

Regulatory Contracts in Israeli Financial Markets

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This article suggests and develops a regulatory contracts approach to describe deals made between regulators and supervised companies regarding the terms of their regulation. These agreements represent a shift in state management from government to what is known as New Governance. A custom-made regulation is set via a dialogue between the parties, in three main layers: rule-setting, supervision and enforcement.

The article demonstrates the regulatory contracts approach in the Israeli financial sector – mainly in commercial banks and investment banks. The first case-study deals with enforcement arrangements in which regulators agree to refrain from action against defaulting financial bodies, in return for the financial bodies' commitment to cease the defaulting behavior, undertake organizational changes, including a shakeup of management, and pay heavy fines. The second case-study deals with agreements referring to the rule-setting stage of the regulatory process, struck between the Supervisor of the Capital Market and various Israeli commercial banks pending their entrance to the pension advisory market. In this framework each bank received a pension advisory license after having negotiated the conditions of future operation, quality of customer service, and the nature of compliance with various regulatory directions in the field.

The case-studies illustrate the characteristics of regulatory contracts in financial markets: consensus, custom-made regulation, a low level of formality, a low level of publicity and transparency, and quid pro quo. The article reviews these characteristics and goes on to identify the challenges these contracts raise as regards their legal, democratic and political legitimacy. The legal discussion focuses on questions from the field of administrative law dealing with the extent to which the contracts accord with the rule of law, the principle of administrative legality and the norm pyramid, the scope of regulatory judgment, and the contracts' enforceability level. The discussion of democratic legitimacy deals with the appropriate levels of transparency and publicity. This matter is also related to the contracts' problem of political-institutional legitimacy, manifest in the fear of foreign influences on the agreements, in the spirit of public choice theory. The article proposes some preliminary ideas for tackling the problems, including legal regulation, administrative structuring, the development of regulatory contracts law, and judicial review.