Self-regulation as a remedy for market turmoil: An over-the-counter or a prescription drug?

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SELF-REGULATION AS A REMEDY FOR MARKET TURMOIL: AN OVER-THE-COUNTER OR A PRESCRIPTION DRUG?

Abstract: The paper tackles the problem of the overwhelming regulatory burden that marks its presence in a post-crisis environment. With evidence of regulatory overload in some cases, paths for more effective design of regulatory frameworks should be sought. Although self-regulation does not enjoy favorable publicity and happens to fail to prove its value in times of distress, it still may serve as a remedy. A number of studies shows that, under specific circumstances, the self-regulatory framework may operate seamlessly for the benefit of all stakeholders. The goal of this paper is to identify these circumstances and validate them on the basis of three concise case studies from the health care, advertising and financial services industry. It is instructive for policy makers in deciding on whether to abandon or reduce public oversight in certain areas, by allowing businesses more freedom in terms of setting and enforcing the rules.
Keywords: self-regulation, self-regulatory organization, regulatory agencies, financial crisis, financial services industry, health care industry, advertising industry

INTRODUCTION

Whatever the new paradigm of market regulation will turn out to be, it will emerge from the ashes of the current financial crisis. The legacy of austerity, public discontent, and citizens' greater vigilance to corporate misconduct, is likely to leave its stamp on it. The rising regulatory pressure emerged as a powerful trend, with the role of regulators growing in significance. This pertains first and foremost to the financial services industry, where the amount of regulations has been growing unceasingly since the outbreak of the downturn. Heavy regulations of ecological nature are also imposed on sectors dealing with energy production, raw materials or building materials.

The overload of regulations may take two forms: the extended coverage of regulatory activities that embraces industries that do not need them; and the elevated scrutiny in regulation, which hinders economic freedom to an unjustified degree. Customer-centrism, the most desired virtue of regulation, decays. The fraction of laws that directly protect customer interest is on remarkable decline. The regulators boost their statistics on the number of bills passed, but are often thought to overlook the utility that should be delivered to ultimate beneficiaries. The Volcker rule or the pressure on regulating the "buyer beware" vehicles, such as private equity or hedge funds 821, could be put forth as examples. In several sectors, the far-flung influence of regulators hampers innovation and curbs entrepreneurship. To introduce a new regulation means to draw the firm away from its core business and make it produce compliance reports and hire consultants.

The once defined basic institutions of capitalism not only remain basic, but enjoy a leading role in the economy and garner political blessing. Over-regulating is typically associated with developed countries (budget of the U.S. regulatory universe amounts to 60 bn USD, i.e. roughly two thirds of Poland's total budget revenue), but the drift towards excessive zeal infests, e.g. to China 20. The costs of public intervention often outweigh the benefits it intends to convey.

Hence, the aim of this paper is to bring about a more conscious application of self-regulatory efforts, being the surrogate for public regulation. They should be given more trust and room for development in industries that are best positioned in this respect. The paper features three case studies from different sectors, in an attempt to detect the characteristics of these industries, which enabled successful private oversight. The term "self-regulation" (alternatively, "private oversight") embodies a situation in which an independent self-regulatory organization (later referred to as SRO) exercises regulatory authority over a certain industry or profession, exclusively or to a certain

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extent. It has to be suitably empowered to perform its duties, either through an explicit government imprimatur (probably in the form of “enforced” self-regulation), a carte blanche for the SRO, or through a pre-emptive move of the SRO, tacitly consented by the public authorities.

RESEARCH QUESTIONS

The criticism around self-regulation rests on the conviction that the quality of oversight would suffer. First, although competitive markets are second to none in terms of efficient production of private goods and accurate allocation of scarce resources, they do not reward market actors for taking care of public welfare. Second, the argument of disastrous market imperfections, unavoidable in self-regulation, is raised. Responding to the first caveat: is public surveillance of a truly superior quality? An average UK small firm has a chance to be controlled for workforce safety once every 80 years [1]. Simultaneously, the level of stress and costs to be borne are high. In this respect, public watchdogs do not hold a candle to their private counterparts. With regard to the second claim, Spinello [22] reminds us of a widespread bias that “market failures” are given more publicity than “government failures”, while the latter are far more evident. Therefore, unless the existence of a regulator freed from imperfections is ensured, the complaint lacks validation.

Some critics say that self-regulation is a new weapon of despaired Wall Street sinners, willing to trade orthodox scrutiny for the meaningless trinket of self-regulation. Certainly, ceding regulatory clout to industry is not a life-saving pill. But it might be a risk diversification tool that will wipe out the overkill of regulators and voice the needs of businesses, making them weigh more in decision making processes. However, self-regulation is not a one-size-fits-all approach. Frameworks should be carefully crafted and take into account the peculiarity of different economic sectors and different jurisdictions, as well as the feature that public and private regulations may complement each other [17], which is actually desirable. The empirical harvest is quite edifying, e.g. López-Gamero et al. [18] proved that voluntary norms have an edge over the command-and-control model. Haufler [12] provides some evidence of improved industry practices, but also delivers counterarguments by stating that self-regulation faces considerable organizational and enforcement difficulties and is sometimes unlikely to respond effectively to the underlying challenges. Indeed, the issue of observance of SRO endorsements is problematic in some frameworks, but it is crucial to note that SROs are designed rather to disentangle disputes than to punish for non-compliance.

Between the extremes of pure play self-regulation and pure play state regulation, there is the so-called enforced self-regulation. In this framework, the state strives to co-opt the regulatory potential of corporations. Such mixed approaches have been extensively researched, yielding both: red flags [13] as well as more neutral conclusions [17], and quite enthusiastic inferences [19]. It is difficult to define the superior incarnation of justice and effectiveness, but it surely would feature some amalgamation of self-regulation and government shackles. Unfortunately, self-regulation is apparently not taken seriously by many influential scholars. Stiglitz [23] labels self-regulation as an oxymoron. In their recent publication, Brunnermeier et al. [5] seem to ostensibly neglect self-regulation, thus presumably expressing their vote of no confidence. Cukierman [7] distrusts the whole genre of SROs, driven by the recent moral abuses by top management.

Has the golden age for self-regulation already passed? Despite the critical stances, it is hardly plausible. Provided that conventional oversight is experiencing its dark ages, the opportunity for refurbishing self-regulation arises. How do we harness SROs effectively for collective social benefit?

SCIENTIFIC HYPOTHESES

Based on the qualitative analysis of available case studies, several hypotheses may be drafted in order to identify the industries in which SROs may add value and become or remain a credible source of regulation. These preconditions are enumerated below.

1. Historical evidence that public opinion is satisfied with the performance of SRO. This is somewhat the easiest prerequisite, as it rests on a broad status quo consensus.

2. Market players are embedded with the capability to effectively control each other and exhibit a true commitment to do so. The motivation for ethical conduct and genuine mutual control must be in place until the misbehaviour of one firm proves detrimental to its peers, prompting the deterioration of the whole sector's image.
3. A market involving very complicated, interdisciplinary knowledge, with numerous interdependencies. This would make the headhunting for skilled public regulators futile or the authorities would incur huge costs when staffing the regulatory body.
4. An environment in which quick decisions are needed, and the public regulators, inherently slow-moving, are not well-positioned to satisfy this precondition. The perfect example of such an environment is the Internet, where self-regulation has recently attracted much attention, although this trend has its contenders, too.
5. A market which is out of or remote from the epicentre of public interest. The institutions are not subject to instigate systemic problems or the parties affected by their potential malfunctioning are limited in number or well-qualified to detect the malfunctioning using their own skills (e.g. accredited investors, involved in hedge funds or venture capital industries). This condition seems to be the most difficult to satisfy.

One must notice that the aforementioned list indicates that if the enumerated prerequisites are met, the existence of SROs is facilitated. However, it cannot evaluate a priori the effectiveness of their operations and, consequently, the quality of the regulations introduced by them.

The break-even point, at which the public authority should step in to ensure soundness of regulation, is when the conflict of interest within an industry is deemed too severe and hampers impartiality. The need for external supervision in such cases has been suggested in literature [6].

RESEARCH ISSUE

This paper is anticipated to lay foundations for the "targeted" self-regulation idea, i.e. the selective application of the private oversight model, basing on thorough analysis of market characteristics. A series of brief case studies will facilitate the accomplishment of this objective.

In the case of the medical industry the situation is unsophisticated. There are three broadly defined self-regulated dimensions in medical professions: standards by which people may enter the profession and practice medicine; teaching the medical community how to properly apply those standards; enforcing those standards and disciplining for non-compliance [4]. The medical society was granted the privilege of self-regulation in the middle of the 19th century [16]. This signifies the magnitude of the status quo (requirement no. 1), since the subsequent four preconditions are either partially satisfied or not satisfied at all. The prerequisite no. 2 is ambiguous. On one hand, unethical or incompetent doctors may spoil the reputation of the entire profession [14]. On the other hand, doctors belong to a hardly substitutable profession and may be immune from public dissatisfaction. However, this is the arousing conflict of interest that marked the slow downfall of self-regulation in this industry, as public opinion has become sceptical of the physicians' ability to balance altruism and self-interests. As for the complexity of knowledge, the discrepancy between practitioners and the general public is still considerable, although many decades ago it seemed much more immense [6]. SROs, such as the American Medical Association in the United States or the General Medical Council in the United Kingdom, still remain a vital element of the social contract. Their Polish counterpart is the Chamber of Physicians and Dentists (Naczelna Izba Lekarska) that is also deeply rooted in history, being founded in 1921.

The Commission of Ethics in Advertising (Komisja Etyki Reklamy, later referred to as KER) illustrates the simplicity of the regulatory regime. KER is a Polish-based SRO, founded by marketing agencies, the media and enterprises. It is an arbitration body of the Advertising Council, which is part of the Europe-wide EASA (European Advertising Standards Alliance, grouping 35 SROs). Consumers who are disgusted or misled by any piece of ad submit a written complaint to KER, which is later judged by independent referees. All signatories of the code of ethics have a formal duty to obey the verdicts and withdraw their advertisements in case they have been found to be in breach of the code’s provisions, but membership also entitles them to use the label “I advertise ethically” for marketing purposes. The advertising industry has been traditionally operating under self-regulatory models in most European countries, as well as overseas (e.g. the Advertising Self-Regulatory Council in the United States), although some public oversight is also present in several jurisdictions. Other preconditions are fulfilled: first, the damage caused by unethical advertisement may heavily spoil the whole industry, therefore mutual control is genuine; second, the environment consists of several stakeholders (advertisers, agencies, media), which makes it difficult to capture for public authorities; third, unethical commercials call for immediate reaction in order to restrain the negative consequences they had prompted (68 per cent of complaints against EASA-associated SROs were resolved within one month [11]); fourth, although the implications of a fraudulent ad are certainly not so devastating as the aftermath of Wall Street misconducts, there is still some component of greater risk (e.g. with pharmaceutical or alcohol ads).

Finally, to feature the case from the most beleaguered financial industry, the 30-year old National Futures Association (NFA) is presented. Contrary to the Advertising Council, membership in the NFA is mandatory for everyone conducting business with the public on the U.S. futures exchanges. There is a dualism in the origin of regulations, since the NFA was created eight years after the state-established Commodity Futures Trading Commission (CFTC) in 1974. Throughout NFA’s history, the CFTC has authorized the NFA to conduct additional regulatory functions. NFA is responsible for market education, setting registration requirements and compliance rules, as well as for enforcement and resolving arbitration or mediation claims. Futures contracts are a relatively complex sub-segment of the financial sector and are dedicated primarily to corporate entities (or high net worth individuals). Nevertheless, the systemic risk component is still present here, as the concentration of failed investments may lead to market-wide turmoil, as the case of Amaranth Advisors hedge fund instructs [2]. Moreover, the self-regulatory Chicago Mercantile Exchange has recently suffered from a wave of criticism for the flaws in futures brokerage firm examination, which contributed to the traumatic bankruptcy of MF Global [10].

Table 1. The matrix of self-regulation preconditions and their fulfilment in selected industries

Economic sector	Historical consensus	Commitment for control	Complex environment	Dynamic setting	Limited, non-systemic risks
Health care industry	Met	Ambiguous	No longer met	Not met	Not met
Advertising industry	Ambiguous	Met	Met	Met	Ambiguous
Futures contracts (finance)	Met	Met	Met	Met	Ambiguous

Source: own analysis.

The financial sector's self-governance is not limited to the NFA. In the United Kingdom the Financial Services Authority, independent of government and funded entirely by the institutions it regulates, has a by far broader scope of competences. However, this entity is being gradually taken over by the British government [25], as it has already happened in April 2010 to its judicial body, the Financial Services and Markets Tribunal [24]. Hence, the tripartite British regulatory framework (i.e. FSA, the central bank, and the Treasury) will soon cease to exist. Seemingly, the self-regulation over the full breadth of the financial services industry was unfeasible. The challenge for the future is whether we may obtain this wisdom *a priori* rather than only *a posteriori*.

The examples were purposely taken from different segments and cannot be directly compared.

CONCLUSIONS AND FURTHER RESEARCH

Self-regulation is certainly not an over-the-counter drug, as the conflict of interest in some industries may turn out to be unmanageable from the inside, which calls for an external rule-setter. However, identifying the attributes of a given sector, decisive for whether self-regulation may be applicable or not, may greatly improve the regulatory standards by increasing the quality of regulation and reducing its cost from the taxpayer perspective. Such an approach sees self-regulation as a prescription drug. The question remains on how to convince policy makers to overweight private regulation at the cost of the public one. For the emerging industries, such as the Internet, the solution is easy: a pre-emptive move of a self-regulatory actor will most probably discourage public authorities from action or will considerably impede this action. However, the situation is much more challenging in already established economic sectors. A qualitative shift from police-like regulation to coordination-oriented regulation is a moderately plausible concept, since vested interests have already petrified the *status quo*. Regulatory authorities have grown in size and influence, and they are now self-protective, immune to changes, unwilling to delegate their bread-and-butter business to SROs and eager to assure markets of their prominence [15]. This is the point where regulators need to be deregulated in order for self-regulation to restore its reliability and regain its momentum. It is not to say that the publicly founded and funded organizations have no commitment for developing operative regulatory principles. Instead, it is to highlight the uncontrolled growth in top-down prescriptive regulations that fail to account for financial sector heterogeneity, dynamism and asymmetries of information and thus overshoot their targets [3]. The right balance between "state" and "self" should be pursued, as the industries can reasonably be expected to be better off with diversified sources of regulation rather than with single-origin rules that lead to the accumulation of all imperfections the lack of diversification implies.

As far as the original contribution to the field of science is concerned, the study – undoubtedly a preliminary one – provides an insight into the problem of identifying the targets for self-regulation. It gives a hint on what market characteristics may be interpreted as a "green light" for the application of the private oversight model. Consequently, conventional regulation might be forsaken or limited in these industries, and SROs may be equipped with more prerogatives.

Researching the issue of regulation is problematic for several reasons. First, the actual impact and quality of regulatory measures cannot be determined a priori. Second, the motivation of the regulator is often opaque, even if it is formally expressed. Some light may be shed on it through experimental economics, which is best in detecting and validating behavioural aspects of regulatory frameworks. The paper also encourages further research in the field of enforced self-regulation, since this model is most feasible in terms of implementation and has showcased some success stories.

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