- Sophistication of parties and capacity of regulated entities

Only way to ensure the ensure the regulated person is doing the correct thing is to have the regulator do it

- But the regulator does not have sufficient information (understanding of complexity and events)
- But the regulator does not have sufficient resources
Pendulum Effect of Regulation

- Overreaction in the face of crisis (Cass Sunstein)
- Capture by interest groups (regulatory failure results from domination of agency by regulated interests) (Paul Quirk)
- Capture by interest group expertise (agency recruits from industry) (Paul Quirk)
- Attempt to overcome information and cost problem (Pan)

How to Overcome Information and Cost Problem?

- Scholz – Tit-for-tat enforcement
- Braithwaite/Ayres – Enforcement pyramid
- Lobel/Trubek/Ford/Black – New Governance Theory
Extra-Regulatory Solutions

- Insurance
- Bans and Prohibitions (e.g., Volcker Rule)
- Size Limitations
- Taxes

Explaining Financial Regulation

Eric J. Pan
Benjamin N. Cardozo School of Law
New York, New York
epan@yu.edu

Presentation to the Department of Risk Management and Insurance
J. Mack Robinson College of Business
Georgia State University

September 10, 2010