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Governmental versus self-regulation of derivative markets: examining the U.S. and Brazilian experience

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Abstract

This paper contributes to the discussion on the choice between governmental regulation and self-regulation of derivative markets (i.e., by financial exchanges) by analyzing in a comparative manner these two alternative regulatory mechanisms and by focusing on regulatory, instead of market, failures. Four types of failures are discussed in the case of governmental regulation: (1) the costs to run regulation bureaus, collect information and monitor the markets, (2) the credibility of the proposed mechanism, (3) rent seeking behavior by constituencies directly or indirectly affected by the regulation, and (4) constraints on financial innovation. Regarding self-regulation, three failures are discussed: (1) lack of competition between exchanges and alternative suppliers of derivative contracts, (2) agency problems in the organizational structure of the exchange, and (3) nonsocially optimal provision of goods. To illustrate this analysis, we contrast the regulation of derivative markets in the U.S. and Brazil. The former is as an example of strong governmental regulation, whereas the latter is an example of how self-regulation can function without strong governmental support (and, sometimes, with governmental actions that apparently run against market efficiency). © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

What is the optimal balance between governmental regulation and self-regulation of derivative markets (i.e., by financial exchanges)? This has long been subject to an intense debate, being recently revisited due to several cases of bankruptcies involving derivative negotiation (e.g., Miller, 1996; Romano, 1996; Pirrong, 1997), popularly attributed to the lack of enough governmental regulation. The debate, however, has provided only limited answers to that question for two reasons. First, governmental regulation and self-regulation are rarely observed in a *comparative* manner, i.e., by evaluating the competencies and flaws of *both* mechanisms simultaneously. Proponents of governmental deregulation focus on the costs associated with government action, thus neglecting failures of self-regulation, while defendants of tight regulatory regimes tend to dismiss the costs of government regulation. Second, the justification for intervention has relied heavily on the existence of market failures, usually disregarding the *feasibility* of the proposed change (e.g., more governmental or self-regulation). The existence of market failures does not imply necessarily that a remedy can be successfully proposed and implemented.[1]

This paper contributes to this discussion by assessing the choice between governmental regulation and self-regulation in a comparative manner and by considering feasible solutions. To support our analysis, we contrast the regulation of derivative markets in the U.S. and Brazil. The former is as an example of strong governmental regulation, whereas the latter is an example of how self-regulation can function without strong governmental support (and, sometimes, with governmental actions that apparently run against market efficiency).[2] Despite its status as a developing country, Brazil has a large derivative market: its main financial exchange, The Commodity and Futures Exchange (BM&F), ranks among the top ten derivative exchanges in the world according to the number of contracts traded. Given that the U.S. case has been extensively discussed in the literature (e.g., Gemmil, 1983; Fischel, 1986; Pashigian, 1986; Edwards & Ma, 1992; Pirrong, 1995; Romano, 1996, 1997), we only provide some general comments about it, and leave a detailed analysis for the Brazilian case.

We owe our main theoretical underpinning to Ronald Coase. First, because he stressed that the analysis of economic organization (regulation being one specific mechanism) should be essentially comparative. In particular, even though the word "regulation" is usually understood as some form of governmental intervention, this is only one alternative way to regulate a market or industry: less understood is how organizations—in our case, financial exchanges—accomplish this task. Within this perspective, Coase (1988) wrote:

> All exchanges regulate in great deal the activities of those who trade in these markets (the times at which transactions can be made, what can be traded, the responsibilities of parties, the terms of settlement, etc.), and they provide machinery for the settlement of disputes and impose sanctions against those who infringe the rules of exchange. It is not without significance that these exchanges, often used by economists as examples of a perfect market and perfect competition, are markets in which transactions are highly regulated (and this quite apart from any governmental regulation that there may be) (Coase, 1988, p. 9).

Thus, although exchanges are usually treated as an example of an "ideal' market, they represent instead a rich example of an organizational effort to reduce costs in market