Market Regulation Preferences: Investor Influence?
Regulation Preference Paradigms of Financial Markets in the 21st century

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Abstract

The emergence of a powerful financial sector in recent years has been both a blessing and a curse in the eyes of many Americans. The analysis in this essay provides key insight into the relationship between preferences on market regulation and the financial markets, specifically following a time of turmoil. Furthermore, it analyzes the nature of citizen's regulation preferences to determine if they are cyclical in nature, or if increased regulation is an upward trend here to stay. Within the analysis, this paper also addresses the different preferences between those who are and are not involved in the stock market and what these presences reveal. Understanding these relationships is critical to understanding the future of policymaking and what is in store for the financial sector. This research utilizes the American National Election Studies data over a number of years in order to detect trends in preferences, and reveal substantial insight into the citizen's view on the U.S. financial sector

Keywords: market regulation, investment vehicle, de-regulation, free market, investor, non-investor.

1. Literature Review

Over the years there has been extensive studies regarding the financial markets. More specifically in the areas of regulation effectiveness, stock market collapses, and market efficiency. The research regarding regulation preferences is outdated, in the sense that it is not being consistently revisited to ensure accuracy in the rapidly changing pace of the world. Furthermore, scholars have dedicated a large amount of resources to researching financial collapses and their causes, but fail to tie these collapses into general investor preferences in the face of the changing financial landscape. There are a number of studies regarding market efficiency, but scholars fail to look at the picture as a whole. We have yet to research the changing regulation preferences of citizens in this dynamic landscape and what implications this might have on the market for future regulation. We have had substantial market collapse in recent years both in 2000 (Internet Bubble) and 2008 (Financial Collapse) but it remains unclear the influence each of these events have had on citizen's individual preferences. Furthermore, the effects these events have had on investor's remains unclear. As the main driver of policy change is the preferences of the people, more of a focus and understanding regarding these preferences is necessary.

For the majority of history, our financial markets have been regulated in some way or another. The goal regarding financial regulation is to stabilize the marketplace so that one institution or a single investor cannot destabilize it by their actions (Buss, 2015). Thus giving more confidence to investors because they know that no one institution can de stabilize the market. In the wake of the financial crisis of 2008, many have doubted the ability of regulators to actively stabilize the market in an effective way, which will improve the overall macroeconomic environment. In a post financial crisis world, politicians are having extensive discussions regarding new initiatives for regulation that will ensure a crisis like that will never occur again. In the face of this discussion, the banking and financial industry are arguing that these new increased measures could inhibit economic growth at a macro level, while imposing increased cost for specific institutions at a micro level (Gadinis, 2013). Regulation within the financial market is viewed differently between those involved in the market, and those on the outside (Romano, 1998).

Those involved are defined as any individual who invests in the stock market. In times of deregulation, markets tend to naturally create winners and losers while working at the most efficient possible level within the scope of capitalism (Clements, 2013). When the market is efficient, companies tend to produce higher profits, which in turn benefit the investors. Therefore, in times of deregulation, although a safety net is removed for the investor, they gets their fair share of benefits in return. For those on the outside, with no involvement in the market, they get no real clear benefit of deregulation in times of growth. But, they do get the negative effects of an economic slowdown due to faults within the deregulated free market system. The two groups essentially share the same downside in the face of deregulation but have completely different upside potential (Newman, 2015). Therefore, it only seems these two groups, investors and non-investors naturally have different preferences on the topic.

With the rapid creation and transformation in the banking industry of both investment vehicles and institutional roles, the Financial Collapse of 2008 greatly differs from any of those seen in previous years. A study done showed that the recent finical crisis had four major causes similar to previous crises (Caprio, 2014). These were substantial increases in asset prices before the crisis, episodes of credit booms, substantial expansion of marginal loans, and regulation that failed to keep up with the rapid developments in the financial market. Furthermore, this study showed that there were also four new aspects, not seen before, which played a role in causing this collapse. These include a widespread use of complex finical instruments opaque in nature, an increase in interconnectedness among finical markets, a substantial increase in the degree of leverage financial institutions took on, and the role of the household sector in this collapse. In the latter four, we see a huge shift in what we previously knew regarding these institutions (Caprio, 2015). In both the increase in complex financial instruments and a substantial increase in operating advantage, little to no risk aversion is shown. A study done from 1980 to 1997 investigated the impact bank regulation had on the probability a country experiences a systematic banking crisis. This study also took an in-depth look at rules restricting bank entry and regulation over banking activities market wide. They found that the fewer regulatory restrictions on banks, the less likely a finical crisis are to occur. By fewer regulatory restrictions, they mean both lower barriers to entry (to increase competition) and fewer restrictions on banking activities. This directly contrasts with the first study which showed that of the eight things which contributed to the collapse, three were in the control of the financial institutions. This leads us to believe a shift is taking place within the finical institutions.

On a micro level, a study, which analyzed 98 large banks across 20 countries, revealed some interesting information (Chan, n.d.). The two substantial revelations from the study show that banks within a less regulated system the market favored in 2006, but showed especially poor returns during the crisis, and banks within systems of stricter regulatory practices on capital requirements performed better during the crisis (Chan, n.d.). The initial revelation shows that a market in a deregulated state does indeed create winners and losers. The banks, which were favored in 2006 and did especially well, were the banks taking substantial risk, and when the market faced severe adversity, these banks were the ones which performed the worst in the aftermath. Furthermore, the latter shows us that the banks under strict capital regulation performed better when the financial crisis hit, but their growth was inhibited prior to this period compared to those in a less regulated market. Furthermore, in this micro level study of individual bank actions, there was a look into the impact that revenue diversity had on the stability of these institutions. This revealed that the large shift to nontraditional banking activities, which generate non-interest sourced income, substantially increased bank's risks and in turn reduced stability of the overall finical market. There is much speculation regarding the effect these nontraditional income-generating sources had on the finical collapse of 2008.

This information reveals that both on a micro and macro level, the paradigms of regulation remain true. De-regulation does indeed create winners and losers, and in bull markets, profits within a deregulated framework tend to be more substantial than those in a heavily regulated market. Furthermore, it is clear that when deregulated systems in bear markets struggle, they tend to struggle to an extreme degree. Additionally, the risk taken on during a bull market tends to contribute to the downfall in a bear market (Gioacchino, 2015). With this being said, deregulation creates instability in the financial markets in a multitude of ways. On the contrary, regulation increases stability, but has the potential to inhibit growth largely (Helbing, n.d.). Although it protects the greater market in times of economic turmoil, some question whether the tradeoff of stability over increased profits is worthy. The substantial change of financial institutions actions and their greater effect on the market is sure to affect the regulation preferences of individuals in a profound way.

Like noted above, the preferences of those are sure to be different between investors, and those who are not investors. Since much of the information shows the risky moves institutions took to increase their bottom line essentially lead to the destabilization of the market, those who are not investors must feel extremely different from investors regarding their view of the greater financial market (Yang, 2012). This difference is sure to be seen within their preferences, since these non-investors had no opportunity to reap the benefits of the risks being taken, but had to deal with the economic slowdown and tightening of labor market in the aftermath, among many other things.

The increased complexity noted here regarding financial institution's investment vehicles poses an interesting question for politicians. Within the government structure of the United States, individuals within their respective states and counties elect members to represent them in Washington. These politicians represent the constituents, and avidly work to create, pass or veto legislation, which models the preferences of the constituents. Historically this system has worked relatively well at creating legislation which represents the peoples voice and best interest. This shift in complexity regarding the role financial institutions play is complicating this situation process. These institutions have become so complex that average citizens, investors or not, have no clue what these institutions actually do to generate revenue. In most cases, they are so misunderstood that they don't even realize that they don't know. The clear problem this poses is that citizens express their preference for something that they don't actually understand. Because their knowledge of this topic is so misunderstood, often times what they prefer can be the worst thing for them. This issue poses a separate question though, and that is what role should politicians play in this situation? Politicians are much better versed in topics regarding legislation and their effects they will have. Although politicians are supposed to represent the voice of the people, what should they do if the people want something that is not good for them? Is it the politician's job to step in, and vote opposite of the voice of the people to protect them? This remains as a vital question.

This remains true of the last three substantial market declines that have occurred in the US. Black Monday in 1987, which is the largest market decline the US has experienced to this day, was believed to be caused by program trading. Program trading is rapid stock executions performed by computers based on external factors in the market such as price, trading volume, or a number of other factors regarding securities. Program trading caused financial institutions to automatically blindly sell stocks once they hit certain lows, which caused a free fall in the market as many program traders started executing these trades due to the fact that they had similar variable inputs within their algorithms. The Internet Bubble was a period between 1995-2001 when internet companies saw a rapid rise in stock market valuation that was a result of over valuation. The NASDAQ hit a price-to-earnings ratio of 200 during this time period, while it is widely considered to be unhealthy if a company's P/E ratio exceeds 35. Blame regarding the bubble falls partially on the financial institutions during this period due to their handling of all the initial public offerings taking place. These IPO's tended to benefit the banks in fees much more than anyone else involved. The most recent substantial market decline being the Financial Collapse of 2008 which has been discussed up to this point. Each of these stock market crashes falls within the framework regarding regulation established above, which is that they destabilized the market as a whole while the financial institutions tried to benefit their bottom line in the process, and ultimately caused major macro level tightening. How citizens view market regulation in the aftermath of these substantial events remains unclear.

2. Hypothesis

1. If an individual is invested in the stock market, they are more likely to prefer a free market with no regulation than those who are not invested in the stock market.
2. After a substantial market decline, those who are investors will see a higher increase in the percentage points of those preferring market regulations over the non-investors.
3. Preferences regarding market regulation are cyclical in nature.

3. Data Compilation

In order to test the foregoing hypothesis, data was gathered from the American National Election Studies survey across years 2000-2012. This data set is widely regarded as the premier source for national information on voter preferences, with its origin going back to 1948. The primary source for collection of this data is through in person interviewing, but other methods are used to ensure the upmost accuracy and representation. For all respondents which "Refused"or "Don't know"their responses were coded as missing within their respective variables.

For Hypothesis 1, the dependent variable is market *regulation* and the independent variable is *involvement in the stock market*. The market regulation variable was gathered using the question "Do we need a strong government to handle complex economic problems, or a free market without government involvement?"with answers coded as 1 (Yes we need a strong government to handle complex economic problems) and 2 (Free market without government involvement). The involvement in the stock market variable was gathered using the question "Do you or your spouse have any money invested in the stock market?"with answers coded as 1 (Yes) and 2 (No).
Hypothesis 2 includes the same data from Hypothesis 1, but introduces a new set of data from Standard and Poor's 500 stock market index (S&P 500). Stock market indexes in general track the performance of a number of companies and compile this together to create an index, which is used to reflect the performance of the market as a whole. For the S&P 500, the measurement used is the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. Hypothesis 2 used the data from Hypothesis 1 and compared it on a timeline to the S&P 500 performance during the respective points in time. The specific dates used from the S&P 500 index performance was the monthly closing price between the periods of January 1st, 1999 through January 1st, 2013. Using these two sets of data in conjunction shows the responses from the American National Election Study respondents and the performance of the stock market (Via the S&P 500 index) during the respective time periods.

For Hypothesis 3, the data set introduced in the first Hypothesis (American National Election Survey) and the second Hypothesis (S&P 500 Index) were both used. The data was analyzed from a different approach to provide insight into hypothesis 3.

4. Results

Cross tabulation was used to test Hypothesis 1, and this data was used in testing both Hypothesis 2 and 3. Each election study (2000, 2004, 2008, 2012) had its own independent cross tabulation ran with a total number of respondents reaching 11,109 between all 4.

2000:

Strong govt to handle complex prbls - Is R invested in stock market Cross tabulation					
			Is R/spouse invested in stock market		Total
			1. YES	5. NO	
Strong govt to handle complex prbls	1. NEED A STRONG GOV'T TO HANDLE COMPLEX	Count	478	436	928
		Is R/spouse invested in stock market	47.6%	55.9%	51.4%
	2. FREE MARKET CAN HANDLE WITHOUT GOV'T	Count	380	191	575
		Is R/spouse invested in stock market	37.8%	24.5%	31.8%
Total		Count	1004	780	1807
		Is R/spouse invested in stock market	100.0%	100.0%	100.0%

2004:

Limit Government: need strong govt for complex probs - Does R/spouse have any money invested in stock market Cross tabulation					
			Does R/spouse have any money invested in stock market		Total
			1. Yes	5. No	
Limit Government: need strong govt for complex probs	1. Need a strong gov't to handle complex economic problems	Count	331	343	683
		Does R or spouse have any money invested in stock market	59.0%	69.7%	64.1%
	2. Free market can handle without gov't involvement	Count	217	133	354
		Does R or spouse have any money invested in stock market	38.7%	27.0%	33.2%
Total		Count	561	492	1066
		Does R or spouse have any money invested in stock market	100.0%	100.0%	100.0%

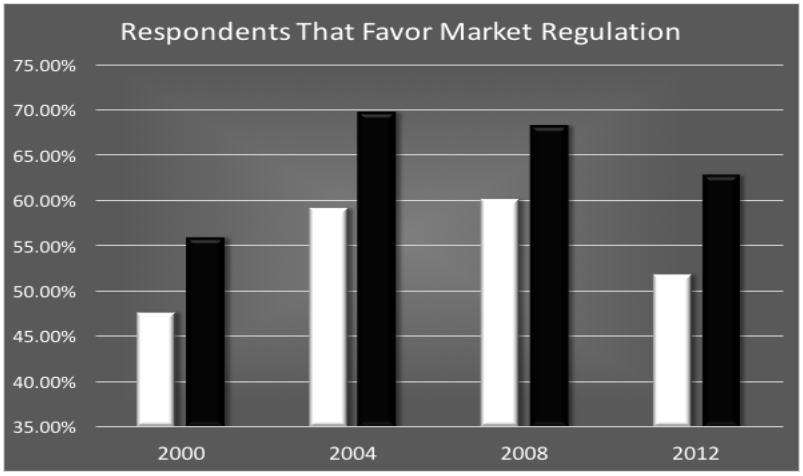
2008:

Need strong govt for complex problems OR free market - Does R or spouse have any money invested in stock market Cross tabulation					
			Does R/spouse have any money invested in stock market		Total
			1. Yes	5. No	
Need strong govt for complex problems OR free market	1. Need a strong gov't to handle complex economic problems	Count	500	1002	1514
		Does R or spouse have any money invested in stock market	60.0%	68.2%	65.2%
	2. Free market can handle without gov't involvement	Count	253	286	543
		Does R or spouse have any money invested in stock market	30.4%	19.5%	23.4%
Total		Count	833	1469	2322
		Does R or spouse have any money invested in stock market	100.0%	100.0%	100.0%

2012:

Need strong govt for complex problems OR free market - Has R ever invested in Stock Market Cross tabulation					
			Does R/spouse have any money invested in Stock Market		Total
			1. Yes	2. No	
Need strong govt for complex problems OR free market	1. Need a strong gov't to handle complex economic problems	Count	1231	2131	3438
		Does R or spouse have any money invested in stock market	51.8%	62.8%	58.1%
	2. Free market can handle without gov't involvement	Count	970	958	1976
		Does R or spouse have any money invested in stock market	40.8%	28.3%	33.4%
Total		Count	2375	3391	5914
		Does R or spouse have any money invested in stock market	100.0%	100.0%	100.0%

The results from this data reveal to us that Hypothesis 1 is correct. If an individual is invested in the stock market, it is more likely that they will prefer a free market than their counterpart which is not invested in the stock market. The spread, in most cases, between those invested and not invested were larger than 10% in their preferences regarding the same variable. On average (across all 4 studies), of those who favor free market with little to no government intervention, 36.93% were investors and 24.83% were non investors for an average spread of 12.1%. Of the respondents who favored regulation, 54.6% were investors and 64.15% were non investors for a spread of 9.55%. The data reveals that being an investor plays a large role in market regulation preferences, as predicted by Hypothesis 1.



After comparing the results from Hypothesis 1 to that of the S&P 500 performance, which is extremely revealing, Hypothesis 2 was proven incorrect. On the graph above the white bars represent the investors, and the black bars represent the non-investors. Recall Hypothesis 2, and note that it predicted that those invested would see a higher percentage point increase of those in favor of regulation after a substantial market decline compared with that of non-investors. This hypothesis was proven incorrect after analyzing the data. The numbers show that after market declines, investors are increasing the percentage who favor regulation, but at a smaller rate than non-investors. Between 2000 and 2004, following the "Internet Bubble "market crash, Investors saw an increase in regulation preferences of 11.4% points while non investors saw an increase of 13.8% points during this exact same time period. Interestingly following a market decline, investors are the ones who are primarily hurt both immediately and directly. While it can be assumed non investors will feel the impact, it would be indirectly and in most cases after a period of time. Supplemental to this data, the analyzation of regulation preferences between 2008 and 2012 shows the percentage levels preferring regulation decreasing lower and revealing insightful information. After the market stabilized following the financial collapse of 2008, the investor's preferences for a regulated market decreased almost double the percentage points of the non-investors, (8.2% decrease for investors, and 5.4% for non-investors, respectively). This data shows that the investors reverted to much lower regulation preference levels (higher percentage preference for a free market) following the aftermath of 2008. Considering the financial collapse of 2008 was widely caused by financial institutions and their respective insiders, it is surprising to see such a decrease in preference for market regulation. A study into the possible reasons why this shift in preferences occurred is offered later in this section.

Focusing on the data introduced above, Hypothesis 3 is correct. When looking at regulation preference levels and the S&P 500 index levels, a clear trend is revealed. As seen in the graph, the four vertical lines represent the point in time, which the survey was completed and are layered over the S&P 500 index performance. The data shows that in bull markets, individuals are much more likely to prefer free markets. Whereas in times of bear markets, or recently recovering from a bear market, individuals are more likely to prefer increased levels of market regulation. Preferences for market regulation saw a large spike in both 2004 (following the internet bubble) and 2008 (in the midst of the great financial collapse). After the market stabilized and started to recover, the 2012 regulation preference data shows levels reverting to a higher preference for a free market, similar to the levels seen in 2000. The time when the study was completed in 2000 was during one of the longest bull markets in history, so seeing the 2012 levels revert so quickly was both surprising and insightful into the cyclical nature proven from the data. Whether or not an upward trend is present in the cyclical nature of the data is not able to be concluded, as there is an insufficient amount of data.

As noted above in the results of Hypothesis 2, following the financial collapse of 2008, the study of 2012 preference levels showed investors decreasing their preference for a regulated market at a much more substantial rate than the non-investors. This is surprising for multiple reasons. First, the financial collapse was caused by a number of factors, many of them attributed to the actions of the financial institutions and insiders within the industry.

There are a number of publications that explain these actions in depth, so there is no need to explain them in depth here. It is necessary to note that the means by which the financial institutions played a role was extremely opaque and complex in nature. The initial thought after seeing the numbers posed in the results of Hypothesis 2 was that it is a possibility investors did not know what happened, or where blame should be shed. Economic contractions do happen, and often times are naturally occurring. To research further, using the same data set from 2012, two cross tabulations were conducted between *Involvement in the stock market* and *Wall St. to blame for poor economic conditions* and *Involvement in the stock market* and *Lenders to blame for poor economic conditions.* Involvement in the stock market was the independent variable for both the cross tabulations, with the other variables being dependent.

			Has R ever invested in Stock Market		Total
			1. Yes	2. No	
How much lenders to blame for poor economic conditions					
	1. A great deal	Count	916	1018	1974
		% within Has R ever invested in Stock Market	38.6%	30.0%	33.4%
	2. A lot	Count	847	979	1870
		% within Has R ever invested in Stock Market	35.7%	28.9%	31.6%
	3. A moderate amount	Count	411	809	1244
		% within Has R ever invested in Stock Market	17.3%	23.9%	21.0%
	4. A little	Count	158	389	564
		% within Has R ever invested in Stock Market	6.7%	11.5%	9.5%
	5. Not at all	Count	31	113	149
		% within Has R ever invested in Stock Market	1.3%	3.3%	2.5%
Total		Count	2375	3391	5914
		% within Has R ever invested in Stock Market	100.0%	100.0%	100.0%

The cross tabulation results show that those who are invested in the stock market are much more likely to attribute the blame of the poor economic environment to either Wall St. or the lenders. Both of these groups are financial institution insiders who took on significant risk in a relatively unregulated framework, which had dire consequences in 2008. These results are surprising considering that investors attribute blame to these financial institutions and insiders, yet, they tended to decrease their preferences for market regulation.

5. Conclusion

This data can reveal a number of conclusions, but what will be focused on here is the fundamental shift-taking place in the value of knowledge within the financial sphere. For years, profits derived from returns to customers and performance of financial instruments the customers understood. What has occurred in recent years is a shift towards knowledge being the underlying factor driving profits. For a financial institution, knowledge unique to them is just as advantageous as ensuring a lack of knowledge in a. In recent years, an increase in complex, opaque financial instruments have been introduced into the markets that are just as confusing as they are secretive. Examples of these instruments include synthetic collateralized debt obligations, credit default swaps, and tranches to name a few. Some of these instruments played a critical role in what devastated the global economy in 2008.

Average investors fail to comprehend a fair portion of what is offered by financial institutions, and this portion is growing. Even if a single investor worked to understand all that was offered, by the time they were done a whole new set of investment vehicles would be entering the market place. The nature of the dynamic environment, which is present today, is a large shift from what has been historically seen in the financial sector. These individuals who prefer lower regulation also primarily attribute the economy to the actions of the exact same financial institutions that they want to have less regulation on. This reveals the clear shift taking place. Average investors may not fully understand what is going on in the financial markets, and the role the predominant financial institutions play. Furthermore, these investors do not understand many of the investment vehicles they often times are involved in. This lack of understanding is what drives profit opportunities for the financial sector. A clear example of this is the Mortgage Backed Securities (MBS) being sold to investors in 2007, while at the same time these institutions were betting through Credit Default Swaps that those same MBS they sold to their client would decrease in value. Another example, which occurs more often than people know, is when an investor is placed into an instrument such as a Variable Annuity to invest their money for retirement.

What these investors do not know is that a Variable Annuity produces commission for the institution that is roughly 4 times larger than that of its similar counterparts (Yang, 2012).

This shift taking place is very dangerous for the average individual who is getting taken advantage of in the marketplace. The most devastating factor is the sheer lack of knowledge by the general public. The average outsider knows so little about what is actually going on that they prefer a de-regulated market once the market has recovered after a decline. These investors shift back to a preference for a free market even after the state of the free market causes a market failure, despite the fact that the average investor typically experiences a major portion of the negative effects of a failing market. This poses an issue in relation to public service, and the role our politicians play. Should politicians work to enact legislation representative of constituent's preferences, even if it is harmful to those constituents? Financial sector operations have purposely become so complex in nature that not only does the average investor fail to comprehend what is occurring, but they are so misinformed that they end up preferring the exact thing which allows themselves to be taken advantage of: A free market.

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