**Regulation as a product of entrepreneurship[[1]](#footnote-1)**

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In the minds of those economists who support a market economy, the words ‘entrepreneurship’ and ‘regulation’ are normally thought of as being in opposition to each other. But, the reason for that is that most economists, whether supporters of a market economy or not, seem to have accepted the myth that regulation is a product of the state. Market economists would argue that regulation arises due to public choice interests and is generally antithetical to an entrepreneurial market economy.

In economic analysis, the case for regulation is normally situated within a ‘market failure’ framework. According to this approach, if some of the conditions that are regarded as necessary for markets to maximise welfare do not hold, regulatory interventions can increase welfare.

But, this approach is flawed as a way of thinking. It ignores that fact that, if regulation is itself beneficial to market participants, markets may develop their own regulatory institutions. Regulation can be thought of as part of the set of services that markets can deliver and regulatory institutions as the product of the market process, competition and entrepreneurship.

I suggest in this paper that we should regard regulation as part of the set of services that need to be generated by the process of entrepreneurship and not as an activity that should be done to the market after the fact by a supposedly disinterested body. I specifically apply the ideas to the financial sector. In this respect it follows from the work of authors such as Stringham (2015), as well as in the tradition of work by Peter Boettke and others. To some extent the approach mirrors that of Elinor Ostrom, but, rather than suggesting that regulation in financial markets should be part of some kind of polycentric system, as Ostrom studied in the case of common-pool resources, I will argue that, in large part regulation of the financial sector can be undertaken entirely by private bodies.

It is worth prefacing the main argument by noting that government financial regulation is a relatively recent innovation in my home country, the UK. The US market has been subject to a much longer history of regulation than has the UK. For example, until 1988, the sale of financial products was regulated only by consumer protection law and by general contract law in Britain. Before so-called ‘big bang’ in 1986, securities markets were generally regulated solely by private stock exchanges except for occasional piece of primary legislation together with the Companies Acts which imposed very specific and limited requirements on those trading in securities as well as on publicly listed companies.

The avalanche of government regulation of the financial sector in the UK started in 1986 with the Financial Services Act, which came into force in 1988. This Act instituted a system of regulation of financial markets that was ultimately accountable to the state and which was all-encompassing within the sectors to which it applied. No person operating in financial or investment markets outside real estate could escape the remit of the regulatory bodies created after the Financial Services Act. Chapter II of the Act stated: “no person shall carry on, or purport to carry on, investment business in the United Kingdom unless he is an authorised person under Chapter III or an exempted person under Chapter IV’[[2]](#footnote-2).

The system of government financial regulation gradually became ever-more all-encompassing covering more and more sectors. In passing, it is interesting to note that, by 2011, the UK financial regulator brought in regulation or issued guidance, advice, discussion documents or consultations, totalling 4.3 million words – more than five times the length of the Bible. This included a 585-page consultation on the regulation of the mortgage market, which led to a 312-page document on regulations relating to the sale of mortgages. In 2015, the FCA levied nearly £1bn of fines.

This is a total change in culture from pre-1986 days. The growth of statutory regulation has been highlighted by Haldane (2012).[[3]](#footnote-3) Haldane is not a supporter of deregulated financial markets in general.[[4]](#footnote-4) However, he points out that “In 1980, there was one UK regulator for roughly every 11,000 people employed in the UK financial sector. By 2011, there was one regulator for every 300 people employed in finance.” He did not point out that, if this trend growth in regulators and people employed in finance were to continue, the number of regulators would overtake the number of people employed in finance by about 2070 – and this excludes those who enforce regulation employed by regulated firms themselves (such as compliance officers).

Government regulation of financial activity has become so pervasive in the last 30 years (or longer in the US) it is difficult to imagine a different approach. It is therefore worth beginning by looking at historical examples of private regulation produced by the market process.

**Examples of regulation arising within markets[[5]](#footnote-5)**

Institutions developed historically within financial markets to deal with known (though not always defined) problems. Institutions that were important in creating a stable order in financial markets included independent professions; intermediaries; trustee bodies; and firms with special corporate governance arrangements (such as customer-owned firms). In addition the use of “brands” or “reputation” helped counterparties and customers to distinguish between good and bad firms.[[6]](#footnote-6) This was genuinely a process of entrepreneurial discovery as, within markets themselves, institutions evolved and there was competition to discover the best way to produce order and promote economic welfare within financial markets.

However, institutions also developed that specifically exist to regulate market activity. Such institutions were not the creation of the state and nor was it compulsory that those participating in markets should be members of such institutions. They arose, it can be assumed, because they raised the welfare of market participants in some way. Three examples will be discussed below.

***Exchanges***

Historically, the most important regulatory institutions in financial markets have been exchanges. These are institutions on which securities and other financial interests or commodities are traded and which generally provide a comprehensive regulatory framework that promotes order. In the past, these institutions operated on a club-like basis. They developed rules to which their members had to adhere. Adherence to the rules came with a cost because the rules involved the prohibition of certain practices that may have been remunerative to individual members of the club. However, the rules also had a benefit because, if they were obeyed by all members of the club, they would enhance the reputation of the exchange as a whole. In other words, market confidence and trustworthiness can be thought of as a club good[[7]](#footnote-7) or service, the benefits from which are excludable but not reducible in consumption, and the price of obtaining that good comprises both membership fees and adherence to the rules. It is important that free riders cannot operate under the protection of the private regulatory body without obeying the rules: that is, it must be possible to exclude rule-breakers.

The development of exchanges is discussed in a number of texts describing the development of the City of London as well as texts on private governance in general.[[8]](#footnote-8) In Britain, modern stock exchanges first developed in coffee shops, such as Jonathan’s coffee house in Change Alley. A group of 150 brokers and jobbers formed a club there in 1761 superseding more informal arrangements that had existed since 1698. This club developed into the first formally (though privately) regulated exchange in 1801 and, the following year, the exchange moved to Capel Court. The characteristics of the stock exchange included restrictions on membership, the publication of prices and lists of stocks that were traded, and the potential for the development of a rule book.

In the early years, the exchange was regulated by convention, reputation and informal rules. For example, when delayed settlement was introduced to increase liquidity, those who did not settle their accounts would be labelled “lame duck” on a board so everybody would know. In many of the historical exchanges, such as Amsterdam, contracts were enforced that were not even recognised in law.

Codification of rules happened in two ways. Firstly, there were rules governing the behaviour of members and the quotation of stock prices. Secondly, there were rules for companies listed on the exchange. The latter type of regulation developed rather later. These are precisely the forms of financial market regulation that it is commonly thought necessary for the state to provide and which the state now does provide.

The first codified rule book covering topics such as default and settlement 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 amongst members had to be listed publicly) and about the quotation of prices. One interesting example of the enforcement of rules was when the exchange absorbed collectively losses from an event of market manipulation and the inappropriate use of insider information in 1814 whilst ensuring that those who attempted to profit did not gain.[[9]](#footnote-9) These are now matters that are entirely handled by government regulation.

Rule books governing the behaviour of members were followed by rules for the quotation of companies. In the mid-nineteenth century, it became a requirement for securities to be sanctioned by the stock exchange committee before being listed on the exchange. At the turn of the 20th century, these rules became more onerous. Also, just after the turn of the 20th century, the exchange strengthened the requirement for the separation of jobbing and broking functions which became an important focus of attention at the time of Big Bang in 1986.[[10]](#footnote-10)

A Royal Commission enquiry in 1877-78 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.”

In 1986, the stock exchange system of private rule-making was broken open. The separation of broking and dealing functions was ended as was the charging of fixed commissions. This was the process known as “big bang”. Big bang is often thought of as a process of deregulation. However, it would be more accurately described as a process whereby certain types of private regulation were prohibited and replaced by regulatory bodies accountable ultimately to the state.

It is not only securities markets that developed their own regulatory codes by which members had to abide. The Baltic Exchange provides another example. This was also established in a coffee house, in 1744. In 1823, to combat ‘wild gambling’, a committee was established to regulate admission and to develop trading rules. These rules evolved over time. The Baltic Code was developed in 1983 and revised in 2012. The motto of the exchange is ‘my word my bond’ and contracts were generally executed on trust without immediate exchange of signatures. The Baltic Code both requires and prohibits certain behaviours[[11]](#footnote-11). Members who flout the code can be expelled or suspended and approaches to mediation and dispute resolution are set out within the code.

***Professional bodies***

Another example of private regulatory institutions is the development of professional bodies.

Professional bodies tend to have a bad name amongst supporters of a free economy. They are often thought to promote restrictive practices and to seek monopolies. Such views have been reinforced by the work of authors such as Friedman[[12]](#footnote-12). However, it is clear that Friedman regards the problem of professions as arising from restrictions on entry to professions combined with a government preventing non-members of a professional body from practising. Of course, such government intervention might well arise from lobbying by a well-organised professional body, but such state-sanctioned restrictive practices should not be regarded as a reason to oppose professions as private regulators as such.

There is no reason in principle why a profession cannot control entry to ensure integrity and competence amongst a defined group of practitioners whilst non-professionals are also allowed to practice, albeit without the ‘badge of approval’ from the profession. In other words where the state does not control entry, professions in financial services can be thought of as part of the “spontaneous product of the market, which has evolved to meet the special problems [of] the financial services industry[[13]](#footnote-13)’. Professional bodies in finance evolved in the UK, but in other, less liberal, cultures they did not. One good example of this is the actuarial profession. Though it is small, from the 1850s onwards, it has been pre-eminent in providing stewardship of insurance and pension funds as well as pricing products and determining distributions of profits between different categories of policyholders in insurance funds.

With regard to the actuarial profession in the UK, though actuaries in the 19th century were split on the question of whether there should be a legal definition of an ‘actuary’ and whether there should be certain protected roles, there was no desire to protect the profession from competition. Indeed, until the 1980s, there was no significant state interference in or licensing of the profession at all. Contemporary reflections suggest that the absence of state regulation helped the profession to thrive and that such private systems of regulation were, in fact, more effective. For example, Nicoll (pp 169 and 170) writes[[14]](#footnote-14):

From what has preceded, it would seem as if there had not been much in the way of aid or protection accorded by the State to the actuarial profession in the performance of its duties. Our Free Trade Government has, however, been rightly - as it seems to us – very chary at all times of seeming to favour any particular society, or set of individuals, more especially if that favouring was at all likely to be at the expense of other members of the community. It is really very doubtful whether the policy of non-interference is not, in most circumstances, the best for a Government to pursue; and, as regards the Institute of Actuaries, it is very questionable if it would have been so vigorous, or so surely founded as it is at the present day if it had depended, at its inception, on assistance or support in any form from the State.

Comparisons are then made by Nicoll with the US market which was much more highly regulated by the state and in which such independent professions did not flourish, at least in this period.

Professionals are valued for their knowledge (which is certified by the professional body) and their judgement in situations in which decisions cannot be made on the basis of objective evidence. Such judgement should be provided from an unbiased standpoint because professionals owe an allegiance to their profession and its codes of conduct as well as to clients or the company for which they are working.

The accountancy profession is another example of a professional body which was important in financial markets. This also evolved in its modern form in the mid-nineteenth century. Its roles included certifying the books of public companies and auditing. The key requirements were for independence, judgement and expertise. Allegiance to a professional body which had the power to control entry could help ensure these. The accountancy profession was important in the UK and in the US. In the US it was not controlled by the state until the 1930s. Reporting and disclosure requirements for companies in the US came from the exchanges, not from the government. In fact, publicly quoted firms in the US did not have to be audited, though many were. By 1926, 90 per cent of companies quoted on the New York Stock Exchange had audited accounts and professional bodies of accountants with their own rules were responsible for auditing in many cases.[[15]](#footnote-15) The American Institute of Certified Public Accountants had codes of conduct for its members[[16]](#footnote-16) as would be expected by a professional body. However, it was carrying out roles that were not licensed and not regulated by the state.

In recent years, professions and their activities have been increasingly regulated by government bodies. They can no longer be regarded as independent regulating institutions that evolve in a competitive market place. Indeed, there is close to an international monopoly of accounting standards promoted by government. However, the history of professions demonstrates that they can be a product of the market order.

***Modern examples of market regulatory institutions in finance***

The club-like institutions described above are no longer the main regulators of activity in financial markets. As far as the main market of the London Stock Exchange is concerned, it is true that there are still special requirements in relation to listing and trading determined by the exchange. However, listing, trading and disclosure rules are so bound up with government regulation and EU directives that the regulatory role of the exchange is now residual.

Nevertheless, there are examples of private regulators that are still important in their own domain. For example, there are some exemptions from EU regulations relating to the trading and listing of securities. The Alternative Investment Market (AIM) has developed to take advantage of those exceptions. Shares are traded on that market, subject to the regulations set by AIM. Statutory regulation still applies in cases of market abuse but, otherwise, the market develops its rulebook independently of government.

AIM requires that companies must produce half-yearly reports and annual audited accounts. Where a company is located outside a jurisdiction that applies specific accounting standards, AIM still requires accounts to be produced according to recognised standards, but allows some discretion. There are also AIM regulations in relation to dealing in shares by directors and similar categories of employees together with other rules dealing with disclosure, conduct and trading[[17]](#footnote-17). The total market capitalisation of all the companies that trade on AIM is over £100bn. There are 14 companies the shares of which are traded on the exchange which have a market capitalisation of over £1bn.

Derivatives exchanges also develop their own regulatory environment. Even off-exchange dealing is regulated by a private regulatory body, the International Swaps and Derivatives Association (ISDA). 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”[[18]](#footnote-18). Members have to apply to join 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 $0.5quadrillion[[19]](#footnote-19). In addition, as part of its regulatory function, ISDA also has a dispute resolution procedure (thus circumventing the need to use 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.

Of course, private regulators exist in many areas of the economy outside finance. The example of sport has already been mentioned. Private regulators are becoming increasingly common in markets where new technology leads to the provision of services in new ways that transcend existing modes of provision that are regulated by the state. Perhaps the most topical private regulator is Uber. Uber is a platform. It regulates the drivers that use the platform and also has methods of regulating the behaviour of its customers. It is a dominant market player as a regulator in its own specific domain. However, it competes with government-regulated taxis, such as the black cabs regulated by Transport for London (TfL) and with other forms of private hire transport. Uber facilitates competition between drivers and breaks down information asymmetries within the market for private hire vehicles by promoting more effective regulation by reputation via the mutual rating of customers and drivers.

There are differences in approach between Uber and black cabs regulated by TfL. Uber uses a pricing system that ensures continuity of supply, but not a fixed price. On the other hand, various requirements are imposed on licensed black cabs (flat fares, knowledge requirements to obtain a licence) which benefit different types of customer. Customers can choose between the regulatory framework offered by licensed taxis and that offered by Uber or other platform operators. There is competition between regulatory frameworks and we should not assume that one framework is better for all consumers.

**Rethinking the market-failure model of regulation**

The general presumption in the economic literature is that state regulation is necessary to deal with what economists often describe as ‘market failure’. This conclusion is often derived from the neo-classical approach to economic reasoning in which it is thought that particular conditions have to hold to maximise welfare.[[20]](#footnote-20) Given that these conditions never can hold, it is generally assumed that an unregulated market fails to maximise welfare and intervention by government is necessary and desirable. Governments and government regulatory bureaus levy taxes or apply regulations to attempt to move the market towards its welfare maximising position.

The image of the ‘market failure’ model is one of the government regulator as a puller of levers designed to move the market towards its welfare-maximising position. There are two problems with this approach. The first is that we have much prior theory and evidence to suggest that government regulators cannot perfect an imperfect market and may not even improve upon its outcome. Secondly, it fails to consider the development of regulation within the market itself as is discussed above.

***Problems of government regulation***

The obvious critiques of government regulation would originate from the Austrian and public choice literatures. Firstly, in the same way that a central planner cannot know in advance how to produce and what to produce in order to maximise consumer welfare, we cannot know in advance what is the welfare maximising form of regulation. Will regulation be too burdensome and costly? Or will it not protect the consumer sufficiently or in the right way? Will the costs in terms of reduced competition and innovation outweigh the benefits? There is no effective way of communicating preferences or communicating the balance of costs and benefits of different forms of regulation and incentivising the regulatory bureau to provide the right amount of regulation in the right way. Indeed, some of the costs are unknowable.

In principle, at least, private regulators can compete and benefit from providing better regulation. A stock exchange would be able to charge higher fees to companies for listing their shares if the regulatory environment led to a lower cost of capital for the company. A taxi regulation platform which led to drivers being expelled from the system if they received one rating below the maximum number of stars would hugely raise the cost to consumers as drivers would be reluctant to use the platform without significant corresponding benefit. On the other hand, one which did not distinguish at all between consumer perceptions of the quality of drivers would be of no benefit to consumers and the platform would not be used. There are built-in incentives in a market for regulation to optimise.

A government regulatory body is not able to accumulate such information on its efficacy and cannot be assumed to improve upon the market outcome. As noted by Hayek: ‘If the factual requirements for ‘perfect’ competition are absent, it is not possible to make firms behave ‘as if’ it existed’[[21]](#footnote-21). If, for example, there were no information asymmetries in a market, the market outcome would be different from the one which arises when there are information asymmetries, but we do not know how different or in what respect it would be different. And we cannot simply require the provision of information to consumers and assume that the market failure is solved. The information is costly to provide, it needs interpretation and a regulator cannot know what information is relevant to a consumer’s decisions. The regulation itself might add to the difficulties faced by both consumers and firms when acting within markets and bring with it other problems. Indeed, it may add to the complexity of the whole process of buying a financial product thus worsening the problem.[[22]](#footnote-22)

Further problems of government regulation relate to its capture by those whose interests it is not supposed to serve. Regulation is intended to serve market participants and perhaps the general public. However, a statutory regulatory body is disciplined by a government formed as a result of quinquennial (or more frequent) elections that are fought on a range of issues and which is very remote from the management of individual regulatory bureaus. In other words, there is a huge principal-agent problem. Furthermore, regulation can be captured by firms who wish to raise the costs to rivals or it can be designed to fulfil the objectives of regulators or politicians[[23]](#footnote-23).

Unfortunately, whilst economic theory can tell us when a market will not give a theoretically perfect outcome, it cannot generally tell us whether the intervention of a state regulator will produce a better one. The market failure approach is simply an intellectual dead end or rabbit hole. The reasoning in the market failure model runs as follows: ‘a given set of assumptions is necessary to maximise welfare; these assumptions do not hold; therefore we should pull regulatory levers to improve welfare’. But, once we accept that the government regulator will not be able to maximise welfare either, there is nowhere left for this line of reasoning to go.

***Critiques of private regulation***

To argue that we cannot know if government regulation will improve upon market outcomes is not to say that there are no problems with private regulation. Indeed, there are a number of potential problems. The first is that it might not deal effectively with external social costs – that is, those costs not borne by the market participants or which are external to the system of parties who subscribe to the regulatory body. For example, if the costs of the failure of a bank have very wide ramifications, it could be argued that government regulation should be considered[[24]](#footnote-24).

It could also be argued that private forms of regulation give rise to concentrations of power. Interestingly, there is a discussion around the edges of this issue without it being related to the question of the institutional advantages and disadvantages of private versus government regulation in Akerlof (1970). In Akerlof’s paper introducing the possibility of ‘market failures’ caused by information asymmetries it was noted that private institutions might address the problem, but it was also noted that such institutions would not be atomistic. This is because such institutions have to govern standards across the whole market or a substantial sub-section of it so regulatory institutions are bound to be few in number in a given market. Interestingly, as has been noted above, it was competition concerns that led to the curbing of the regulatory powers of stock exchanges. Of course, government regulators are monopolistic by design. Private regulatory systems, on the other hand, will generally have competitive elements. They may also be contestable or, in an international context, there may be effective competition. Uber, for example, competes against other different forms of regulatory mechanism in the provision of taxi services and also has the threat of entry from other similar platforms. Indeed, it is Transport for London (TfL) has used its monopoly power as a statutory body to try to prevent regulatory competition between Uber and TfL-regulated taxis. In the case of securities’ markets, it is highly likely that the development of technology, combined with the removal of exchange controls seven years before ‘big bang’, would have led to international competition curbing the restrictive practices of the stock exchange. Indeed, exchanges do compete on an international basis.[[25]](#footnote-25) Off-exchange dealing was also possible before big bang whereas, after the enactment of the Financial Services Act, all those participating in securities markets were regulated by the monopoly regulator

A third problem with private regulation is that there might be problems such as information asymmetries that are so radical that their existence is not understood and so the value of market institutions to resolve them is not recognised by market participants. As a result, private regulatory institutions may not develop. Related to this may be the difficulty consumers have in determining the efficacy of private regulators[[26]](#footnote-26).

The final possible problem is that private regulatory institutions might lack powers of enforcement. Such limitations will generally arise from government law. For example, government law might prevent a profession or other organisation from expelling people on the ground that to do so would be regarded as a restraint of trade.[[27]](#footnote-27) This in itself is related to the perceived monopoly status of the regulatory body. Or there may be limits on the fines that can be levied on those who submit themselves to private regulation. Clearly, a private regulatory body could not imprison a market participant who broke the rules under most penal codes. This problem is not, of course, a market failure, but there may not be an obvious way to resolve this problem in most legal jurisdictions.

**A realistic approach to the economics of regulation**

If market failure analysis leads to a dead end, it is clearly not the right starting point for analysis.

The starting point should be a rejection of the idea that the market develops separately from regulatory institutions and that the latter need to be created to correct so-called failures in the former. Instead, we should regard the regulations that dictate how various parties to transactions operate as part of the set of services that can be provided by the market and which are produced by the entrepreneurial process.

Regulatory services can be provided directly by market participants and also by independent institutions, such as exchanges or professions. If regulation is understood as part of the package of services which is produced by the market process then the process of competition is necessary to discover the best form of regulation. It is not in doubt that the market can provide regulatory services as has been shown above. The open questions relate to the market’s efficacy in doing so. It is clear that regulation is not something that has to be ‘done’ to a market from outside.

Instead of market failure analysis, the right framework for the economic analysis of regulation should involve three steps.

Firstly, a comparative institutions analysis will help us understand whether market institutions or government institutions are likely to be most effective at maximising welfare in particular circumstances. At least it can help us define the relative advantages and disadvantages of private and government regulation in a particular context. In the market failure model, government regulation is always theoretically desirable because the market will never settle on a theoretical welfare-maximising position. Secondly, we can determine the legal environment most conducive to the evolution of regulatory institutions within the market. Thirdly, if government regulatory institutions are preferred, we can consider the policy environment in which they might best complement, rather than replace, evolved market institutions. In other words, we should consider the relative merits of alternative institutional approaches to the provision of regulation. This approach is not widely discussed in the literature[[28]](#footnote-28).

In terms of practical policy, the most obvious approach in financial markets is to make government regulation optional whilst requiring market participants to make very clear whether their products are regulated by the state. That would at least ensure that the possibility of private regulation was not closed off. If private regulatory institutions developed, the public can choose whether they want to obtain services from institutions that are also regulated by the state.

This approach of ‘regulatory competition’ between state and private regulators does work, but only at the margins. As has been noted above, AIM provides a regulatory environment for the trading of shares in smaller companies, many of which are not affected by EU directives on listing and trading. Secondly, in a different field, in London, consumers can choose between cab services provided by Uber, with its own approach to regulating quality, and state, TfL-regulated black cabs with a different approach to regulating both quality and price. The danger with this approach, it should be noted, is that the state regulator lobbies for the power of private regulators to be curbed.

Furthermore, the state should be very careful before restricting the activities of private regulators on competition grounds. At the very least, when considering such issues, the market should be defined widely and the case that a regulatory platform might be contestable should be considered. Uber, for example, may have a virtual monopoly in its product field, but it competes with taxis, private hire cars, buses, tubes and private cars. The state should also apply the same competition policy to its own regulators that it applies to market regulatory institutions.

The market failure model in which we think about regulation should be jettisoned. Instead, we should think in terms of a market process model by which we consider how the process of competition can deliver regulatory institutions. This approach should be borne out of a realistic view of the limitations of statutory regulators and a recognition that incentives exist within markets for participants to increase welfare by developing regulatory institutions. Like all other market structures, such institutions are subject to a process of trial and error – some will fail and some will last. But, impediments on the process of competition should be removed.

1. An extended and amended version of this paper will appear in Capie and Castañeda (Eds.): ‘Has regulation gone too far? And do banks really need all the extra capital?’. (Forthcoming, 2019, Edward Elgar). [↑](#footnote-ref-1)
2. See: <http://www.legislation.gov.uk/ukpga/1986/60/pdfs/ukpga_19860060_en.pdf> [↑](#footnote-ref-2)
3. Haldane (2012), *The dog and the Frisbee*, speech to Jackson Hole Economic Policy Symposium <https://www.bis.org/review/r120905a.pdf> [↑](#footnote-ref-3)
4. Though he did cite Hayek approvingly in the paper. [↑](#footnote-ref-4)
5. It should be noted that non-state regulatory institutions are not unique to finance. They were pervasive in British society from the 1850s until the Second World War. For example, regulatory institutions developed in every branch of sport. The Royal and Ancient started to codify the rules of golf in 1897. The Football Association started to codify the rules of soccer in 1863, but then regulatory competition developed between the Rugby Football Union in 1871 and the Rugby League in 1895. [↑](#footnote-ref-5)
6. See Macey J. (2013*), The Death of Corporate Reputation: How Integrity Has Been Destroyed on Wall Street,* Prentice Hall. [↑](#footnote-ref-6)
7. The analogy with Buchanan’s idea of a club good (see Buchanan J. (1965), An Economic Theory of Clubs, *Economica* 32(125), 1-14) is perhaps not exact. [↑](#footnote-ref-7)
8. See, for example, Kynaston D. (2012), *City of London – The History,* Vintage; Stringham E. (2015), *Private Governance: Creating Order in Economic and Social Life,* OUP; and Arthur T. and Booth P. M. (2010), *Does Britain Need a Financial Regulatory?*,Hobart Paper 169, Institute of Economic Affairs, London and the references contained therein. [↑](#footnote-ref-8)
9. See: Davis, L., Neal, L. and White, E. N. (2004) The development of the rules and regulations of the London Stock Exchange, 1801– 1914. Paper prepared for the Vanderbilt University seminar, 2004. [↑](#footnote-ref-9)
10. See *The Times*,1st February 1909, reproduced in Burns J. (1909), *Stock Exchange Investments in Theory and Practice,* Charles and Edwin Layton, London. [↑](#footnote-ref-10)
11. See: <https://www.balticexchange.com/dyn/_assets/_pdfs/documentation/baltic_code_nov14.pdf> [↑](#footnote-ref-11)
12. See, for example, Friedman (1962), *Capitalism and Freedom,* University of Chicago Press, especially chapter IX. [↑](#footnote-ref-12)
13. Booth P. M. (1997), The Political Economy of Regulation, *British Actuarial Journal,* 3(3), 675-707 page 697. [↑](#footnote-ref-13)
14. Nicoll, J. (1898). The relation of the actuarial profession to the state. Journal of the Institute of Actuaries, 34, 158-251. [↑](#footnote-ref-14)
15. See Zeff S. A. (2003), How the U.S. Accounting Profession Got Where It Is Today: Part I, *Accounting Horizons,* 17(3), 189-205. <http://www.ruf.rice.edu/~sazeff/PDF/Horizons,%20Part%20I%20(print).pdf> [↑](#footnote-ref-15)
16. Indeed, A. C. Ernst resigned from the Institute because of the rule book and never re-joined. His firm was later to become Ernst and Young *ibid.* [↑](#footnote-ref-16)
17. The rule book can be found here: <http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/aim-notices/aimrulesforcompaniesjan16.pdf> [↑](#footnote-ref-17)
18. See: <http://www2.isda.org/about-isda/mission-statement/> [↑](#footnote-ref-18)
19. See Bank for International Settlements statistics at: <http://www.bis.org/publ/otc_hy1705.htm> [↑](#footnote-ref-19)
20. For example, perfect information, the absence of externalities and so on. [↑](#footnote-ref-20)
21. Hayek F. A. (1979), *Law, Legislation and Liberty, Volume 3 The Political Order of a Free People,* Routledge, London, page 70. [↑](#footnote-ref-21)
22. The author examined the information provided with a unit trust product, the provision of much of which is encouraged by the regulator. During the purchase process of a very simple product, the customer was advised to read no fewer than nine documents. One of these was over 1,000 pages long and another about 500 pages long. These two documents had little information that was relevant to the particular fund. No attempt was made to be discriminating. Of course, this is not all required by regulation, but a risk averse provider, in the face of regulation designed to promote information provision will tend to provide more rather than less. In another example, it has been reported that the regulations implemented by the UK Financial Conduct Authority in respect of the EU Market in Financial Instruments Directive (II) run to 1,700,000 paragraphs. These regulations are designed to promote transparency. [↑](#footnote-ref-22)
23. See the literature on public choice economics. [↑](#footnote-ref-23)
24. Though, it may be preferable to ensure that we have bankruptcy procedures that are designed to reduce the spillover effects of failure. [↑](#footnote-ref-24)
25. Also, there were a number of different exchanges in the UK up to 1973. Furthermore, there was competition between different ways of providing capital to companies. [↑](#footnote-ref-25)
26. Of course, with private regulators, despite the argument above relating to market power, there can be comparison, discussion and scrutiny. [↑](#footnote-ref-26)
27. A particularly good example of this problem is the case between the Test and County Cricket Board (TCCB) and the players who joined Kerry Packer’s World Series Cricket (WSC) in 1977. The TCCB, as the regulator of the game, banned players from county and test cricket who joined WSC. The court accepted that the regulation of cricket was good thing, but that the action of the TCCB amounted to a restraint of trade and therefore was not valid. This was the case even though WSC provided an alternative way for players to gain a livelihood – there was regulatory competition. [↑](#footnote-ref-27)
28. There are analogies here with the work of Elinor Ostrom who won the Nobel Prize in 2009 who did ask some of these questions in relation to the institutional framework for managing environmental resources. [↑](#footnote-ref-28)