License to Deal: Mandatory Approval of Complex Financial Products

Saule T. Omarova, Cornell Law School

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Abstract:
In the wake of the recent crisis, policy-makers and academics continue to debate how to control and reduce systemic risk associated with financial innovation, complexity, and growing interconnectedness of global financial markets. This Article argues that an effective method of achieving that goal is to establish ex ante regulatory controls that target risk before it is introduced into the financial system. The Article offers the first comprehensive analysis of one particular method of such ex ante regulation – mandatory pre-market product approval – and its potential applicability to complex financial instruments, including derivatives, asset-backed securities, and other structured products.

The Article examines key features of three historical experiments with product approval regulation: licensing of pharmaceutical drugs by the U.S. Food and Drug Administration, the European Union's newly adopted Regulation on Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH), and a system of mandatory pre-approval of commodity futures contracts administered by the Commodity Futures Trading Commission from 1974 to 2000. Building on these examples, the Article discusses whether, and how, a similar regime can operate as a gatekeeping device that aims explicitly at reduction of systemic risk and strategic complexity in financial markets.

The core of the proposal advanced in this Article is the process for product approval, which would require financial institutions to make an affirmative showing that each complex financial product they intend to market meets three statutory tests: (1) an "economic purpose" test, which would place the burden of proving commercial utility of each proposed financial instrument on the financial institutions seeking approval; (2) an "institutional capacity" test, which would require a review of the applicant firm's ability to manage the risks and monitor the market dynamics of the proposed product effectively; and (3) a broad "systemic effects" test, which would require a finding that approval of the proposed product does not pose an unacceptable risk of increasing systemic vulnerability and otherwise does not raise significant public policy concerns. The proposed approach does not seek to prohibit any financial activities. It merely imposes the duty to provide information necessary for evaluating potential risks and benefits of a specific financial product on the party that has the best access to such information and the greatest incentives not to disclose it voluntarily. Acknowledging significant implementation challenges, the Article argues that mandatory product approval should be taken very seriously as a potentially effective method of advancing the public interest in the more robust systemic risk prevention, as well as enhancing the efficient operation of financial markets.