How Should the Financial Markets Be Regulated?

By Tamar Frankel
Tamar Frankel is a Professor of Law at Boston University Law School and a Michaels Faculty Research Scholar

The financial markets should be regulated mostly by examinations, not by prosecution. And examinations should be far more intense when prices rise, not after a crash.

It makes more sense to devote most of the Securities and Exchange Commission's resources to on-going examinations. The examinations should focus on (1) large institutions (financial or industrial), whose failure by fraud might affect investors' trust in prices and lead to a crash; and (2) institutions whose share-prices have risen persistently signaling the "too good to be true" syndrome.

Most importantly, examinations should intensify with a general and persistent rise in market prices. This is the time when fraud and violations of the law might accompany true and tested justifiable success. This is the time when "irrational exuberance," as former Federal Reserve Chairman Alan Greenspan once described market bubbles, is probably on the rise.

Continuous examinations are not new for the regulators and those subject to the examination. They are likely to be less costly than court cases, especially against huge corporations, using well-staffed law firms. The focus of the examinations should be on institutions whose failure may shake the system. Visits by regulators may produce a mild deterrent. Instead of harsh sentences and inflexible rules, examinations and small suggested corrections can enhance and inculcate good habits to overcome temptations.

Examining regulators would learn the newest financial innovations and developments in the markets. Had regulators understood the terms of the sub-prime mortgages, they might have been alerted to the amazing AAA-rating that these mortgages received. Examiners should learn about—not regulate—unregulated financial techniques, and acquire knowledge which they should share with colleagues. If regulators understand today's bubble mechanisms and identify attendant violations of the law, they could stem the trend towards empty prices before they rise and inevitably result in a painful crash. Examinations do not mean publicity. Regulators, by law, should assure examined institutions of confidential treatment.

We have been doing just the opposite. Half of the SEC's resources are devoted to enforcement, including investigation of particular discovered offenses. The Commission's Office of Compliance is far smaller. In our current system, financial institutions are left virtually free of regulation during the rise of a bubble. With the inevitable crash, regulators are energized to investigate, prosecute, and come to the rescue of failing institutions.

There are proposals to tighten regulation in anticipation of problems; and there are proposals to reduce regulation and let the market solve problems. Neither of these proposals is satisfactory. Addressing possible harmful activities before they actually occur, may stifle innovations, harm the investors, and weaken the financial system. Adopting a "wait and see" policy, and looking for a clear evidence to prosecute and plugging legal loopholes that are uncovered, may address problems that might not occur again soon. These prosecutions and new regulations are similar to acting after the "horse got out of the barn."

There are proposals to tighten regulation in anticipation of problems; and there are proposals to reduce regulation and let the market solve problems. Neither of these proposals is satisfactory

Like all things, the good features of the financial system can turn bad. Small bubbles offer increased liquidity, which is good. At a break-point, bubbles can lead to devastating crashes. These are bad because markets cannot exist without trust in the prices and pricing mechanisms. The transition from good to bad is impossible to determine. In 1996, Greenspan noted: "How do we know when irrational exuberance [bubbles] has unduly escalated asset values, which then become subject to unexpected and prolonged contractions [crashes].” Of course, we cannot. But we can examine, investigate and enforce the current law against violations, even in good times.

Bubbles are accompanied by violations of existing law, perhaps at higher rate than in flat markets. Bubbles are likely to rise with the help of illegal “encouragement,” advice, and “cooking the books.” To be sure, bubbles and crashes will likely continue to occur with or without examinations. Yet, moving from after-crash prosecution to ongoing, long-term examinations—with frequent regulators’ visits—may minimize the devastating impact of crashes and the horrendous results and costs that the market solutions impose.

Problems may be resolved if we do nothing—or, as some people call it “market solutions.” But the cost of “market solutions” may be so high as to undermine our entire system and our economy. It may take years to rebuild a healthy system.

So better let the regulators watch rather than regulate. Let them be the “police on the beat.” Let them acquire a far better sense of trouble that may be brewing. But let them act only by enforcing the existing law and enforce before, not after, the crash—throughout the evolution and rise of bubbles. Then, perhaps, bubbles will burst early and the crash will be a “blimp” rather than a nuclear explosion.