Lecture 3: How does the law regulate the financial system?

Some common features.

In our previous classes we have discussed what the financial system is and why the law regulates it. Now, we have to understand how the law regulates the financial system.
The answer to this question is structured in three parts. Two parts are common around the world, while the third focal point is peculiar to the European Union.

Around the world financial regulation is characterized by the fact of being special, it means that around the world exist a regulatory strategy specifically designed for financial markets, which is based on what layers call rules and standards. This is the first main feature. The second feature is the fact that this financial regulation, which is special, is very often delegated from the Parliament to someone else, the so-called independent administrative agencies (for example securities commission). So that, the law-making powers, which originally are vested with the Parliament, are delegated to independent administrative agencies and therefore financial regulation features this fact to be delegated. The third characteristic is that financial regulation, in the European Union, is mostly based on EU law.

Rules and standards.

In order to understand what exactly means the fact that financial regulation is special we should look to how the law works, or to be more precise how the law can be tracked.
In very general terms, the law translates social policies or political principles, which are the backbone of every society (for example truth, fairness, efficiency, democracy), into a number of legal directives. Laws typically translate detailed these very broad background principles and then as a second step decisionmakers apply these legal directives to particular facts.
These mediating legal directives, mediating because as we have seen are in the middle between the very large broad background principles and the decisions in the peculiar case, may take different forms that vary related to the discretion that they afford to the decision-maker.

For example, imagine a law says that driving faster than 130 km/h results in a fine of 200€. In this case we have a law prohibiting a specific behaviour which identify a very precise triggering fact for this law to be applied: if you go beyond 130 km/h the law will apply, if you stay before 130 km/h it will not. So, in this case, the legal directive connected to the law is structured focusing on this very precise triggering fact, so that the decision-maker is bound to the triggering fact identified by the law. Any time that one drives more than 130 km/h the decision-maker, in this case the policeman, will apply the fine. This way of building laws is called rules. Rules require or prohibit specific behaviours and bind a decision-maker to respond in a specific way to the presence of delimited triggering facts, even when direct application of the background principle to the fact would produce a different result.
The other possibility is to have a standard. A standard is much more similar to the background principle that the law is supposed to apply. So, for example, going back to our case, a standard can be written as “drivers in a highway shall drive carefully”. In this case, the adjudicator the decision-maker has a very broad room for discretion been applying this principle, and therefore the precise determination of the plan to the European law is decided by the adjudicators ex-post, after the fact the adjudicators can identify whether driving under certain speed was compliant or not with this very broad directive of driving carefully. Standards tend to collapse decision-making back into the direct application of the background principle, by leaving the precise determination of compliant to adjudicators after the fact.

So, rules are based on specific triggering facts that bind the decision-maker and decline detailed quite precisely the background principle. To the opposite standards are much more similar to the background principle and leave a very broad room for discretion to the adjudicators and therefore they apply only after the fact.
The distinction between rules and standards is a theoretical distinction because in the real world we do not have pure rules or standards, and marks a continuum meaning that you may have a rule with a number of exceptions to the point it resembles a standard, or you may have a standard which attach a number of fixed weights to the factor that it considers to resemble a rule. Also, all kinds of hybrid combinations are possible. So, rules and standards are theorical concepts rather than actual norms, but their distinction is very useful to understand how the law is structured and the implication of choosing one approach rather than the other.

Rules and standards can be compared for the implications that they may have.

The first point to take into address is the *rule-making mechanism* meaning how the norm is made. Rules prescribe specific behaviors which can be identified ex-ante, before the fact. To the opposite standards leave broad discretion for adjudicators to determine ex-post, after the fact, whether violations have occurred.
A second perspective from which we can look at this distinction is *adjudication* meaning the decision-making. Because, if a rule is very well-drafted, rules at least in principle may be mechanically enforced (speed tester). To the opposite standards inevitably require that the court or other adjudicators to become more deeply involved in evaluating the behaviours and sometimes shaping the behaviours so that it fits with the standard. For the reason because they imply such a broad discretion standard suffer the possibility for the decision-maker to be incompetent or biased. Incompetent means that the adjudicator is not completely familiar with the matter. Biased means that the adjudicator has some pre-conception in one sense or in the other regarding to the fact to be adjudicated.
The third perspective we could look at the distinction between rules and standards from is *completeness* which is the capacity of a norm to capture both the background principles they are supposed to apply and the specific circumstances of the fact. In this case rules have a problem, because their capacity to be complete to capture the principles and the peculiar features of a certain situation is very weak. Rules suffer loopholes, they may not cover precisely all the matters they are supposed to cover, and therefore rules produce errors. These errors are either of over-inclusion or under-inclusion. It means that rules may not get enough or may get too much of a matter to be regulated. Let's go back to the example of driving and imagine that I'm driving at 129 km/h in a day characterized by a heavy rain. In this case rules are very clearly over-inclusive because I am following the rule but at the same tame my behaviour is very imprudent. My behaviour is exactly the opposite of the background principle that the rule is supposed to apply. The rule is over-inclusive because it includes a case which is not supposed to be included. To the opposite a rule is under-inclusive when it includes a behaviour which is completely fine. On the other hands, standards are perfectly inclusive because the decision-maker's behaviour is judged after facts depending on the situation.

Once we understood that the difference between standards and rules has to do with the ex-ante/ex-post rule-making mechanism (a level of discretion in evaluating ex-ante ex-post), with the level of discretion in adjudication (no discretion mechanical enforcement for rules, large discretion for standards with the possibility of incompetence and biased by the decision maker), and with the completeness point (rules are over/under-inclusive, standards are inclusive), we understand the implications of these technical tools for very interesting matters.

The first implication is efficiency. While rules are characterized by very high initial specification costs, but they have low enforcement and compliance costs, for standards is exactly the opposite. Standards are very cheap in making but much more expensive in enforcing and in compliance with. Thus, as far as rules afford certainty and predictability to private actors, rules are much better than standards because they save compliance costs. And, rules are better than standards also when they are frequently applied, and the incidence of adjudication may also be frequent. In the sense that any time rule is frequently applied you have a cost for enforcement: the more the rule is precise the lower is the enforcement cost and therefore rules are more efficient anytime the incidence of the adjudication is frequent.
To the opposite, there are areas of the law in which the underlying economic and social conditions change frequently and therefore also the optimal set of legal decision changes with them. In this case standards are much more efficient than rules because the rules in this situation tend toward obsolescence or can even create incentive for exploitations and opportunistic behaviours because information is asymmetrical.

The second implication is fairness. Fairness is much better sourced by standards than by rules. Because rules being so precise, specific, identifiable with triggering facts, tend to suppress relevant similarities and differences. Whereas standards being inclusive allow to decision-makers to treat like cases that are substantially alike. Because fairness consists of treating like cases alike, standards must be fairer than rules.

The third and final prospective is distribution. Rules favour allocational efficiency tends to save the distributive status quo. Whereas standards allowing more discretion by the decision-maker may favour distributive and paternalist motives.

Rules and standards in financial regulation.

After this discussion of general theory of the law we can move to rules and standards in financial regulation which explain why financial regulation is special. In general term, the relative effectiveness of rules and standards depends upon the fact of whether one is more concerned with reducing the risk of under- or over- inclusiveness (and so he will go for standards), or the risk of decision-maker incompetence or bias, therefore uncertainty and unpredictability (and in this case he will go for rules). For example, criminal law is strictly rule based and the reason is that in this case law makers consider that the risk of a biased decision by a criminal adjudicator should be avoided much more than the risk of over- or under- inclusiveness.
If now we move to financial regulation what we see is that certainty and predictability are a crucial need for the efficient functioning of financial markets, and therefore financial regulations tend towards rules rather than standards, at the cost of being under- or over- inclusive. In other words, a standard base financial regulation will lead to the risk of uncertainty and unpredictability, because of the broad discretion left to the decision-makers, and therefore traditionally financial regulation prefer rules, and exactly because prefer rules financial regulation needed special rules (Taylor made). Therefore, it is the reason way financial regulation is special: it is something specifically focused on banking and finance. Obviously, this choice for rules instead of standards implies the risk of be under- or over- inclusive and that can be the source for opportunistic behaviours. The major example is the scandal of Enron in 2002. Enron was the seventh American company for money capitalization, it was an oil company and went bankrupt basically because its managers turn Enron from an oil company into a derivative speculative firm and they did so manipulating balance sheets exploiting some loopholes of the American accounting principles of the time. As a result, we can see that in finance rules can be very dangerous because of their under- or over- inclusiveness, nevertheless standards are supposed to be, at least now, worst.

The delegation of rule-making power.

As we have seen, financial regulation has three main features:

1) It is specific designed for banking and finance (special)
2) It is often delegated from the parliament to administrative agencies
3) It is based on the EU laws at least in the European Union

Now we focus on the second features. In order to understand what it exactly means we have to remember that under the traditional democratic paradigm the political power is divided among:

1) an executive power (the government in common words)
2) a law-making power (the parliament)
3) a judiciary power (typically vested with the court system)

The reason of this division of the political power in three parts with three different entities lies in the famous explanation by Montesquieu, a French philosopher of the eighteenth century. According to Montesquieu when the legislative and executive power are united in the same person, or in the same body of magistrates, there can be no liberty. In other words when these three powers are concentrated in a single person the risk of no liberty is much higher than in the case where this power is spited in three. In financial terms, the traditional division of the political power in three parts can be compared with a diversified portfolio. As in a diversified portfolio the risk of each security is diversified and then reduced, at the same time vesting the political power in three different bodies reduces the risk for liberty and protects the life of citizens.
Under the same traditional democratic paradigm, law-making power is vested in a Parliament elected by people. In other words, those who are supposed to make the laws are people elected by citizens. This concept comes from another French philosopher, Tocqueville, who says that “the nation participates in the making of its laws by the choice of its legislators”. In this way, common people, citizens, are part of the law-making power by choosing the ones who are supposed to write these laws. Therefore, in this system, the law-making power of elected representatives is balanced in their political responsibility: legislators are free to structure the law in the way they think, typically respecting only one condition which is the compliance with the foundational norms of a community (which is typically called Constitution), if the people do not like the way elected representatives used the law-making power vested in them, the people do not vote for them in the next election (political responsibility).
Very often the legislative power may be delegated from the Parliament to someone else, in the specific to the executive branch of the Government, either (or both) to the executive body (typically the Ministers) or (and) to independent administrative agencies (for example the financial market regulator or the banking regulator). This approach under which the Parliament sets the basics norms and leaves the identification of the technical details to the executive branch is called “delegation”. This delegation typically occurs with a branch of the executive body, but in our field this delegation is for independent administrative agencies. An independent administrative agency is an agency belonging to the executive branch, exactly as minister, but at the same time it is independent, so it has not the duty to report its operate to the ministers.

Delegation of rule-making power and financial regulation.

Law-making power in banking and finance is often delegated by the Parliament to independent administrative agencies. The rational for this delegation is twofold.

The first reason is quite easy to understand. The banking and finance, and therefore financial regulation, tends to be complex and technical. As a consequence, Parliament can be unable to do its job, it can be incompetent. At the same time, the Parliament tends to be very slow in law-making, whereas typically financial regulation deals with problem which are ever-changing over time. Therefore, this slow process can be unfit with financial regulation. To the opposite independent administrative agencies are better equipped to cope with these issues, because they have both the flexibility and the technical expertise to do that.

At the same time, this approach is problematic because independent administrative agencies lack political responsibility. There is no balance in their political power, they are not voted by citizens but are appointed typically by the Parliament or by the Government, and therefore they have a discretionary in making rules and lack political responsibility. On the other hand, independent administrative agencies are more subject to the influence of groups of interest than members of Parliament, where interest tends to thwart interest. So, the administrative agencies can be pushed by the groups of interest to do what they want rather than allowing a true independence.

As a result, the delegation is great but risky because of this lack of political responsibility and the fact that independent administrative agencies are subject to capture by groups of interest more than members of the Parliament.

So, in this situation what we could do is to void any form of delegation because the risks are more than the benefits. But, at the same time, some forms of control are required. However, even if everybody agree that some forms of control are required, the precise form of control is very problematic. Judicial review, for example, is very problematic. Judicial review is a challenge of the regulation before a court which is typically the way in which you control the administrative ex-post. But courts are often incompetent and the fact that are incompetent leads either to deference or to some forms of scepticism against the regulation adopted by the independent adiministrative agencies.

Once it was realized that judicial review is ineffective for controlling delegated regulation a better solution adopted was a kind of ex-ante strategy. Instead of challenging the regulation after it was enacted to provide some form of democratic control over the work of agencies lacking political responsibilities, the idea was to impose to independent administrative agencies to consult with the market before the regulation is enacted and therefore getting through this consultation some form of approval by the affected industry. In other words, instead of having a control ex-post, the idea was of controlling the regulation ex-ante by leading the industries affected by the regulation to say a critical observation on the proposal of regulation which the market was called to examine and to evaluate in this consultation process. This form is something which saves democracy because the affected industries by the regulation, in this way, have the possibility to exercise a kind of control on the content of it. Therefore, it is the path that is typically followed in financial regulation both at domestic level and at European level.