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Seeking an End to Financial Hyperregulation

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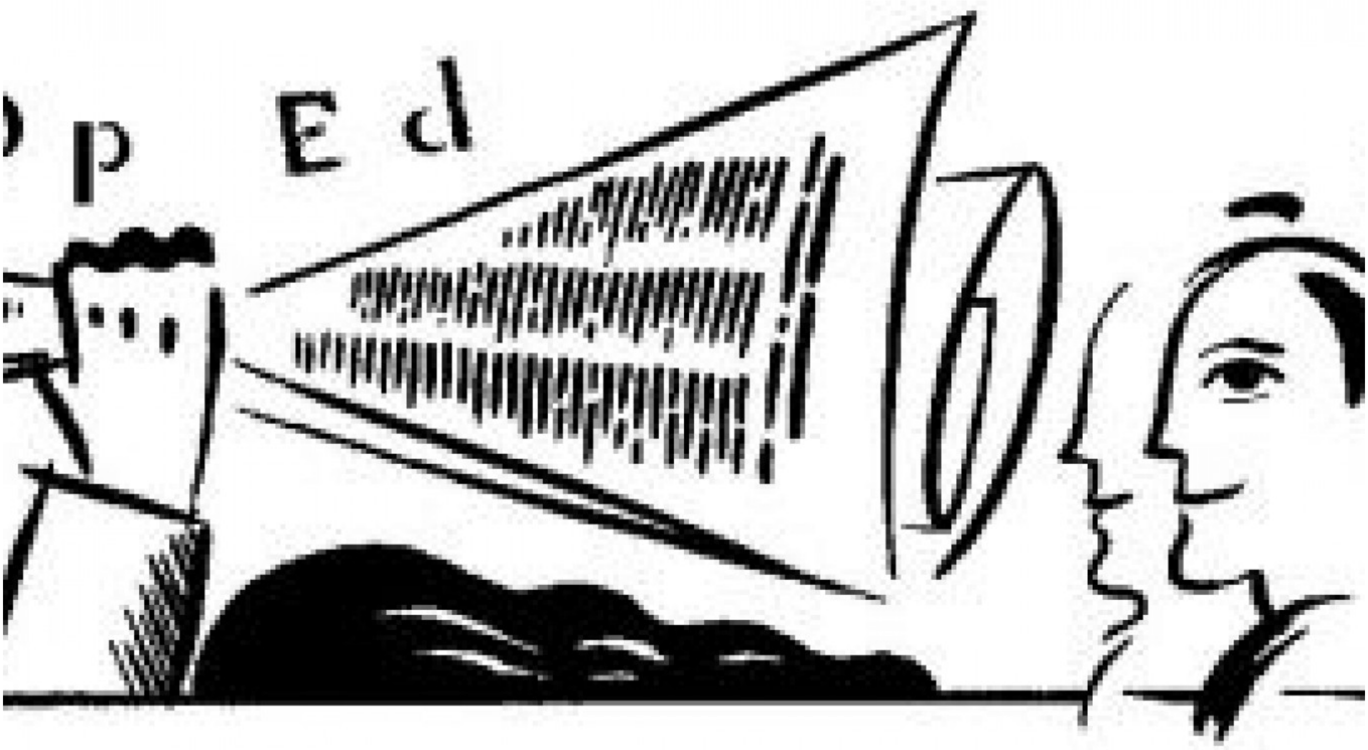

Biologists say nature generally tends toward re-establishing ecological balance in the aftermath of a systemic shock. In any ecosystem — a jungle, a lake or a desert, for example — nature seeks to maintain optimal balance between predators and prey, between animal life and vegetation. In theory, this principle should apply to financial markets as well. If a market is underregulated, it veers out of control. If overregulated, then growth is stunted. But relying on such natural forces could be misguided.

The current arc of regulatory ascent began in 2008 with the implosion of the mortgage-backed securities market and the chain reaction of unmet margin calls on derivatives and other complex financial instruments. Once stopgap legislation was put in place to contain rampant panic in the markets, the cry for more aggressive regulation became inevitable. Investment-house traders were now seen as out of control and requiring more robust regulatory oversight.

Although regulators would be loath to admit it, there is de facto competition among them to implement increasingly strict and invasive standards. When Eliot Spitzer was the notorious sheriff of Wall Street as New York attorney general, his attacks on big investment houses led to requirements that equities research departments be walled off from investment bankers. Not to be outdone, Britain's Financial Services Authority extended this information barrier to include fixed-income research. This trend toward heavy-handed regulation does not occur in a vacuum, of course.

Today's iteration of the Inquisition features a defensive investment bank CEO enduring the populist wrath of U.S. and European lawmakers, with television crews filming every righteously indignant barb and zinger. In this atmosphere, it would be unusual for financial regulators not to ratchet up their oversight and control. So welcome to 2013, the year of the hyperregulator in the financial sector. Given the forces at play, there can't be too many chefs in this regulatory kitchen. The eurozone crisis has fueled a new rash of regulation of securities markets. As German Chancellor Angela Merkel announced, "We planned to regulate every financial center, every financial actor and every financial market product."

In this spirit, European bank regulators have launched an ambitious new regime for capital adequacy known as Basel III. As the name suggests, this is the third in a series of reforms designed to enhance the equity reserves and Tier I capital ratios of Europe's banks. Although widely hailed as necessary medicine, the Basel III requirements remain controversial due to concerns that the cumulative effect could be an overall brake on economic recovery in Europe.

In Russia, size matters. Structurally, an initiative is under way to merge the Federal Service for Financial Markets, the country's securities exchange regulator, with the Central Bank, which regulates domestic banking activity. This follows last year's consolidation of Russia's former insurance industry regulator with the Federal Service for Financial Markets.

Parallel with these developments, the formerly independent RTS, the dollar-denominated bourse, merged with MICEX, the leading ruble-denominated exchange, in December 2011. In all cases, the thinking seems to be that a single, bulked-up entity can more effectively maintain proper control of the domestic securities markets.

In terms of substantive regulation, the beginning of 2012 saw the introduction of Russia's Law on Inside Information and Market Manipulation, a complex set of procedures for identifying and formally notifying specified categories of market insiders. Many in the Russian market, including the regulator, appear to agree that this law is well-intended but overengineered and unnecessarily burdensome. So let's hope we see procedural refinements in the coming year.

But the mother of all securities regulators remains the U.S. Indeed, U.S. regulators are evidently incapable of undertaking initiatives that are not extraterritorial in scope. Just as the American armed forces invaded Afghanistan and Iraq, U.S. financial regulators unleashed the Foreign Accounts Tax Compliance Act and Dodd-Frank.

The concept behind the Foreign Accounts Tax Compliance Act is as simple as it is audacious: Any bank anywhere in the world offering accounts to U.S. citizens must act as an agent of the IRS. The implicit infringement on national sovereignty and de facto U.S. regulation of foreign banks are causing many a furore, including among Russian banks.

Even more epic in scale is Dodd-Frank, 16 'titles' of new legislation that boldly stakes its claim to change the rules of the game for the financial industry. Most vexing of all, we have already crossed several take-effect deadlines but without the benefit of a clearly articulated regulatory road map.

In addition to mandatory swap-dealer registration for over-the-counter derivatives deemed to be "in scope," a major feature of Dodd-Frank is the so-called Volcker Rule, which has also kicked in. The Volcker Rule attempts to steer investment banking by major banking groups back toward a posture that prevailed prior to the presidency of Bill Clinton. The policy goal is to prevent investment banks from undertaking specified high-risk transactions and investments that could jeopardize the bank's overall financial stability. Many of the details have yet to be defined, but a two-year phase-in period buffers market players from an overly abrupt transition.

Taken as a whole, no non-U.S. financial regulator comes close to approximating the magnitude of change that the Foreign Accounts Tax Compliance Act and Dodd-Frank have instigated. Whether and when global financial markets will veer away from such hyperregulation and back toward equilibrium will not become evident for at least another year.

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