Chapter 3: Regulation

Introduction

1. Introduction
    a. Regulation is important because without it, investors have the potential to lose income and savings and companies (and therefore interrelated companies and the entire economy) can suffer losses.
2. Regulations
    a. Regulations are defined as rules that set standards for conduct and that carry the force of law. They are set forth and enforced by government bodies and organizations that are authorised by government bodies.
    b. Failure to abide by regulations has the potential to hurt investors, companies, reputation and trust of the investment industry, and the economy as a whole.

Objectives of Regulation

1. Protection of Consumers:
    a. Consumers include borrowers, depositors, and investors. Regulation seeks to protect their interests and to curb unethical behavior on the part of investment professionals.
2. Foster Capital Formation and Economic Growth:
    a. Financial markets' function is to allocate funds from suppliers of capital to users of capital. Regulation seeks to ensure that this is done effectively, efficiently, that the capital is being put towards good use, and that financial markets are healthy, stable, and reductive in risk.
3. Support Economic Stability:
    a. High proportions of debt funding and the interrelated nature of financial services participants increases the risk for Systemic Failure (where an event causes the failure of the system). Regulation seeks to ensure stability by managing the risks associated with this dimension of the industry.
4. Ensure Fairness:
    a. Regulation seeks to ensure "fair and orderly" financial markets by addressing their inherent asymmetries of information (whether across different participants or professionals to consumers) by mandating certain disclosures of information.
5. Enhance Efficiency:
    a. Regulation standardizes some processes of documentation and transmission of information in order for the operations of financial markets to be more efficient.
6. Improve Society:
    a. Regulation seeks to improve society through increasing availability of credit, increasing home ownership, increasing savings rates, etc… Another example would be regulation the use of illegal money in financial markets (i.e. money laundering)

Consequences of Regulatory Failure

1. Failure to properly regulate the financial services industry can lead to failing to accomplish the objectives listed above. This can hurt consumers, investors, financial institutions, other financial institutions, and the economy as a whole.

A Typical Regulatory Process

1. Perceived Need
    a. The proposition of regulation arises when there is a perceived need for it. This can come from a number of sources (political, social, economic, etc…)
2. Legal Authority
    a. The proper legal authority must be identified. Sometimes this may be more than one body.
3. Analysis
    a. Regulators must conduct analysis to determine what the proper form of regulation is given the circumstances. Additionally, regulators must analyze the efficacy and cost of the proposed regulation to ensure that it is both effective and worth it.
4. Public Consultation
    a. Regulators often consult the public to gain consensus of the proposed regulation. Often, this will involve the parties involved in the regulation, whether it is those who are being regulated or the parties who have the potential to be affected by it. (These discussions often relate to costs, benefits, alternatives, and quality.)
5. Adoption
    a. Regulations are then adopted by the regulating body. This entails formalizing the regulation in some way (codifying, defining, informing, etc…)
6. Implementation
    a. Implementation entails the process of regulation becoming official and the relevant parties changing and adopting the new policies.
7. Monitoring
    a. Regulating bodies monitor the status and actions of the organizations that they are regulating. Often, this involves looking for specific behaviors, ensuring that there are proper controls within the organization to curb specific behaviors, creating a system that allows regulating bodies to receive complaints, and investigating supposed instances of regulated behavior.
8. Enforcement
    a. Regulators must have the ability to enforce the regulations that they put in place. In the financial services industry, this entails cease and desist orders, fines, fees, settlements, and can include (for the individual) loss of license, prison terms, and banishment from the industry.
9. Dispute Resolution
    a. It is beneficial for there to exist methods of dispute resolution that are fast, effective, and fair (and ideally outside court) in order to maintain efficiency and integrity of financial markets.

10. Review
    a. Regulations should be continually reviewed as time goes on, the financial services industry and its available technology changes.
11. *Note that regulation may not always be explicit and backed by law. Regulating bodies can publish guidelines that affect the interpretation and enforcement of legal regulation.

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1. Classification of Regulatory Regimes
    a. Regulatory Regimes are typically divided into two types:
        i. Principles-Based Regimes: in which regulators establish a broad set of principles within which the investment industry is expected to operate. This avoids the legal complexity and allows regulators to interpret the guiding principles on a case by case basis.
        ii. Rules-Based Regimes: in which regulators establish explicit regulations that (ideally) offer clarity and legal certainty to investment industry participants.
        iii. *Typically, most regulatory regimes are a hybrid of the two.
    b. Regulatory Regimes can also be described as being either:
        i. Merit-Based: in which regulators attempt to protect investors by limiting the products that can be sold to them (often based on level of knowledge, available resources, and investment experience.)
        ii. Disclosure-Based: in which regulators attempt to ensure that all relevant information is disclosed to investors, rather than deciding which types of investments are proper for them.
        iii. *Again, typically most regulatory regimes are a hybrid of the two.

Types of Financial Market Regulation

1. Gatekeeping Rules
    a. Gatekeeping rules govern who is allowed to operate as an investment professional as well as if and how products can be marketed.
    b. Personnel: regulation aims to ensure that the people working as investment professionals meet standards of competency and integrity. Financial markets often require individuals to pass licensing exams to ensure that they have the requisite knowledge of financial laws and products.
    c. Financial Products: financial products must comply with regulation before they can be sold. This is necessary because some financial products are complex and difficult to understand, and investment professionals have incentives to sell clients the wrong products.

2. Operations Rules
    a. Operational rules dictate how firms are allowed to operate.
    b. Net Capital: regulation that aims to ensure that financial institutions have enough capital to honor their obligations. Highly leveraged companies pose a threat to their investors

and the economy as a whole. The collapse of a financial institution can lead to contagion, a situation in which the financial shock spreads to other locales or markets. Regulators pose limits on the amount of leverage that financial institutions can use.

c. Handling of Customer Assets: regulations that pose restrictions on how financial institutions can use their clients' assets. Specifically, these regulations require that financial institutions separate the assets of their clients from their institutional assets. Mishandling of funds exposes clients to unnecessary risk.

3. Disclosure Rules
    a. Proper functioning of financial markets requires that participants have access to information regarding companies, governments raising funds, specific financial instruments, etc… There is regulation in place that aims to ensure necessary information is being disclosed to its relevant parties.
    b. Corporate Issuers: regulators require issuers of securities to disclose information to their potential buyers. This information typically includes audited financial statements, general business information, use of the proceeds, and important risk factors.
    c. Market Transparency: regulation requires a degree of disclosure of information regarding the market for trading specific securities. In order to assess the value of a security, it is important to consider what other investors are willing to pay for it and the price that was previously paid for it.
    d. Disclosure Triggers: there are certain disclosures that financial firms are required to make in the event of specific trigger events (such as things relating to corporate ownership/takeover, firm's own position on companies, etc…)

4. Sales Practice Rules
    a. Sales Practice regulation aims to ensure that the selling practice of investment professionals are ethical and in the best interests of the client.
    b. Advertising: regulation relating to advertising seeks to ensure that advertising of financial products is both accurate and ethical. Issues relating to this are guaranteeing certain returns and accurately reporting previous performance.
    c. Fees: regulations exist to limit commissions that can be earned on the sales of financial products, as well as on the mark ups/downs that firms can put on selling their own securities.
    d. Information Barriers: many financial institutions offer both investment banking and equity research services. This duality can create a conflict of interest in which investment professionals have incentive to create biased research. There are systems within financial institutions to create barriers between IB and research.
    e. Suitability Standards: regulations exist to ensure that investment professionals are accountable for the financial advice that they give their clients. Law requires that the advice actually be in the clients best interests, some standards being higher than others (such as fiduciary responsibility.)
    f. Restrictions on Self-Dealing: regulations exist to ensure that transactions in which financial institutions sell securities from their own inventories to their clients are done so in an ethical manner. Firms have incentive to sell in ways that are not in the best interest

of their client, and so there are regulations relating to whether or not it is legal to do so, what information must be disclosed, and methods of trade which are optimal.

5. Trading Rules
    a. Market Standards: some regulation sets market standards for things such as the length of time over which a trade can take place.
    b. Market Manipulation: some regulation aims to stop market manipulation, which involves taking actions intended to move the price of a stock in order to gain a short-term profit.
    c. Insider Trading: regulation aiming to stop insider trading, which is trading based on knowledge of information that is not public.
    d. Front Running: regulation aiming to stop front running, which is the purchase (by an investment professional) of a security before completing a purchase order for a client of that same security (the aim being to take advantage of the increase in price that the client's order will cause in the security.)
    e. Brokerage Practices: regulation aiming to moderate the behavior of investment managers who use commission earned on securities transactions to pay for external research.

6. Proxy Voting Rules
    a. Across different financial markets, there are different procedures relating to how proxy votes are made for shareholders. In some markets, stock brokers distribute relevant materials, and in others the corporations the corporate issuers of stocks are responsible for doing so.

7. Anti-Money Laundering Rules
    a. Money Laundering relates to the use of illegal money for the purposes of laundering, tax evasion, and funding of terrorism. Regulation exists to ensure that this is stopped within financial markets by requiring financial institutions to perform due diligence, proper reporting, and comply with specific laws.

8. Business Continuity Rules
    a. Given the essential nature of the financial services industry as a part of the economy as a whole, regulation exists to ensure that in the event of some kind of disaster, client records and processes are backed up and can continue to operate.

Company Policies and Procedures

1. Introduction
    a. Companies within the investment industry are expected to have policies and procedures that regulate employee behavior such that they comply with legal regulation. Policies are defined as principles of action adopted by a company, and procedures are defined as what employees must do to achieve desired outcomes. Companies can be sanctioned or even barred from the industry if they do not have sufficient policies and procedures. Policies and procedures can arise through a process similar to that of legal legislation.

2. Supervision Within Companies
    a. Companies are responsible for ensuring the integrity of their employees. This begins prior to employment, with proper background checks, followed by orientation that includes information about regulation and compliance.
    b. It is important for companies to also provide continuing education to inform employees of new regulation and reinforce fundamentals. Companies are responsible for having systems that can promote furthering education, demonstrate that it has been achieved, and have systems in place to make sure compliance is actually achieved.

3. Compensation Plans
    a. Companies in the investment industry need to be aware of the fact that compensation plans can create adverse incentives and conflicts of interests for their employees. They need to design them in a way that accounts for this, and compliance and ethical standards should be a part of compensation determination.

4. Procedures for Handling Violations
    a. Companies are responsible for establishing culture and systems that allow for proper and immediate reporting of violations of regulation, as well as for actually handling those violations.

Consequences of Compliance Failure

1. Compliance failure can lead to consequences that affect clients, employees, their managers, companies as a whole, and even the entire economy. Consequences can take many forms including fines, fees, loss of licenses, barring from the industry, and shutdown.