



I-1.11 Distinction between economic Regulation and financial Regulation

It is believed that the lexical distinction between two words necessarily involves the allusion to two different things. In this view, economic regulation differs from financial regulation. Based on what financial regulation is, which is not reduced to an addition of rules and regulations but is a set of mechanisms, institutions, decisions, principles and rules revolving around risk, competition law could be used as a means for financial regulation, although it is usually solely applied to ordinary markets of goods and services. But a new ambiguity has surfaced between financial regulation and economic regulation. Therefore, a wall between economic regulation and financial regulation cannot be built on the single difference between the “economic sector” such as the market of goods and services, and the “financial sector”. A more sophisticated partition could take into account the notion of « individual risk ».

By Marie-Anne Frison-Roche
Director of the Journal of Regulation

1. It is believed that the lexical distinction between two words necessarily involves the allusion to two different things. In this view, economic regulation differs from financial regulation.
2. But such distinction is far from obvious. Indeed, one may consider that financial markets belong to the broader category of economic markets, and therefore are compelled to the same legal framework as them, which includes competition law rules. According to Walras, such amalgam is the truest example that financial markets are no different than any another economic markets¹. Competition authorities also intend to bring back financial organizations and financial services providers under their scope, and call these market participants to order as to their mandatory compliance to competition law rules, in the name of « regulatory competition »².
3. In fact, the expression « regulatory competition » is nothing less than an oxymoron, since true competitive markets involve the free meeting of supply and demand, while regulation implies the maintenance of certain equilibriums in certain sector of the economy by the exogenous authority of a regulator. But as competition law integrated merger control, which is an *ex ante* act, it became closer to regulation, far from any liberalization enterprise. Moreover, the crisis occurrence appears to be another excuse to bring closer both regulations³.
4. Based on what financial regulation is, which is not reduced to an addition of rules

¹ Pour les conséquences en droit des contrats, v. BOUTHINON-DUMAS, Hugues, *Le droit des sociétés cotées et le marché boursier*, coll. « Droit et Economie », préf. Philippe DIDIER, 452 p., LGDJ, 2007.

² DAHAN, Thierry, « De la régulation Concurrentielle », *Revue Concurrences*, in *Concurrences*, n°3-2009 et n°4-2009.

³ JENNY, Frédéric, « La crise économique et financière, la régulation et la concurrence », in *Concurrences*, n°2-2009, pp.59-69.

and regulations but is a set of mechanisms, institutions, decisions, principles and rules revolving around risk⁴, competition law could be used as a means for financial regulation, although it is usually solely applied to ordinary markets of goods and services. For example, competition law can be used to preclude the capture of the financial regulator by financial organizations plotting together, or to avoid conflict of interests⁵.

5. This is why the British Prime Minister announced that the *Financial Services Authority* (FSA) was about to be dispossessed of certain of its powers, to be granted to the Central Bank, the Bank of England. The latter's new mission mainly consists of enhancing competition between banks, ever since it was observed that financial regulators had failed to prevent the crisis, if not broadly contributed to it with their lack of foresight⁶.
6. Furthermore, the Central Bank is expected to insure the protection of investors, a trend also perceptible in France in the creation of a common pole bringing together the French Prudential Control Authority and the French Financial Markets Authority⁷. The President of this regulatory authority expressly describes his mission as one of protection of « consumers », a choice of words meant to designate investors. Moreover, the US financial regulation reform that President Obama succeeded in having promulgated, is entitled the « **Wall Street reform and Consumer protection Act** »⁸, the word consumer designating non-expert investors. It is usually not left to financial regulation to uphold such objective of protection, as it is rather the main goal of economic regulation⁹.
7. It is not a given that the described American reasoning would be agreed with across oceans, and it is one of the many dangers of comparative law¹⁰. Indeed, most of US citizen have money invested on markets, either directly or indirectly, in part because of the US retirement regime. The same reading may not be done in France which hosts a contributory pension scheme. Therefore, protecting the investor in the United States means protecting the citizen and upraising a low level of information. In France, the outline of systemic risk is slightly different, and the analogy between finance and economy does not have the same shape or weight.

⁴ V. d'une façon générale FRISON-ROCHE, Marie-Anne, *Les 100 mots de la régulation*, coll. « Que Sais-Je ? », PUF, sous presse, et d'une façon particulière, les entrées « Risque », « Asymétrie d'information », « Autorité des marchés financiers », « Autorité de contrôle prudentiel », ainsi que les infra-références.

⁵ LASSERE, Bruno, « Editorial », in Rapport annuel de l'Autorité de la concurrence, La documentation française, 2010, pp. I-IV.

⁶ *Financial Times*, 17 juin 2010.

⁷ CULLIN, Marie, "Speech given by Christian Noyer, Governor of the 'Banque de France' (Central Bank of France) and President of the 'Autorité de Contrôle prudentiel' (French Prudential Control Authority), on April 30, 2010, on the occasion of the signature of an agreement between the 'Autorité des Marchés Financiers' (French Financial Markets Authority) and the 'Autorité de Contrôle prudentiel' to create a joint consumer information service", *The Journal of Regulation*, III-3.5, 2010

⁸ SEVE, Margot, « The Dodd-Frank Wall Street reform and Consumer protection Act: may an Act check all of Regulatory Law's boxes? », *The Journal of regulation*, coming soon.

⁹ Par exemple, en matière de régulation de communication électronique, TREPPOZ, Stéphane, *Le consommateur au cœur des modèles*, La Revue Trimestrielle de l'ARCEP, juin 2010, p.25.

¹⁰ CARBONNIER, Jean, *A beau mentir qui vient de loin, ou le mythe du législateur étranger*, in *Essais sur les lois*, 2^{ième} éd., Répertoire du notariat Defrénois, 1995, p.227-238.

8. More than that, a new ambiguity has surfaced between financial regulation and economic regulation. Indeed, finance was traditionally the natural vehicle for economic trades, since any trade demands that a certain amount of money be put in the middle of the process of two goods being exchanged. Further, to enhance the liquidity of economic systems, the mechanism of credit, amplified by the trust put in banks which led them to lend more than they possessed, allowed for the prosper expansion of ordinary markets. Therefore, finance was indisputably the vehicle necessary to economic trade, and consequently appeared as part and parcel of it. From this stand point, no autonomy between financial regulation and economic regulation is conceivable, and the former could be a subdivision of the latter.

9. But the days are gone when currency was solely a vehicle for trade transactions, as it lives out today autonomously, consequently to the “financial world” ’s own emancipation. The business of finance has indeed gained its autonomy as a result of its dematerialization, and because it functions without constraints of time, corporality nor frontiers. Simply put, it has reached a global dimension¹¹. Its characteristics make finance, evasive by nature, reluctant to regulation. Such phenomenon was perfectly described in 1985 by historian Fernand Braudel. More specifically, his “*Civilisation matérielle, économie et capitalisme* ¹² »’s three volumes describe how two separate routines coexist: one the hand, the traditional practice of commercial transactions, carrying out on competitive markets that calls for economic regulation (see. Vol. 2) ; on the other hand (see vol. 3), the purely capitalistic practices, which indeed achieved to differ from regular economic trades. The historian described this second phenomenon as the “Days of bankers”, craftsmen of an autonomous financial industry which has gone wild. The days of bankers are the days of oppression on those who are under, those who are tied to the real economy (mainly poor people) ; these are the days when the game of offer and demand is destroyed and entails the destruction of competitive markets. These are the days of overindulgence.

10. To some extent, these many excesses come from the fact that the financial industry is not structured by the competitive market and because economic regulation, which governs the latter (either to force a market built on public monopolies to drift towards free competition, or to attempt to achieve a balance between the way competitive markets operate, and a-competitive or anticompetitive goals, such as the goals of public service), is not here to help restraining such excesses. Moreover, classic economic literature (e.g. Schumpeter’s work) demonstrated that the efficient economic agent, the decent entrepreneur, is the one who takes risks, because he is motivated by the will to undertake and the belief that taking such risk will make him rich. Therefore, risk runs in competition’s blood and one may say that nothing is less dangerous than a cartel or a dominant position that one would be tempted to abuse. This is why, in

¹¹ FRISON-ROCHE, Marie-Anne, *Les 100 mots de la régulation*, préc., « Globalisation ».

¹²BRAUDEL, Fernand, « *Civilisation matérielle, économie et capitalisme* », Paris, Armand Colin, coll. Références, 1979. Tome 1 « Les structures du quotidien », Tome 2 « Les jeux de l’échange », Tome 3 « Le temps du monde ».

economics, the theory of contestable markets came to temper the systematic sanctioning of dominant positions.

11. Conversely, financial markets are built on a balance of risks and require investors willing to take them, whilst not being entrepreneurs since do not build anything *per se*. Ergo, these investors are nothing less than speculators, which is why the game theory is particularly fit for these markets. That in mind, financial regulation does not aim at limiting that amount of risk one is willing to take for himself, especially because in a liberal system each and everyone is free to take the risk to go bankrupt while hoping to end up golden. On the contrary, financial regulation has the task to reduce the collective risk that one individual's risky behavior may create for the entire system, a situation best described by the term 'systemic risk'¹³.
12. Therefore, financial regulation grows on risk and apprehends it as an item to be challenged, whereas economic regulation may grow on risk, but only to put it into balance with the principle of free competition (for example when it comes to network security or passengers transportation)¹⁴.
13. But more technically, difficulties arise when, due to the financialization of the economy, the financial industry starts creating financial instruments that are for the purchase or sale, or based on the value of goods that belong to a more classic market of goods. For example, risk transfer instruments such as energy or commodity swaps. In the United States, the energy sector's regulator (Commodities Futures Trading Commission - CFTC) attempted to regulate on the possibility left to financial organizations to speculate through over-the-counter trading in energy, since these risk transfer instruments entail releasing a potential systemic risk into the energy industry¹⁵. The main futures market operator¹⁶ contested the regulator's authority to do so, based on the reasoning that the regulator of the market of goods (or services) to which the financial instrument refers to does not have a legal mandate to regulate over-the-counter derivatives, which has indeed become, based on the Braudelian logic, independent from the real economy of markets of goods (or services). L'opérateur financier principal a contesté sa compétence pour le faire, estimant que le régulateur du sous-jacent n'a pas le pouvoir de réguler l'instrument financier devenu, selon le modèle Braudélien, autonome de celui-ci. Although the futures market operator rationale was followed by the Court, provisions of the Wall Street Reform (Dodd-Frank Act)

¹³ FRISON-ROCHE, Marie-Anne, « Régulation bancaire, régulation financière », in *Mélanges offerts à Paul Didier*, Paris, Economica, 2008, pp.173-187

¹⁴ FRISON-ROCHE, Marie-Anne, « Définition du droit de la régulation économique », D. 2004, chron., p.126-129

¹⁵ The proposed regulation was designed to prevent price fluctuations caused by speculation, which have an effect on the entire energy market by causing sharp rises and falls in commodity prices. Price fluctuations in consumer energy prices can sometimes have no basis in reality, and be caused only by unchecked speculation on the markets. This leads to a situation where consumer associations and energy firms have complained that high energy prices are partly due to speculation, which should be controlled in order to reduce consumer prices and lessen corporate and investor uncertainty. See Marie-Anne Frison-Roche, "The CME Group challenges the Commodity Futures Trading Commission's January 26, 2010 proposition to regulate speculation on energy futures, option contracts, and derivatives", *The Journal of Regulation*, II-5.1, 2010.

¹⁶ The CME Group (the principal American futures market operator)

recently passed into law empowers the CFTC to implement limits on speculation on energy futures and derivatives, as well as to impose a much stricter declaratory and supervision regime for over-the-counter trades in futures and derivatives in general¹⁷.

14. Further, should the single criteria of systemic risk be taken as the main criteria to single out financial regulation from economic regulation (the prior carrying systemic risk by nature, while the latter does not), the criteria seems already outdated. Indeed, in many sectors, certain market participants are qualitatively or quantitatively vital for the industry, up to the point to which their own failure could suffice, without any wave of panic, to bring down other participants along with it¹⁸. It is based on this reasoning that General Motors benefited from the same treatment by the State as the one provided for in the US Bank rescue program, even though such company does not belong to the financial industry.
15. Therefore, a wall between economic regulation and financial regulation cannot be built on the single difference between the “economic sector” such as the market of goods and services, and the “financial sector”. A more sophisticated partition could take into account the notion of « individual risk », i.e. a risk which could singly, should it come true, make the entire industry collapse, or at least whole sectors of the economy¹⁹. Most American current works on economics seem to put forward such reasoning under the notion, currently confined to banking and financial sectors, of “systemically important operator”²⁰.
16. This means that, on the one hand –whether on markets of goods and services or financial ones-, should a market participant behave or encounter difficulties which do not affect others, no systemic regulation would be needed. On the other hand - whether on the market of goods and services or on financial markets-, should certain market participants be designated as “crucial” or “systemic” (or “systematically important institutions”), they would encompass a particular type of regulation, mainly *ex ante*, in which the regulator would publish a list of all

¹⁷ Marie-Anne Frison-Roche, “Provision of the financial reform bill (Dodd Bill) currently being examined by the United States Congress would empower the Commodities Futures Trading Commission (CFTC) to impose speculative limits on energy futures positions”, *The Journal of Regulation*, II-5.3, 2010 ; See also SEVE, Margot, « The Dodd-Franck Wall Street reform and Consumer protection Act: may an Act check all of Regulatory Law’s boxes? », *The Journal of regulation*, coming soon.

¹⁸ For example, “insurers are considered systemically important for a variety of reasons: they might, for example, have a large lending arm, such as Aviva, or a complex financial engineering business, akin to that of Swiss Re”. Patrick Jenkins and Paul J Davies, “Thirty financial groups on systemic risk list”, *The Financial Times*, November 29th 2009.

¹⁹ International Monetary Fund Working Paper, Systemic Banking Crises: A New Database, *Luc Laeven and Fabian Valencia*, WP/08/224, available at <http://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf>

²⁰ Financial Stability Board, « Reducing the moral hazard posed by systemically important financial institutions, Interim report to G20 Leaders », June 18th 2010, available at http://www.financialstabilityboard.org/publications/r_100627b.pdf

identified market's systemic operators²¹. Such systemic regulation would also be more strict as to its *ex ante* supervision and audit programs, in order to prevent any *ex post* domino effect. Granted, resorting to a "systemically important operator" criteria means admitting that the financialization of the economy renders the intellectual distinction between economic regulation and financial regulation void. It is especially true when it comes to dealing with events such as crises, which hit both at the same time the economic world and the financial world, not so much in a ricochet manner, but rather in parallel. Crises remain a challenge for States as to their coordinated management and prevention.

²¹ According to the Financial Times, such data gathering has already "unofficially" begun, under the supervision of the Financial Stability Board. See Patrick Jenkins and Paul J Davies, "Thirty financial groups on systemic risk list", The Financial Times, November 29th 2009 : "Thirty global financial institutions make up a list that regulators are earmarking for cross-border supervision exercises, the Financial Times has learnt. The list includes six insurance companies – Axa, Aegon, Allianz, Aviva, Zurich and Swiss Re – which sit alongside 24 banks from the UK, continental Europe, North America and Japan. The list has been drawn up by regulators under the auspices of the Financial Stability Board, in an effort to pre-empt systemic risks from spreading around the world in any future financial crisis".