Securities exchanges can police market abuses if government provides them the needed tools.

Self-Regulation and Securities Markets

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Enron, Arthur Andersen, Tyco, ImClone, WorldCom, Adelphia — as American investors reel from accounting scandals and self-dealing by corporate insiders, the question of trust in the securities markets has taken on a new urgency. Securities markets cannot operate without trust. Markets known for fraud, insider trading, and manipulation risk a downward spiral as investors depart in search of safer investments. Today, many investors are rethinking the wisdom of entrusting their financial futures to the stock market. Absent trust in the integrity of the securities markets, individuals will hoard their money under the proverbial mattress.

Washington has responded to public outrage over corporate shenanigans by proposing a laundry list of new laws and regulations to crack down on corporate abuses. Some of the abuses, however, can be traced back to regulatory laxity. Until recently, Congress had more important uses for the taxes generated from securities transactions than policing the securities markets. An understaffed Securities and Exchange Commission long ago gave up periodic review of company filings because it had other priorities. Accounting fraud ranked low on the enforcement agenda, trailing the vendetta against insider traders and the pursuit of teenagers engaged in Internet stock scams. Justice Department prosecutors had no appetite for explaining complicated accounting transactions to jurors; bank robbery and drug trafficking afforded easier convictions. Only in the late 1990s did the SEC make financial reporting a priority. Once financials were put under the microscope, the agency claimed itself to be shocked to find that chief financial officers were playing fast and loose with the numbers. Once the SEC started looking at the books, the number of restatements skyrocketed and we had a "crisis" on our hands.

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Is more regulation the answer to failed regulation? In Washington, the answer usually is yes. So, questionable auditing of public companies is addressed by a raft of restrictions on auditors and a quasi-governmental entity to regulate auditors under SEC control. A lack of SEC oversight is answered by a mandate for periodic review of all public company filings by the SEC. The failure of prosecutors to pursue corporate malfeasance leads to new criminal sanctions for prosecutors to use (or continue to ignore). And, of course, Congress throws more money at the "crisis."

Some of the new reforms may help improve the quality of financial reporting. Others, such as longer prison terms for fraud, are election-year posturing and unlikely to add much additional deterrence. The changes have, however, added to the expense and risk of being a public company. Premiums for directors' and officers' insurance have gone up sharply, as have auditors' fees. Those expenses will be passed along to shareholders in the form of a diminished corporate bottom line. And shareholders can expect to pay again when companies are hit by a fresh wave of lawsuits that the new legislation encourages. Finally, by threatening foreign CEOs with jail time, Congress has handed London a great marketing weapon in its competition for listings with New York.

New financial markets Is more government the only answer to shaken investor confidence? Although Congress is unlikely to abandon big government anytime soon, self-regulation remains an option for many developing countries. As developing economies have emerged from the quagmire of socialism and protectionism, financial markets have arisen as well. Those countries must now choose their principal regulator: the government or the market. The stakes are high for the fledgling markets – countries that fail to establish regulatory structures that instill investor confidence may find stock trading

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migrates to countries that have done a better job at protecting investor interests.

Investors will be reluctant to invest and trade if they believe that the markets are stacked against them. Therefore, financial intermediaries seek to promote confidence in the integrity of public offerings and the fairness of trading markets. That economic incentive is a precondition to the establishment of fair and efficient markets, but it is far from being sufficient. There are many obstacles on the path to trust. To begin at the firm level, every brokerage house wants its customers to believe that it puts their interest first. A reputation for integrity is an essential marketing tool. But brokerage firms must act through their employees, and sometimes the interests of those agents may diverge from the interests of the firm. An external monitor may help control the agency costs. Moreover, the line between reasonable pursuit of profits and taking advantage of one's customer often will be unclear. Investors will have greater confidence if an independent entity draws that line. Finally, an individual brokerage house, acting alone, cannot control the integrity of the trading environment where it matches its customers' orders with the orders of other investors. Nor can it control the governance and management of the companies in which it places its investors' funds.

We need institutions with a broader reach to control those risks: the securities exchanges or the government. Exchanges can help create the trust that leads to deep and liquid securities markets by designing transparent trading mechanisms, vigilantly monitoring trading, and imposing demanding disclosure standards on companies. Government, too, has the authority to protect investors. With a few exceptions, both institutions are of sufficient scope to control the potential abuses that discourage investor participation in the securities markets. How should regulatory authority be allocated between securities exchanges and the state?

EXCHANGE OR GOVERNMENT REGULATION?

Do exchanges or the government have better incentives to regulate? My answer: Exchange participants' quest for trading volume is the best incentive for effective and efficient investor protection. Government actors, by contrast, will seek to avoid crisis and scandal, which will have very different implications for regulation and its costs.

Exchange incentives Exchanges live or die with trading volume. Broker-dealers make a substantial portion of their revenues from trading commissions; another chunk comes from trading for their own accounts. More trading by customers obviously means more commissions, but more liquid markets also enhance the profitability of broker-dealers' own trading. Exchanges attract trading volume by encouraging companies to list their shares and by encouraging investors to trade in those listed shares. Those two goals are largely consistent, as companies will want to list their shares on exchanges that provide the greatest liquidity because liquidity minimizes their cost of capital.

Economic theory and empirical evidence support the proposition that insider trading and market manipulation harm liquidity, and there is little evidence of any offsetting gain in pricing accuracy. The theory is relatively straightforward: Insider traders hold information advantages over outsiders. Those information asymmetries lead to trading profits — insiders buy low and sell high. To avoid the corresponding trading losses, outsiders would prefer to trade only with other outsiders. Securities markets are anonymous, however, so outsiders have no way of knowing when they are trading with an insider, but they do know that they will systematically lose when they do. Market makers who supply liquidity to the markets on an uninformed basis will increase their spreads to reflect the possibility of dealing with an insider. As a result, insider trading simply becomes a transaction cost of all trading. Uninformed shareholders will discount the amount that they are willing to pay for shares by their expected losses from trading with insiders; they may attempt to avoid losses from trading with insiders by trading less frequently. Less trading means less liquidity, and less liquid securities markets raise the cost of trading. Consequently, insider trading reduces the demand for trading services provided by the exchange. For that reason, exchanges have long imposed disclosure requirements on listed companies; disclosure reduces the information gap between insiders and outsiders. More recently, they have developed sophisticated computer surveillance systems that allow them to monitor trading to uncover abuse.

Securities fraud by companies has the same effect on trading volume — fraud will discourage investor participation if someone is aware of the deception and trades on the information. For example, corporate officers who manipulate accounting numbers while dumping their stockholdings are engaged in both fraud and insider trading, with predictable effects on liquidity. Market manipulation also creates information asymmetries. Attempts to manipulate share prices through the typical techniques of wash sales, matched orders, and "touting" are all inherently deceptive, and that deception creates an information asymmetry between its perpetrators and other investors. Consequently, exchanges will have an incentive to discourage both fraud and manipulation. Breaches of fiduciary duty by brokers have the same character: Brokers stepping in front of a customer's order can profit only by deceptively concealing their conduct from their customers. Brokers who provide credible certification that they do not cheat their customers that way will take business away from those who do not so certify.

Exchange incentives are less clear with regard to the other form of manipulation: attempts to "corner" the market. Craig Pirrong argues that attempts to corner a market may lead to increased trading volume, thus undermining exchange incentives to combat that form of manipulation. Exchanges' lack of incentive to regulate volume-increasing manipulation suggests a path toward locating the dividing line between exchange and government regulation.

Exchanges sometimes play a role as certifying intermediaries in requiring good governance from corporations that list on the exchange. The Enron debacle has brought further demands on American exchanges to play a role in certification. They have responded by requiring more independent boards and shareholder approval of options plans. But exchanges will have little incentive to regulate unless the regulation promotes trading volume. Exchanges may play an important role in setting disclosure standards for listing corporations and enforcing those standards because of the relation between the availability of information and liquidity. We cannot expect them, however, to play an important investor protection role in other corporate governance questions such as the enforcement of fiduciary duties. Investors need protection from executives like John Rigas (who treated the Adelphia corporate coffers as his own piggy bank), but self-dealing has only a tenuous connection to trading volume. Government regulation may be necessary to curb abuses of this type, particularly if longstanding practices must be overcome to bring companies into line with current best practices.

> Fraud discourages investor participation, with predictable effects on liquidity. Thus, exchanges have a strong incentive to discourage fraud and manipulation.

Government incentives Government is more ambivalent about trading volume. Policymakers recognize in the abstract that encouraging liquid securities markets will facilitate capital formation, and thus, economic growth. On the other hand, politicians and other policymakers also worry about "speculative excesses" in the trading markets. Fortunately, governmental concerns over excessive trading are likely to be suppressed during bull markets when investors' primary focus is counting their gains and chasing the next "sure thing."

Bear markets inevitably follow bull markets, however. Corporate mismanagement and corruption can be obscured by rising stock prices in a bull market, but the dirty laundry has a way of surfacing in bear markets. The bad news produces dissatisfied investors who clamor for government intervention. Politicians who happily ignored ever-climbing stock markets become profoundly interested in disclosure policy when the financial news migrates from the business page of the newspaper to the front page. The accounting scandal *du jour* provides an opportunity to fulminate, hold a series of show trials called "legislative hearings" to rake some greedy businessmen over the coals, and then enact legislation to protect investor confidence. The recent spectacle of politicians falling all over themselves to outdo each other in "getting tough on corporate crime" is only the latest chapter of political overreaction to the fallout of corruption revealed by a bear market.

That dynamic means that demands for financial market regulation will arise in times of crisis, particularly if that crisis spills over into the real economy. Crisis, however, does not create the ideal environment for developing balanced, cost-effective policy interventions. Politicians will want to "do something," even if the proposed "something" may prove to be ineffective or counterproductive. Responsible officials in government agencies will be called to the carpet by legislators looking to hold someone accountable for the market decline. Bureaucrats tend not to enjoy such encounters. Not being paid very well, they expect to at least lead quiet lives, which leads them to a strong preference for conservatism in regulation. From the bureaucrat's perspective, the optimal number of regulatory failures is zero. If a rule makes an incremental contribution to the avoidance of a future crisis, government regulators may be quick to see the rule's wisdom, discounting its costs. Those costs will be borne by investors generally, in the form of small reductions in their investment returns and disclosure documents that bury important information in a sea of minutia. Those costs are sufficiently diffuse that they are unlikely to generate a groundswell for regulatory reform. Thus, the cumulative effect of regulation in response to crisis is a ratchet effect pushing toward greater, more intrusive regulation. It may take multiple crises to push government regulations to the point where they become a serious drag on the financial markets, but having reached that point, it becomes very difficult to turn the ship of state toward less regulation. Interest groups that benefit from the regulatory apparatus will fight hard to preserve their prerogatives. Deregulation requires a mammoth (and unusual) mustering of political will.

Government impartiality? Government regulation also poses the risk that well-organized interest groups may exert undue influence over policymakers. Critics of self-regulation commonly complain that market participants may be lax in regulation because of the need to respond to competition. Compared to what? The forces demanding less stringent regulation from exchanges will demand the same from government. The forces of rent seeking do not recognize any boundary between the public and private spheres. Exchanges respond to the preferences of broker-dealers and executives of listing companies because they do not want to lose market share in listings and trading volume. Governments respond to those same groups because they are well organized, well financed, and have a strong interest in lobbying politicians. The only difference is that the rent seeking will be in the form of efforts to influence political decision-making as opposed to being mediated through the forces of competition. For example, corporations poured millions of dollars into the campaign war chests of strategically placed congressmen to head off the Financial Accounting Standards Board's efforts to require that options grants be accounted for as an expense. Congress then bullied the supposedly independent FASB into submission.

This investment in lobbying is not surprising. The crucial point is that government has little incentive to reconcile the conflict between corporate executives and brokers on the one hand, and investors on the other, in the most cost-effective manner. Identifying the competition for listings as a limit on the regulatory zeal of the exchanges tells us nothing about whether the government would do a better job. Allocating authority to government redirects rent-seeking energy into the public sphere, but it does not dissipate it.

The government's attitude toward insider trading and manipulation is also complicated. In addition to its effect on trading volume, insider trading raises moral issues that may have political resonance. Insider trading is "unfair" because it involves a corporate officer or an investment banker exploiting his position to make (occasionally enormous) secret profits at the expense of unwitting shareholders. Whether the moral outrage over insider trading is driven by a sense of equity or envy, it carries potent political appeal. Coming down hard on insider traders is an easy sell; most voters have no opportunity to engage in insider trading themselves. Once the campaign against insider trading has begun, regulators may lose sight of other priorities. In the United States, the 1980s saw important market players very publicly hauled off in handcuffs, accused of insider trading. The charges were later dropped against many of those arrested (this time without a media presence) for lack of evidence. That minor setback did not hold back the rise of the prosecutor responsible for those arrests, Rudolph Giulani, to political power. The SEC similarly benefited from the high profile attention it has received for its "war" on insider trading. The *in terrorem* effect of this governmental enthusiasm for pursuing insider traders is difficult to quantify, but it is surely non-trivial. If insiders are cowed by those efforts into selling their shares only when they believe that they are undervalued, firms will be forced to pay greater sums in stock-based compensation.

Lessons for others Those concerns about potential over-regulation may seem misplaced after a series of accounting scandals. Although this is a natural reaction to regulatory failure, countries just developing their regulatory regimes for their securities markets must worry that those regulatory choices may be path-dependent. The United States has the regulatory scheme it does because of political choices that were made in the wake of the market crash of October 1929. Franklin Delano Roosevelt campaigned for, and Congress adopted, the Exchange Act of 1934 to punish the New York Stock Exchange for its perceived role in "causing" the depression that followed. The choices made then have led the United States to the point where regulation by the exchanges is done largely at the behest of the SEC. We cannot know what an autonomous scheme of self-regulation would look like in the United States securities markets today because that possibility was extinguished in 1934. Government regulation is far too entrenched in the United States for self-regulation to be a likely alternative today. For developing markets, however, the choice remains open. A number of important securities markets, including Hong Kong, Singapore, and Australia, continue to allocate primary regulatory authority to their exchanges.

OBJECTIONS TO THE EXCHANGE AS REGULATOR

Exchange regulation provokes three principal objections:

- The exchanges can be subject to conflicts of interest.
- Some issuers can exert inappropriate influence on the exchanges.
- The exchanges can produce a cartel of regulated firms.

Those problems with exchange regulation, while manageable, have important implications for the scope of regulatory authority allocated to exchanges.

Conflicts of interest Broker-dealers are not homogenous. Broker-dealers segment themselves to appeal to different market sectors; some brokers cater to small investors while others specialize in institutional trading. Some brokers have a stronger presence in investment banking, with less emphasis on trading services. Those different business models lead to different perspectives on exchange governance, and could lead to differing views on the importance of regulation. For example, brokers that cater to retail investors are likely to favor vigorous enforcement of rules reducing information asymmetries because their clients will benefit the most. Brokers with institutional clients, by contrast, may tolerate informational advantages in the securities markets if (as seems likely) their clients are the holders and beneficiaries of those advantages. How can those competing interests be reconciled?

The economic answer is that the constituency having the greater intensity of preference — backed by willingness to pay — should see its views prevail. That outcome maximizes the profits of the exchange membership as a whole. Although the outcome is straightforward as a matter of economic theory, it is no small thing to achieve as a matter of governance. If members of the exchange each have one vote, brokers representing small investors may outnumber brokers who deal with institutional investors, thereby allowing the preferences of small investors to prevail. That result can occur even if the institutional shareholders engage in more trading and contribute more to the overall profits of the exchange's membership.

Governance problems of that sort have driven the recent trend toward demutualization, first by the Stockholm Stock Exchange, and more recently by others, including NASDAQ in the United States. The NYSE proposed a transition to private ownership, but that move has stalled. Competition is driving the transition from mutual ownership to for-profit public corporations. The introduction of electronic trading systems threatens the future of more traditional trading systems. Established exchanges have found it difficult to update their own trading systems in response because the shift to alternative trading structures could destroy the livelihood of some exchange members. With governance determined by vote, brokers who are threatened can block changes even if they make economic sense.

The obvious solution is to buy off the opposition of brokers dependent upon the old trading system. The sticking point, however, is who should fund the buyout? The equally obvious answer is the brokerage firms (primarily those serving institutional clientele) that would benefit from the development of new trading systems. But that solution presents daunting collective-action problems. Who would be required to pay and how much? A public offering promises a large sum of money to grease that wheel.

In addition to providing the funding needed to buy out dislocated brokerages, shifting from a mutual ownership structure to a publicly held corporate structure promises to facilitate sensible decisions concerning changes in trading platforms and rules. A publicly held exchange controlled by professional managers will adopt the trading system that maximizes the demand for its trading services while minimizing its costs, thereby maximizing profits for its investors.

The happy implication for exchange regulation is that the trend toward public ownership should lead exchanges to adopt regulatory structures that maximize the demand for trading services at the least cost. Public owners will demand that exchanges regulate to the point where the last dollar spent brings in an added dollar in trading or listing fees, regardless of whose ox is gored by that regulation. The shift from mutual ownership to a publicly held, for-profit corporation makes the title "self-regulation" no longer apt. "Market regulation" might be a better description. Member firms would no longer be regulating themselves, but would be subjecting themselves to external regulation by an independent market. In some respects, that is simply a final step on the path of private regulation from informal regulation by member broker-dealers to the modern system delegating enforcement to professional staffs. Public ownership is the last step to a completely independent, but still market-based, regulatory structure. Exchanges with governance structures that provide independence from those being regulated have more credibility and can safely be given greater regulatory authority.

Pandering to issuers Exchanges require disclosure to encourage investors to trade. The quest for trading volume will be tempered, however, by the exchanges' need to compete for listings. That raises the concern that exchanges will be reluctant to require full disclosure and impose sanctions on companies and their officers for fear that they will discourage listings.

To be sure, exchanges will want to weigh the costs of disclosure against its benefits. They also will take care in sanctioning insider trading, fraud, and manipulation because baseless punishments will drive listings away. Exchanges will investigate thoroughly before bringing claims against a listing company and provide fair procedures to ensure that only the guilty are sanctioned. Honest companies (i.e., those that have adopted effective procedures to discourage their managers from insider trading and deceptive financial practices) can signal their executives' integrity by pre-committing the company and its agents to pay sanctions if they have engaged in abusive behavior. That signal, if credible, would reduce the companies' cost of capital. Exchanges that under-invest in deterring insider trading and manipulation will lose honest companies, leaving behind those companies most likely to take advantage of outside investors. Thus, accuracy in enforcement leads to a "race to the top" as exchanges that prosecute only genuine insider trading and manipulation will attract more listings.

The prediction that companies will seek exchanges with strong disclosure requirements and enforcement becomes less clear if we relax the assumption that corporate managers act as faithful agents for their shareholders. Presumably, managers who are willing to take advantage of their shareholders by engaging in insider trading and fraud are also willing to impose agency costs on their shareholders when making listing decisions.

degree of confidence in the listing decisions of managers of established companies. If managers obstruct the implementation of more stringent listing rules, exchange regulation will be undermined.

The ability of an exchange to impose more stringent requirements will turn on the credibility of its threat to de-list companies that refuse to comply with the new rules. The credibility of that threat will in turn be determined by the ability of de-listed companies to obtain a listing providing comparable liquidity elsewhere. For most developing countries, the primary competitive threat is that their companies may decide to list their securities in New York, Frankfurt, or London. The leading markets of the United States and Europe are anxious to get a share

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Companies making listing decisions can be divided into two primary classes: startup companies that are considering initial public offerings and deciding where to list their shares for the first time, and established companies that are already listed and have the option of switching exchanges. Agency costs are lower for a start-up company because the corporate managers making the listing decision usually own a substantial portion of the company's equity. In addition, they frequently are under the watchful eye of the venture capitalists, who also hold substantial equity. If the managers list on an exchange that under-enforces insider trading, manipulation, and fraud prohibitions, investors will discount the amount that they are willing to pay in the public offering. That discount will reflect the shares' lower value in the secondary trading markets resulting from expected trading losses. The discounting directly harms managers selling shares in the public offering. Because managers in that situation will internalize the costs of their decisions, we can have confidence in their initial listing decisions.

Managers of already listed companies are less likely to internalize the costs of their decisions because they generally hold a smaller portion of their companies' equity. Moreover, they may favor the interests of long-term shareholders over those of short-term shareholders (who value liquidity more highly). That concern is particularly acute in developing markets, which have a high percentage of companies dominated by controlling shareholders. As a result, managers of established companies may favor exchanges with lax enforcement. On the other hand, managers interested in trading profits paradoxically may prefer a market with more stringent enforcement. Greater enforcement produces more liquidity, which allows insider traders greater latitude to disguise their trades among the many liquidity trades. Whether the need for liquidity will dominate the fear of sanctions is uncertain. Thus, we cannot have the same

of the trading volume for the most successful companies in the developing world. But listing in New York or London, the most prestigious alternatives, would put companies from developing countries and their controlling shareholders under greater regulatory scrutiny than they are likely to face from even a more-intrusive domestic exchange. The alternative of listing on a less well-known exchange would send a clear signal to investors that the controlling shareholder was indifferent to the protection of minority shareholders, likely leading to a substantial decline in the company's share price. The primary victim of that decline would be the controlling shareholder. Thus, the alternatives to domestic listing will not put much competitive pressure on domestic exchanges to be lenient in its regulation. The greater concern for exchanges in the developing world has to be companies seeking greater enforcement from better-established securities markets, not less enforcement from laxer ones.

Restraints of trade A perennial concern with self-regulation is its potential use as a means for suppressing competition. Exchange self-regulation historically has been used to enforce cartel arrangements and punish cheating on those agreements, allowing exchange members to extract monopoly prices for trading services from investors.

While that history is a source of concern, government regulation of the securities markets is not the answer. The U.S. experience suggests that government regulation by a specialized securities agency is more likely to protect cartel arrangements than dismantle them. The SEC quietly tolerated the price-fixing arrangements of the NYSE for close to 50 years, acting to eliminate fixed commissions only under congressional pressure. By then, competitive forces had undermined the fixed commission system. If government intervention to prevent cartelization were desired, it would make more sense to leave antitrust scrutiny to the competition authorities. The antitrust agency, while lacking the industry expertise of the securities agency, is far less likely to succumb to industry capture.

In any event, the risk of cartelization has diminished substantially with internationalization. When markets were geographically distinct, cartelization was a viable strategy for the securities industry. Investors today, however, allocate their capital on a global basis. Markets that try to extract rents will lose listings to markets that trade freely. Competition is the most effective antidote to attempts to suppress competition.

THE GOVERNMENT AS AUDITOR OF EXCHANGE REGULATION

Governmental authority is necessary in some areas to enhance the effectiveness of exchange regulation. That intervention must be narrowly tailored, however, so that oversight does not become de facto control. Government control over exchanges could undermine their incentives to respond to market forces. Government intervention should be limited to providing exchanges with authority to regulate and auditing regulation by exchanges to provide investors with the information they need to evaluate the integrity of the markets in which they trade.

Lack of jurisdiction Exchange regulation is hampered by the exchanges' lack of jurisdiction over non-members and lack of criminal authority. Those holes in exchange authority reflect the limitations of private, rather than state, regulation. Private actors can regulate only those individuals and entities that consent to regulation, and even that regulatory authority may be limited by the state.

The absence of state authority creates two potential problems for exchange regulation. First, there may be individuals who engage in or facilitate misconduct such as insider trading or fraud, but who are beyond the exchange's enforcement power. Both investigation and enforcement may require authority over individuals who have not contracted with the exchange. Second, civil sanctions will not deter insider trading and manipulation, given the enormous profits available from those activities and the relatively low probability of detection. We need punitive sanctions to achieve adequate deterrence.

Limited jurisdiction Exchanges currently rely on two forms of authority to enforce their rules: listing agreements with corporate issuers and membership rules that apply to broker/dealers. In both cases, the power to regulate flows from contractual consent. The exchange's power to exclude from its facilities gives it the ability to regulate: Corporations can be de-listed if they refuse to comply with disclosure requirements and broker-dealers can have their trading privileges terminated if they manipulate trading. The power to exclude includes the lesser authority to suspend temporarily. That authority, however, misses a large part of the regulatory problem. Insider trading, for example, is typically engaged in by individual corporate officers and brokers, not the entities for which they work, which have their own incentives to discourage such abuses. Corporate officers are not parties to the listing agreement signed by the corporation, and individual brokers are unlikely to be members of the exchange. Effective regulation requires the power to fine those individuals, terminate their employment, and exclude them from positions of trust.

In the United States, legislation gives exchanges jurisdiction over persons associated with broker-dealers, along with the power to impose civil penalties on such persons. That solution could work equally well with listed corporations. There remains the problem of individuals unconnected to either listed corporations or broker-dealers who may engage in insider trading and manipulation, or assist those who do. One solution to that problem is a mandatory contract, administered by the broker-dealers, similar to the mandatory arbitration contracts that investors sign in the United States. Anyone who desires to trade using the facilities of the exchange would be required to agree to abide by exchange rules and subject themselves to exchange penalties for violating those rules. Statutory authority could provide the exchanges with the tools necessary for investigating violations, including the ability to interview individuals who might have information concerning potential violations.

Criminal authority The question of criminal sanctions is more complicated. It obviously is not politically feasible to delegate criminal authority to the exchange itself. More realistically, exchanges could be allowed to call upon the government for criminal enforcement of violations of exchange rules. Enlisting the state in the enforcement of private rules is not unusual. For example, governments regularly prosecute individuals for violations of property rights. Georgetown University allows me to use the computer that I am using to write this essay. If I give the computer to my nephew to use, I might find myself in the D.C. jail. Violation of the terms of private contracts can have criminal consequences. In the United States, insider trading is defined in large part by contractual understandings between private parties, but violation of those agreements leads to criminal penalties.

Criminal sanctions for violating exchange rules are a small step from those existing practices. The exchange would determine disclosure requirements and prohibitions on insider trading and manipulation, but the state would decide the appropriate criminal sanctions for violations of those rules and would enforce those sanctions through its ordinary criminal processes.

Transparency of exchange regulation Critics of self-regulation sometimes charge that exchanges avoid enforcing their own rules because it might create bad publicity. That criticism underestimates the ability of sophisticated institutional investors to evaluate the quality of regulation in different securities markets. Liquidity levels vary dramatically across different nations. Recent studies suggest that cross-national variations in investors' willingness to commit their funds depend in large measure on the quality of regulation in that market. There clearly is an international competition to attract investor capital, and effective regulation provides a competitive advantage. Moreover, it is unclear that government enforcement is any more transparent than exchange enforcement; government regulators also have an incentive to portray the markets within their jurisdiction as uncorrupted. Revelation of widespread problems could lead to adverse political consequences. Even if exchanges could suppress information about violations, it does not follow that government should displace exchange regulation.

Enhancing transparency through government oversight One step short of government regulation would be the U.S. regime, under which the SEC oversees exchanges' enforcement. Not only can the SEC sanction exchanges for non-compliance with their own rules or the securities laws, the agency also must approve any change in exchange rules and can change those rules itself if it is dissatisfied with them. In addition, the SEC issues numerous rules of its own affecting the exchanges and broker-dealers. Consequently, the exchanges have been all too willing to implement regulatory proposals at the behest of the SEC, resulting in a self-regulatory veneer covering a government regime. Exchanges subject to displacement by government regulation essentially regulate the way the government would. In the United States, industry participants perceive exchange regulators as an arm of the SEC. That is not regulatory competition.

Enhancing transparency through government auditing A less intrusive approach can produce transparency without displacing regulatory competition among the exchanges. Transparency can be achieved through periodic review and reporting by government regulators of trading processes, random screening of exchange investigations, and review of sanctions imposed by the exchange. Institutional investors, in particular, are likely to be avid consumers of such reports. The government would report, however, on the exchange's compliance with its own rules. Government regulation would certify that those rules were being enforced, not determine their content. Government verification can enhance the credibility of exchange regulation by ensuring that the exchange actually enforces the rules that it advertises to the investing public, protecting their interests. Regulation is a service like any other, and consumers who are informed about the quality of that service trade off cost and quality in the way that best serves their interests. Government would be limited to facilitating the market for regulation by providing the public good of information.

CONCLUSION

Securities markets cannot operate without trust. Investors can trust exchanges to regulate because of their powerful incentive to maximize trading volume. The many choices that investors have today remind exchanges that investor protection is a crucial part of their business. Investors will leave markets that fail to protect investors to find markets that will. Government regulation, by contrast, is unlikely to be as responsive to the needs of the securities markets and risks burdening investors with the cost of unnecessary regulation.

Notwithstanding the advantages of exchange, government must play a role even in a largely self-regulatory scheme. Government must provide exchanges with sufficient authority to regulate and provide criminal enforcement of exchange rules when necessary. In addition, government has an important role to play in auditing the exchanges to ensure that they enforce their rules as written. As President Ronald Reagan put it in another context: "Trust, but verify." Investors need to be able to verify the quality of self-regulation when allocating their capital among different markets. Armed with that information, investors can weigh for themselves the tradeoff between the cost and quality of regulation. Auditing, however, should not be allowed to slip into outright control. To exploit fully the advantages of exchange regulation, exchanges must have discretion over the content of their rules. If exchanges become government pawns, government priorities will dictate the form and content of exchange regulation.

If government provides exchanges with the necessary tools, financial markets can produce the regulation that encourages investor participation while retaining the powerful incentive provided by competition. As Adam Smith explained long ago, competition is the most powerful tool known for channeling man's baser instincts toward the social good. Securities regulation cannot afford to ignore that tool. R

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