Regulation from market institutions

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Introduction

The usual way economists and, sadly, regulators think about regulation and competition policy is in terms of market failure. The problem with that model is that it obscures some of the most important features of real life. The model begins by making unreasonable assumptions about markets which, according to those assumptions, will always 'fail'. However, governments do not have the knowledge, nor the incentives, to be able to 'correct' market failure.

This model also fails to recognise that markets themselves can develop regulatory institutions to address some of the so-called failures. One group of those private regulatory institutions is stock exchanges. The fact that the government, in 1986, decided to prohibit a private institution (the Stock Exchange) from regulating equity and gilts markets in many important ways on the grounds that the London Stock Exchange was inhibiting competition and that this act (Big Bang) is generally referred to as an act of 'radical deregulation' should perhaps tell us something.

In fact, it tells us three things. The first is that governments are not necessary to regulate markets. The second is that private institutions might, in fact, regulate markets more strictly than government regulatory bodies. The third is that the focus of economists should not be on so-called market failures being corrected by government bodies but on analysing the relative advantages of private and government regulation.

I will illustrate this by five examples, though not all relate to specific market institutions.

Example one: Private regulation and stock exchanges

In Britain, modern stock exchanges first developed in coffee shops, such as Jonathan's coffee house in Change Alley, where a group of 150 brokers and jobbers formed a club in 1761 superseding more informal arrangements that had existed since 1698. This club developed into the first formally (though privately) regulated exchange in 1801.

In the early years, the exchange was regulated by convention, reputation and informal rules. The first codified rule book was developed by the London exchange in 1812. This rule book included provisions for settlement, arbitration and dealing with bad debts. There were also rules about general behaviour designed to increase transparency (for example, partnerships among members had to be listed publicly) and about the quotation of prices. The exchange absorbed losses collectively from an event of market manipulation and the inappropriate use of insider information in 1814 while ensuring that those who attempted to profit did not gain. These are now matters that are entirely handled by government regulation.

In 1844 it became a requirement for securities to be sanctioned by the stock exchange committee before being listed on the exchange. This was the origin of listing rules. Without an orderly market, companies will not seek a listing, and, without reasonable listing rules, investors will be discouraged from trading on the market. Both are necessary to reduce the cost of capital to companies.

The ability of the exchange to determine its own membership and to set the rules by which members work was crucial. The benefits of those rules were excludable in that the benefits would not be obtained by companies not quoted on the exchange or by those involved in exchanging stocks and shares who were not members of an exchange with a good reputation: regulation was a club good and not a public good.

From 1909, members were prohibited from performing broking functions if they also traded on their own book – something which reduced the likelihood of conflicts of interest but which was abolished in the Big Bang.

A Royal Commission, which reported in 1878, noted that the exchange's rules 'had been salutary to the interests of the public' and that the exchange had acted 'uprightly, honestly, and with a desire to do justice'. It further commented that the exchange's rules were 'capable of affording relief and exercising restraint far more prompt and often satisfactory than any within the read of the courts of law.'

Not only were the benefits of the club rules excludable, it was possible for non-members to form a competing exchange with different rules, though exchange controls inhibited international competition for a crucial time after World War II. Furthermore, capital could be raised by companies on unregulated markets such as the eurobond markets. It is true that, according to our competition rules, the Exchange was a restrictive practice, but there was pretty strong competition at the margins.

The Big Bang came in 1986. This prohibited the Stock Exchange from imposing certain rules – indeed, some of the most important ones. Although, of course, exchanges can still make their own rules, increasingly this function has passed in the UK to statutory regulators (it did so much earlier in the US). However, we must be absolutely clear about what the Big Bang was. This was not, as is generally suggested, a Thatcherite experiment in deregulation. It was government limitation of the autonomy of private rule-making bodies on competition grounds as a result of an agreement between the Exchange and the Government to call off an Office of Fair Trading inquiry.

Example two: Professions

Until 1990, the accounting professions were independent and their standards formed recommendations to members of the profession. Those standards were produced by the profession. The first such recommendation, SSAP 1, published in 1971, was just eight pages long. In recent years, professions and their activities have been increasingly regulated by government bodies. The International Financial Reporting Standards dictating accounting requirements within the EU, for example, are now over 3,000 pages and they are imposed, in most circumstances, by governments whatever the nominal position of the standard-setting bodies themselves. Indeed, the standards have to be approved by the EU.

However, firms subjected themselves to audit long before governments required it. By 1926, 90 per cent of companies quoted on the New York Stock Exchange had audited accounts despite there being no requirement

for them to do so. Professional bodies of accountants operating with their own rules were responsible for auditing. The American Institute of Certified Public Accountants had codes of conduct for its members, as would be expected by a professional body. However, it was carrying out roles that were neither licensed nor regulated by the state.

Of course, there were scandals – and this, in itself, is quite interesting. It is notable that many of those scandals in the US arose after the government prohibited the profession from imposing certain regulations on its members – specifically, for example, the government prevented the professional body (an independent rule-setting professional body of which nobody was required to be a member) from banning its members from advertising as such rules were deemed anti-competitive. Once again, we have private regulation undermined by competition policy.

I should add in passing that I am opposed to giving professions statutory reserved rolls: that has brought them into disrepute.

Example three: Industry agreements

The third story is industry agreements. This story is of a cartel. Cartels have a terrible reputation, but one of the purposes of a cartel is to provide regulation which can sometimes bring order to markets: this happens a lot in sport. It has been suggested that a cartel could, usefully, bring an end to free in-credit banking, which, in the long run, would increase competition. I suspect that some of the problems in higher education could probably be resolved if universities were allowed to act as a cartel in some specific areas. It would also be helpful if local shops were able to form cartels – which would be contestable cartels – to regulate things such as Sunday shopping hours.

However, this example is the insurance maximum commission agreement. Up to the mid 1980s, the insurance market developed mechanisms to regulate product sales through the intermediary market. Major insurers had a maximum commission agreement. This was an agreement between life insurance companies that limited the amount of commission that could be charged by intermediaries (such as insurance brokers) when selling companies' products. This helped to ensure that intermediaries made recommendations based on the soundness of the life insurance company the policies of which they were recommending, or on the basis of other characteristics valued by the purchaser, rather than on the basis of the amount of commission they would receive. Insurance companies were

known to be either in this agreement or out of it and those that were out of it had an inferior reputation – they might have other advantages, however, such as being more innovative.

This agreement was abolished under pressure from the EU on competition grounds – presumably the main losers from this cartel were the brokers, which, to me, would not be a high public policy priority.

Since then there have been never-ending mis-selling scandals related to the sale of insurance products motivated by commission brokers received rather than by the needs of the customer. We now have literally thousands of paragraphs of conduct of business regulation relating to the sale of financial products as well as it being illegal to practice as an insurance salesperson unless the Financial Conduct Authority registers you. Tacit information – possibly the most important form of information in markets – has effectively been abolished by regulation to be replaced by formal processes and formal information provision to customers designed to ensure that products are suitable to them. Most of that information goes unread – for good reason.

On competition grounds (which, in my view, were spurious), we have replaced simple regulation through a market mechanism with complex regulation by a monopoly government regulator.

Example four: International Swaps and Derivatives Association

Derivatives markets also develop their own regulatory environment. Even off-exchange dealing is regulated by a private regulatory body, the International Swaps and Derivatives Association (ISDA). The ISDA's mission is to foster 'safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products.' It achieves this by 'Developing standardized documentation globally to promote legal certainty and maximum risk reduction'. Members have to apply to join the ISDA and can have their membership revoked.

Members can choose to use the ISDA master agreement. This was used for 90 per cent of outstanding derivatives contracts at the end of 2016 of almost $0.5 quadrillion (again, people might raise an eyebrow from a competition perspective). In addition, as part of its regulatory function, the ISDA also has a dispute resolution procedure, which avoids reliance on government courts in most instances, and a Credit Derivatives

Determinations Committee. The latter uses a set of rules to determine whether a credit default event has taken place and thus whether counterparties to a derivative contract need to settle.

Example five: Uber

Uber is an individual company of course. But it has a clear regulatory structure for drivers and customers and also very clear ways of enforcing its regulations. Recently, Uber has come under the Competition and Markets Authority's scrutiny for a proposed merger. However, we should remember something very important. Uber is not just a platform for competition between drivers, it is a vehicle for regulatory competition. Customers (and drivers) can choose between the demand-responsive pricing of Uber, together with its mechanism for regulation of both drivers and customers and the fixed pricing of systems regulated by local authorities which some might prefer for specific purposes. We should have regulatory competition.

It is worth noting that this is all made more complex by the fact that Uber is now deemed to employ its drivers rather than act as a regulator for self-employed drivers and their customers. Nevertheless, the main point stands. Uber should be seen, at least partly, as a regulator which should be in competition with other vehicles for regulation.

Conclusion

Recognition of private forms of regulation has come from a surprising source. In his famous 'lemons' paper, Akerlof (1970) did not argue that institutions could not develop within the market to deal with problems such as information asymmetries, but he did argue that such institutions might accrue significant market power to which there might be objections. This is a much more subtle and insightful way of thinking about the problem than that of so many of his followers who talk about information asymmetries and the apparent resulting need for statutory regulation.

What we should be debating instead is the relative merits of regulation from different sources. And we should worry that, by obsessing about threats to competition, we undermine subtle regulatory institutions within markets.

Let me end by simply listing the factors which we should consider and be researching. These are the relative merits of government and market institutions in regulating markets:

- Private forms of regulation can be monopolistic or cartelistic and encourage restrictive practices, though they are always contestable by nature. However…
- Government regulation is monopolistic by nature and normally does not allow any regulatory competition whatsoever. Furthermore, regulatory bureaus such as the FCA do not have any meaningful process of accountability to the people in whose interest they are supposed to regulate. Competition authorities should always ask the question 'compared with what?' in any competition case.
- Private regulation cannot necessarily deal with broader public interest issues outside the domain of the market in which they are operating. However, these issues can be subject to special legislation.
- The sanctions available to private regulators may be limited – though they are extensive.
- On the other hand, government regulators might be taken over by interest groups including the industry that they regulate.
- And then there is the knowledge problem. Private regulators are exposed to competition, but government regulators lack the knowledge to know the optimal approach to regulation and lack any market discovery mechanism. Exchanges, for example, have to compete with each other.

The debates surrounding regulation have tended to assume that markets cannot develop their own regulatory institutions. History demonstrates that they can. Instead, we should debate two different questions. Firstly, the empirical matter as to the efficacy of private and state regulation. Secondly, there is the question of whether private regulation, in certain circumstances, gives rise to an undesirable concentration of power in private markets and whether that is more or less problematic than a government regulatory monopoly.

There seems to be a lack of curiosity from economists in relation to the development of regulatory institutions within markets themselves. However, many forms of regulation can be seen as a set of services which does not have to be provided by the state. Anybody with even a passing interest in the history of sport would appreciate that.

References

Akerlof, G. A. (1970) The market for 'lemons': quality uncertainty and the market mechanism. *Quarterly Journal of Economics* 84(3): 488–500.