Securities Regulation in the International Environment

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Abstract

It is undisputed that the world's securities markets are becoming increasingly international and increasingly integrated. The internationalization of the world's securities markets is one of the most significant developments affecting the securities markets of many nations. "How should regulators respond?" is an issue that is hotly contested. The purpose of this thesis is not to introduce a new theory but rather to offer a comprehensive analysis of past and present practice, in order to identify what is effective and what is not.

There are three competing approaches to international securities regulation – harmonization, regulatory competition and cooperation. Thus the thesis analyzes these three leading current theoretical arguments in turn as paradigms for international securities regulation. On this basis, the paper will focus on these three approaches and address the fundamental questions posed by the internationalization of securities markets: which regulatory approach is the proper and best way to govern securities regulation in the new international market? Are there any areas which need to be improved? And therefore, how can international regulation be improved? The thesis will answer these questions in two ways: in theory and in practical application. With regard to theory, the thesis examines the definitions and arguments given to each approach. Harmonization is the idea that rules and regulations should be standardized across countries as much as possible. In contrast to the harmonization is the regulatory competition approach. Under this model, countries do not coordinate with one another – each country is free to enact whatever rules and regulations it chooses. Whereas, the third approach cooperation traditionally is an instrument to reduce conflicts and tensions. International cooperation is defined as conscious policy coordination among states. On a practical level, the thesis delineates the current stage of harmonization, regulatory competition and cooperation developments in the EU, US, as well as internationally.

It should be recognized that each of the three securities regulatory approaches analyzed in this thesis have contributed much towards international securities regulation. However, as discussed each approach has its problems, none is perfect. As long as there are regulations, there will be abuses and room for improvements. One of major problem in the international

arena is that there are no international law-making institutions vested with legal authority to address these issues. Instead of a formal international securities regulator there is a set of international institutions which include a limited number of countries which produce standards and norms that are then adopted by national authorities on a voluntary basis. Because of the diversity, complexity, and universality of issues likely to continue to arise over the next decade, a single international body should be considered to facilitate world cooperation in addressing these issues.

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List of Abbreviations

ADR	American Depositary Receipt
AIM	Alternative Investment Market
CBRC	China Banking Regulatory Commission
CESR	Committee of European Securities Regulators
CFTC	Commodities Futures Trading Commission
CPSS	Committee on Payment and Settlement Systems
CRD	Capital Requirements Directive
CSRC	China Securities Regulatory Commission
ECB	European Central Bank
ESCB	European System of Central Banks
EU	European Union
FASB	Financial Accounting Standards Board
FSA	Financial Services Authority
FSA 1986	Financial Services Act 1986
FSMA 2000	Financial Services and Markets Act 2000
FSAP	Financial Services Action Plan
FSAP	Financial Sector Assessment Program
GEM	Growth Enterprise Market
GAAP	Generally Accepted Accounting Principles
HKSE	Hong Kong Stock Exchange
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
ICMA	International Capital Market Association
ICSA	International Councils of Securities Associations
IDD	Insider Dealing Directive
IDS	International Disclosure Standards
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
ISD	Investment Service Directive

ISDA	International Swaps and Derivatives Association
ISITC	International Securities Association for Institutional Trade Communication
LSE	London Stock Exchange
MAD	Market Abuse Directive
MiFID	Markets in Financial Instruments Directive
MLATs	Mutual Legal Assistance Treaties
MOU	Memorandum of Understanding
NASDAQ	National Association of Securities Dealers Automated Quotations
NYSE	New York Stock Exchange
PCAOB	Public Company Accounting Oversight Board
PD	Prospectus Directive
RIE	Recognized Investment Exchange
SEC	Securities and Exchange Commission
SGX	Singapore Exchange
SESDAQ	Stock Exchange of Singapore Dealing and Automated Quotation Systems
SRO	Self-regulatory Organization
SSSs	Securities Settlement Systems

Introduction

Internationalization is a global phenomenon. Every area of life has been affected by it. Thus, it is not surprising that the securities markets have also undergone a metamorphism in this international environment. Since the 1980s, the internationalization of securities markets has accelerated its pace and broadened its scope as it has become easier to trade securities around the world. A new securities market has formed with parameters that are international. The internationalization trend of securities markets around the world has become a twentieth century phenomenon that is changing the face of world finance. It requires a rethinking of securities regulation because the world today is significantly different from that of decades ago. Importantly, it is not the international form of the markets that is novel; it is the regulation of that international marketplace that produces the difficulties. The internationalization of securities regulation is a direct response to the increasing inter-dependence of the world's securities markets. This is the situation in its simplistic form but the question still needs to be asked: what kind of international securities regulation is ideal and how can it be fulfilled? Discussion on the international aspects of securities regulations started after the Securities Exchange Commission (SEC) of United States issued its 1987 report on the internationalization of the securities markets. Since then more than twenty years have passed, many efforts have already been made to track and comprehend the dynamics of this rapidly emerging market and its wide-ranging implications. The process of internationalization in the new global market has been the focus of study by academics and practitioners since the beginning of the 1990s. Therefore, this is not a new subject. The purpose of this thesis is not to introduce a new theory but rather to offer a comprehensive analysis of past and present practice, in order to identify what is effective and what is not. On this basis, the thesis will address the fundamental questions posed by the internationalization of securities markets: which regulatory approach is the proper and best way to govern securities regulation in the new international market? Are there any areas which need to be improved? And therefore, how can international regulation are improved? These are the core questions which will be explored in this thesis. However, enforcement of international securities regulation in detail and accountability of regulators are not covered by this thesis.

Before touching on the core questions, the thesis begins with some analytical throat-clearing, by setting out what is meant by "securities market", "securities exchange", "securities regulation” and “securities regulator” in the introductory chapters. The starting point in understanding the main theme of this thesis is to define what they are. Chapter 1 will firstly consider the regulated entities, i.e. securities market and securities exchange as these are of considerable importance. A securities market and a securities exchange are concepts which are neither new nor very sophisticated. Both of them were known from very early times as the most important components of a capital market. The history and research of the securities market as well as the securities exchange is well documented. However, the study of them both has changed beyond recognition over the last century. During that period, the important role played by securities market has increased within the economy and many securities exchanges have transformed from not-for-profit member-owned organizations to for-profit shareholder-owned corporations.[1] Following chapter 1, chapter 2 will go on to explain the roles of securities regulation and securities regulator. Regulation as a social and political activity is universal, it is understood nowadays more specifically to refer to rules and procedures created by statute and administered by dedicated agencies.[2] Securities regulation as a discrete subject separated from company law during the 1930s. It can be loosely defined as being concerned with the way in which the marketing of all recognizable investment vehicles are regulated, either by the statute or administered by dedicated financial agencies established by statute. Securities regulation in order to function proficiently would logically need a regulator, but in many countries securities markets started to develop without the existence of a public regulator. Self-regulatory organisations (SROs), such as exchanges and industry associations, carried out the main regulatory function in the jurisdiction. It is now widely accepted that the existence of a public entity charged with the regulation and supervision of the market and market participants, is key to the healthy development of markets.

As has been noted, one of the most significant developments within the world’s securities market is internationalization; it has had an affect on the securities regulation of many nations. Today, it is almost commonplace for issuers of securities to seek financing beyond the borders of their home country, accessing overseas capital markets, conducting public offerings addressed to foreign investors and obtaining listings in one of the major exchanges around the world. Internationalization has opened the way for a new platform concerning

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[1] Pamela S. Hughes, ‘Background information on demutualization’ in Shamshad Akhtar (eds), *Demutualization of stock exchanges problems, solutions and case studies* (Manila, Asian Development Bank, 2002), 33.
[2] Iain G MacNeil, *An introduction to the law on financial investment* (Oxford, Hart Publishing, 2005), 20.

national and international regulation. International securities regulation has developed due to the growth of international portfolio investment. It is necessary to understand the causes and magnitude of this phenomenon in order to evaluate different regulatory responses. Chapter 3 attempts to do this. Firstly it will discuss all the details necessary in order for us to fully understand what internationalization actually is; particularly when it is applied to the securities markets, and also, we need to comprehend what influences internationalization has in the securities market. It will point out the main changes that have occurred in the securities market as well as the risks now involved because of this changing market. The main change has been from a national level to an international one. National regulators faced questions which were beyond the scope of national regulatory regimes. It draws attention to the importance of examining the interaction of participants within the regulatory system in order to understand its operation and the risks that are involved. The risks are credit risk, liquidity risk, position risk, operational risk, legal risk, and – resulting from these – systemic risk. These new or aggravated risks are often poorly understood by individual investors and perhaps also by professional investment managers. In a worst case scenario, the failure of major market participants (e.g., securities firms or banks) with heavy commitments in several countries could have grave detrimental results for national financial and payment systems and possibly for entire economies.

Now considering the core question: what kind of international securities regulation is ideal? The thesis will answer that question in two parts, theory and practical application. On the theory level, the thesis will examine the dominant ideas: harmonization, competition and cooperation. As different jurisdictions have divergent national securities regulation, issuers seeking to raise capital in a foreign market will be faced with the task of reconciling these differences. Depending on the degree of divergence between home and host country, reconciliation can become a costly and time-consuming exercise, thus constituting a significant barrier for issuers seeking cross-border financing. The quest to eliminate the reconciliation requirement has led to the development of two distinct approaches: harmonization and competition. The first approach is based on the notion of making the regulatory requirements or governmental policies of different jurisdictions identical, or at least more similar.[3] Harmonization is the process of reconciling two or more models in order to achieve greater similarity. In its absolute form, the harmonization approach pursues the goal of unifying the differences among various nations. A noticeable trend among securities regulators and practitioners is a movement towards and support of harmonization in securities regulation. It suggests that the harmonization of securities regulation would result in more efficient financial markets and improved investor protection. The competition approach is based on the premise that different regulators (whether nations, states, agencies, securities exchanges, or the like) compete to attract regulated subjects. This is different from harmonization which seeks to unify the regulation. Regulatory competition could yield a diversified set of regimes from which market players could pick and choose. Also the bulk of the academic literature considers regulatory diversity a component of international regulatory competition. The two approaches although distinct in nature and effects, have become largely interconnected. It is also true that the two approaches share similar concerns even as they adopt different mechanisms to address these concerns. Nonetheless, different approaches reflect not only different responses to similar problems, but also deliberate policy choices. Regulatory cooperation is another important reaction to the internationalization evolution. Whether the approach is harmonization or competition, enforcement of standards of fairness and honesty needs cooperation. As internationalization has accelerated, securities regulators are also experiencing a corresponding rise in securities fraud originating from abroad. It is now not uncommon that illegal activities occurring in the domestic market of one country, or multiple countries, are being controlled by persons resident in another country, often in a jurisdiction which affords protection to such persons through blocking statutes and bank secrecy laws. This has increased the incentives for domestic regulators to extend their reach abroad. Securities regulators recognize that their enforcement programm must include an international dimension. Responses to inquiries from foreign regulators should be made with dispatch. Establishment of agreements governing on-going exchanges of investigatory and regulatory information need to be encouraged. In response, efforts to formalize cooperation among regulators have redoubled, to the point where "international cooperation...is blossoming among the world's regulators".[4]

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[3] David W.Leebron, 'Lying Down with Procrustes: An Analysis of Harmonization Claims' in International and European Law Department (eds), *Harmonization in the European Union Part I: Capita selecta EU Law* (Katholieke Universiteit Nijmegen, 2001).

[4] David Zaring, 'International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations' (1998) 33 *Texas International Law Journal*, 281.

Chapters five, six and seven will focus on a practical level. The aim of these chapters is to delineate the current stage of developments in the EU, US, as well as internationally. These chapters will examine the harmonization, competition and cooperation efforts being made in order to improve international securities regulation. They will examine the extent to which all these methods have had individual achievement. The principal issues confronting national securities regulators are—disclosure, insider trading and other fraud, capital adequacy, clearing and settlement, and accounting — these are the same issues that must be dealt with by international securities regulators. Therefore harmonization, competition and cooperation will have to be based on the above issues under discussion. This part will focus on case studies.

The last question that needs to be asked is: how can we fulfil the ideal international securities regulation? We will identify several roadblocks on the way to the internationalization of securities regimes. One of major problems in the international arena, however, is that there are no international law-making institutions vested with legal authority to address these issues (aside from the European Union which is not open to the international community at large). Accordingly, the question of international securities regulation devolves into a ‘Hodge Podge’ of national or non-governmental regulations which are working fitfully, sporadically, and sometimes at cross-purposes on one of the most complex economic problems of our times. Nevertheless, the international community has not, to date, made a major commitment to developing a system of international securities regulation. Only the European Union has developed a comprehensive system of securities regulation that transcends national boundaries.

The final conclusion of the paper is that we need international securities regulation rather than regulation based on national regulatory systems. After examining all the methods that have been used, the conclusion is that there is no single method that is best for all situations. The appropriate regulatory response may well depend largely on the specific type of regulation with which we are concerned. The ideal international securities regulation is one that minimizes risks, protects investors and promotes internationalization of securities markets. Correspondingly, we need a strong international organization to take full responsibility for addressing these issues.

Chapter One: Securities Markets and Securities Exchanges

1.1 Introduction

Before we move into the main discussion we face the preliminary questions of what is a 'securities market' and what is a 'securities exchange'? Quite often the answer has been given that the securities market and the securities exchange are one and the same thing. Are securities market and securities exchange the same thing? Can the terms be used interchangeably? In many ways they are similar but they also have significant differences. One of them is that a securities exchange has dual roles. It is not only regulated entity but also a self-regulatory organization (SRO). The securities exchange could set rules and regulations to ensure that the securities market operates efficiently and fairly for all parties involved. The securities exchange also acts as a firm that market transaction services to facilitate trading and generate revenue from listing and other transaction fees. These characteristics make the securities exchange different from the securities market, and merit separate discussion.

1.2 The Characteristics of Securities Markets

Securities markets have grown considerably in developed and developing countries over the last century, but when people talk about the securities market, it is still not always immediately clear what they are referring to. Why do we have securities markets? Are securities markets merely burgeoning casinos where more and more players are coming to place bets? Do we need them? For many people the answers to all these questions are merely abstract ideas. This section will explore the answer in four parts; these are (1) the emergence and development of securities markets; (2) securities markets and economic development; (3) the typology of securities markets and (4) the functions and dealing systems of securities markets.

1.2.1 The Emergence and Development of Securities Markets

Today, there is no doubt that the emergence of securities markets are a pure macroeconomic phenomenon. The development of securities market is a complex process that is intimately connected to real economic activity.[1] Early observations by Gurley and Shaw[2] and Goldsmith[3] indicate that as economies develop, self-financed capital investment first gives way to bank intermediated debt finance and later to the emergence of equity markets as an additional instrument for raising external funds. In the early stages of economic development financial markets are very thin and very rudimentary. During these stages financial markets are dominated by banks, or similar types of financial intermediaries. Stock markets are completely absent or, if they exist in any form, their size is negligible.[4] As the economy grows, securities markets develop further. We can say that without economic development we would not have seen the development of securities markets. Indeed, a large body of empirical studies clearly shows that as economies develop securities markets tend to expand both in terms of the number of listed companies and in terms of market capitalization. For instance, Levine and Zervo sample 47 countries from 1976 to 1993 and find that securities market liquidity, measured as the value of stock traded relative to the size of the market and the size of the economy, is strongly and positively correlated to the rate of economic growth.[5] Blackburn et al. found capital accumulation can influence the development of equity markets because it can affect the degree of control that the lender has over these choices.[6] Securities markets appear to emerge and develop only when economies reach a reasonable size and the level of capital accumulation is high. This is a solid and uncontroversial result and it appears to be true across time and for many countries.

1.2.2 Securities Markets and Economic Development

It is true securities markets are born from economic growth and are associated with its development but conversely, securities markets developments also play a crucial role in economic growth and financial stability. Thus the robust relationship between the

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[1] Salvatore Capasso, ‘Stock Market Development and Economic Growth: A matter of information dynamics’ (2006) September, *Research Paper No. 2006/102*, available at: http://www.wider.unu.edu/publications/rps/rps2006/rp2006-102.pdf.

[2] Gurley, John G., and Edward S. Shaw, ‘Financial Aspects of Economic Development’ (1955) 45 *American Economic Review*, 515.

[3] Goldsmith, Raymond, W., *Financial Structure and Development* (New Haven, Conn.: Yale University Press, 1969).

[4] See Capasso, ‘Stock market development’, above, n.1.

[5] Ross Levine and Sara Zervos, ‘Stock market development and long-run growth’ (1996) 10 (2) *World Bank Economic Review*, 223.

[6] Blackburn, K., Bose, N., and Capasso, S., ‘Financial development, financing choice and economic growth’ (2005) 9 *Review of Development Economics (2)*,135.

development in the securities markets and the economic growth is not one way but it works both ways. There have been a number of studies supporting the proposition that as an 'engine' of general financial development, a well functioning securities market is conducive to sustained economic growth. Also the level of securities markets development does a good job of predicting future economic growth. Atje and Jovanic using cross-sectional regressions conclude that stock markets have long-run impacts on economic growth.[7] An important study by Ross Levine and Sara Zervos finds that the stock market development is highly significant statistically in forecasting future growth of per capita GDP. Their regressions forecast that if Mexico or Brazil were to obtain stock markets as advanced as Malaysia, then they might obtain an additional per capita GDP growth per year of 1.6%.[8] Harris shows within a cross-sectional framework that stock markets promote growth, although this occurs only for developed countries.[9] Rousseau and Wachtel analyze 47 economies and report that stock markets influence growth via value traded of shares.[10] Arestis *et al.* using time-series on five industrialized countries also indicate that stock markets play a role in growth.[11] Bekaert *et al.* go further to show the important part that equity market liberalization plays in boosting economic growth.[12]

In light of securities markets influence growth through a number of channels: liquidity, risk diversification, acquisition of information about firms, corporate governance and savings mobilization.[13] As shown by Levine and Bencivenga, Smith, and Starr, securities markets may affect economic activity through the creation of liquidity. Many profitable investments require a long-term commitment of capital but investors are often reluctant to relinquish control of their savings for long periods. Liquid equity markets make investment less risky and more attractive because they allow issuers to acquire much needed capital quickly, hence facilitating capital allocation and enhance prospects for long-term economic growth. At the same time, companies enjoy permanent access to capital raised through equity issues.

[7] Atje, R. and Jovanovic, B, 'Stock markets and development' (1993) 37 *European Economic Review*, 632.
[8] See Levine and Zervos, 'Long run growth', above, n. 5.
[9] Harris, R.D.F, 'Stock markets and development: A Reassessment' (1997) 41 *European Economic Review*,139.
[10] Rousseau, P.L. and P. Wachtel, 'Equity markets and growth: cross-country evidence on timing and outcomes 1980-1995' (2000) 24 *Journal of Banking and Finance*, 1933.
[11] Arestis,P., P.Demetriades and K. Luintel, 'Financial Development and Economic Growth: The Role of Stock Markets' (2001) 33 *Journal of Money, Credit and Banking*, 16.
[12] Bekaert,G., C.R. Harvey and C. Lundblad, 'Does financial liberalization spur growth?' (2004) 77 *Journal of Financial Economics*, 33.
[13] Charles K.D. Adjasi and Nicholas B. Biekpe, 'Stock market development and economic growth: the case of selected African countries' (2006) 18 *African Development Review*, 144.

Further, by making investment less risky and more profitable, stock market liquidity can also lead to more savings and investment. Risk diversification through internationally integrated stock markets is another vehicle through which stock markets can affect economic growth. Because high-return projects also tend to be comparatively risky, securities markets that facilitate risk diversification encourage a shift to higher-return projects.[14] Due to the availability of portfolio diversification, firms have the opportunity to specialize in production activities thus increasing firm efficiency.[15] Securities markets also spur growth through the regular provision of information about firms. The ease and timeliness of release of information affecting prices and profits of shares of listed firms enhances research and development which further boosts growth. Well-developed financial markets may encourage information gathering and processing. Large, liquid securities markets can stimulate the acquisition of information. Moreover, this improved information about firms should improve resource allocation substantially with corresponding implications for economic growth.[16] In terms of corporate governance, securities markets provide proper incentives for managers to make investment decisions that affect firm value over a longer time period than the managers' employment horizons through securities-based compensation schemes.[17] Greenwood and Smith also showed that securities markets lower the cost of mobilizing savings, facilitating investments into the most productive technologies.[18]

1.2.3 The Typology of Securities Markets

There are different types of markets where securities are issued and traded. This thesis will focus on the concepts which are discussed in the proceeding chapters.

The common securities markets include the primary market, where new issues are distributed to investors, and the secondary market, where existing securities are traded. The primary market is the market where the securities are sold for the first time and for new long term

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[14] Obstfeld, Maurice, 'Risk-Taking, Global Diversification, and Growth' (1994) 84 *American Economic Review*, 1310.

[15] Acemoglu,D and F.Zilibotti, 'Was Prometheus unbounded by chance? Risk diversification and growth' (1997) 105 *Journal of Political Economy*, 709.

[16] Ross Levine, 'Financial development and growth: views and agenda' (1997) *June Journal of Economic Literature*, 688.

[17] Dow, James and Gary Gorton, 'Stock market efficiency and economic efficiency: is there a connection?' (1997) 52 *Journal of Finance*, 1087.

[18] Greenwood, J. and B. Smith, 'Financial markets in development and the development of financial markets' (1996) 21 *Journal of Economic Dynamics and Control*, 145.

capital. It introduces new companies or government agencies to a market or raises capital for existing ones.[19] This is typically done through a syndicate of securities dealers. The process of selling new issues to investors is called a public offer. The offer may be underwritten by a syndicate of banks or investors, thus guaranteeing its success. In the case of a company's securities being listed for the first time, this sale is an initial public offering (IPO). In the secondary market, securities are sold by and transferred from one investor or speculator to another. In effect the secondary market provides a second-hand market, allowing investors a form of liquidity which would not be possible if they had to hold securities until they were redeemed.[20] Liquidity refers to the ease with which investors can buy or sell securities.[21]

Distinctions can be drawn by reference to the type of investors. If the investors are private individuals, it is called the retail market. Retail offers require more detail in respect of the information to be provided in the prospectus. If the investors are institutional, it is the wholesale market or professional markets. Wholesale offers require less detail to be disclosed in the document.The attraction of retail markets is that they provide liquidity and ensure some degree of investor protection.

Securities markets can also be divided into main markets and growth markets. Main markets refer to main securities exchanges where shares of listed companies are traded. London Stock Exchange (LSE), New York Stock Exchange (NYSE), Hong Kong Stock Exchange (HKSE), Singapore Exchange (SGX) and Euronext are the leading main markets in the world. Differing from main markets, growth markets focus on attracting younger and smaller companies with high growth potential. These companies would otherwise not qualify for the more stringent listing requirements of the main markets. The Alternative Investment Market (AIM), The National Association of Securities Dealers Automated Quotations (NASDAQ), The Growth Enterprise Market (GEM) and The Stock Exchange of Singapore Dealing and Automated Quotation Systems (SESDAQ) are outstanding examples of growth markets. Growth markets have, in the past, primarily appealed to locally based smaller and mid cap companies. However with increasing numbers of companies opting for dual listings or international listings, the tide may be turning. They are now increasingly attractive to international investors

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[19] Peter D. Spencer, *The structure and regulation of financial markets* (Oxford, 2000), 77.
[20] Ibid, 79.
[21] See generally M O'Hara, *Market Microstructure Theory* (Oxford, Blackwell, 1995).

as there are generally no different requirements between international and local companies. When compared with the main markets, qualifying growth markets often have less stringent admission criteria.

1.2.4 The Functions and Dealing Systems of Securities markets

Securities markets have four main functions. The first is to provide a mechanism for companies to sell securities in order to finance corporate expansion. The securities market is one of the most important sources for companies to raise money.[22] A Company that wishes to set up a new business or expand its existing business can raise the capital it requires by issuing shares to investors. This will move money from people who save to people who have productive investment opportunities.[23] Secondly, the securities markets provide a venue for the buying and selling of shares. It ensures transferability of securities which is the basis for the joint stock enterprise system.[24] The attraction of markets is that they provide liquidity. The liquidity available to investors does not inconvenience the enterprises that originally issued the securities to raise funds. The existence of the securities market makes it possible to satisfy simultaneously the needs of the enterprises for capital and of investors for liquidity. The liquidity the market confers and the yield promised or anticipated on securities encourages people to make additional savings out of current income. In the absence of the securities market the additional savings would have been consumed otherwise, thus the provision of securities market results in net savings. Thirdly, it encourages risk-taking by spreading risks and rewarding profitable investment.[25] Well-developed securities markets facilitate risk diversification and enhance the ability to avoid liquidity risk. It enables a person to allocate his savings among a number of investments. This helps him to diversify risks among many enterprises which increases the likelihood of long term overall gains.

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[22] In July 2008, the new listed companies raised the following capital through an initial public offer: LSE \$1499.8 million; Nasdaq \$636,9 million; NYSE Group \$61.3 million; HKSE \$920,9 million. This data shows that securities markets are one of the important ways in which companies can raise considerable new capital. The source of this data is the World Federation of Exchanges (at www.world-exchanges.org) last updated in August 2008.

[23] Veronika Dolar and Césaire Meh, 'Financial Structure and Economic Growth: A Non-Technical Survey' *Bank of Canada Working Paper 2002-24 September 2002* available at:
http://www.bankofcanada.ca/en/res/wp/2002/wp02-24.pdf. (last visited, October 2007).

[24] Shri G. N. Bajpai, 'Significance of securities market in the growth of an economy: An Indian Context' (2003) March 13, available at:
http://www.sebi.gov.in/chairmanspeech/chsp4.pdf (last visited, October 2007).

[25] Yuwa Wei, 'The Development of the securities market and regulation in China' (2005) 27 *Loyola of Los Angeles International and Comparative Law Review*, 47.

Finally, through transfers of corporate control, it allows managerial and governance failure to be corrected through its markets.[26] A well-functioning securities market encourages public companies to improve managerial efficiency and correct managerial failure in order to be admitted into a stock exchange and maintain their profiles.[27] This is because companies must comply with the listing rules of the stock exchange. Also, once there, the share price of a company reflects the managerial efficiency of the company. With a low share price a poorly managed company faces the threat of takeover. A takeover inevitably replaces the under-performing management team. Hence, takeovers contribute to the governance process in two ways: (1) the possibility of a takeover encourages management to act in the interests of the shareholders or the corporation as a whole;[28] and (2) most likely, a takeover would seek to remedy the problems caused by unsuccessful incumbent management by replacing it.[29] For these reasons takeovers are argued to be an effective mechanism for corporate governance. Likewise, well-functioning securities markets allow managerial compensation to be attached to stock price performance which in turn helps to align the interest of managers with those of firm owners.

There are three dealing systems that have been adopted in the securities markets. One is the order-driven/auction market system in which buyers and sellers are directly matched together, usually via a computer system.[30] Most systems in Continental Europe have operated on this basis since the late 1980s. Another one is the quote-driven/dealer market system which is the traditional system used by Nasdaq. This system is based around buy/sell quotes made on a continuous basis by market-makers who trade as principals and provide liquidity

[26] Colin Mayer, 'Stock-markets, Financial Institutions, and Corporate Performance' in Nicholas Dimsdale & Martha Prevezer (eds) *Capital Markets and corporate governance* (Oxford University Press, 1994), 179; Paul Marsh, 'Market Assessment of Company Performance' in Nicholas Dimsdale & Martha Prevezer (eds) *Capital Markets and corporate governance* (Oxford University Press, 1994), 66, 67.

[27] Clyde E. Rankin, III, 'Unites States Corporate Governance: Implications for Foreign Issuers' in Dennis Campbell and Susan Woodley (eds) *Trends and developments in corporate governance* (kluwer Law International, 2003), 286, 291.

[28] Pauline O'Sullivan, 'Governance by Exit: An Analysis of the Market for Corporate Control' in Kevin Keasey, Steve Thompson and Mike Wright (eds) *Corporate governance: Economic and Financial Issues* (Oxford University Press, 1997), 122, 122-23.

[29] Ibid, 122-123.

[30] International Financial Services London, 'Securities dealing' available at: http://www.ifsl.org.uk/pdf_handler.cfm?file=CBS_Securities_Dealing_2003&CFID=831901&CFToken=61327085 (last visited, September 2007).

to the market.[31] The last one is a hybrid system. It has both order-driven and quote-driven characteristics.[32]

1.3 The Characteristics of Securities Exchanges

The analysis of this part has two main goals. The first goal is to answer the chapter question: are securities markets and securities exchanges the same thing? At the conclusion of this part it should now be possible to understand the difference between securities markets and securities exchanges. As discussed above, securities markets are not only physical but abstract. An exchange is an institution, organization, or association which hosts a market where stocks, bonds, options and futures, and commodities are traded. Securities exchanges may have different roles. If confused the two concepts may blur the functions of securities exchange as a regulator and a firm. The second goal is to track the history of securities exchanges. The Demutualization process from non-profit mutual or membership to for-profit shareholder-owned corporations is an important issue because it makes exchanges comparable and more integrated. This has resulted in increased competition among securities exchanges.

1.3.1 Defining a Securities Exchange

The hallmark of a securities exchange historically has been the centralization of trading on an exchange floor.[33] Normally an exchange may be defined as a place for organized trading of stocks or other financial instruments and the performance of ancillary services that are associated with stock exchanges.[34] But it ignores its strong business character: to pursue profits. There is now widespread recognition that exchanges are handling commodity business of buying and selling securities. As such, exchanges are increasingly opting to operate as a "firm" that seeks business for profit. Another unique thing worth paying attention to is that securities exchanges are both regulators and regulated entities: regulators insofar as they oversee the market they organize, and at the same time regulated to the extent

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[31] Iain G MacNeil, *An introduction to the law on financial investment* (Oxford, Hart Publishing, 2005), 288.
[32] See International Financial Services London, 'Securities dealing', above, n.30.
[33] Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 3rd edition (Aspen,1995), 604.
[34] Ruben Lee, *What is an exchange?* (Oxford University Press, 1998), 322-23.

that they are subject to the national control and supervision. A securities exchange is a firm, a regulator and a regulated entity, each of those different aspects are discussed below.

1.3.1.1 Securities Exchange as a Firm

This "firm view" of the securities exchange is shared by Mulherin. He stresses the definition of a financial exchange not as a market, as is usually done, but as a firm that creates a market in financial instruments and thus has the property of the price information produced.[35] Furthermore, a securities exchange can then be seen as a firm that produces a composite good which it can sell: listing services, trading services, settlement services and price-information services. The exchanges do not sell the financial instruments themselves but merely allow market participants to buy and sell the instruments. As in other business companies, expenses and income matter, management tends to focus on cutting the former and increasing the latter. The main expenses of securities exchanges are in maintaining and regulating the marketplace (most importantly for the electronic trading system and regulatory staff), while their income is derived from various sources. From one of the few analyses of the balance sheet of the European exchanges[36], it emerges that the revenues come from three major sources plus two minor sources: trading fees (both membership and trading fees) (27.8%); listing fees (both initial and yearly listing fees) (32%)[37]; information and price-dissemination fee (17.2%);settlement fees (16.1%), even if little by little exchanges are transferring this activity to specialized entities where exchanges are, in general, among the shareholders. Other revenues come from the developing and selling of proprietary software and information technology (19.5%).

Exchanges' business is different from that of firms engaged in other businesses. From an industrial organization point of view, the first thing that makes exchanges different from other firms is that, due to ownership structures, some of the customers may be the owners of

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[35] Mulherin H., Netter J. and Overdahl J., 'Prices are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective' (1991) *Journal of Law & Economics*, 591.

[36] Based on 1993-94 balance sheet of 11 European stock exchanges. Carmine Di Noia, 'Competition and Integration among Stock Exchanges in Europe: Network Effects, Implicit Mergers and Remote Access' (2001) 7 *European Financial Management*, 39

[37] Listing fees are generally of two kinds: original and continuing annual.

the firms as well**.** Secondly, it is important to note that the exchange produces a special "good" as a sort of public utility, even if the firm has a private nature. There is a public interest in the exchanges as a central element of the capital raising process. Exchanges are a locus of collision between the private and the public, often combining private membership or ownership with responsibilities that have public characteristics. They are important national assets that serve public and private interests.[38]

1.3.1.2 Securities Exchange as a Regulator

Comprehensive governmental regulation of securities markets is a twentieth-century phenomenon.[39] For most of its history, securities exchanges have been the primary regulators of securities markets. As regulators of the market they organize the securities exchange mandate which includes all elements of market regulation from making rules to monitoring and enforcement. I will look at all elements of market regulation in turn. Firstly, exchanges which grew from relatively informal beginnings found that they needed to impose rules on market participants. Exchange rules which are of regulatory concern may be generally grouped into two categories: (i) rules regulating market activities; (ii) rules governing listing of public companies. To maintain a high-quality marketplace, exchanges focus on establishing criteria that can determine how bargains could be struck and performed, what standards of financial responsibility brokers must meet and which securities they are going to admit. Thus, exchanges put in place a signaling function: a stock's being listed indicates to investors that the stock is worthy of investment.[40] Over time, exchanges developed their own rules and procedures. For instance, The New York Stock and Exchange Board from its inception operated a miniature legal system, with its own rules governing securities trading and its own mechanism for resolving trade-related disputes.[41] The exchange also offered to listed companies a "panoply of rules" to govern their activities.[42] Exchanges required listed companies to offer ongoing disclosures on their business activities, their investments, their obligations, and their future plans. Moreover, seeking to ensure investors that they are

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[38] See Securities Exchange Act of 1934, § 11A (a) (1) (A), 15. U.S.C. § 78k-I (a) (describing the securities markets as "an important national asset which must be preserved and strengthened").
[39] For more details see the following chapter: Securities Regulation and Securities Markets Regulator.
[40] See Jonathan R. Macey & Hideki Kanda, 'The Stock Exchange As a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges' (1990) 75 *Cornell Law Review*, 1007, 1009.
[41] Stuart Banner, 'The Origin of the New York Stock Exchange' (1998) 27 *Journal of Legal Studies*, 113, 132.
[42] Jonathan R. Macey & Maureen O'Hara, 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective' (1999) 28 *Journal of Legal Studies*, 17, 22.

protected against abuses of corporate power, securities exchanges even adopted corporate governance standards for their listed firms.[43] All market participants and affiliates, particularly the broker-dealers that trade on the market and the issuers of the traded shares, are subject to rules that securities exchanges enact particularly for their marketplace.

Secondly, apart from making rules the securities exchanges often undertake a policing role within their markets. Securities exchanges are empowered to monitor the participants' compliance with the regulatory regime. By doing so, securities exchanges perform an important role to provide for fair trading and accurate price discovery, both critical components in fostering investor confidence. For the case in which someone fails to abide by any of the rules, the securities exchanges are vested with numerous enforcement powers, from fining violators to permanently banning them from the marketplace.

In summary, many securities exchange rules in the era before governmental regulation were premised on the idea that to attract investors, the exchange had to provide elementary protections against defaults, forgeries, fraud, manipulation, and other avoidable risks.[44] Thus, securities exchange rules dealt with most of the broad categories of issues with which modern securities regulations are concerned.

1.3.1.3 Securities Exchange as a Regulated Entity

Because securities exchanges are an important element in the capital formation process they must be seen to be clean. Transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto.[45] Therefore like other financial institutions such as banks, insurance companies or investment funds, securities exchanges are regulated. In the U.S securities exchanges are regulated under the Securities Exchange Act of 1934.[46] The Exchange Act sought to ensure that securities exchanges were no longer run as "private clubs

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[43] Stavros Gadinis and Howell E. Jackson, 'Markets as regulators: A survey' (2007) 80 *Southern California Law Review*, 1247.

[44] See Paul Mahoney, 'The Exchange as Regulator' (1997) 83 *Virginia Law Review*, 1462.

[45] See 15 U.S.C. § 78b.

[46] Section 4 of the Exchange Act created the Securities and Exchange Commission ("SEC" or "the Commission") and gave it the authority to administer the 1933 and 1934 Acts and subsequent securities legislation.

to be conducted only in accordance with the interests of their members," but as public utilities or "public institutions which the public is invited to use for the purchase and sale of securities listed thereon."[47] In the U.K. exchanges are currently regulated under the Financial Services and Markets Act 2000 (FSMA 2000).[48] Under the regulation of the FSMA, a regulated exchange must be a 'recognized investment exchange' (RIE). To be recognized, an exchange must comply with the requirements set by the Act and regulation made by the Treasury under the Act.[49] Once recognized, an exchange operates without the controls imposed on authorized persons but the FSA can nevertheless veto rule changes and issue directions to an exchange. The FSA has the power to determine the manner in which they operate.

Today, regulation of financial exchanges is based on the idea that investors will only trade financial instruments in markets which work properly, which are not rife with fraud, which have accurate information about the price of the financial instruments readily available and in which trading, clearing and settlement procedures are efficient.[50] To achieve these, the regulators have to perform adequate oversight of exchanges in order to deal with: (i) the conflict of interest between owners of exchange and the business they offer, (ii) rules governing primary and secondary market trading, (iii) qualification, operative and ethical practices of market participants in particular brokers and dealers, (iv) investor protection, and (v) transparency of market transactions, etc. Under all circumstances, exchanges ought to operate on established criteria as defined in the securities law and the regulators to retain the authority to license an exchange or to revoke it if it fails to comply with the requirements.[51]

1.3.2 The Development of Securities Exchanges

1.3.2.1 The birth of securities exchanges

[47] United States House of Representatives, Committee (H.R.Rep) No. 73-1383 (1934).
[48] See Financial Services and Markets Act 2000, Section 3(2) of the Act makes it clear that the "financial system" includes "financial markets and exchanges".
[49] The FSMA 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, SI 2001/995.
[50] Caroline Bradley, 'Demutualization of financial exchanges: Business as usual?' (2001) 21 *Northwestern Journal of International Law and Business*, 657.
[51] Shamshad Akhtar, 'Demutualization of Asian Stock Exchanges—Critical Issues and Challenges' in Shamshad Akhtar (eds) *Demutualization of Stock Exchanges Problems, Solutions and Case Studies* (Manila, Asian Development Bank, 2002), 3.

Usually, most businesses are established by entrepreneurs who believe a promising market exists for their products and services, a demand they can profitably supply. However, no one set up a stock exchange and offered the service to people who wanted to trade. Instead, stock exchanges were established the opposite way: those who wanted to trade in stocks--brokers and dealers--looked for a place and system that guaranteed reliable and permanent trading.[52] As no such organized marketplace yet existed, they launched one--the birth of stock exchanges. At the original stage traders gathered in a small house, such as a coffee shop. They shouted orders across the crowded, noisy and frequently smoke filled room, every trader knowing every other trader and what they were good for.[53] The Amsterdam Stock Exchange, created in 1602, became the first official stock exchange when it began trading shares of the Dutch East India Company.[54] These were the first company shares ever issued to the public. Unlike many other businesses, securities exchanges were founded by their customers and thus were customer controlled from their very beginning. Their intention was not to attract traders--they were themselves the traders--but to have a convenient forum to trade securities (with the prospective benefit of commission fees when they acted for others, or direct profits when acting for their own account).

1.3.2.2 Securities Exchanges Demutualization

Traditional stock exchanges adopt a floor-based trading system that requires traders to be physically present on the floor of exchange. Value enhancement of the exchange was achieved by restricting access. However the most distinguishing feature of the traditional stock exchange structure is its member's cooperative or mutual model. Mutual businesses are businesses that are designed to be run by managers for the benefit of their members. Before 1993, stock exchanges operated in the form of non-profit mutual or membership organizations. They were founded and owned by brokers and dealers who managed their stock exchange like an exclusive club, with high barriers for new entrants and a regional or even national monopoly, comparable to a medieval guild. [55] Exchange profits were returned to broker and dealer members in the form of lower access fees or trading profits.

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[52] Andreas M. Fleckner, 'Stock exchanges at the crossroads' (2006) 74 *Fordham Law Review*, 2541.

[53] Ruben Lee, 'Changing market structures, demutualization and the future of securities trading' (2003) April 15, 5th Annual Brookings/IMF/World Bank Financial Markets and Development Conference, available at: http://www.oecd.org/dataoecd/5/15/18450470.pdf.

[54] Advanced Financial Network, 'Stock Exchanges' available at: http://www.advfn.com/StockExchanges.html (last visited, September 2007).

[55] See Fleckner, 'Stock exchanges at the crossroads' above, n.52.

In this traditional structure the assets of the exchange are controlled by the members who take decisions democratically, on a one-member-one-vote basis. The distinguishing feature of a mutually owned exchange is that the owners of the enterprise, its decision-makers and the direct users of its trading services usually are the same persons: the member firms.[56] It means that members of exchanges who provide brokerage services have three roles. (1) They are owners. Exchanges formalized their ownership structure by granting 'seats' to members—a seat entitled the owner to trade on the floor of the exchange (or 'sit' on the exchange) and each seat holder had an equal vote on the exchanges' affairs. (2) As it is a closely held entity, they are usually managers of the stock exchange as well. (3) The owners of the mutual enterprise are also its customers.[57] Owner/customers may share in the net gains of the enterprise in proportion to their ownership interest. Under the traditional model, exchanges earned revenues largely through membership fees and trading fees charged to members on each transaction. Ownership rights may not be freely tradable and terminate with cessation of membership. Mutuals seldom are able to raise capital from anyone other than members.

Starting in the early 1990s, securities exchanges around the world have been undergoing major organizational and operational changes due to the simultaneous convergence of a number of powerful developments. The most notable of these have been the pressures of competition, globalization and technological change. The traditional exchange governed by its members is seen to be unable to respond adequately to above pressures, because member decision making is slow and encumbered by the many, and often conflicting interests of the individual members. The question then arises: where should the securities exchanges go? Starting with the Stockholmsbörsen (Stockholm Stock Exchange) in 1993, securities exchanges worldwide transformed from member-owned companies into publicly held companies, a development known as demutualization. The Chicago Mercantile Exchange, which demutualized in November 2000, becoming Chicago Mercantile Exchange Inc., [58] identified five major objectives for its demutualization: a governance and managerial structure that could respond quickly to competition; a financial decision-making model based

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[56] Frank Donnan, 'Self-regulation and the Demutualisation of the Australian Stock Exchange' (1999) 10 *Australian Journal of Corporate Law*, 3.

[57] Jennifer Elliott, 'Demutualization of Securities Exchanges: A Regulatory Perspective' (2002) *International Monetary Fund Working Paper*.

[58] See Chicago Mercantile Exchange Press Release, 'CME Becomes a For-Profit Corporation' (November 13, 2000) available at http:// www.cme.com/news/00149corp.html.

on stockholder value; the possibility of pursuing new business strategies; unlocking members' equity values; and facilitating working with strategic partners.[59]

In the strictest sense, demutualization refers to the change in legal status of the exchange from a mutual association with one vote per member (and possibly consensus-based decision making), into a company limited by shares, with one vote per share (with majority-based decision making).[60] A demutualized exchange may take many forms each raising its own issues. Some exchanges have demutualized and become public companies listed on their own exchanges. Other exchanges have demutualized but have remained private corporations. Still others are subsidiaries of publicly traded holding companies.[61] The exchanges demutualization occurred as follows:

[59] See Chicago Mercantile Exchange, Inc., 'Amendment No. 5 to Form S-4 Registration Statement', 4 (Apr. 25, 2000) available at http://www.cme.com/news/cme_s4.pdf.
[60] See Akhtar, 'Critical Issues and Challenges', above, n.51.
[61] The Australian Stock Exchange is a public company listed on its own exchange. The London Stock Exchange is also a public company which listed on their own main market in July 2001.The Euronext and The Toronto Stock Exchange are presently private corporations. The Pacific Exchange in the United States converted its equity business into a wholly owned subsidiary of the exchange and the OM Stockholmsbörsen AB is a wholly owned subsidiary of a listed company.

Table 1-1 Exchanges Demutualization

Demutualized Exchanges	Year
Stockholm Stock Exchange	1993
Helsinki Stock Exchange	1995
Copenhagen Stock Exchange	1996
Amsterdam Stock Exchange	1997
Borsa Italiana	1997
Australian Stock Exchange	1998
Iceland Stock Exchange	1999
Simex	1999
Athens Stock Exchange	1999
Stock Exchange of Singapore	2000
Hong Kong Stock Exchange	2000
Toronto Stock Exchange	2000
London Stock Exchange	2000
Deutsche Börse	2001
Euronext	2001
The Nasdaq Stock Market	2001
Chicago Mercantile Exchange	2002
TSX Group	2002
New York Stock Exchange	2005

Demutualization alters the governance structure of the exchange although its operations and services may remain the same. The transformation of exchanges from mutual to demutualized structure involves two key features: the first is a change in the ownership structure. In a publicly traded stock exchange the members are no longer the sole owners of the exchange. In contrast, most for-profit enterprises are organized as corporations with share capital under which the owners of the company, its decision-makers and its principal customers may well be three separate groups.[62] The shareholders vest decision-making power for the company in a board of directors who are subject to election and removal by shareholders and this power is exercised on a day-to-day basis by the management of the corporation. Trading rights and ownership are separated; shareholders provide capital to the exchange and receive profits, but they need not conduct trading on the exchange. The second is a change in legal as well as organizational form. The legal structure for the demutualized exchange is based on considerations similar to that for any profit-making company including decisions on number of shareholders (partnership vs. corporation), voting procedures, limitation of liability (liability limited to equity invested vs. joint and several liability for all debts), accounting and reporting requirements (based on taxation laws and on partners/shareholders' access to information of the company) and distribution of dividends (re-investment needs vs. distribution to partners, taxation).

The result of demutualization is that the commercial nature of the exchange becomes more evident: maximizing profits becomes an explicit objective. The essence of demutualization is the separation of ownership from trading rights. In general, the demutualization of the exchanges has been observed to offer a wide range of advantages. It allows exchanges to abolish the members/traders' monopoly over intermediation and be responsive to the needs of its issuers (listed companies) and investors by allowing them direct and cost effective access to the exchange. The for-profit motive of exchanges allows it to generate the desired levels of investments, while offering appropriate returns to owners. Demutualization also lends itself to improved governance. The Toronto Stock Exchange said that being a "for-profit" business ... will help the organization to become more competitive, more entrepreneurial and more customer-focused.[63]

1.3.2.3 Conflict of Interests under Demutualized Securities Exchanges

In general, a degree of conflict of interest at the exchange level exists whether an exchange has a mutual or a demutualized structure. In the mutual exchange, the key challenge is how to balance the members' (who are owners) interest with that of the public interest of investors

[62] IOSCO Technical Committee, 'International Organization of Securities Commissions Discussion Paper on Stock Exchange Demutualization' December 2000, available at:
http://www.iosco.org/library/pubdocs/pdf/IOSCOPD112.pdf. (last visited, October 2007).
[63] Toronto Stock Exchange, 'Demutualization of the TSE' available at: http:// www.tse.com/tse_inc/demutual.html (last visited, October 2007).

and issuers; meanwhile the demutualized exchange has to balance its commercial objectives with those of protecting the public interest. However, many regulators and exchanges believe that conflicts of interest increase when exchanges convert to for-profit businesses.[64]

First, demutualization is perceived to create new conflicts of interest between the business operations of an exchange and its regulatory role.[65] The commercial role and objectives of an exchange may be contrasted with its regulatory and public interest role.[66] It can be argued that there would be conflicts of interests between shareholders and members in a demutualized exchange environment that would diminish the ability of exchanges to engage in effective self-regulation. These worries increase when securities exchanges become for-profit companies, which dramatically sharpen their focus on reducing expenses and enlarging income. Where exchanges need to maximize profits from attracting listings and trades, their rules may either benefit the managements of issuers, or encourage trading. If managements of issuers of securities have the power to decide where the issuer's securities should be listed (or re-listed) they may decide to list with the exchange with the rules that give them the most leeway.[67] Thus, rules that would benefit shareholders in the exchange might harm the interests of shareholders of other issuers listed on the exchange. Exchange rules that encourage speculative stock trading may benefit exchange members but reduce collective investor welfare. The maximization of profits for the benefit of the shareholders of the exchange may therefore be inconsistent with the interests of investors in issuers whose securities list on, or trade through, the exchange.

Second, with ownership separated from the customers, there is another new conflict within the exchanges: stockholders versus customers competing for the corporation's profits, with customers demanding low prices and stockholders the opposite. Securities exchanges will have to please both, because if they overly favour one, the other will be deterred and change to a competitor (by trading on another marketplace or investing in another company). To make things more complicated, the stock exchanges' customers themselves have conflicting interests: issuers want low listing fees; traders want low trading fees; some customers might

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[64] John W. Carson, 'Conflicts of Interest in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them?' *World Bank Policy Research Working Paper No. 3183,* 1 available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=636602.
[65] Ibid,4.
[66] See Donnan, 'Self-regulation and the demutualisation', above, n.56.
[67] Marcel Kahan, 'Some problems with stock exchange-based securities regulation' (1997) 83 *Virginia Law Review*,1509, 1511-1512.

want a floor (particularly those who work on it), while others might prefer an automated trading system. It is important to note, however, that these conflicts are not limited to publicly traded stock exchanges. Every company with owners different from its customers faces this challenge to the same extent. The reason that this conflict attracts attention in the case of publicly traded stock exchanges is only that, for stock exchanges, it is a new conflict.

Third, another completely new conflict presented by demutualization is that raised by the exchange listing on itself. When stock exchanges demutualize and go public, they have to make fundamental decision: where should the exchange's own shares be traded, i.e., on which market should the exchange itself be listed? The answer is obvious. Not surprisingly, all demutualized securities exchanges have listed their shares or that of their holding companies on their own markets, usually referred to as self-listing.[68] Examples of self-listing include Archipelago and Nasdaq (although before it became a stock exchange) as well as the Australian Stock Exchange, the Frankfurt Stock Exchange (Deutsche Börse), Euronext N.V., the London Stock Exchange, OMX Group and the Stock Exchange of Hong Kong (Hong Kong Exchanges and Clearing Limited).The self-listing of the public issue on its own exchange can pose issues of conflict of interest if listing standards and its oversight are compromised by the exchange concerned. If the exchange self-lists, can it function effectively as its own regulator? This is an even more fundamental conflict than those inherent in a self-regulatory organization. Does self-listing make the possible conflicts with overseeing competing entities or business associates that are also listed on the exchange worse? Recognizing this, most of the Asian exchanges have developed specific arrangements and memoranda of understanding for regulating and oversight of self-listing.[69] The common approach has been to lay down a credible approach and proper regulatory standards to avoid conflict of interest at exchange level in relation to its own prospective listing. The listing standards for exchanges have to be the same as for other listed companies and the listing fee for the exchange has to be determined and collected by the securities regulator.

[68] See IOSCO Technical Committee, 'Discussion Paper', above, n.62.
[69] See Akhtar, 'Critical Issues and Challenges', above, n.51.

Chapter Two: Securities Regulation and Securities Markets Regulators

2.1 Introduction

Because of the special characteristics and developments that have occurred within the securities markets as well as within the securities exchanges it has been necessary to regulate securities markets along with the security regulators. The securities markets have a very strong relationship with economic growth stressing the importance of government intervention and institutional arrangements. But this has not always been the case. It is interesting that in its early history the securities market was unregulated. It was not until the 1930s that modern securities regulation first started in the US. Securities regulation in order to function proficiently would logically need a regulator, but in many countries securities markets started to develop without the existence of a public regulator. Self-regulatory organisations (SROs), such as exchanges and industry associations, carried out the main regulatory function in the jurisdiction. It is now widely accepted that the existence of a public entity charged with the regulation and supervision of the market and market participants, is key to the healthy development of markets. Regardless of the institutional structure chosen, it is important that the responsibilities and functions of the regulator be clearly defined. The basic goal of this chapter is to emphasize the significance of the securities regulation and regulator for the success of the system.

2.2 What is securities regulation?

Although securities regulation has probably been around as long as securities have, it was for a long time not considered an independent subject till the 1930s. Before that time, to a large degree, securities regulation was attached to company law. Modern securities regulation in a systematic and sophisticated form first began in the US in 1933 with the passing of the Securities Act.[1] Since then, securities regulation has emerged from under the wing of company law. But is it necessary for it to be so? If securities regulation should stand alone, what is it and what are its objectives? All these questions need to be explored.

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[1] Ben Pettet, *Company Law* 2nd edition (Harlow, Pearson Education Limited, 2005).

This part will include four sections: (1) The history of securities regulation; (2) The relationship between company law and securities regulation; (3) The scope of securities regulation and (4) The objectives of securities regulation.

2.2.1 The History of Securities Regulation

Nowadays the securities market is subject to rigorous regulation, however initially the securities market was in essence unregulated. In some ways the securities market was left to its own devices-- in other words self-regulation was tolerated. But it did not last forever. After financial crisis and scandals occurred, government regulation was called for and introduced.

2.2.1.1 The Era of Self-regulation

What does “self-regulation” mean? On a purely etymological level, it suggests a process by which a person, organization, or group of persons establishes and enforces rules to govern its, or their own conduct without the need for regular outside intervention.[2] Dombalagian also stated that self-regulation was the “result of historical accident and political expediency”.[3] Self-regulation is intended to strike a balance between “the limitation and dangers of permitting the securities industry to regulate itself” and “the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale”.[4] Self-regulatory organizations (SROs) are non-governmental organizations, entrusted with quasi-governmental authority, to establish and enforce the federal securities laws. In the context of the IOSCO Principles ‘SRO’ is given a broad definition: any organization other than the statutory regulator that is responsible for regulation.[5] In the securities industries, the basic structure of self-regulation assumes that broker-dealers would be members of at least one SRO, that members would be fairly represented in the governance of SROs, and that SROs would undertake to enforce compliance with their rules by their members. In history, generally, the securities exchanges are SROs. The conceptual core of SROs is standard-

[2] Onnig H. Dombalagian, ‘Self and Self-Regulation: Resolving the SRO Identity Crisis’ (2007) 1 *Brooklyn Journal of Corporate, Financial & Commercial Law*, 317.
[3] Onnig H. Dombalagian, ‘Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System’ (2005) 39 *University of Richmond Law Review*, 4.
[4] S. Rep. No. 94-75, at 4 (1975), reprinted in 1975 U.S.C.C.A.N. 183.
[5] Ana Carvajal and Jennifer Elliott, ‘Strengths and Weaknesses in Securities Market Regulation: A Global Analysis’ (2007) *IMF Working Paper*.

setting. The SROs primary regulatory duties are rulemaking for and discipline of its membership. Essentially, self-regulation gives members of a self-regulatory organization license to set collectively the ground rules for carrying out their business, subject to public notice, comment and Commission approval.[6] No one said it better than the former chairman of the SEC, Justice William O. Douglas: "[Self-Regulation] is letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used." [7] Self-regulation is most effective when the self-regulatory organization has the power to set baseline standards of conduct or other standard terms of dealing for all persons involved in a particular line of business--e.g., lawyers, doctors, accountants, and other professionals. Failure to comply with the rules and regulations of the self-regulatory organization may result in a suspension, revocation, or other limitations on the right to exercise one's profession.

There are several advantages of self-regulation. One thing is that compared to the government, self-regulation organizations have more wisdom and superior knowledge of the regulated industry. If anyone can best understand and identify fraudulent and illegal behaviours, so the argument goes, it is the industry itself. Another acknowledged advantage of self-regulation is that self-regulatory organizations can rely on the industry's funds and are therefore better and more efficiently funded than a governmental agency.[8] Furthermore, rules enacted by the affected persons tend to be accepted and observed sooner than rules set by outsiders. [9] In addition, self-regulatory organizations may be better able to respond to misconduct that falls short of fraud.[10]

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[6] See Dombalagian, 'Demythologizing the stock exchange', above, n.3, 4.

[7] William O. Douglas, 'Democracy and Finance' (1941) 54 *Harvard Law Review*, 905.

[8] John C. Coffee, Jr. & Joel Seligman, *Securities Regulation: Cases and Materials* (University Casebook Series,2002).

[9] IOSCO Technical Committee, 'International Organization of Securities Commissions Discussion Paper on Stock Exchange Demutualization' (2000) December, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD112.pdf.

[10] See Coffee & Seligman, *Securities Regulation*, above, n.8.

2.2.1.2 The Era of Government Regulation

Needless to say, relying solely on self-regulation bears some risks, because self-regulators are not disinterested but instead biased by their industry affiliation. Unfortunately, in practice, the pattern of self-regulation is followed by crisis and scandals. For instance, the burst of the South Sea Bubble in the early 18th century caused the collapse of the entire financial market in the United Kingdom.[11] In the United States, the failure of the securities market added further devastation to the economic depression in the 1930s. In the main, most countries, including the U.S and UK, have now concluded that a heavy reliance on self-regulation is no longer appropriate in financial markets, but some have continued to recognize that it can be beneficial to allow for some degree of self-regulation within the system.[12] That is where government comes in, providing, or at least threatening, impartial control. Explaining the need for financial regulation, LSE Professor Charles Goodhart stated, “The goal of financial regulation is to influence the behaviour of intermediaries so that the policy objectives are achieved.”[13] Now securities markets are regulated in many countries. Although the U.S and UK were not the first country to regulate securities markets they did introduce a comprehensive framework of securities regulation before other countries. The government regulation had precedents in U.K. law and in U.S. state law. Currently most countries’ regulation of securities markets is adapted from the American and UK model. For this reason we will focus on the UK and U.S. system of regulation.

In the UK prior to the Financial Services Act 1986 (FSA 1986), the regulation stressed listing standards and the importance of self-regulation by market players and did not rely on a comprehensive securities act. The self-regulation approach, historically, is a distinctive feature of financial services regulation in the UK. Although before 1986 there were several instances of statutory intervention in the working of the financial markets, the intervention had a less significant influence on the operation of markets than self-regulatory rules.[14] However, this situation changed when FSA 1986 was introduced. Financial scandals in the

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[11] See Lewis Melville, *The South Sea Bubble* (London: D. O’Connor, 1921) vii (threatening the nation with political and social ruin).
[12] Iain G MacNeil, *An introduction to the law on financial investment* (Oxford, Hart Publishing, 2005), 30.
[13] Andrew Sheng, ‘Securities Regulation versus Prudential Regulation’ 2005 May, available at: http://www.iosco.org/library/speeches/pdf/securities_regulation_vs_prudential_regulation_may05_as.pdf.
[14] See MacNeil, *Introduction to the law*, above, n.12, 34-35.

late 1970s and early 1980s, combined with the privatization program that the Conservative Government had embarked upon, highlighted a growing need for investor protection legislation. So, in July of 1981, the Minister of Trade commissioned Professor Jim Gower to undertake a report on investor protection. Proposals were put forward by Gower that resulted in the FSA 1986. The FSA 1986 represented the beginning of the modern era of regulation of investment business in the United Kingdom.[15] The Act created a hybrid system which combined the Securities and Investment Board (SIB) responsible for all investment business and self-regulatory organizations (SROs) responsible for the regulation of particular parts of the investment industry. FSA 1986 created a single statutory regime for the regulation of financial services. As a regulator, SIB required SROs to satisfy certain standards laid down by the Act in order to be recognized. During the 1990s, due to dissatisfaction with the failure of regulation to avert the Maxwell pension collapse and the widespread selling of inappropriate pension policies, the Labour administration came to office with the clear intention of overhauling and strengthening the system. The result was that The Financial Services and Markets Act 2000 (FSMA) was passed by the Houses of Parliament in 2000. With 433 sections and 22 schedules, FSMA certainly marks a formal shift in regulatory culture from the self-regulation approach. The Act 2000 has been broadly welcomed for enhancing investor protection and eliminating the complex system of overlapping self-regulation organizations that previously existed.[16] It is intended to curb abuses and build public confidence in the financial services industry by providing more governmental oversight. A new statutory body, the Financial Services Authority, has been created by the government to replace its predecessors, the SIB and its accompanying self-regulatory organisations. FSMA confers on the FSA responsibility for the regulation of all investment, banking and insurance business conducted in the UK.

In the U.S. Kansas was the first state to pass a “blue sky law”[17] in 1911. Other states followed. These laws were designed to protect investors through antifraud provisions, regulation of brokers and dealers and registration of securities. However, prior to the 1930s, no national regulation of the securities industry existed, although individual states had

[15] See MacNeil, *Introduction to the law*, above, n.12, 38.
[16] Colin Mayer, ‘Regulatory Principles and the Financial Services and Markets Act 2000’ in Eilis Ferran and Charles A.E. Goodhart (eds) *Regulation Financial Services and Markets in the Twenty First Century* (Oxford, Hart, 2001).
[17] The term “blue sky” originated from the fact that these laws were originally enacted to prevent the offering and sale of worthless securities, which were worth no more than a piece of the “blue sky” in the opinion of some legislators.

enacted various antifraud laws. The 1929 Wall Street crash changed the situation dramatically. It preceded a massive national depression and many blamed the problems of the economy on the activities of the financial markets.[18] Ferdinand Pecora, counsel for the Senate Committee on Banking and Currency, investigated practices on the stock exchanges and in the banking and securities markets. These investigations, known as the Pecora Hearings, lasted from January 1933 to July 1934.[19]

The hearings found considerable evidence of stock price manipulation. Various schemes were used to manipulate the stock price so that the manipulator could make a profit at the expense of ordinary investors. The revelation of these practices gave rise to a huge public outcry and to demands for wholesale reform of the regulatory structure of the financial markets. The outcome was a series of new laws including the Securities Act of 1933 (1933 Securities Act) [20] and the Securities Exchange Act of 1934 (1934 Exchange Act). [21] Government intervention then became a permanent feature of national financial systems in the 1930s, reflecting a collapse of trust in markets to deliver stability. These laws are the basis for the current regulatory structure in the United States. The 1933 Securities Act, called a “truth-in-securities” law, tackled abuses in the new-issue markets by requiring issuers of securities to disclose relevant financial information so that would-be investors could make more informed judgments about the stock on offer. The 1934 Exchange Act was more extensive and tackled fraudulent trading practices. The Act’s major provisions cover the initial securities registration, the filing of periodic financial reports, the registration of broker-dealers, and general disclosure and anti-fraud provisions. The Act created the Securities and Exchange Commission (SEC) to oversee trading on securities exchanges and to administer the provisions of the new securities laws. With the adoption of the Exchange Act, Congress also vested considerable authority in self-regulatory organizations (SROs), such as New York Stock Exchange (NYSE) and the National Association of Securities Dealer (NASD), both subject to SEC oversight.[22] The regulation of securities exchanges was based on the notion

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[18] Henry Laurence, ‘Spawning The SEC’ (1999) 6 *Indiana Journal of Global Legal Studies*, 647.
[19] See Ferdinand Pecora, *Wall Street under oath: the story of our modern money changers* ((New York: Augustus M. Kelley Publishers, reprinted 1968, originally published 1939) (for a first-hand account of the hearings).
[20] 15 United States Code §§ 77a-77aa (1933).
[21] 15 United States Code A. § 78d (1934).
[22] See Exchange Act § 6, 15 U.S.C. § 78(c)(a)(26) (2004); Exchange Act § 15A, 15 U.S.C §78(f). The SROs police the activities of their members to prohibit manipulative and abusive practices and also maintain disclosure requirements and financial and conduct standards for companies that list securities for trading in the markets they control.

that the government should promote efficient securities markets.[23] An efficient securities market is deemed to be essential to the efficient allocation of capital and other resources.[24] SEC regulation of securities markets thus grew out of a fear of economic collapse and showed a concern for the most efficient allocation of resources in the market. Although the SEC obtained oversight authority over the securities exchanges, they continued to have rulemaking and regulatory authority with respect to their members, their trading markets and their listed companies. The Securities Acts Amendments of 1975 further enlarged the SEC's oversight role over the stock exchanges and the NASD by, among other things, giving the SEC the power to initiate, as well as approve, SRO rulemaking,[25] expanding the SEC's role in SRO enforcement and discipline,[26] and by allowing the SEC to play an active role in structuring the market. [27] The Sarbanes-Oxley Act of 2002, which was adopted by Congress in response to the collapse of several prominent U.S. companies as a result of financial fraud, applies to both domestic and foreign companies whose securities (including debt securities) are registered with the SEC and represents a broad expansion of U.S. securities laws in the areas of corporate governance, accounting matters, disclosure, enforcement and other topics. Following adoption of Sarbanes-Oxley in 2002, the SEC released a number of new regulations implementing the provisions of the Act and can be expected to make minor, ongoing adjustments to these new regulations.

2.2.2 The Relationship between Company Law and Securities Regulation

The historical origins of the disclosure and anti-fraud components of modern securities regulation derive from traditional company law.[28] Securities regulation has long been a key component to corporate law in the United States. For decades, the securities laws' disclosure requirements, civil and criminal liability under Exchange Act Rule 10b-5 and the stock

[23] See Lynn A. Stout, 'The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation' (1988) 87 *Michigan Law Review*,613.
[24] Ibid.
[25] See Exchange Act § 19(c), 15 U.S.C. § 78s(c) (2000).
[26] See Exchange Act § 19(c), (d), (g).
[27]See Exchange Act § 11A, 15 U.S.C. § 78k-1 (2000).
[28]Amir N. Licht, 'Stock exchange mobility, unilateral recognition, and the privatization of securities regulation' (2001) 41 *Virginia Journal of International Law*, 607.

exchange listing standards have played a leading role in regulating the conduct of corporate officers and directors and protecting shareholder rights.[29] In fact, some scholars argue that the federal securities regime has begun to overshadow traditional corporate law in defining standards of conduct for officers and directors.[30] Even now, many issues such as public offerings of shares, insider dealing and takeovers are covered both in mainstream company law and securities regulation. Therefore we can see that there is a close and interdependent relationship between company law and securities regulation. This has caused the question to be asked: why does securities regulation need to spring out from the traditional company law and become a discrete field? Although they overlap in scope, there is a basic sense in which the two bodies of law are materially distinct. Firstly, securities as a financial product are not the same as search goods, such as clothing, because their quality cannot be ascertained in advance.[31] When shares are offered to the public there is high risk of fraud if the investors lack the information required to make informed investment decisions. However company law provides limited disclosure of information to the new investors because it generally does not require information to be volunteered to the other side. Company law was not designed specifically for public listed companies and even today private companies form the majority. Additionally company law emphasizes the protection of the company, shareholders and creditors' interests equally rather than protecting just the investors' interests. In order to attempt to ensure that investors in public listed companies have accurate information and their interests are protected requires special laws. Securities regulation exists because of unique informational needs of investors. Secondly, company law is generally held to be private law.[32] It is concerned with the contractual relationship which the various participants in companies enter into. Usually the various participants in companies are private individuals and groups. The state has a low profile in the company law. Due to the character of company law defining the rights and duties of private individuals and groups; it focuses primarily on "private law".[33] On the contrary, securities regulation is often viewed as public law which involves vertical relationships. In other words, the state, in whatever capacity and shape, is a

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[29] Renee M. Jones, 'Dynamic Federalism: Competition, Cooperation and Securities Enforcement' (2004) 11 *Connecticut Insurance Law Journal*, 108.

[30] Robert J. Thompson & Hillary A. Sale, 'Securities Law as Corporate Governance, Reflections Upon Federalism' (2003) 56 *Vanderbilt Law Review*, 859.

[31] Nelson, 'Information and consumer behaviour' (1970) 78 *Journal of Political Economy*, 311.

[32] Iain G MacNeil, 'Company law rules: an assessment from the perspective of incomplete contract theory' (2001) 1 *Journal of Corporate Law Studies*, 107.

[33] Randy E. Barnett, 'Foreword: Four Senses of the Public Law-Private Law Distinction' (1986) 9 *Harvard Journal of Law & Public Policy*, 267.

party. The state has a high profile in securities regulation through the presence of a powerful regulatory authority to protect investors. Thirdly, company law in general is enabling. It offers a set of default rules that can be changed by express agreement between the parties or by company organizers to fit their preferences. It leads to the result that any 'investor protection' rules that arose from the company law could in principle be avoided by agreement. In contrast, securities regulation like other fields of public law is mostly mandatory and often prohibits opting out of its provisions. Thus, the basic culture of securities regulation and company law are public versus private law, respectively. However, the main reason for securities regulation being separate and distinct from company law is to truly protect investors. Both state intervention and mandatory rules are subject to this objective.

2.2.3 The Scope of Securities Regulation

The term 'regulation' is nowadays understood more specifically to refer to rules and procedures created by statute and administered by dedicated agencies.[34] Securities Regulation is designed to address asymmetries of information between issuers and investors, clients and financial intermediaries and between counterparties to transactions; and to ensure smooth functioning of trading and clearing and settlement mechanisms that will prevent market disruption and foster investor confidence.[35] It comprises of the regulation of public issuers of securities, secondary markets, asset management products and market intermediaries. Securities regulation can be loosely defined as being concerned with the way in which the marketing of all the recognizable investment vehicles is regulated, either by the statute or administered by financial dedicated agencies. The scope of securities regulation in any system can be explained by reference to (a) securities and (b) regulated activities. Generally, over time, the scope of securities regulation has expanded both by securities and regulated activities.

Securities are not inherently valuable. The value of securities depends on the issuer's financial condition, markets, management, competitive and regulatory climate. The term "securities" has two definitions: a narrow one and a broad one. The US has adopted a broad-based concept.

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[34] See MacNeil, *Introduction to the law*, above, n.12, 20.
[35] See Carvajal and Elliott, 'Strengths and Weaknesses', above, n.5.

In its definition, securities are broadly defined so as to include all of the readily recognizable investment techniques. The vast ranges of unconventional investments fallen within the ambit of the securities regulation's coverage is due to the broad statutory definition of a security.[36] In deciding whether a particular investment vehicle is a security, the investors' perceptions and expectations will be a significant factor.[37] EC adopts the narrow definition. In Markets in Financial Instruments Directive (MiFiD) the term 'securities' is only used for shares, long and medium term debt securities and hybrids between these two types.[38] Ordinary shareholders provide the firm with equity capital and receive in return, at the latest with the dissolution of the company, an entitlement to the yield remaining after deduction of contractual liabilities. Like a loan, a debt security is a simple credit contract. Shares, debt securities and hybrids are all used by companies (and with respect to debt securities, by the state) in order to raise capital. Short term debt securities are called 'money-market instruments'.[39] Futures, options, swaps and units of investment funds are only financial instruments. The EC differ from the US in that they do not view financial instruments as securities. It is interesting that, different from the US and the EC, the UK does not define a security but rather focus on investments. FSMA 2000 stated that an investment includes any asset, right or interest.[40] According to its definition, investment includes security. The term Securities used in this paper refers mainly to the narrow definition. Special instruments are not covered by this paper.

The definition of regulated activities is central to the system of regulation because it defines the sphere of activity in respect of which authorization is required.[41] Before turning to the regulated activities, we should verify who has the right to do it. FSMA 2000 states that any firm wishing to do a regulated activity in the UK by way of business must be authorized or

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[36] Section 2(1) of Securities Act 1933 is representative: The term "security"means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
[37] Thomas Lee Hazen, *The law of securities regulation* 4th edition (West Group, 2002), 30
[38] Directive 2004/39/EC (OJ 2004 L145/1) of 21 April 2004, art 4 (1).
[39] Ibid
[40] 22 (4) of FSMA 2000.
[41] See MacNeil, *Introduction to the law*, above, n.12, 64.

exempt.[42] Authorization is achieved by applying to the FSA for permission to engage in the relevant activity.[43] FSMA 2000 and the secondary legislation (in particular the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001)[44] set out the exact circumstances where authorization is required and the consequences of not obtaining it. Authorization is the cornerstone of the regulatory system as it represents an initial vetting process for firms wishing to operate in the financial services market and ensures their ongoing scrutiny by the FSA. In addition to the requirement for firms to seek authorization, certain individuals within the firm must seek individual approval from the FSA. In the UK a person engaging in regulated activities without authorization and approval will be committing a criminal offence.[45] Regarding regulated activities, FSMA 2000 states as follows:[46]

> An activities is a regulated activity for the purposes of this Act if it is an activity of a specified kind which is carried on by way of business and –
>
> (a) relates to an investment of a specified kind;
>
> (b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind.

Section 22 explains further that "Investment" includes any asset, right or interest.[47] But more detailed definitions of specified activities and investments are not contained in FSMA 2000 itself. Instead, they are found in Regulated Activities Order 2001[48] defined by the Treasury.

2.2.4 The Objectives of Securities Regulation

Different objectives will automatically lead us in different directions especially concerning legal principles and approach. Therefore to know the objectives of securities regulation is important. The essential goal of securities regulation is to create a dynamic and competitive market to protect investors. The protection of investors is the basic and most important aim of securities regulation. International comparisons suggest that both the UK and the USA

[42] FSMA 2000 Part II section 19.
[43] FSMA 2000 Part IV Permission to carry on regulated activities.
[44] The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544, Generally referred to as the "RAO".
[45] FSMA 2000 Section 23.
[46] FSMA 2000 Section 22 (1).
[47] FSMA 2000 Section 22 (4).
[48] See MacNeil, *Introduction to the law*, above, n.12, 102, 107.

offer investors high levels of protection.[49] The unique characteristics of securities markets, i.e. information intensive, abundance of asymmetric information and significant agency problems, therefore, investors can best be protected by making certain that they all trade on the basis of equal information, this is often referred to as 'market egalitarianism'. In order to get equal information, issuers must make all the information transparent for the investors and make transparency in securities markets far more important than any other field. It is not surprising that mandatory disclosure is the mainstay principle of the securities regulation. The disclosure requirements have been seen as a less intrusive and more successful regulatory mechanism, which serves competitive, efficiency and prudential concerns in the securities markets.[50] Furthermore, most securities regulators seeks to ensure that market participants behave within ethical and statutory parameters that do not harm the market. In other words, regulation is here to influence market behavior that can damage market integrity, such as market manipulation, fraud, mis-selling, insider dealing and the like. The UK FSMA 2000 provides four objectives, they are: to maintain market confidence in the financial system, to promote public awareness of the financial system, to secure the appropriate degree of protection of consumers and to reduce financial crime.[51] These objectives have their basis in the market failures that afflict financial markets; market manipulation, systemic problems, asymmetries in information, incomplete contracts and difficulties in the enforcement of contracts. Another reference may be made to the statement contained in the influential International Organization of Securities Commissions (IOSCO) document Objectives and Principles of Securities Regulation.[52] It states that the core objectives of securities regulation are the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk.[53] Since September 11th, one might add the elimination of financial crime and international terrorism as a separate goal. Apart from these three objectives there are other broader social objectives, such as combating organized crime or facilitating home ownership and provides the justification for many other regulations. Based on these objectives, the document sets out 30 principles of

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[49] See R.La Porta, F.Lopez-de-Silanes,, A. Schleiter and R.Vishny, 'Legal Determinants of External Finance' (1997) 52 *Journal of Finance*, 1131.

[50] Mahmood Bagheri and Chizu Nakajima, 'Competition and integration among stock exchanges: the dilemma of conflicting regulatory objetives and strategies' (2004) 24 *Oxford Journal of Legal Studies*, 69.

[51] FSMA 2000, ss. 2, 3-6.

[52] See International Organization of Securities Commissions, 'Objectives and Principles of Securities Regulation', (May 2003),
available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf (last visited, September 2008).

[53] Ibid,1.

securities regulation. According to an IOSCO spokesperson, "[a] country's adherence to these 30 principles will install confidence in international investors and enhance that country's participation in the global financial community."[54]

2.3 Securities Markets Regulator

A unique feature of securities regulatory systems is the widespread use of SROs to carry out regulatory functions. In the past securities exchanges were used as the main regulator but this situation has changed because of the securities markets becoming formally regulated. It raises the question, if SROs are not suitable to be regulators, who should be responsible for regulating securities markets? Current practice indicates that national public regulators have now become more widely accepted around the globe. Although today the majority of regulation duties have already been transferred to public regulatory agencies, securities exchanges still undertake some responsibilities. This raises another question, in the latter, what role should national public regulators play? The answer to this question, as well as the responsibilities and functions of the regulator will be discussed in the following section.

2.3.1 National Public Securities Markets Regulators

Securities exchanges predate government agencies as regulators of the securities market. Before the 1930s in the era of self-regulation[55] governments interfered little in the operation of securities markets, largely leaving them to regulate themselves. However, this situation did not last long. The first formal national regulator was established in the United States with the1934 Exchange Act. The result was a radical transformation in the relationship between securities exchanges and the government. What happened in the United States was later to provide a model subsequently followed by most countries reflecting the prevailing mood. Now the need for public regulators to oversee operations within the securities markets have been recognized the world over.

2.3.1.1 The Rationale of National Public Regulator

[54] International Organization of Securities Commissions, Press Communique 1 (1998).
[55] For more details see 2.2.1.1 'The era of self-regulation'.

Firstly, the history of securities regulation has shown that self-regulation is often followed by crisis and scandals.[56] These crises have resulted in a high degree of government intervention in order to prevent a complete financial collapse. Therefore, securities regulation has been changed from self-regulation to government regulation. Regulators always go hand in hand with regulation. Thus, changes in regulation have required that the securities markets regulator need to be changed from SROs to a national public regulator. Secondly, while exchanges arguably have a clear picture of trading activity in their markets, they often lack the investigative powers that government entities usually possess. SROs in the United States, for example, do not possess power to subpoena entities or individuals. [57] Moreover, the sanctions available to them are limited as they are often exhausted after expulsion from the exchange. Thus, the enforcement apparatus of the securities exchange has many imperfections. Thirdly, exchange demutualization challenged the regulatory position of securities exchanges. Starting from 1993, one after the other, most stock exchanges "demutualized": they abandoned their traditional non-profit mutual membership structure in favor of a for-profit corporate format. [58] Some privatized securities exchanges took the additional step of listing their shares on their own markets. As a result of demutualization, the ownership structure of stock exchanges changed. While exchanges were traditionally accused of harboring a "clubby" perspective in terms of protecting the interests of their members, they are now oriented toward maximizing profits for their shareholders. The orientation of the exchange operation changes from catering to the interests of its members to catering to the interests of its shareholders. Demutualization of securities exchange ownership also introduces new and potentially significant conflicts of interest.[59] The conflict between the exchange's business goals and regulatory mission is apparent. The conflicts of interest inherent in demutualized securities exchanges raised the question: are securities exchanges that are designed to maximize shareholder value well-suited to regulate their own markets? Andreas Fleckner, for example, has questioned whether an exchange can perform its role as guarantor of the quality of listed firms and as a link for the transmission of accurate information to investors when the financial interests of the exchange's shareholders may be in conflict. [60] Demutualization led to propose a restructuring of the securities markets

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[56] For more details see 2.2.1.2, 'The era of government regulation'.
[57] Ernest E. Badway & Jonathan M. Busch, 'Ending Securities Industry Self-Regulation as We Know It' (2005) 57 *Rutgers Law Review*, 1351, 1355.
[58] For more details see 1.3.2.2, 'Securities exchanges demutualization'.
[59] For more details see 1.3.2.3, 'Conflict of interest under demutualized securities exchanges'.
[60] Andreas M. Fleckner, 'Stock exchanges at the crossroads' (2006) 74 *Fordham Law Review*, 2541.

regulatory framework, for example, to create new government regulatory bodies. If the activities of exchanges become subject to supervision by a government agency, it will help to overcome the perception that exchanges are being operated only for the benefit of their members.

2.3.1.2 The Roles of National Public Regulators

A national financial regulator performs five main tasks: authorization of market participants; the provision of information to enhance market transparency; surveillance to ensure that the regulatory code is obeyed; enforcement of the code and disciplining of transgressors and the development of policy that keeps the regulatory code up to date.[61] Based on Stavros Gadinis and Howell E. Jackson's findings, three distinct models of allocation of regulatory powers can be identified: Government-led Model, Flexibility Model and Cooperation Model.[62]

Countries in the "Government-led Model" (France, Germany, and Japan) preserve significant authority for central government to control securities markets regulation, albeit with a relatively limited enforcement apparatus. In all the Government-led Model jurisdictions, the central government has shaped the securities regulatory framework to maintain important channels of influence in the operation of market institutions. Sometimes, these channels of influence are direct, as powers to approve the establishment of a securities exchange or a clearinghouse rest with a central government official, such as a Minister.[63] Often, these channels are indirect, expressed through a tight relationship between the central government and the administrative agency responsible for the regulatory oversight of the securities markets. For example, the Japanese Financial Services Agency (JFSA) is positioned under the Prime Minister's Cabinet in the Japanese regulatory hierarchy, and some of its rules require the Prime Minister's approval before implementation. In France, all the Autorité des Marchés Financiers (AMF) rules require the approval of the Ministry of Finance before implementation. Moreover, the Ministry can influence the AMF deliberation process through

[61] John Eatwell, 'New issues in international financial regulation' in in Eilis Ferran and Charles A E Goodhart (eds), *Regulating Financial Services and Markets in the 21st Century* (Oxford, Hart Publishing, 2001), 239.
[62] Stavros Gadinis and Howell E. Jackson, 'Markets as regulators: A survey' (2007) 80 *Southern California Law Review*, 1239.
[63] Ibid.

its directly appointed representative on the AMF board.[64]In this way, central governments in these jurisdictions maintain a strong grip over the regulation of securities markets.

The “Flexibility Model” countries (the United Kingdom, Hong Kong and Australia) grant significant leeway to market participants in performing their regulatory obligations, but rely on government agencies to set general policies and maintain some enforcement. Agencies in the Flexibility Model enjoy greater independence from central government and greater flexibility in monitoring and enforcing securities laws. Within the Flexibility Model, central governments have provided more independence to administrative agencies and market infrastructure institutions, maintaining only limited power to affect their day-to-day operation and decision making process. Thus for governments their power over securities markets operation consists only of approving the agency decision to establish a new stock exchange or clearinghouse.

The “Cooperation Model” countries (the United States and Canada) assign a broad range of power to market participants in almost all aspects of securities regulation but also maintain strong and overlapping oversight of market activity through well-endowed governmental agencies with more robust enforcement traditions. The essence of the Cooperation Model lies in the ways government agencies and SROs work together to regulate securities markets effectively. For example, the SEC has delegated significant authority to private sector bodies. For securities firms, it has allowed many oversight responsibilities to be carried on by the National Association of Securities Dealers (NASD), a “self regulatory organization” (SRO). The securities exchanges are also SROs and thus exercise certain regulatory authority over their membership and over the corporations whose shares they list. The SEC, however, may veto rulings of these nongovernmental bodies and may require them to modify their rules (or adopt new ones) as well as to exercise further oversight over them.

2.3.2 The Division of Regulatory Responsibilities

The structure of the securities markets regulator may vary from a single-agency specialized in securities regulation to a unified regulator that regulates more than one sector. There are

[64] Ibid part V.A.

two basic models of securities regulatory framework: the American type—multiple regulators and the British type—single regulator.

2.3.2.1 The American Type

In the United States, securities markets, futures markets, government bond markets and banks have different regulators. The Securities Exchange Act of 1934 created the SEC —an independent regulatory body—responsible for making and enforcing securities law so as to protect investors. The SEC consists of five presidential-appointed Commissioners, four Divisions and 18 Offices. With approximately 3,100 staff, the SEC is small by federal agency standards. Headquartered in Washington DC, the SEC has 11 regional and district Offices throughout the country.[65] The SEC primary function is securities regulation and market efficiency. The SEC has been given broad authority to adopt rules and regulations to maintain fair and orderly securities markets. The federal securities laws require companies that sell securities to the public to register with the SEC. In addition to the SEC, the Commodities Futures Trading Commission (CFTC) regulates the futures markets, whose activities have expanded from trading in future contracts on agricultural commodities to trading in futures on securities indexes. Insurance regulation is based almost entirely at the state level. States have been the primary regulator for insurance for over 135 years. At this moment, three federal regulators (the Federal Reserve System, the Federal Deposit Insurance Corporation [FDIC] and the Office of the Comptroller of the Currency [OCC]) have separate but overlapping jurisdictions with respect to commercial banks. The National Credit Union Administration (NCUA) is the independent federal agency that charters and supervises federal credit unions.

The United States current regulatory structure may have been appropriate at one time but it was not built to address the modern financial system with its diversity of market participants, innovation, complexity of financial instruments, convergence of financial intermediaries and trading platforms, global integration and interconnectedness among financial institutions, investors and markets.[66] In March 2008 the Untied States Treasury released Blueprint for a

[65] Securities Exchange Commission website, available at: http://www.sec.gov/.
[66] Henry M. Paulson, ‘Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform’ available at: http://www.ustreas.gov/press/releases/hp897.htm (last visited, September 2008).

Modernized Financial Regulatory Structure[67] in order to adapt to the dynamic U.S. marketplace while improving oversight. Blueprint recommends a regulatory model based on objectives. This model would have three regulators: a market stability regulator focused solely on market stability across the entire financial sector; a prudential financial regulator focused on safety and soundness of those institutions supported by a federal guarantee and a conduct of business regulator focused on protecting consumers and investors.[68] A major advantage of this structure is its timelessness and its flexibility. It can more easily respond and adapt to the ever-changing marketplace because it is organized by regulatory objective rather than by financial institution category. According to the Blueprint recommendation all federal bank regulators will consolidate into a single prudential regulator. By its singular focus on prudential regulation that ensures the safety and soundness of institutions with federal guarantees, this regulator would serve a role similar to the current OCC. Many of the SEC and CFTC roles will transfer to conduct of business regulator.

Another typical example of the American type is China. Similar to the United States, in China, securities markets, insurance business and banks also have separate regulators. The main securities regulatory body China Securities Regulatory Commission (CSRC) was created in 1992 and governs over all securities exchanges and future markets activity within the People's Republic of China. Similar in its charge to the SEC, the CSRC is mandated to perform functions such as: creating and reviewing securities legislation; regulating the trading, issuing and settlement of stocks, fixed income securities and securities funds; supervising the conduct of shareholders and securities brokers; overseeing the issuance of overseas company listings and offerings (such as H-Shares listed on the Hong Kong Exchange).[69] The CSRC includes more than 30 regulatory bureaus that cover different geographic regions of the country, and two supervisory bureaus at the nation's two largest securities exchanges in Shanghai and Shenzhen. The China Insurance Regulatory Commission (CIRC) was set up in 1998 to regulate the insurance market and promote its development. Originally, the People's Bank of China (PBOC) was responsible for insurance but this sector was transferred to the CIRC to deepen financial reforms, minimize financial

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[67] United States Treasury: 'Blueprint for a Modernized Financial Regulatory Structure' March 2008, available at: http://www.ustreas.gov/press/releases/reports/Blueprint.pdf (last visited, September 2008).
[68] Ibid.
[69] See China Securities Regulatory Commission website, available at: http://www.csrc.gov.cn/n575458/n4001948/ (last visited, September 2008).

risks and shore up the fledgling financial services industry. China's banking regulatory body, the China Banking Regulatory Commission (CBRC), was established in Beijing in 2003. The regulatory objectives of the CBRC are to protect the interests of depositors and consumers; maintain market confidence through prudential and effective supervision; enhance public knowledge of modern finance and combat financial crimes.[70]

2.3.2.2 The British Type

Different from the American model, the UK established a single statutory regulator-Financial Services Authority (FSA)-for financial services. The Chancellor of the Exchequer, Gordon Brown, announced in May 1997 that the responsibilities for financial services regulation in the UK would be merged into a single entity.[71] This would entail the bringing together of nine regulatory bodies,[72] including those responsible for banking, securities and insurance business, and for markets and exchanges. The FSA is the single direct statutory "super-regulator" responsible for making rules, regulations, and codes that govern the entire financial services industry.[73] It has a single handbook of rules and guidance. However, the UK was not the first country to introduce a single financial services regulator. The single regulator was created in Norway in 1986, which then was followed by Denmark in 1988 and Sweden in 1991. Although a few other countries already have single financial services regulators the FSA is the first and the most famous in a major international financial centre. Meanwhile, there has been a reconsideration of regulatory structures in some other countries. East Asian countries like Japan and South Korea followed suit in the late nineties. Japan introduced a single regulator (the Financial Supervisory Authority) covering banking, securities and insurance in June 1998, as did Korea in April 1998 with the new Financial Supervisory Service which was modeled explicitly on the UK's FSA.

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[70] See China Banking Regulatory Commission website,
available at: http://www.cbrc.gov.cn/english/home/jsp/index.jsp (last visited, September 2008).

[71] Clive Briault, 'The Rationale for a Single National Financial Services Regulator' (1999) May *FSA Occasional Papers in Financial Regulation*.

[72] The Securities and Investments Board, the Personal Investment Authority, the Investment Management Regulatory Organization, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of Trade and Industry, the Friendly Societies Commission, and the Registrar of Friendly Societies.

[73] Section 2 of FSMA 2000.

The main argument is that a single financial regulator is superior as it mirrors the nature of modern financial markets where old distinctions between different sectors and different products have broken down. Accompanied by a blurring of the boundaries between sectors and products, the number of the financial conglomerates (usually defined as a group which undertakes at least two major financial services activities) has increased. The "emergence of financial conglomerates has challenged traditional demarcations between regulatory agencies"[74] and the "boundaries between regulators simply no longer reflect the economic reality of the industry".[75] There is a clear need for regulatory oversight of a financial conglomerate as a whole, since there may be "risks arising within the group … that are not adequately addressed by any of the specialist prudential supervisory agencies that undertake their work on a solo basis".[76]

Another argument in favour of a single regulator is that it will be more efficient in allocating resources. A single regulator's position allows it to look across the entire financial industry and devote regulatory resources (both human as well as financial resources) to where they are most needed.

The supporters of a 'single market regulator' system further argue that in the case of a single market regulator the responsibility and accountability is clear. The single regulator cannot transfer the blame of any failure to another regulatory body. If a single regulator is given a clear set of responsibilities then it ought to be possible to increase the transparency and accountability of the single regulator,[77] not least in terms of its accountability for performance against its statutory objectives, for the regulatory regime, for the costs of regulation, for its disciplinary policies, and for regulatory failures.[78]

Another argument in favour of a single regulator is information sharing. Single regulators will have the advantage of sharing information among various regulating divisions which

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[74] Goodhart, C A E, Hartmann, P, Llewellyn, D T, Rojas-Suarez, L and Weisbrod, S, *Financial Regulation.* (Routledge, London and New York, 1998), 143.
[75] Taylor, M, 'Peak Practice: How to reform the UK's regulatory system' Centre for the Study of Financial Innovation, London, 1996, October, p4.
[76] See Goodhart et. al., *Financial Regulation*, above, n.74, 148.
[77] Taylor, M, "Twin Peaks": A regulatory structure for the new century. Centre for the Study of Financial Innovation, London, 1995 December.
[78] See Briault, 'Single regulator', above, n.71.

will go a long way toward preventing fraud as well as in handling crisis. Multiple regulators have problems in sharing information on time.

2.3.3 The Functions of Securities Markets Regulators

The main functions of a regulator are making and enforcing regulations. The securities industry is simultaneously governed by specific rules and general principles. In most cases, the securities industry is regulated by specific requirements set forth in rules. Simultaneously, the securities industry is also governed by broad principles largely set forth in statutes and the common law. Therefore, there are two different approaches toward making regulations: a rules-based approach and a principles-based approach. It is also very important for the regulator to be able to enforce its regulations. "Enforcement" refers to the agency's ability to both affect compliance with regulation (through active supervision) and its ability to bring an action against a person or entity that has violated regulations.[79] When conduct violates a rule, the regulatory response is clear – enforce the rule. This straightforward enforcement of a rule can be called a "rules-based" enforcement action. When the conduct violates a broader principle it is a principles-based enforcement action. Principles-based enforcement actions reflect the demand that regulators punish conduct violating principles reflecting public values. For the most part, the public prefers the decisiveness of principles-based enforcement. In contrast, the regulated prefer the more predictable rulemaking approach. To some extent, these attitudes reflect different assumptions about the regulatory scheme and its goals. This paper does not take a position on whether a rules-based approach is better than a principles-based approach, as that remains an open issue that requires further research.

2.3.3.1 Rules-based Approach

Before taking a rule-based approach regulator develop norms through enforcement actions, but that approach has been attacked as introducing uncertainty into the system. The first variation of the critique was set forth in a 1982 book by former SEC Commissioner Roberta Karmel.[80] In that book, Karmel criticized the tendency of the SEC to make policy through enforcement actions rather than through rulemaking. As a result, she argued the SEC was

[79] See Carvajal and Elliott, 'Strengths and Weaknesses', above, n.5.
[80] Roberta S. Karmel, *Regulation by Prosecution: The Securities and Exchange Commission versus Corporate America* (New York: Simon and Schuster, 1982).

unnecessarily antagonistic towards business and pursued cases that were only tenuously related to securities regulation. In a later article Harvey Pitt coined the phrase “Regulation by Enforcement”.[81] Pitt used the phrase to criticize the SEC’s efforts against insider trading. Insider trading was and still is an offense where the SEC and Congress have not precisely defined the applicable legal norm. Instead, the current body of law governing insider trading was created in an ad hoc way through enforcement actions pursued by SEC staff and approved by lower courts.[82] As a result, Pitt argued individuals do not have clear notice as to what conduct is insider trading.

The Regulation by Enforcement critique reflects a general sense that norms are best initiated by rulemaking while enforcement actions should merely enact previously defined rules. It held up rulemaking as the ideal generator of norms governing the securities industry.

A “rules-based” regulatory system, like those the United States uses, relies on stating specific requirements or prohibiting certain actions by law. Rulemaking reflects the mentality that securities regulation is a technical enterprise that should be left to experts who have created a comprehensive, efficient, administrative scheme.

The main advantage of a rules-based regulatory regime is its predictability. The regulated want clear rules that specifically tell them what they can’t do, and more importantly, what they can do. The regulated may view questionable conduct as justified because the rules are unclear. Their preferred response is that the regulator clarifies the law not just punishes the conduct. The rules-based approach can satisfy industry demand for specificity with regard to legal duties and compliance responsibilities. It can give a clear baseline of acceptable conduct with regard to investor protection. It also can provide for ease of communication within firms with regard to standards and requirements while affording regulators clear standards and requirements to use in the monitoring and enforcement of those firms. The regulated can make decisions without the worry that their actions will be second-guessed by regulators. When conduct violates a rule, the regulatory response is clear – enforce the rule. This straightforward enforcement of a rule is called a “rules-based” enforcement action.[83]

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[81] See Harvey L. Pitt and Karen L. Shapiro, ‘Securities Regulation by Enforcement: A Look Ahead At the Next Decade’ (1990) 7 *Yale Journal On Regulation*, 149.
[82] Ibid.,178.
[83] James J. Park, ‘The Competing Paradigms of Securities Regulation’ (2007) 57 *Duke Law Journal*, 625.

The second characteristic is that regulatory norms be developed by experts. Because the securities markets are complex, only specialists with experience are qualified to govern them and can assess what rules are appropriate. An administrative agency such as the SEC depends on its expertise in establishing its legitimacy to regulate. The SEC has such expertise because it deals with the securities industry on a constant basis. It supervises registration of public offerings, does inspections of brokerage firms and encourages investor education. Rulemaking allows experts with deep industry knowledge to carefully define regulatory norms. The rules that administrative experts promulgate are part of a coherent framework that takes into consideration the holistic experience of the agency.

The third characteristic is that rules should be defined through a process with procedural safeguards. Because the securities industry is so complex, even experts may make mistakes when promulgating rules. Thus, the rulemaking process as governed by the Administrative Procedure Act requires that a rule may only be passed after the regulated and other interested parties are given a significant amount of notice and opportunity for comment. The notice and comment period helps regulators ensure that they are not missing considerations that militate against the adoption of the rule.

2.3.3.2 Principles-based Approach

The term “principles” can be used simply to refer to general rules, or also to suggest that these rules are implicitly higher in the implicit or explicit hierarchy of norms than more detailed rules: they express the fundamental obligations that all should observe.[84] Principles-based regulation means moving away from reliance on detailed, prescriptive rules and relying more on high-level, broadly stated rules or principles to set the standards by which regulated firms must conduct business.[85] John Tiner, former chief executive of the FSA, has remarked that principles-based regulation is essentially about outcomes or ends. It allows firms to decide

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[84] Julia Black, ‘Making a success of principle-based regulation’ (2007) 1 (3) *Law and Financial Markets Review*, 192.
[85] Ibid, 191.

how best to achieve required outcomes and as such, it allows a much greater alignment of regulation with good business practice.[86]

Principles-based regulation was a response to recognize that traditional, rule oriented legal regimes are limited in their ability to deal with some broader organizational and cultural problems. It is against these backdrops that a clarion call has been raised in recent years in countries in the common law world to reform the way laws are drafted in those countries.

Compared with the rules-based approach's decreased flexibility, the first outstanding advantage of principles-based approach is to provide flexibility to regulated entities in the way they comply with the legislation. The need for a more flexible style of drafting is most keenly felt in the financial industry because of the fast pace of change in that industry. Flexibility makes entities free to choose the practices and controls to adopt in order to secure the regulatory outcomes. There may be more than one way to achieve these outcomes. The primary responsibility for achieving these remains is belonging to each firm's senior management. This in turn encourages innovation and competition and aligns legislation with good business practices.[87]

Secondly, principles-based legislation is scaleable in that the legislative requirement can be adjusted to fit a product or an entity.[88] Based on the rules-based approach, regulators could set themselves the task of creating a rule for every conceivable source of risk or detriment, but they would not succeed in this. The complexity of the financial system means that the number of ways in which firms can damage markets, investors or themselves is increasing exponentially. It is impossible to foresee every development in the future and find a set of rules that works for all products or for all entities. Further, the specific nature of the rules also makes it more likely that something relevant will be left out. The legislator will forever be trying to play catch up with the rapidly changing environment. Since no system of rules ever can anticipate all cases, rules would need to be amended frequently. For example, the Singapore Securities and Futures Act was amended no less than 6 times (often substantially)

[86] John Tiner, Speech before APCIMS Annual Conference (Oct. 13, 2006), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1013_jt.shtml.
[87] See John Tiner, 'Principles-based regulation: the EU context' available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1013_jt.shtml (last visited, August 2008).
[88] Ibid.

since its enactment in 2001.[89] One reason for this is that the Act had to be modified each time a new investment product was introduced into the markets; this was due to the Act's product-specific nature. A law drafted in terms of well expressed outcomes, on the other hand, is less likely to become outdated or need frequent amendments.

Thirdly, a rules-based approach can result in increased implementation and compliance costs. Financial firms face many different types of conflict of interest and the number grows every day as business practices evolve. An army of regulators could be employed solely to codify these and write rules specifying how they should be managed. The detailed nature of the rules encourages a loophole mentality where much expense and effort is wasted on looking for and defending loopholes in the law. It is therefore much more efficient to make it clear to firms that they must manage all types of conflict capable of creating detriment and to explain to regulators and other interested parties how they do it.

Finally, a principles-based approach is more readily comprehensible when compared to the detailed, convoluted and voluminous nature of prescriptive legislation. Both the regulated and regulator can better understand and appreciate the policy behind the law as it is stated upfront rather than lost in a mass of detail.

In addition, as regulatory rule book becomes thicker and more convoluted by the day, the purpose and spirit of each rule becomes lost to the ones it is intended to govern. Compliance becomes merely a matter of satisfying the regulator. In theory at least, principles-based legislation ought to achieve higher levels of compliance.[90] By requiring entities to comply with the spirit of the law rather than the letter of the law,[91] they are forced to come to grips with the reasons behind a law rather than blindly follow it. Further, it does away with the counter-productive practice of looking for or defending loopholes in the law.

[89] Ter Kim Cheu, 'From 'fussy' to 'fuzzy': the priciples-based approach to legislative drafting' available at: http://www.agc.gov.my/agc/agc/rev/agcjc/2nd/pdf/session3/Singapore.pdf (last visited, July 2008).
[90] See Tiner, 'Principles-based regulation', above, n.87.
[91] The letter of the law versus the spirit of the law is an idiomatic antithesis. When one obeys the letter of the law but not the spirit, he is obeying the literal interpretation of the words (the letter) of the law, but not the intent of those who wrote the law. Conversely, when one obeys the spirit of the law but not the letter, he is doing what the authors of the law intended, though not adhering to the literal wording.

A principles-based approach has lots of advantages but also brings its own drawbacks. Some commentators point out that a principles-based regime shifts some of the regulatory burden to industry, in terms of the costs of identifying what constitutes compliance with broadly-worded regulatory principles.[92] In a principles-based system, how a principle will be applied remains at the discretion of the regulator, but apart from this, principles-based regulation reduces the rules transparency essential for a competitive market. A rules-based regime tells everyone what is required to enter a field and compete. A principles-based regime is open to interpretation by a regulator and could be used to deny entry to would-be competitors.

The move towards principles-based legislation also will often create uncertainty among the regulated community. They now have little choice but to devise their own practices to meet the spirit and intent of the law when previously they need only follow it to the letter. Even so they will not know for certain that their practices will pass muster with the regulator or the courts. Additional guidance is therefore desirable to foster certainty and predictability in the affected industry. For example, the UK FSA is required under the Financial Services and Markets Act 2000 to issue codes of practice “for the purpose of helping to determine whether or not a person’s conduct complies with a statement of principle”.[93]

From an early stage, the United Kingdom’s Financial Services Authority (FSA) has been a thought leader on principles-based financial services regulation. The FSA’s approach is built on a framework of principles, although the FSA also has a large rulebook to accompany the eleven different sets of principles it has laid out. The FSA claimed that they have been a principles-based regulator since 2001.[94] The FSA moved to a comprehensive principles-based regime in 2003.[95] During the years 2007 and 2008, the FSA aimed to do away with roughly half of the contents of the rule book and thereby take another step closer to principles-based regulation.[96]

In addition to the UK, the province of British Columbia (B.C.), Canada, is an ambitious champion of principles-based securities regulation and outcome oriented regulatory practice.

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[92] Louis Kaplow, ‘Rules versus Principles: An Economic Analysis’ (1992) 42 *Duke Law Journal*, 557, 559-60.
[93] Section 64 of the Financial Services and Markets Act 2000.
[94] See Tiner, ‘Principles-based regulation’, above, n.87.
[95] Christie L Ford, ‘New Governance, Compliance, and Principles-Based Securities Regulation’ (2008) 45 *American Business Law Journal*, 1.
[96] See Thomas Huertas, ‘Counting on compliance: the implications of more principles-based regulation’ available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0131_th.shtml.

In 2004, British Columbia passed a new bill (bill 38) to create a new Securities Act with the intention of creating a responsive, flexible regulatory system.[97] Instead of detailed, prescriptive rules, a number of provisions of the Act were drafted generally and briefly. Bill 38 and its associated proposed rules and regulations (know as the B.C. Model) would have established the most comprehensively principles-based regime in securities regulation in North America.[98]

With the trends towards principles-based regulation the United States also cannot avoid it. Hank Paulson, US Treasury Secretary, has suggested that in order to preserve its global competitiveness, the United States should move toward a more flexible, U.K.-style approach to regulating capital markets.[99] Even the U.S. Securities and Exchange Commission, often characterized internationally as a particularly rule-oriented and prescriptive securities regulator, has made recent moves toward a more principles-based approach. The primary U.S. accounting standard-setter, the Financial Accounting Standards Board, was criticized in the wake of the Enron debacle for relying too much on detailed rules to determine appropriate accounting treatment with respect to accounting standards. Thereafter, considerable work went into drafting more “principles-based” Generally Accepted Accounting Principles (GAAP).

[97] Bill 38-2004, Securities Act, 5th Sess., 37th Parl., British Columbia, 2004, §203. Bill 38 and the research studies and other documents associated with it are available on the BCSC website at www.bcsc.bc.ca.
[98] See Ford, ‘Principles-Based Securities Regulation’, above, n.95.
[99] Jeremy Grant and Krishna Guha, ‘Paulson Seeks British-Style Flexibility in Capital Markets’ (2006) 21 November *Financial Times (U.K.)*, at Ed1.

Chapter Three: Internationalization

3.1 Introduction

In the first two chapters we have discussed the basic concepts of securities market, securities exchange, securities regulation and regulator. But in order to fully understand the topic of the thesis we also need to know the background to international securities regulation. We will now look at, on what kind of platform does the international securities regulation performs. Today's world is totally different from the history even as little as a decade ago. History told us the journey to find the trade route to China took medieval Italian traveller Marco Polo 15 years. Now, a European trader wanting to buy goods in China can get it in a minute through the internet. The world is increasingly international, and many facets of society have undergone a global metamorphosis. It is difficult to imagine any securities market that has not been impacted to some degree by this kind of the trend toward internationalization. A dramatic internationalization trend is presently transforming the nature of securities markets and the nature of transactions conducted in those markets. Propelled by advancing technology, global linkages are increasingly being forged and significant trans-national movements of capital have become the norm rather than the exception.[1] As a result, securities markets have increased their international scope. In other words, today's capital markets know no national boundaries.

Internationalization provides a new platform for international securities regulation. In order to have a clear and full picture of international securities regulation, we must firstly establish a working definition of internationalization and an understanding of "securities market internationalization" and why it is so significant to build up the legal system of international securities regulation.

This chapter evaluates the forces encouraging the development of international securities markets, the obstacles that must be overcome, and the risks. It is necessary to understand the causes and magnitude of this phenomenon in order to evaluate different regulatory

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[1] Kellye Y. Testy, 'Comity and Cooperation: Securities Regulation in a Global Marketplace' (1994) 45 *Alabama Law Review*, 927, 928.

approaches. Finally, it outlines the influences to be faced as the span of securities trading stretches beyond the scope of national regulatory regimes.

3.2 The Characteristics of Internationalization

3.2.1 Defining Internationalization

Internationalization is a common concept used to describe the interconnectedness of the world's economies and cultures. The purpose of internationalization is to make localization easier, faster, higher quality and more cost-effective. It allows holders of mobile assets to pick and choose the country in which they do business, and their decisions will be based at least in part on the relative attractiveness of each country's policies.[2]

While precise, the above definitions are highly abstract. In the specific securities regulation field, when internationalization is applied to securities markets, what does it mean? The liberalization of trade in securities market is often called "securities market internationalization". Finance theorists have agreed upon a definition: markets for assets (bonds or stocks) are internationalized if assets with the same return and risk characteristics have the same price in different countries.[3] The internationalization of markets means that a substantial number of transactions involve participants and financial assets are from different nations.[4] It requires the removal of legal barriers and regulatory restrictions to international financial flows. It assumes integration of markets, mobility of actors, interconnectedness, and multilateral relations. A true international securities market is one in which investors and issuers have no incentives to restrict their securities activities to their own national jurisdiction.[5] The institutional form of such a market might be either a central market or a set of competing decentralized markets. In such a market, an issuer or borrower from any part of

[2] Henry Laurence, 'Spawning The SEC' (1999) 6 *Indiana Journal of Global Legal Studies*, 647.
[3] Mustafa N. Gultekin et al., 'Capital Controls and International Capital Market Segmentation: The Evidence from the Japanese and American Stock Markets' (1989) 44 *Journal of Finance*, 849; Rene M. Stulz, 'A Model of International Asset Pricing' (1981) 9 *The Journal of Financial Economics*, 383.
[4] Maura B. Perry, Note, 'A Challenge Postponed: Market 2000 Complacency in Response to Regulatory Competition for International Equity Markets' (1994) 34 *Virginia Journal of International Law Spring*, 701.
[5] David E. Van Zandt, 'The Regulatory and institutional conditions for an international securities market' (1991) 32 *Virginia Journal of International Law*, 47.

the globe could raise funds from investors in all other parts of the globe. Likewise, investors around the world would compete on an equal footing for new issues of securities.

Regarding the primary market, the distinctions between offerings into a domestic market and a foreign market would disappear. The allocation of such securities would depend not on domestic regulation, but rather on the distribution of risk and return preferences of investors around the world.

The secondary market would be similarly international. Unlike today's segmented securities markets, participants would trade securities through a single electronic and twenty-four hour market. Even if it were not feasible to do away with separate exchanges or market systems, each system would be linked into the international network to provide the depth and liquidity necessary for improved efficiency.

3.2.2 The Process and Illustration of Securities Markets Internationalization

Internationalization is not just a theory; it is a real. The internationalization of capital markets is a phenomenon associated with the 1980's, although the economic forces that drive international flows of capital are not new.[6] In fact, during the second half of the nineteenth century, British and other European investors had already provided much of the capital needed to construct the early American railroad system. But the 1980s and 1990s have witnessed the advent of a truly international marketplace.[7]

At the end of World War II, the financial markets of most countries were closed to cross-border trade in financial assets. In the 1970s, only a handful of countries – particularly the United States and Canada – were exceptions to the prevailing world of tight controls on international capital flows.[8] Since then, many countries have sharply reduced such barriers. During the 1980s, restrictions on cross-border capital flows were gradually relaxed in the

[6] See Perry, 'Market 2000', above, n.4.

[7] Marc I. Steinberg & Lee E Michaels, 'Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity' (1999) 20 *Michigan Journal of International Law*, 207.

[8] Malcom D. Knight (General Manager of the BIS), 'Globalization and Financial Markets' at the 34th Economic conference of the Austrian National bank, in Vienna 22 May 2006 available at: http://www.bis.org/speeches/sp060522.html (last visited, January 2008).

major industrial countries. Great Britain set a trend by lifting exchange controls in 1979. Other countries followed suit: Japan (1980); the Federal Republic of Germany (1981); Australia (1983); New Zealand (1984); the Netherlands (1986); Denmark (1988); France (1989); Austria, Finland, Norway, and Sweden (1989-1990); Belgium, Ireland, and Luxembourg (1990); Portugal and Spain (1993); Greece (1994); and Iceland (1995).[9] At the end of 1986, the United Kingdom permitted foreign financial firms to enter the domestic securities market; other countries did likewise. Regulatory burdens were lightened; fees and charges reduced. Financial markets were increasingly liberalized, deregulated, and integrated in a worldwide network. The number of issuers and investors involved in international activities has increased significantly since the beginning of the 1980s. It is not expected to abate in the foreseeable future and will be a permanent mark. Internationalization of securities market is a term that covers a variety of related growth trends. It includes cross-listing of securities, cross-national portfolio investment, open national exchanges and "passing the book". All of these are now growing, although at different rates.

The simplest form of internationalization of securities markets is the cross-listing of securities in several countries. Cross-listing simply means that a company incorporated in the United Kingdom lists its securities on an exchange in another country. Starting from 1980s, many firms choose to raise capital or list their shares in foreign markets. Several statistics illustrate this process. In the ten-year period from 1990 to 2000, the number of foreign corporations listed on the two main U.S. exchanges increased 450%.[10] In the same ten year period, American Depositary Receipt (ADR)[11] programs also increased. In 1990, 352 depository receipt programs from 24 countries were in effect in the United States,[12] but by 1999, this

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[9] Barry Eichengreen and Michael Mussa, *Capital account liberalization: theoretical and practical aspects* (International Monetary Fund, Washington DC, 1998), 7.

[10] See John C. Coffee, 'Competition Among Securities Markets: A Path Dependent Perspective' (2002) *Columbia Law and Economics Working Paper No. 192*.

[11]ADRs were developed by JP Morgan in 1927 as a vehicle for investors to register and earn dividends on non-U.S. stock without direct access to the overseas market itself. U.S. depositary banks hold ... overseas securities in custody in the country of origin and convert all dividends and other payments into U.S. dollars to receipt holders in the United States. Investors, therefore, bear all currency risk and indirectly pay fees to the depositary bank. Each depositary receipt denotes shares that represent a specific number of underlying shares in the home market, and new receipts can be created by the bank for investors when the requisite number of shares are [sic] deposited in their custodial account in the home market. Cancellations or redemptions of ADRs simply reverse the process. See Stephen R. Foerster & G. Andrew Karolyi, 'The Effects of Market Segmentation and Investor Recognition on Asset Prices: Evidence from Foreign Stocks Listing in the United States' (1999) 54 *Journal of Finance*, 981, 983.

[12] See Stijn Claessens, Simeon Djankov, and Daniel Klingebiel, 'Stock Markets in Transition Economies' (2000) September *World Bank Financial Sector Discussion Paper No. 5*, 17.

number had grown to 1,800 programs from 78 countries[13] -- an increase of over 500 percent. This process has continued into the 2000s.

Another measure of internationalization is cross-national portfolio investment, the degree to which Country A's investors buy securities listed in Country B. For all countries, investment in non-domestic securities was $250 billion in 1984 and $1,281 billion in 1987, a fivefold increase in 3 years.[14] In 1950, foreign investors held a little more than 2 percent of U.S. securities; by mid-1988 it was nearly 12 percent.[15] During the 1990s, the total dollar amount of cross-border securities holdings where non-U.S. investors held U.S. securities, or vice versa, grew from approximately $1.5 trillion to approximately $6.9 trillion.[16]

The third illustration of securities market globalization is open national exchanges. Holding membership in another country's exchanges is another form of internationalization. Many countries opened their exchanges for membership by foreign firms in 1980s. For example, the first 6 foreign members were allowed to join the Tokyo Stock Exchange in February 1986, and in 1988 16 more seats were made available to non-Japanese firms.[17] After the "Big Bang"[18] of 1986 in London, many U.S. securities firms and banks applied to buy seats on the LSE. Merrill Lynch was the first U.S. firm with an affiliate on the London Exchange. By 1987, it had become the second largest Eurobond underwriter, and had a staff of 1600 in London.[19] In December 1997, the World Trade Organization (WTO) finalized an accord to liberalize worldwide financial markets. Previously, only 45 nations offered serious market-opening measures in the WTO context. The current agreement commits over 102 WTO members to liberalize their domestic markets and provide access to foreign financial services providers.

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[13] Ibid.
[14] Source: Securities Industries Association. Global Equity Analysis Reports.
[15] OTA-BP-CIT-66, *Trading Around the Clock: Global Securities Markets and Information Technology* (Washington DC, Diane Publishing, 1990), 31.
[16] Roel C. Campos, 'Speech by SEC Commissioner: The Global Marketplace and a Regulatory Overview' 2004 September 17, available at: http://www.sec.gov/news/speech/spch091704rcc.ht (last visited, January 2007).
[17] Motohiro Ikeda, 'Foreign Securities Firms'(1988) *The Japan Economic Journal*, 39.
[18] The Big Bang was a deregulation effort for British financial markets which began on October 27, 1986.
[19] Craig Forman, 'Merrill Scales Down London Ambitions' (1988) June 15 *Wall Street Journal*, 20.

A fourth trend in the globalization of financial markets is called "passing the book", whereby control of trading is passed between traders at exchanges around the globe.[20] This enables 24-hour trading of a financial instrument. An example of this would be a U.S. investment firm trading from New York during U.S. and Japanese hours and from its London desk during U.K. hours. The more common practice of passing the position book between time zones is actually to transfer the handling instructions between trades. However, most 24-hour trading now is in foreign exchange and bullion, not equities.

3.3 Driving Forces of Internationalization

Many factors are attributable to internationalization. It is instructive to examine them in turn in order to understand their mutual influence and to evaluate the alternative regulatory approaches in the international market. The most important reason for this growth was the increase in the demand for and supply of securities in the 1980s. This growth was aided by radical advances in technology, international diversification as well as changes in regulation.

3.3.1 Capital Imbalances

Capital market imbalances have increased the demand for an international market for securities.[21] When more capital is needed, more issuers will sell securities to the investor community. The supply of securities will grow. The opposite is also true. When there is an excess of liquidity there will be more demand for securities.

The revival of the world economy by the mid-1980s increased corporations demand for capital. Many businesses expanded aggressively and their needs soon began to outstrip the availability of local capital. Another force causing demand for private capital has been the privatization in the United Kingdom and Japan of-very large industries that had been owned by the state.[22] Many stock had to be offered in several countries at the same time because they are too big to be absorbed by investors in a single country. Since the mid-1980s, the collapse

[20] Jodi G. Scarlata, 'Institutional Developments in the Globalization of Securities and Futures Markets' available at : http://research.stlouisfed.org/publications/review/92/01/Developments_Jan_Feb1992.pdf.
[21] See Zandt, 'International securities market', above, n.5.
[22] See OTA-BP-CIT-66, *Trading Around the Clock*, above, n.15, 26.

of Communism in the former Soviet Union and Eastern Europe, and the economic reforms in China, Latin America and Southeast Asia, have also created a strong demand for capital in developing countries.[23] These in turn, has led to the continuing need for an international securities market. By tapping into the international markets, many businesses and governments found that they could raise capital at lower costs than if they restricted themselves to their domestic markets. They thus began to supply an increased number of securities to the international market.

On the other side of this equation, some countries have accumulated "excess capital" not matched by productive domestic investment opportunities. That money is available for investment through the securities markets of other countries. One example is Japan, with its high volume of exports. European investors also find that their domestic markets cannot meet their investment demands.[24] Another extremely significant event on the securities demand side was the growth of the institutional investor, especially the pension funds and insurance companies in the United States and the United Kingdom. They are becoming a major supplier of capital in the international markets. Such investment funds began in the 1980s to find that the available domestic financial assets in which they could invest were insufficient to absorb their growing treasures of money. In other words, an increase in the supply of funds became available for international investment. In 1975 institutional investors held less than 30% of the total outstanding equity in the U.S.[25] In the 1990s institutional investors hold about 50% of all equity in the U.S. market.[26] In the U.K. and Japan, institutional investors account for about 80% and 76% of overall equity ownership respectively.[27] Institutional investors and mutual funds are more sophisticated and better equipped to act in the international market than are individual investors. By pooling large quantities of capital, they reduce the cost of trading internationally. Finally, the maturation of currency swaps allows investors to convert foreign income streams into whatever currency they want quickly and cheaply.[28]

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[23] Jay D. Hansen, 'London Calling?: A Comparison of London and U.S. Stock Exchange Listing Requirements for Foreign Equity Securities' (1995) 6 *Duke Journal of Comparative & International Law*, 197, 219-20.
[24] Roy C. Smith, 'International Stock Market Transactions' in Thierry Noyelle (ed), *New York's Financial Markets: The Challenge of Globalization* (Boulder, CO: Westview Press, 1989), 8.
[25] Uri Geiger, 'The Case for the Harmonization of Securities Disclosure Rules in the Global Market' (1997) *Columbia Business Law Review*, 250.
[26] Ibid.
[27] Ibid.
[28] See Zandt, 'International securities market', above, n.5.

3.3.2 Technological Innovations

The inventions of telegraph, telephone and internet have speeded up the process of globalization and are reshaping the international capital markets. Four technological trends contributed to the globalization or internationalization: (1) expanding computer capability and declining costs; (2) digitization of data, and the resulting convergence of computer and telecommunications technologies; (3) satellite communications development; and (4) fibre optics development.[29] All these developments shrink distances and time differences tie together national securities markets. The ability to communicate instantaneously with distant parts of the world is a prerequisite for the creation of an international securities market.[30] Technology provides not only the basic conditions for an international market, but also the necessary liquidity. Internet trading lowers the costs of entry which allow a greater number of actors to participate in international activities and they provide the depth and liquidity that the market needs. Internet facilitates the breaking down of traditional walls between securities markets. "On-line Financial Supermarket" based on a single website has become a new model for financial service providers. Technology has also made possible the development of advanced analytical tools used for managing risk exposure in the global market and for arbitrage across markets.[31]

3.3.3 The Advent of Modern Portfolio Theories

International diversification is another force driving the globalization of securities trading. Portfolio theory was developed back in the 1950s by Henry Markowitz.[32] However, only during the 1980s did it become clear that an internationally diversified portfolio provides a significantly greater degree of risk reduction than a portfolio of domestic shares. This is due to the low correlation between returns on foreign and domestic securities.[33] Many institutional investment managers want to diversify fund holdings outside of their own country to protect

[29] See OTA-BP-CIT-66, *Trading Around the Clock*, above, n.15, 11.
[30] See Geiger, 'The Case for the harmonization', above, n.25.
[31] See Perry, 'Market 2000', above, n.4 (describing the use of computers for efficient pricing and hedging across markets).
[32] Henry Markowitz, 'Portfolio Selection' (1952) 7 *Journal of Finance*, 77.
[33] See Geiger, 'The Case for the Harmonization', above, n.25.

against both potentially adverse currency fluctuations and domestic economic recessions.[34] The value of cross-border portfolio investments by U.S. private-sector pension plans grew from $21 billion in 1980 to $225 billion by the end of 1988.[35] The ability to reduce portfolio risk by international diversification has become a driving force in the internationalization of equity markets.

3.3.4 Deregulation of the Major Securities Markets

The final factor behind the internationalization is the general deregulation of financial markets. Regulatory barriers have long been an obstacle to international securities trading. The removal of competitive barriers, referred to loosely as deregulation, has been both a driving force and a political response to internationalization.[36] Two types of deregulation are identifiable. The first, "access deregulation", meaning the reduction or elimination of regulatory barriers, such as exchange and capital market controls, has been justified as a stimulus to internationalization.[37] In addition, access deregulation requires that regulatory structures be modified to facilitate foreign participation in domestic markets. Access deregulation, however, must be distinguished from "prudential deregulation." The latter relates to the removal of rules primarily designed to protect investors against insolvency of markets participants, illiquidity, and uncertainty. Prudential deregulation is often justified on the basis of laissez faire political policies and free market economic efficiency theories.[38] The1980s saw a wave of access deregulation across Europe. For example, in 1986, the U.K. went through a major regulatory revolution (the "Big Bang").[39] The United Kingdom's "Big Bang" abolished numerous restrictions on brokerage companies and permitted foreign firms to become members of the stock exchange. "Big Bang" led to a floorless, electronic trading

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[34] From 1985 to 1987, U.S. pension plans increased their foreign equity holdings by $19 billion, while their holdings of U.S. equities decreased by $47 billion. See Roy, 'International Stock Market', above, n.188. At the end of 1988, U.S. private-sector pension funds had $52,5 billion in foreign investment. United Kingdom private pension plan investment overseas was $69 billion at the end of 1988, Japanese private pension plan investment overseas was $33 billion. Foreign private-sector pension plans had approximately $62.4 billion in portfolio investments in the United States at the end of 1988, and this had grown to $67.7 billion by June 1989. (Information provided by Intemec Research Corp., November 1989).

[35] Figures for 1980 and 1987 from SEC Staff Report to U.S. Senate Committee on Banking, Housing, and Urban Affairs and U.S. House of Representatives Committee on Energy and Commerce, 'Internationalization of Securities Markets' 1987, p. 88; 1988 figure provided by Intersec Research Corp. to OTA, November 1989.

[36] Manning Gilbert Warren III, 'Global Harmonization of Securities Laws: The Achievements of European Communities' (1990) 31 *Harvard International Law Journal*, 185.

[37] See OTA-BP-CIT-66, *Trading Around the Clock*, above, n.15.

[38] See Stigler, 'Public Regulation of the Securities Markets' (1964) 37 *Journal of Business Law*, 117.

[39] See Hansen, 'London Calling?' above, n.23, 212-213.

system for securities capable of adaptation to twenty- four-hour trading of the world's securities. Elsewhere in Europe, France beginning in 1985, removed foreign exchange controls that prevented its citizens from holding foreign securities,[40] and eliminated the ten percent withholding tax.[41] In the same period, West Germany was revamping its laws to permit futures trading, to allow shares to be listed in foreign currencies, and to reduce barriers to exchange listing of foreign securities. [42] While Spain meanwhile was experiencing its "muted Big Bang", which resulted in more foreign participation in its securities markets despite the dominance of Spanish banks.[43] In 2004, the EU further reformed its financial regulatory regime expanding its integrated scope to Multilateral Trading Facilities (MTFs).[44] The Markets in Financial Instruments Directive (MiFID)[45] introduced a new "investment service" relating to the operation of MTFs.[46] This allowed the operators of such systems to be authorized investment firms, subject to a customized regulatory regime. Following the implementation of MiFID by Member states, MTF operators were able to benefit from the Directive's "common passport," and make their trading facilities and services available to users throughout the EU, on the basis of home country authorization.[47] Europe's deregulatory wave has provided unprecedented access to its capital markets.

Likewise in the US, The US Securities and Exchange Commission (SEC) took a number of steps to facilitate offerings by foreign issuers in the domestic United States market, including the promulgation in 1982 of a series of modified forms for foreign private issuers.[48] In 1996 Japan's regulators come out with a new plan to deregulate Japanese securities laws with a view to making Japan a global financial center to rival New York and London. The plan, announced by the Japanese Prime Minister in November 1996, included the deregulation of

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[40] Nicolas Grabar, 'France: the aftermath of exchange controls' (1988) Oct *International Financial Law Review*, 8.

[41] Maxwell Watson, *International Capital Markets: Developments and Prospects* (International Monetary Found, Washington DC,1988).

[42] See HighBeam research, 'Sweeping Away Frankfurt's Old-fashioned Habits' (28 January 1989) *Economist (US)*, 73; HighBeam research, 'Fresh Air for Germany's Stuffy Stocks' (15 November 1986) *Economist (US)*, 99

[43] See Warren III, 'Global Harmonization', above, n.36.

[44] See Emillios Avgouleas, 'EC securities regulation, a single regime for an integrated securities market: harmonized we stand, harmonized we fail? Part 1' (2007) 22 (2) *Journal of International Banking Law and Regulation*, 82, 86.

[45] Directive 2004/39/EC (OJ 2004 L145/1)of 21 Apr 2004.

[46] See MiFID Annex I – List of Services and Financial Instruments, Section A – Investment services and activities.

[47] Article 31 (5) of MiFID.

[48] See Zandt, 'International securities market', above, n.5.

brokers' commissions, foreign-exchange controls and legal, tax and accounting barriers, and the lowering of the wall between the securities and commercial banking businesses. [49]

3.4 The Influences of Internationalization of Securities Markets

3.4.1 Consolidation

Internationalization of securities markets brought competition to a new level, forcing securities exchanges to consider in earnest, for the first time, real mergers and alliances in order to survive. Twenty one years ago, in 1987, there were four exchanges in Hong Kong. Now there is only one exchange in Hong Kong, operating with a single floor and under a single management.[50]Although technically different, a similar consolidation has occurred in Australia and Germany. In1988 Australia had six exchanges; now there is one, which consists of several floors linked electronically, but centrally governed.[51] Eight German exchanges have also merged.[52] United States exchanges, of course, have been electronically linked since the 1970s through the inter-market trading system (ITS).

In Europe, the most prominent is the merger of the Paris Bourse, Amsterdam Stock Exchange, Brussels Stock Exchange, and Portuguese Stock Exchange to form Euronext [53] where companies listed on each exchange are traded across the same order book. OMX has gone the furthest, bringing together the Copenhagen, Stockholm, Helsinki, Iceland, Riga, Tallinn and Vilnius exchanges into a single exchange with uniform listing rules. The LSE acquired Borse Italiana.[54] And both Euronext and Deutsche Börse have attempted, albeit unsuccessfully, to merge with the LSE.[55]

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[49] Sheryl WuDunn, 'Japan Announces New Plan to Deregulate Financial Markets' (1996) Nov. 12 *New York Times*, at D9 (describing the new Japanese Big Bang).

[50] See Reuters, 'Hong Kong Board Reshaped' (21 July 1988), *New York Times*, at D11.

[51]Aulana L. Peters, 'Securities regulation in the nineties' (1990) 9 *Annual Review of Banking Law*, 375.

[52] Ibid.

[53] Euronext website, Euronext History, http://www.euronext.com/editorial/wide/0,5371,17324427342,00.html (last visited Feb. 17, 2007).

[54]Alistair MacDonald, 'LSE Snags Borsa Italiana' (2007) June 23 *Wall Street Journal*, at B3.

[55]Alistair MacDonald, 'For LSE Chief Furse, Takeover-Fighting Skills Could Be Put to the Test' (21 September 2007) *Wall Street Journal*, at C1.

There is also international consolidation. Shareholders of both the NYSE Group and Euronext have approved the merger of the two entities.[56] In April 2007, the NYSE and Euronext merged into a single cross-border entity, named NYSE Euronext, to operate exchanges in Europe and the United States. Deutsche Börse and Borsa Italiana have also at various times been in negotiations to join the NYSE-Euronext combination.[57] The Nasdaq has agreed to acquire OMX.[58] As of February 27, 2008, the deal has just been completed.The Deutsche Börse and TSE also have been rumoured to be further participants in this global consolidation with either each other or other exchanges.[59] Deutsche Börse has sought link-ups with several European exchanges. Euronext is entering into a memorandum of understanding with the Shanghai Stock Exchange,[60] and both the London Stock Exchange and NYSE have sought to build alliances with the Tokyo Stock Exchange.[61] Meanwhile, more modest initiatives have also taken place, such as the Boston Stock Exchange's joint venture with the Montreal Stock Exchange to develop a common operating platform for options trading.[62]

The message is clear: the securities exchanges of the world are uniting. Within a few years, a handful of securities exchanges will dominate the global equity markets, and it is not clear yet whether the US exchanges will be leading partners in these ventures. The economic benefit of exchange consolidation is to concentrate trading on a single platform. They have several potential benefits: cost savings; increased liquidity; reducing the transaction costs of purchasing foreign securities; and diversification of the exchange's business into new product areas. But consolidation also raises the pressing question of how these international exchanges are going to be regulated?

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[56] See generally Roberta S. Karmel, 'The Once and Future New York Stock Exchange: The Regulation of Global Exchanges' (2007) 1 *Brooklyn Journal of Corporate, Financial & Commercial Law*, 355.

[57] Gaston F. Ceron, 'NYSE Group's Shareholders Approve Takeover of Euronext' (21December 2006) *New York Times*, at C3.

[58] Julia Werdigier, 'Nasdaq Agrees to Buy OMX, Operator of 7 Stock Exchanges in Europe' (26 May 2007) *New York Times*, at C3.

[59] Gaston F. Ceron, 'NYSE and Tokyo Tie a Knot' (1 February 2007) *Wall Street Journal*, at C2. On January 31, 2007, the TSE and NYSE announced a non-exclusive alliance to work together on trading technology, investment products, marketing and regulation.

[60] Euronext Sets Cooperation Pact, *Wall Street Journal*, (21 September 2006), at C4.

[61]Andrew Morse & Aaron Lucchetti, 'NYSE and Tokyo Exchange Discuss an Alliance' (27 October 2006) *Wall Street Journal*, at C3; Alistair MacDonald, 'London Bourse Flirts With Tokyo' (6 November 2006) *Wall Street Journal*, at C3; Heather Timmons & James Kanter, 'British Shun a New Offer by Nasdaq' (21 November 2006) *New York Times*, at C1.

[62] See Boston Options Exchange website, available at: http:// www.bostonoptions.com/ove/ope.php (last visited, August 2008).

3.4.2 Access to International Securities Market

The benefit of internationalization is access to markets otherwise inaccessible.Access to worldwide capital markets may allow a country to smooth its financial needs, borrowing in bad times and lending in good times. The internationalization of securities markets has increased the breadth and depth of securities markets, giving issuers' unparalleled access to a global investor base, and has increased investment opportunities and diversification of investment risks for investors. In the past, issuers used to have their securities listed on their home country market. Now investors in most developed countries have access to foreign securities, and issuers in almost every country can tap the major securities markets in the United States and Europe to raise equity capital. Without leaving home, listing and investing abroad became a practical story. With foreign listing, firms can obtain access to more liquid markets, attract more easily funds at lower costs and better terms, and tap into wider investor bases. Cross-border securities transactions have also enabled practices developed in one jurisdiction to be adapted and used elsewhere. [63]

3.4.3 Financial Infrastructure

Financial internationalization tends to improve the financial infrastructure. An improved financial sector infrastructure means that borrowers and lenders operate in a more transparent, competitive, and efficient financial system. In this environment, problems of asymmetric information are minimized and credit is maximized.

Another most important area of progress is the speed with which information is processed and disseminated to market participants. Firstly, internet technology has significantly enhanced information disclosure. In most countries, information on the listed companies is required to be disclosed entirely on the websites of the stock exchange. In China, in 2001, these financial statements enjoyed 90 million investor visits. 5.7 million of downloads or an average of 5000 downloads for each listed company were made.[64] In an emerging market like China's, internet is enabling a large number of new investors to leap frog to the new way of information

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[63] Kun Young Chang, 'Reforming U.S. Disclosure Rules in Global Securities Markets' (2003) 22 *Annual Review of Banking and Financial Law*, 237.
[64] Zhou Xiaochuan (Chairman of the China Securities Regulation Commission), 'Securities Market Regulation in the Internet Age' Speech at the 2001 IOSCO Annual Conference (27 June 2001), available at: http://www.iosco.org/library/annual_conferences/pdf/ac15-6.pdf (last visited, September 2007).

access.[65] Secondly, the rapid rise of information technology increases the familiarity of foreign corporations and their operation. This spread of information reduces one of the traditional obstacles to foreign investment and opens up both savings and investment opportunities. Furthermore, increased flows of market data provide greater accessibility to foreign markets. In turn, the larger number of participants using a market, the greater the liquidity of the market. Final but not least, information technology makes the process of disseminating faster and easier. The trends toward better, faster, cheaper, sooner are so powerful that they have revolutionized the industry in a relatively short period of time, and there is every reason to believe that this pace of change will, if anything, increase.[66]Consider, for example, the process of clearance and settlement. It was once an intensely physical process. Today, however, the vast majority of securities ownership positions are documented in electronic book-entry form. When a purchase or sale of a security takes place, the only physical thing that happens is the transfer of bits and bytes of data among databases.

3.4.4 The Risks

Trading in securities markets whether done domestically or across national boundaries, involves risks. Some of these risks are more important in an international setting than a strictly domestic setting. This was demonstrated when a series of corporate scandals of a global magnitude unravelled. The financial crises that erupted during the 1990s in the Nordic countries, east Asia, Russia, and Latin America – which were often associated with periods of rapid liberalization of the domestic financial system and the opening up of the capital account. The crises in Asia and Russia in 1997–98, Brazil in 1999, Ecuador in 2000, Turkey in 2001, Argentina in 2001, and Uruguay in 2002 are some examples that captured worldwide interest. These simultaneous collapse of the securities markets worldwide, have been recognized at the highest levels of government. [67]

The most critical risks for international securities trading, but also the most concerted efforts at problem resolution, are in the area of clearing and settlement. The term ‘Clearing' and

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[65] Ibid.

[66] Joseph A. Grundfest, ‘The Future of United States Securities Regulation in an Age of Technological Uncertainty' (2000) September *Stanford Institute For Economic Policy Research Discussion Paper No. 00-29.*

[67] For example, at the twenty-second annual meeting of the leaders of the G7 countries, one of the topics of the meeting focused on the opportunities and challenges presented by the increased integration of global capital markets. See generally G7 Economic Communique, Making a Success of Globalization for the Benefit of All (1996). The G7 countries are Canada, Italy, France, Germany, Japan, the United States, and the United Kingdom.

‘Settlement’ are used in different senses in relation to banking and investment exchanges.[68] In banking, clearing is used in a narrow sense to refer to the calculation of payment obligations. Clearing in the context of investment exchanges encompasses the narrow banking definition but also refers to the process by which a clearing-house becomes counterparty to transactions undertaken on the exchange and thereby guarantees performance of the contract.[69] Likewise, settlement in banking used in a narrow way, it refers to the transfer of value to discharge a payment obligation. In the investment context, settlement can also bear this meaning (eg in respect of exchange-traded derivatives which are settled by a monetary transfer) but it also refers to the performance of the mutual obligations of buyer and seller under a contract for the transfer of legal title to securities.[70] The clearing and settlement process is a series of complex tasks that start with trade confirmation and continue through the clearing process up to the actual settlement of a trade. The successful functioning of this system or series of systems is largely dependent on the close interaction of a number of intermediaries, each responsible for a distinct part of the process. Clearing and settlement system for financial instruments differ greatly within and across countries, in procedures, in timing of settlement, in the institutions involved, and in the degree, nature, and locus of risks.

Risks occur at various stages of the clearing and settlement procedures. Unlike risks commonly associated with price uncertainty, the risk in clearing and settlement procedures involve uncertainty about the timely payment of funds and transfer of assets in financial trade. Whenever risk in the post-trade industry is discussed, several risk categories are mentioned: credit risk, liquidity risk, position risk, operational risk, legal risk, and – resulting from these – systemic risk. The types of risk related to cross-border post-trade services (e. g. risks related to the settlement of a foreign security) are the same as for domestic post-trade services, although the risks are greater in terms of probability (but not necessarily in terms of exposure). Cross-border transactions often involve more parties, require a larger number of interfaces, and are more complex in nature. They often implicate uncertainty about the financial soundness of the parties involved. Most importantly, differences in legal frameworks represent a source of risks that is absent in the domestic context.

[68] Iain G MacNeil, *An introduction to the law on financial investment* (Oxford, Hart Publishing, 2005), 305.
[69] Ibid, 306
[70] Ibid, 307

Credit risk is the risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter.[71] This risk is much the same in domestic and international trades, but it may be made worse by internationalization because it is harder to make judgments about the reliability of counterparties, the quality of assets, or the degree of protection afforded by disclosure rules. Credit risk is increased as participants trade in several domestic and foreign markets, where regulatory standards and safeguards may vary widely. On the other hand, greater opportunities to divers' activities may help to reduce total credit risk. Many countries are now acting to improve their clearing, settlement, and payment mechanisms, and in some cases the sharing of information and this should moderate the increased credit risk.

Closely related to credit risk is liquidity risk, which is the risk that settlement of an obligation will be made not on the due date, but on some unspecified date thereafter.[72] At settlement, counterparties are exposed to both credit and liquidity risks. Liquidity risk occurs because settlement may not occur on the specified date; credit risk occurs because the other party may not deliver at all. Thus, at settlement, the parties may not know whether the problem will be one of liquidity or credit. The settlement of international trades can exacerbate the problem of simultaneously exchanging securities for payment because of time zone differences.

Position risk is large relative to an institution's capacity to bear loss can seriously injure or even destroy a financial institution.[73] It is the most important category of risk facing securities firms because proprietary positions in a wide range of financial instruments are closely allied with the core activities of underwriting, trading, and dealing in securities. A long list of firms, including many of the most active international financial institutions, has incurred trading losses that have exceeded at least one quarter's earnings.[74] International trading can reduce position risk by offering a greater choice of markets, more opportunities to hedge, and a greater variety of trading strategies. On the other hand, globalization of markets tempts traders to trade in environments where they do not understand all of the dangers and may lack buffers such as back-up lines of credit.

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[71] CPSS publications, 'Report on netting schemes (Angell Report)'. Basle, February 1989, (see glossary of terms) available at: http://www.bis.org/publ/cpss02.htm.

[72] Ibid.

[73] Richard Herring and Til Schuermann, 'Capital Regulation for Position Risk in Banks, Securities Firms and Insurance Companies' in H. Scott (ed.) *Capital Adequacy: Law, Regulation, and Implementation* (Oxford University Press).

[74] Ibid.

Operational risk is the risk of a human error or a breakdown or deficiencies of some components of the hardware, software or communications systems that are crucial to the settlement process.[75] It covers both operational reliability and business continuity/contingency issues. Technology provides powerful capabilities for getting things done, and for guarding against the human risks of error, inattention, incompetence, misfeasance, and malfeasance. But technology entails its own risks of breakdown and misuse, which almost certainly increase with internationalization. Technologically sophisticated systems have failed in all countries, including the United States, for example, telephone networks, electric power distribution systems, and air traffic control systems. The ability to develop and maintain technological systems is not the same in all countries. Technological backups may be inadequate or untested, or may fail for the same reasons that the primary system fails. In late 1989 and early 1990, for example, a severe drought in the Philippines caused a shortage of hydroelectric power, causing blackouts and making it impossible to depend on electric systems in the financial sector. In addition, dependency on technological systems increases the vulnerability when the system fails, because manual skills, interpersonal relationships, and alternative means of operating have often been forgotten or lost. In global trading, some of these alternative and backup procedures have never been developed. At the same time, expectations of speed and efficiency have increased because of technology, and so the impact of breakdown maybe greater.

Legal risk is the risk that a poor legal framework or legal uncertainties will cause or exacerbate credit or liquidity risks.[76] It relates to the unexpected application of a law or regulation or to the possibility that title, a legal interest, or a contract cannot be enforced. The regulatory environment and the legal structures covering central securities depositories are critical to ensure the safety of the assets and contract enforceability. Legal risks may cause one party to a trade to suffer losses because laws or regulations do not support the rules of the securities settlement system or the property rights and other interests held through the settlement system.

[75] Assessment of NBB SSS against the CPSS-IOSCO Recommendations for SSS, available at: http://www.nbb.be/doc/ti/assessmentnbbsss_cpss_iosco_july2005.pdf.
[76] Committee on Payment and Settlement Systems (CPSS) report, 'Core Principles for Systematically Important Payment Systems', January 2001, p. 7.

There is a further risk of unknown dimensions that comes with internationalization—systemic risk. Systemic risks are low-probability, high-impact events. That term refers to the risk that the failure of a very large firm might affect other firms, creating a potential domino effect, in other words a simultaneous collapse of the securities markets worldwide. Systemic risks arise because "enhanced linkages across national and international financial markets increase the volatility of capital flows", thus creating the "potential for concentrated disturbances".[77] In the context of payment and settlement systems, the size and duration of credit and liquidity exposures experienced by financial institutions in the course of settling their transactions contributes to systemic risk because as these exposures increase so too does the likelihood that some institutions may be unable to satisfy their obligations.[78] Systemic risk is also related to the relative propensity of payment and settlement systems to transmit exposures suddenly or unexpectedly from one participant to another - and from one market to other markets - in ways that increase the difficulty all participants will have in managing and containing their exposures.[79]

The above risks are always aggravated in the international field which are often poorly understood by individual investors and also perhaps by professional investment managers. In the worst case, the failure of major market participants (e.g., securities firms or banks) with heavy commitments in several countries could have gravely detrimental results for national financial and payment systems and possibly for entire economies. This consideration to the fore in the recent Federal Reserve Rescue of AIG, the world's largest insurer, which had links to all the major securities markets.

3.5 Calling for International Securities Regulation

Along with internationalization, the world's securities markets have changed dramatically. As discussed above, international securities markets have already witnessed the consolidation of different exchanges from various regions of the world, as well as great growth of securities in cross border transactions. The basic aim of all regulation is to control the risks associated with

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[77] See Joseph J. Norton, ''International Financial Law', An Increasingly Important Component of 'International Economic Law': A Tribute to Professor John H. Jackson' (1999) 20 *Michigan Journal of International Law*, 141

[78] Report of the Committee on Interbank Netting Schemes of the central banks of the Group of Ten countries, November 1990, http://www.bis.org/publ/cpss04.htm.

[79] Ibid.

regulated conduct. For the international field it is more important because the risks are greater than those of the national field. It then becomes inevitable to consider the role and position of the securities regulatory body in an international financial market. The growth of cross-border mergers and transactions raises the pressing question of how these international exchanges and cross list trades are going to be regulated. Will one country's regulator regulate them? Will each subsidiary market be regulated separately by a nominal home nation regulator who may apply different standards? Will national regulators develop coordinated regulatory systems based upon shared mutual principles of regulation and mutual deference to coequal regulators? All these changes have directly challenged regulators abilities to achieve their over-riding regulatory objective of protecting investors, promoting market integrity, and reducing systemic risk in a cross border regulatory environment.

Unfortunately, the securities regulation does not keep pace with the international tide. Generally, most modern securities markets are regulated on a national basis. As a result of the disparate times and circumstances under which the various financial markets of the world were born, each nation developed its own regulatory regime to govern its markets in relative isolation.[80] For a long time, each nation regulated its securities markets in different ways, and these differences were often significant. So each time issuers cross-list an issue, they must contend with regulation. There are nevertheless major obstacles, such as legal, regulatory, and cultural differences between nations and markets. Some of these differences impose serious risks to investors, market organizations, and other financial institutions. One scholar has described the diversity of the international securities market as "a nightmare", [81] due in part to the variety of securities markets that exist worldwide. Traditional territorial based regulatory regimes represent significant obstacles to the development of a truly international securities market. The current fragmented infrastructure is increasingly perceived as a source of cost inefficiencies and significant risk.[82] This practice creates a challenge in light of the increased internationalization of the securities markets and the increasing interdependence among them. In a more competitive and transformed capital market, historical national securities regulation is increasingly inapposite and in need of reform in order to bring it into the modern age. Thorstein Veblen, a North American social thinker in the early part of the 20th century,

[80] See Steinberg & Michaels, 'Commonality and Reciprocity', above, n. 7.
[81] Peter E. Millspaugh, 'Global Securities Trading: The Question of a Watchdog' (1992) 26 *George Washington Journal of International Law & Economics*, 359.
[82] Francis Braeckevelt, 'Clearing, settlement and depository issues' *The Bank for International Settlements (BIS) Papers No 30*, 284.

expressed the timelessness of the challenge we continue to face: "Institutions are products of the past process, are adapted to past circumstances, and, are therefore never in full accord with the requirements of the present".[83] This is true. When the environment of securities markets changed, the corresponding regulation also needs to change. "The only real impediment to a global market is regulatory, and not technological. Specifically, what is lacking is an appropriate regulatory framework within which the market can operate."[84] Territorial oriented regulatory systems must be replaced by a regulatory regime which provides the necessary legal infrastructure to support the development of a truly international securities market.

The challenges that regulators and market participants face in building an internationally robust and efficient infrastructure are numerous and complex. As the world's capital markets struggle to meet the ever-increasing demand for capital,[85] development of a comprehensive global securities regulation plan is essential. Such a plan would serve two objectives: (1) enhancement of international economic good through capital formation; and (2) avoidance of an international economic crisis.[86]

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[83] See Knight, 'Globalization and Financial Markets', above, n.8.
[84] Laura S. Unger, 'The Global Marketplace, Ready or Not Here it Comes, Remarks at the Third National Securities Trading on the Internet Conference (January 24, 2000) available at: http://www.sec.gov/news/speech/spch344.htm (last visited, 2007 October).
[85] See Andreas J. Roquette, 'New Developments Relating to the Internationalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community, and Germany' (1994) 14 *University of Pennsylvania Journal of International Business Law*, 565, 566.
[86] Samuel Wolff, 'Recent Developments in International Securities Regulation' (1995) 23 *Denver Journal of International Law and Policy*, 347,417.

Chapter Four: Theory of International Securities Regulation

4.1 Introduction

Undoubtedly, as discussed in the previous chapter, the internationalization of securities markets presents both opportunities and challenges for issuers, investors and regulators. Since securities markets internationalization is on the increase, there is a great need to structure a regulatory regime based on an international economy. It is worth noting that the international market will most certainly be characterized by not only the cosmopolitan nature of the players, but also the differences within geographical settings. Internationalization has challenged traditional notions of regulation and enforcement. Administering and enforcing national laws against foreign companies is often limited and difficult because of the principle of state sovereignty, which provides a state with exclusive and supreme power within its national borders. It is a new reality which requires a rethinking of securities regulations for the world. It requires an appropriate international legal and regulatory response. Although international regulators can usually agree on the basic goals and objectives of regulation, there exist fundamental differences in the regulatory approach taken, including the form and content of regulation. The large number of participants and the massive dollar amounts involved in international activities make it vital to determine which regulatory regime can govern these activities most efficiently. In general, alternatives to the conventional territorial based regulation falls somewhere along a spectrum of models of international securities regulation, with the concept of harmonization at one end, and regulatory competition at the other. There is also a third approach that falls somewhere between the two extremes of harmonization and regulatory competition which is cooperation. In response to various market failures, different regulatory regimes are introduced but, naturally, regulatory responses can overlap or conflict. Therefore, a regulatory system is not only conditioned on the economic, political, legal, cultural and administrative environment but also depends on how different regulatory measures are organized to combat market failures in an efficient manner. The management of the coexistence of diverse regulatory objectives therefore poses a challenge to policy makers and regulators. To understand the various regulatory models, it will be helpful at the outset to clarify certain regulatory concepts. Therefore this chapter will focus on a discussion of the theory. Thereafter, the following chapters will discuss the practice.

4.2 Main Theories

Internationalization has challenged regulators to seek new mechanisms to deal with cross border regulatory issues. So what can regulators do in the rapidly evolving world? Put simply, there are at least three options: harmonization, competition and cooperation. Although different in approach, one thing is for certain: any regulatory theory considered for international application must appreciate the diverse, complex and pluralistic world in which we live, as well as the quickness in which international financial transactions are conducted. This part will analyze these three leading current theoretical arguments in turn as paradigms for international securities regulation.

4.2.1 The Theory of Harmonization

It is not difficult to give a definition of harmonization. The problem lies in the fact that in the securities regulation field there are other concepts that exist at the same time which could possibly confuse people. Harmonization is not the only word that has been used to describe efforts to move towards a single system of regulation. The terms unification and convergence have also been used. It is not uncommon to see that harmonization has been replaced by unification and convergence. Do they have the same meaning or is there a fundamental difference between them? Without answers to these questions, we can not fully understand harmonization of securities regulation. Firstly, this part will give a brief definition of harmonization. Secondly, the thesis will analyze the relationships between these concepts in order to make a clearer picture of harmonization.

4.2.1.1 Defining Harmonization

Harmonization can be loosely defined as making the regulatory requirements or governmental policies of different jurisdictions identical, or at least more similar.[1] A "Harmonization claim" is a normative assertion that the differences in the laws and policies of two jurisdictions should

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[1] David W.Leebron, 'Lying Down with Procrustes: An Analysis of Harmonization Claims' in International and European Law Department (eds), *Harmonization in the European Union Part I: Capita selecta EU Law* (Katholieke Universiteit Nijmegen, 2001).

be reduced.[2] It is one response to the problems arising from regulatory differences among political units, and potentially one form of inter-governmental co-operation. Harmonization is the process of reconciling two or more models in order to achieve greater similarity. Countries may achieve harmonization by ceding lawmaking authority to an international body or agency; alternatively, countries may agree to enact similar rules through their normal, domestic rule-promulgating procedures. Harmonization allows for at least two approaches. The first, "commonality", means the development of uniform international rules enforced in all countries.[3] The second, "reciprocity" or "comparability", calls only for substantially equivalent minimum standards.[4] This approach has as its goal the mutual recognition by one country of the regulatory scheme and related documents of another country as long as certain minimum standards are met. Arguably, harmonization through reciprocity is easier to achieve, particularly in view of the fact that there is not a single international regulator charged with overseeing global offerings.[5]

4.2.1.2 The Relationship between the Concepts

Firstly, consider harmonization versus unification**.** Harmonization should be used to refer to the process of reducing, so far as is desirable and possible, the discrepancies between the national legal systems by inducing them to adopt common principles of law. Unification, in comparison, can be described as harmonization with a zero margin[6], where no, or minimal, differences are tolerated. The degree to which a harmonization requirement continues to tolerate difference is the harmonization "margin". When the margin is zero, this is called unification. In other words, unification is full harmonization. The difference between harmonization and unification is often one of degree, and one indicator may be the effect of the instrument that is produced by the process and whether it is binding.

Secondly, consider harmonization versus convergence**.** The original meaning of convergence is the observed tendency of living forms, which are quite unrelated systems, to respond to

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[2] Conference, 'Seoul Conference on International Trade Law: Integration, Harmonization, and Globalization' (1996) 10 *Columbia Journal of Asian Law*, 305.

[3] Manning Gilbert Warren, III, 'Global Harmonization of Securities Laws: The Achievements of the European Communities' (1990) 31 *Harvard International Law Journal*, 185-186.

[4] See Bevis Longstreth, 'A Look at the SEC's Adaptation to Global Market Pressures' (1995) 33 *Columbia Journal of Transnational Law*, 319, 320.

[5] Ibid.

[6] See Leebron, 'Harmonization claims', above, n.1.

similar contingencies of life by developing similar structures.[7] It is the development of similar characteristics by organisms of different ancestry. In this thesis, the convergence is regulatory convergence. It is the process by which the rules, regulations, or political institutions governing economic activity in different countries become more similar. Under this definition, regulatory convergence implies that regulations in two or more countries become more similar over time, but it does not necessarily imply that regulatory structures are, or will become, identical.[8] It is possible to distinguish three forms of regulatory convergence: voluntary, semi-voluntary and mandatory. Mandatory convergence is typical of the EC process of approximation of national laws, and depends on some form of authority being given to a supranational body. Harmonization does not adopt a one-size-fits-all approach, but accommodates national differences. Convergence on the other hand is moving together towards a common result. Harmonization has evolved into convergence: soft harmonization provides for a flexible and effective convergence of different legal systems.

All in all, we can see that although they are similar, harmonization is different from unification and convergence. They should not interchange each other from time to time. It also can be included that harmonization may have a greater chance of success compared with unification and convergence in securities regulation.

4.2.2 The Theory of Regulatory Competition

Regulatory competition is not a new concept. It has more than a 200 year history. It originated from Adam Smith's famous theory of the "invisible hand of the market." According to Adam Smith there is a kind of natural force guiding free market capitalism through competition for scarce resources.[9] Since Smith, many economists have believed that a competitive market is the perfect way to allocate social resources.[10] The "mature theory of regulatory competition" can be traced back to a classic 1956 article by Charles Tiebout.[11] While Tiebout's model was essentially applied to the provision of public goods, it was quickly and logically applied by

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[7] See The Meaning of Convergence, available at: http://custance.org/old/evol/3ch1.html (Last visited, 2005 November).

[8] See Henry Laurence, 'Spawning The SEC' (1999) 6 *Indiana Journal of Global Legal Studies*, 649.

[9] Invisible hand definition available at http://www.investorwords.com/2633/invisible_hand.html.

[10] Uri Geiger, 'The Case for the Harmonization of Securities Disclosure Rules in the Global Market' (1997) *Columbia Business Law Review*, 241.

[11] Charles M. Tiebout, 'A Pure Theory of Local Expenditures' (1956) 64 *Journal of Political Economy*, 416.

others to the private market and the regulation of business firms. The basic rationale for competition is that law is a product, competition among suppliers results in products that better satisfy consumer preferences.[12] In our modern day, the theory of regulatory competition has had its most prominent explication in the area of corporate law. The paradigmatic example of this regulatory competition phenomenon is the market for corporate charters in the United States. Corporate charter competition among U.S. states has been held out as a model of welfare-enhancing regulatory competition. It offers a plausible success story. In this system, corporations are free to choose - independent from their physical location - the state of incorporation and therefore the substantive rules applicable to their internal corporate affairs. According to Romano, this competition produces corporate law that maximizes firm values and investor returns.[13] The securities law competition model was derived from it. Since inter-state regulatory competition in the U.S. has been effective in producing high regulatory standards, advocates of regulatory competition have extended the logic of state securities law competition to the international realm by proposing multinational securities law competition.[14] In Romano's view, competition over securities regulation will similarly cause regulatory regimes to converge around the rules that issuers and investors want.[15]

Generally speaking, regulatory competition theories are based on the premise that different regulators (whether nations, states, agencies, stock exchanges, or the like) compete to attract regulated subjects. It can be defined as a contest among regulatory jurisdictions to attract market participants by offering them the most efficient regulatory environment in which to operate.[16] Along with the competition theory's development, the argument about a race to the top or a race to the bottom is becoming topical. The terms "race to the top" and "race to the bottom" have become familiar shorthand expressions in a longstanding academic debate in the United States over whether competition among states for corporate charters produces more or less efficient legal rules. The "race to the top" hypothesis predicts that in an open world economy states will engage in competitive re-regulation. Romano, a leading race-to-the-top

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[12] Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 *Journal of Law, Economics, and Organization*, 225.
[13] Roberta Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 *Yale Law Journal*, 2359.
[14] Ibid, 2418-24; also see Roberta Romano, 'The Need for Competition in International Securities Regulation' (2001) 2 *Theoretical Inquiries Law*, 387, 388; Stephen J. Choi & Andrew T. Guzman, 'Choice and Federal Intervention in Corporate Law' (2001) 87 *Virginia Law Review*, 961, 982-83.
[15] See Romano, ' Empowering Investors', above, n.13.
[16] Maura B. Perry, Note, 'A Challenge Postponed: Market 2000 Complacency in Response to Regulatory Competition for International Equity Markets' (1994) 34 *Virginia Journal of International Law Spring*, 701.

exponent, analyzed empirical evidence as showing that the race is more to the top because the many markets in which firms operate--the capital, product, and corporate control markets--constrain managers from choosing a legal regime detrimental to shareholders' interest.[17] David Vogel argued that increased levels of international trade have been accompanied by an upward shift in the regulatory standards for consumer and environmental protection. In his words, the "California effect" has outweighed the "Delaware effect".[18] On the contrary, the original expression of a "race to the bottom" was coined by William.L. Cary, who defined the race-to-the-bottom as a system where the legal infrastructure, enforced by the courts, allows an environment in which corporate management is able to benefit most from their decisions without regard to the needs of the shareholder.[19] The "race to the bottom" hypothesis posits that regulations are costly to business. Therefore, businesses will whenever possible migrate to the country with the lowest level of regulations. As soon as financial investors are able to transact in foreign markets, they will flock to the country with the lowest level of regulations. Ralph Bryant writes that because: financial intermediation is more "footloose" than most other economic activities ... the scope exists for an individual locality or nation to try to lure financial activity within its borders by imposing less stringent regulation, taxation, and supervision than that prevailing elsewhere.[20]

According to the above theory, in the securities regulation field, companies should be free to choose from a menu of securities regulation options offered by nations around the world and the world's stock exchanges. Professor Romano and Professors Choi and Guzman envision companies being able to choose to be governed by the laws of countries that provide for much, little, or no disclosure; much, little, or no fraud protection; and many, few, or no corporate governance rules.[21] Whereas Romano generally posits a sprint to the top, Choi and Guzman admit that some issuers may choose regimes of little or no fraud protection for investors, but suggest that investors, being "rational and informed," will simply discount what they are

[17] Roberta Romano, *The Genius of American Corporate Law* (AEI press, 1993), 14-24.
[18] David vogel, *Trading up: consumer and environmental regulation in a global economy* (Cambridge: Harvard University Press, 1995),248.
[19] William L Cary, 'Federalism and Corporate Law: Reflections Upon Delaware' (1974) 83 *Yale Law Journal*, 663, 666 (explaining the competition for corporations leads to a "race to the bottom" because states have "watered [down] the rights of shareholders vis-à-vis management.").
[20] Ralph Bryant, *International Financial Intermediation* (Brookings Institution Press,1987), 6.
[21] Robert A. Prentice, 'Regulatory competition in securities law: A Dream (that should be) deferred' (2005) 66 *Ohio State Law Journal*, 1155.

willing to pay for those shares.[22] However, Merritt B. Fox[23]and James D. Cox[24] claim that competition would result in a race to the bottom, with issuers choosing the lowest level of disclosure possible.

4.2.3 The Theory of Cooperation

Cooperation theory is based on empirical (as opposed to theoretical) reasoning; it recognizes that decentralization might not enhance market welfare or generate sufficient competitive pressure on territorial regulators.[25] Cooperation traditionally is an instrument to reduce conflicts and tensions. International cooperation is defined as conscious policy coordination among states.[26] However, cooperation has its problems. Opponents of cooperation argue that efforts on the part of countries to construct workable international cooperation into securities regulation, although fine in theory, it is most likely to fail. In theory, countries may design efficient securities regulations through international cooperation that would be enforced globally. Parties engaging in securities fraud, for example, would find it difficult to escape enforcement under a perfect global regulatory regime. In practice, of course, the existing global regulatory regime is far from perfect. Although the SEC has met with some success in gaining cooperation from other countries regarding insider trading laws, international cooperation remains limited. Opponents also state that cooperation is not readily attainable, and assume that unilateral regulation measures will be the paradigmatic form of regulation in the foreseeable future.[27] They further argue that the fundamental incentive of securities regulators is not to cooperate with their colleagues to the extent that such cooperation might undermine their country's competitive position.[28] Despite the above, it cannot be denied that the confluence of an international world economy and diverse national regulations prompts cooperation. Cooperation supporters hold that states in general and in particular should

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[22] Stephen Choi, 'Promoting Issuer Choice in Securities Regulation' (2001) 41 *Virginia Journal of international law*,815, 816.
[23]Merritt B. Fox, 'Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment' (1999) 85 *Virginia Law Review*, 1335.
[24]James D. Cox, 'Regulatory Duopoly in U.S. Securities Markets' (1999) 99 *Columbia Law Review*, 1200
[25] See Daniel C. Esty & Damien Geradin, 'Regulatory Co-opetition' (2000) 3 *Journal of International Economic Law*, 241-42.
[26] See Kenneth A. Oye, 'Explaining Cooperation Under Anarchy: Hypotheses and Strategies' in Kenneth A. Oye (eds) *Cooperation Under Anarchy* (Princeton: Princeton University Press, 1986),6.
[27] Amir N. Licht**,** 'Games Commissions Play: 2x2 Games of International Securities Regulation' (1999) 24 *Yale Journal of International Law*, 61.
[28] Ibid.

enhance cooperation and assist their fellow-regulators.[29] Strengthening the inter- and intra-jurisdiction cooperation of regulatory agencies can lead to improved regulatory effectiveness. Faced with the growing complexity of modern securities markets, some national securities regulators have recognized the need for greater cooperation. For example, in the area of enforcement of judgments, the United States, the United Kingdom, and Japan have already expressed the view that means should be developed to enhance cooperation.[30]

There are some reasons to support cooperation. Firstly, internationalization and technological advances affecting financial markets facilitate both cross-border flow of capital and cross-border flow of fraud.[31] This indicates the need to fight organized crime and drug trafficking.[32] Among the challenges to combat financial crimes effectively in an international marketplace, it is particularly difficult for a regulator in one territory to accurately assess a firm's capital risk exposure unless that regulator has access to information relating to such firm's operations in other jurisdictions. In many instances, no single regulator will have access to all of the information necessary to protect the interests of investors and the integrity of domestic securities markets.[33] If any one particular country had sufficient unilateral power, it might not take into consideration the possibility that another country could object to its attempts to seek information, evidence, and enforcement of court orders in their jurisdiction. However, no country today has such power, and each country must concern itself with the willingness of other countries to cooperate. A primary objective of any securities regime must be to maintain justifiable public confidence in the integrity of the securities markets by ensuring the flow of reliable information to investors. To accomplish this goal, a securities regime must provide investors adequate remedies for fraud and deter wrongdoing by promising public enforcement efforts to detect and punish fraud. Effective enforcement of securities laws requires that

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[29] David Charny, 'Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities' (1991) 32 *Harvard International Law Journal*, 423; Steven R. Salbu, 'Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach' (1992) 66 *Tulane Law Review*, 837; Manning Gilbert Warren, III, 'Global Harmonization of Securities Laws: The Achievements of the European Communities' (1990) 31 *Harvard International Law Journal*, 185.

[30] Trilateral Communique on Cooperation between the SEC, the DTI and the SIB of the United Kingdom, and the Securities Bureau of the Ministry of Finance of Japan, 47 SEC Docket 373 (October 1, 1990).

[31] SEC staff, 'International cooperation in securities law enforcement' (2004 Prepared for the international training institute) available at: http://www.sec.gov/about/offices/oia/oia_enforce/intercoop.pdf (last visited, September 2008).

[32] Caroline A.A. Greene, 'International Securities Law enforcement: Recent Advances in Assistance and cooperation' (1994) 27 *Vanderbilt Journal of Transnational Law*, 635.

[33] Michael D. Mann, William P. Barry, 'Developments in the internationalization of securities enforcement' (2005) 39 *International Lawyer*, 667.

regulators be able to thwart the dissipation or secreting of the fruits of international securities fraud, and to facilitate the return of the illicit profits to injured investors.[34] Accordingly, an important step toward the recovery of funds is the ability to seek asset-freezes.[35] In the absence of such asset-freezes, the effectiveness of a final judgment commanding disgorgement may be undermined by a defendant dissipating or secreting the funds.

Secondly, in a world of separate sovereignties, it becomes necessary for one sovereign to seek the cooperation of another in order to make the first sovereign's law effective. This is because it is possible for persons who break the first sovereign's laws to travel to the territory of the second sovereign, or to locate their business records or their properties that might be used to satisfy a judgment in the territory of the second sovereign. For example, someone who was an inside trader could evade detection by using a Swiss bank account. Also, in the midst of contagious crises, governments tend to lack sufficient resources to stop a currency attack, and individual governments can do little to stop crises being originated in foreign countries. In these cases, international financial coordination can help individual governments achieve their goals.

The unilateral acts of foreign states who enact blocking laws to shield investors from the onslaught of imposition, if continued, could be harmful to the internationalization of the securities markets, relations between states, and individual investors. Cooperation on an international level is necessary to resolve this conflict in state practice.[36] Conflicts of law which currently frustrate enforcement efforts must be resolved. New means must be developed to investigate and prosecute those who transact business from abroad in violation of national securities laws. Cooperation holds the key to any solution. As a result, regulators must be able to gather and share information with their regulatory partners world-wide to detect, investigate and prosecute fraud effectively.

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[34] Michael D. Mann, Paul A. Leder, Elizabeth Jacobs, 'International Regulatory Competition and The Securities Laws' (1992) 55 *Law and Contemporary Problems*, 303.

[35] Ibid, 332.

[36] Roger A. Patkin, 'Arbitration of extraterritorial discovery disputes between the securities and exchange commission and a foreign broker-dealer: a new approach to the restatement balancing test' (1987) 5 *Boston University International Law Journal Fall*, 413.

4.3 The Relationship among Harmonization, Competition and Cooperation

Among scholars of international regulatory reform, harmonization is often viewed as the polar opposite—the nemesis—of competition. In the securities regulation sphere, the main arguments opposed to regulatory competition are its incompatibility with harmonization and its potential to create bigger barriers rather than covering the gaps.

Harmonization and competition, however, may not necessarily be antipodal in all contexts. Far from incompatible, competition and harmonization may be complements in some circumstances. Tung argues that minimal harmonization is required for certain forms of regulatory competition to exist such as the portable reciprocity which underlies the European passport. [37] Furthermore, in theory, competition should cause a tendency toward harmonization, provided economic agents have similar concerns. In fact, the principle of mutual recognition has been associated with regulatory competition since its inception. Lannoo also said some degree of competition between jurisdictions can do no harm.[38] On the other side, harmonization is a means of improving competition by reducing investment barriers, increasing mobility, making information cheaper and diminishing market power effects. Harmonization would eliminate the major obstacles to competition. [39] Issuers and investors would find access to foreign markets easier, and this would increase sound competition among domestic markets. Harmonization would also increase inter-firm competition. Companies from all around the world would have easier access to foreign capital. For their part, investors would be much more receptive to foreign investment. They would face lower information costs and would be able to compare the risk-return characteristics of companies in all markets using a single set of documents. The goal of abolishing barriers can also be achieved through a regulatory competition between States. It is inferred that it cannot absolutely be said that regulatory competition is incompatible with harmonization and it also would not be convincing to say that only harmonization by directives can lead to uniformity and that competition among rules will lead to diversity.

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[37] Tung, F, 'Passports, Private Choice, and Private Interests: Regulatory Competition and Cooperation in Corporate, Securities, and Bankruptcy Law' (2002) *SSRN Working Paper & Chicago Journal of International Law 3(2)*.

[38] Karel Lannoo, 'Updating EU securities market regulation' Report of a CEPS task force, available at: www.fese.be/initiatives/european_representation/2001/ceps.pdf.

[39] Uri Geiger, 'The Case for the Harmonization of Securities Disclosure Rules in the Global Market' (1997) *Columbia Business Law Review*, 250.

Both harmonization and competition have a close relationship with cooperation. Without a sound cooperation system, harmonization or competition maybe unsuccessful. The process of harmonization will require compromises among many domestic regulators that hold different views about securities regulation. Political opposition by various interest groups can hinder, if not stop, the process of harmonization. Moreover, when standards are “formally” harmonized, their enforcement and interpretation might differ among nations. All these things required substantial cooperation between different regulators and interest groups. If different regulators do not all cooperate, nations might be forced to offer securities regulation that are below the level of stringency which they think are desirable. The result could be a race to the bottom. Furthermore, regulatory competition also can exist in a cooperative framework that permits different regimes to coexist. Such systems encourage potential subjects of regulation to choose which regime they will follow. These choices in turn encourage states to offer regulatory packages that will attract transactions, from which they can extract taxes and other rents.

Chapter Five: Harmonization

5.1 Introduction

According to internationalization, as discussed in chapter 3, there is a definite need to reform the present national regulatory system. The creation of a harmonized regime for securities regulation has been said to be one way of regulating the phenomenon of internationalization. The movement towards and support of international harmonization has already gathered momentum. This chapter will examine the harmonization efforts[1] being made in order to improve international securities regulation.

The structure of this chapter is as follows. Firstly this chapter will examine the rationales for harmonization. Secondly it will proceed to examine briefly the processes of harmonization. Thirdly it will discuss how to harmonize and what kinds of techniques have been used. The last two sections will considers the scope of harmonization and then discuss the roadblocks to harmonization.

5.2 The Rationales for Harmonization

It is true that harmonization of the securities regulation is now broadly accepted, but we should not take it for granted. The reasons as to why we need harmonization still need to be explored. Such an examination will provide guidance as to the goals or objectives of harmonization. Harmonization has been pursued for a host of reasons, both internationally and nationally.

5.2.1 Common Reasons

Firstly, one of the reasons is the influence of internationalization. The internationalization of the world's securities markets has become a well-established phenomenon.[2] It has resulted in a

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[1] In this thesis, the harmonization efforts which examined referred to harmonization as to content.

[2] Uri Geiger, 'Harmonization of securities disclosure rules in the global market—a proposal' (1998) 66 *Fordham Law Review*, 1785.

rapid increase in securities transactions that cut across the national borders of more than one country. In the past, the vast majority of securities transactions involved only residents of the same country, regulators could simply focus on their own individual jurisdictions. Today, investors in most developed countries have access to foreign securities, and issuers in almost every country can tap the major stock markets in the United States and Europe to raise equity capital. Hence, individual country regulators can no longer avoid the question of how regulatory authority should be allocated for such transactions.[3] The present territorial approach to securities regulation suffers from numerous flaws. As in the case of other forms of mandatory regulation, territorial regulators may make errors and are subject to pressure from special interest groups in the securities industry. Regulators might also seek to maximize their own prestige and power through overly complicated regulations. Harmonization of different country securities regulatory regimes is not the only way, but at least, it is a response to it.

Secondly, the harmonization of rules is, from the economist's perspective, regarded as justified where it is necessary to correct a market failure, which extends beyond national boundaries and cannot be corrected by the action of an individual State. The scholarly literature has also begun to embrace the notion that harmonization is the mechanism by which unfair differences in legal and other regimes are eliminated, and the level playing field, the metaphoric symbol of fairness, is restored.[4] In the securities regulation sphere, harmonization is typically regarded as justified where markets interact such that intermediaries, investors, and transactions move between them, leading to the potential for cross-border externalities such as fraud and systemic risk. Harmonization is a means of achieving goals such as greater efficiency or fairness as well.[5]

Thirdly, harmonization reduces transaction costs. Currently, both issuers and investors bear significant transaction costs when participating in international activities. A company seeking to expand its operations into a foreign country must continue to comply with home country regulations, and additionally, undertake certain actions to comply with host country regulations. More recently, in 2005, an E.U. regulator indicated that he believed that among

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[3] Stephen J. Choi, 'Assessing regulatory responses to securities market globalization' (2001) 2 *Theoretical Inquiries in Law*,613.
[4] David W.Leebron, 'Lying Down with Procrustes: An Analysis of Harmonization Claims' in International and European Law Department (eds), *Harmonization in the European Union Part I: Capita selecta EU Law* (Katholieke Universiteit Nijmegen, 2001).
[5] Ibid, 25.

the approximately 250 E.U. issuers listed in the United States, the largest companies spend between $1 million and $10 million per year to reconcile International Accounting Standards (IAS) to the United States Generally Accepted Accounting Principles (U.S. GAAP).[6] Investors who trade in foreign markets also incur high transaction costs because of the numerous forms of disclosure documents and their need to gather the additional information required for efficient pricing in these markets. These costs reduce the advantages of investing internationally and might prevent many investors from participating in the international market. Harmonization ameliorates this problem, and in particular, full harmonization eliminates the problem completely, as companies only need to comply with one set of regulatory requirements. Harmonization also has other benefits. Proponents argue that it reduces the cost of information production, internalizes externalities across jurisdictions, achieves economies of scale, enhances the mobility of market participants, and prevents a regulatory "race to the bottom."[7]

5.2.2 EC Reasons

Europeans have long dreamed of a single European market. Securities markets constitute an integral part of the single market. It is generally recognized that integration of European securities markets is economically beneficial to the Member States of the European Union and the European Economic Area.[8] In a 1985 white paper[9], it reconfirmed the importance of single European securities market, stating:

Work currently in hand to create a European securities market system, based on Community stock exchanges, is also relevant to the creation of an internal market. This work is designed to break down barriers between stock exchanges and to create a Community-wide trading system for securities of international interests.

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[6] Charlie McCreevy, 'E.C. Strategy on Financial Reporting: Progress on Convergence and Consistency' available at: http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/750&format=HTML&aged=0&language=EN&guiLanguage=en.

[7] Roger Van den Bergh, 'Regulatory Competition or Harmonization of Laws? Guidelines for the European Regulator' in Alain Marciano & Jean-Michel Josselin (eds.), *The Economics of Harmonizing European Law* (Northampton: E. Elgar, 2002), 27.

[8] Hallgrímur Ásgeirsson, 'Integration of European securities markets' available at http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=2819.

[9] Completing the Internal Market: White Paper from the Commission to the European Council, COM (85)310 final, paras 102-103.

In order to fulfil the goal of an internal single securities market, EC regulators must harmonize the different securities laws within the individual European nations. Harmonization is deemed necessary for the completion of the 'single securities market'. It claims that the differences in the laws and policies of member states should be reduced. It clearly facilitates cross-border activity by issuers, reducing the transaction costs inherent in diverging regimes. It also protects investors by ensuring that minimum standards apply to issuers who access the capital markets.

5.2.3 US Reasons

Generally speaking, the beginning of harmonizing US securities regulation at national level was a response to the 1929 stock market crash. Although the 1929 crash was a direct factor leading to harmonization, it was not the only reason for harmonization. In fact, before the 1930s, US securities markets were fragmented and largely self-regulated. Every state in the union had its own set of securities laws known as "blue sky" laws.[10] Although states enacted blue-sky laws, they were not thought to effectively protect stockholders.[11] The state laws, standing alone, were generally recognized to be inadequate. For example, they were not effective in protecting citizens in one state from sales efforts that originated in a second state; inadequately funded by most states to provide for effective enforcement of fraud provisions; and the state law were riddled with exceptions and exemptions. These issues were among those that provided the incentive for the enactment of many federal securities laws. The purpose of federal laws is to protect investors from abuses in the market and to restore their confidence.

5.3 The Process of Harmonization

An analysis of how harmonization in securities regulation was developed can start with a short overview of developments in a historical perspective. Looking back can help us to understand clearly, why today, we are at this particular point of development, but more importantly, it can help us to know where we should go from here.

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[10] The term "blue sky" originated from the fact that these laws were originally enacted to prevent the offering and sale of worthless securities, which were worth no more than a piece of the "blue sky" in the opinion of some legislators.

[11] Shalini M. Aggarwal, 'From the Individual to the Institution: The SEC's Evolving Strategy for Regulating the Capital Markets' (2003) 2 *Columbia Business Law Review*, 581, 585.

5.3.1 The Evolution of US Harmonization

Compared with the EC's harmonization, the process in the US is not too complicated. Historically, states led the way in providing legislation to protect investors from exploitation by unscrupulous securities promoters. Until the adoption of the Securities Act of 1933 (the "Securities Act") states were the only regulators of securities transactions. Kansas adopted the first blue sky statute in 1911. Other states quickly followed suit, so that by the time Congress adopted the Securities Act, every state except Nevada had a securities law.[12] Despite their prevalence, state securities laws were largely ineffective in eradicating fraud.[13] The failure of state regulation and the abuses that preceded the Great Depression set the stage for the adoption of the federal securities laws.[14] The dual regulatory structure created by Congress, and recognized the states' experience and expertise in the field would be necessary to provide remedies beyond those which the new federal statutes created. From 1933 to 2002, Congress has enacted many federal securities laws in order to federalize US securities regulation. The process of uniformity, at the national level, can be divided into four stages. Between 1933 and 1940 the United States Congress adopted six federal statutes. Four of these 1930s laws form the core of the United States federal securities law today. Apart from 1933 Act, the Securities Exchange Act of 1934 (Exchange Act) was adopted the following year creating the Securities and Exchange Commission (SEC). The Securities Act of 1933 is largely concerned with the initial distribution of securities rather than with their subsequent trading. The Securities Exchange Act of 1934 addresses the post-distribution period, that is, subsequent trading. The Investment Company Act of 1940 is a regulatory measure for mutual funds and other investment companies that engage primarily in the business of investing and reinvesting in securities of other companies. The Investment Advisers Act of 1940 requires registration with the SEC of persons engaged for compensation in the business of rendering advice or issuing analyses or reports concerning securities. Despite the advent of federal securities regulation the 1933 and 1934 Acts included explicit provisions preserving existing state authority to regulate intrastate activities. Through these "savings" clauses the era of a federal-state dual system of regulation was created.[15]

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[12] Today all 50 states have a securities statute.
[13] Thomas Lee Hazen, *The law of securities regulation* 4th edn., (West Group, 2002), 21.
[14] Ibid.
[15] The federal government may regulate all or virtually all aspects of securities trading involving interstate commerce given the authorization of the Constitution's Commerce Clause "to regulate commerce . . . among the several states." A state generally may regulate all aspects of securities trading within its jurisdiction.

In 1956, the second stage began. In order to minimize the diversity in state laws and to promote uniformity, the Uniform Securities Acts were produced. They include (1) the 1956 Act, (2) the Revised Act of 1985, and (3) the New Uniform Act of 2002. Uniform state securities laws were developed in order to reduce variations in state securities laws, and not as an alternative to concurrent federal-state regulation. The drafters of the Uniform Securities Acts, whenever feasible, used phrases that had acquired fixed meanings from having been construed by courts and administrators. Thirty-nine states and the District of Columbia substantially have adopted the Uniform Securities Acts of 1956 or 1985. The new 2002 Act has yet to be adopted in any states.

Beginning in the 1990s the dual regulatory regime was subject to a full-scale legislative assault.[16] In 1996, recognizing the costs and unduly burdensome nature of a dual registration system, Congress restructured federal-state securities regulation through National Securities Markets Improvement Act (NSMIA) ,[17] which is the mark of a third stage. The adoption of NSMIA was a step towards a single regulatory system which, however, left certain powers to the States. States retain the authority to investigate and bring enforcement actions with respect to fraud, deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions. NSMIA pre-empted state law from establishing additional capital, custody, margin and other requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers. As a general matter, NSMIA did not cause states to reduce the size of their securities regulatory bodies, despite the increased scope of federal pre-emption that NSMIA introduced.

In the final stage, reacting to corporate governance scandals within U.S.-based Enron Corporation, Congress passed the Sarbanes-Oxley in 2002,[18] which is generally viewed as the largest single reform in corporate governance since the US securities laws were first enacted during the Great Depression. The crisis of confidence in the capital markets in the United States was the impetus behind the swift enactment of Sarbanes-Oxley. The Act radically redesigns federal regulation of public company corporate governance and reporting obligations.

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[16] See Rutherford B. Campbell, Jr., ‘The Insidious Remnants of State Rules Regarding Capital Formation’ (2000) 78 *Washington University Law Quarterly*, 407, 411-13.
[17] Pub. L. No. 104-290, 110 Stat. 3416 (1996).
[18] Pub. L. No. 107-204, 116 Stat. 745 (2002).

Securities regulation in the US is now found primarily in the federal securities laws as administered by the SEC. Although states have rights to administer intrastate or local securities offerings, broker-dealers, and investment advisers, federal standards have been established for covered securities, broker-dealer firms registered under the Securities Exchange Act, and investment advisers above specified assets under management threshold.

5.3.2 The Evolution of EC Harmonization

The harmonization of the EC securities regulation is more than 40 years old, taking the publication of the Segré Report [19] in 1966 as a starting point. The first stage of the harmonization approach, during the late 1970s and early 1980s, was to introduce detailed harmonized rules in order to make national standards equivalent.[20] This was the approach taken in the preparation of the first generation of EC Directives, such as the Admission Directive,[21] the Listing Particulars Directive[22] and the Interim Reports Directive.[23] These three directives, plus the Major Share-holdings Directive,[24] were consolidated by a single directive [25] in 2001 in order to simplify the legislative framework for common market exchanges. Within this stage, all of these laws were helpful in beginning to structure a more uniform system of regulation. However, neither the scope nor the degree of harmonization is broad and deep.

The 1985 White Paper,[26] the 1987 Single European Act[27] and the 1992 Single Market Programme for completing the internal market intensified efforts to develop greater harmonization.[28] This second series of directives included, among others: the Undertakings for Collective Investments in Transferable Securities Directive,[29] which attempted to open the EC market for particular investment funds, or undertakings for collective investment in

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[19] The name of the report is Development of a European Capital Market which identified obstacles to the integration of capital and securities markets and proposed corrective measures, notably with regard to the capital-raising process and the harmonization of disclosure standards.
[20] Vanessa Edwards, *EC Company Law* (Oxford University Press, 1999), 231-233.
[21] Council Directive 79/279/EEC (OJ 1979 L66/21) of 5 March 1979.
[22] Council Directive 80/390/EEC (OJ 1980 L100/1) of 17 March 1980.
[23] Council Directive 82/121/EEC(OJ 1982 L66/21) of February 1982.
[24] Council Directive 88/627/EEC(OJ 1988 L348) of 12 December 1988.
[25] Council Directive 2001/34/EC (OJ 2001 L184/1) of 28 May 2001. The Consolidated Admissions and Reporting Directive ('CARD').
[26] COM(85) 310 of 14 June 1985.
[27] Single European Act (OJ 1987 L169) of 29 June 1987.
[28] Warren, M.G, 'The harmonization of European Securities Law' (2003) 37 *International Lawer*, 213.
[29] Council Directive 85/611/EEC (OJ 1985 L375/3) of December 1985.

transferable securities; the Public Offers Directive,[30] which partly harmonized the rules for public offers of securities; the Insider Dealing Directive,[31] which provided the first common market prohibition on insider trading; and the Investment Services Directive,[32]which is often described as the cornerstone of EC securities regulation. The second stage introduced a new era of EC securities regulation based on the model of mutual recognition and minimum harmonization. Mutual recognition represented a shift from commonality to reciprocity. This means that compliance with the legal and regulatory processes in the home Member States is recognized as being compliance with those in the host Member States.

During the latter part of the 1990s, there was a widespread view that although some progress had been made in the previous decade, insufficient work had been done to fulfill the single securities market. In 1999, The Financial Services Action Plan (FSAP)[33] was adopted which is an extensive reform program of 42 measures, designed to finalize the integration of national financial markets and provide a coherent regulatory framework for the pan-EC capital market. The FSAP led to extensive changes in securities market regulation: new laws; new law-making processes; and more attention to the mechanisms for the supervision of securities market activity and enforcement. With the adoption of the cornerstone Markets in Financial Instruments Directive (MiFID) in April 2004[34]which is a core investor protection and market integration measure, the FSAP is now, in large part, complete.[35]

The Lamfalussy Report 2001[36] is central to post-FSAP generation of EC securities measures. At the core of the Report is the realization that securities-market legislation is comprised of two layers: basic political choices which can be articulated as broad, but sufficiently precise, framework rules; and detailed technical measures, which conform to and implement the objectives of the framework rules. [37] A four-level approach to harmonization and

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[30] Council Directive 89/298/EEC (OJ 1989 L124) of 17 April 1989.
[31] Council Directive 89/592/EEC (OJ 1989 L334) of 13 November of 1989.
[32] Council Directive 93/22/EEC (OJ 1993 L141) of 10 May 1993.
[33] Financial Services: Implementing the Framework For Financial Markets: Action Plan, COM(99)232 final at 6 (hereinafter Financial Services Action Plan).
[34] Council Directive 2004/39/EEC (OJ 2004 L145/1) of April 2004.
[35] Niamh Moloney, 'Time to take stock on the markets: the financial services action plan concludes as the company law action plan rolls out' (2004) 53 *International & Comparative Law Quarterly*, 999.
[36] The Committee of Wise Men, Final Report of The Committee of Wise Men On The Regulation of European Securities Markets (2001), available at
http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf.
(hereinafter Lamfalussy Report)
[37] Niamh Moloney, *EC Securities Regulation* (Oxford University Press, 2002).

implementation of financial services regulation throughout the EC is set up based on this duality in the report. Following the Lamfalussy report, the two committees were newly constituted: the European Securities Committee (ESC)[38], which is comprised of high- ranking officials of Member State governments and Commission officials, and the Committee of European Securities Regulators (CESR)[39], which is an advisory committee comprised of representatives of Member States' national regulators and Commission representatives. Framework principles are the level 1 legislation and involve the EU Commission, Council and Parliament. Level 1 legislation is followed by level 2 legislation (implementing measures) which involves the EU Commission, the ESC and the ESRC. Level 3 rules are imposed by national regulators through co-ordinated EU action, following consultation within the CESR, and should be applied consistently across the European Union in order to ensure common and uniform implementation of level 1 and 2 legislation. Level 4 refers to implementation and enforcement of enacted legislation and involves the Commission and the member states. In the Lamfalfussy report, the Committee of Wise Men set forth the following priority items: a single prospectus for issuers with a system of shelf registration; modernization of listing standards; mutual recognition for wholesale markets; modernization of rules for investment funds and pension plans; adoption of international accounting standards; and a single passport for recognized stock markets.[40] In harmony with it, a surge of new legislatives from the UCITS Management Company and Prospectus Directive 2002[41] to the Transparency Directive 2004[42] were adopted in order to fulfil its goals. The main technique, used at this stage was to provide a single passport through home state authorization. All of these directives constitute important milestones in the development of a unified capital market in the EC.

Although the harmonization of EC securities regulation produced remarkable achievements, many areas still demand legislative and regulatory attention, such as internet-accessible

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[38] Commission Decision establishing the European Securities Committee, COM (2001) 1493 final, June 6, 2001.
[39] Commission Decision establishing the Committee of European Securities Regulators, COM (2001) 1501 final, June 6, 2001.
[40] See Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets (Novermber 7, 2000), available at http:// www.europa.eu.int/comm/internal_market/en/finances/banks/report.pdf.
[41] Council Directive 2001/07 (OJ 2002 L41/20).
[42] Council Directive 2004/109/EC of December 2004. The other directives are The International Accounting Standards Regulation 2002, Council Regulation 1602/2002 (OJ 2002 L243/1); The Prospectus Directive 2003, Council Directive 2003/71/EC (OJ 2003 L345/64) of 31 December 2003; The Market Abuse Directive 2003, Council Directive 2003/6/EC (OJ 2003 L96/16); The Markets in Financial Instruments Directive (MiFID) 2004, Council Directive 2004/39/EEC (OJ 2004 L145/1) of April 2004.

electronic filing system for all prospectuses and periodic reports and clearance and settlement system. The process of harmonization needs to continue to accelerate at an unprecedented rate.

5.3.3 The Evolution of International Harmonization

Despite differences underlining national regulatory regimes, endeavours to create a harmonized securities regulation acceptable to all participants of the global securities market have progressed. The International Organization of Securities Commissions (IOSCO)[43] is playing critical rules for developing a process of harmonization of the international financial market. In 1987, in response to concerns raised by the increasing internationalization of the securities market, the Technical Committee of IOSCO established a Working Party on Multinational Equity Offers (later renamed the Working Party on International Equity Offers) to perform a study of the world's capital markets and the issues related thereto. At the November 1988 meeting of IOSCO, the US SEC released a policy statement entitled Regulation of the International Securities Markets.[44] The policy statement identified three areas of regulation that should be addressed in an effective international securities market regulatory system: efficient structures, sound disclosure systems, and fair and honest markets.[45] In its statement the SEC said that "in seeking solutions to common problems, securities regulators should be sensitive to cultural differences and national sovereignty concerns. As regulators seek to minimize differences between systems, the goal of investor protection should be balanced with the need to be responsive to the realities of each marketplace." In May 1998, following the meetings of the Executive and Technical Committees in Paris, IOSCO released for public consultation four documents relating to global securities regulation. The first, entitled Objectives and Principles of Securities Regulation (Objectives), sets forth thirty fundamental principles of securities regulation. The Objectives adopted in 1998 and updated in 2002, are based on three purposes: protecting investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk.[46] The second, entitled International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (International Disclosure Standards) presents

[43] For more details see 8.5.2, 'The IOSCO'.
[44] Regulation of International Securities Markets, Exchange Act, Release No. 6807, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P84,341[hereinafter Release No. 6807].
[45] See Release No. 6807, The SEC further advised that "securities regulators in each nation should work closely with their foreign counterparts and seek coordinated international solutions to world market problems".
[46] IOSCO, Objectives and Principles of Securities Regulation (2002), at available http://www.iosco.org/download/pdf/2002iosco_objectives_and_ principles_of_securities_regulation.pdf.

a set of non-financial statement disclosure standards aimed at facilitating cross-border offerings through the use of a single disclosure document. These standards address non-financial statement disclosure requirements and do not relate to accounting or auditing principles. The basis of IDS is to assist cross-border offerings by creating a single disclosure document to be used by foreign issuers.[47] Today about twenty countries around the world have already adopted the IDS. The acceptance of the International Disclosure Standards demonstrates a considerable movement towards the harmonization of the mutual efforts to fulfil the common goal.[48] Perhaps the greatest obstacle facing multinational offerings in developed markets has been accounting practices. Accounting standards provide the essential means of disclosing information for valuation of companies to provide a comparison for investors' decisions. The absence of the same accounting language on the global securities market hinders the reduction of investors' burdens of protection. From1989, IOSCO has supported the International Accounting Standards Committee (IASC) to set international accounting standards. By 1992, IOSCO's Working Party on Multinational Disclosure and Accounting had completed a review of the IASC auditing standards. The Presidents Committee of IOSCO adopted a resolution urging members of IOSCO to recognize International Accounting Standards (IASs) for use in international offerings as well as continuous reporting by foreign issuers.[49] In an attempt to promote uniformity in international accounting standards, in 1994 IOSCO completed a review of the accounting principles issued by the International Accounting Standards Committee (IASC). In May 2000, IOSCO announced its examination of the accounting standards issued by the International Accounting Standards Committee and recommended that its members use thirty IASC standards, as "supplemented by reconciliation, disclosure and interpretation where necessary"[50] to facilitate cross-border offerings and listings by multinational enterprises.[51]

[47] IOSCO, International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (1998), at http:// www.iosco.org/download/pdf/1998-intnl_disclosure_standards.pdf.
[48] See Release No. 6807, above, n.42
[49] Samuel Wolff, 'Recent Developments in International Securities Regulation' (1995) 23 *Denver Journal of International Law and Policy*. .
[50] International Accounting Standards Committee Standards Press Release (May 17, 2000), Available at, http://www.iosco.org/iosco.html.
[51] Ibid.

5.4 The Techniques of Harmonization

Harmonization of law constitutes a purposive instrument for the realisation of market integration. It is therefore not surprising that different techniques have been developed which are used to address the different stage of harmonization. The techniques can be distinguished as discussed below.

5.4.1 Detailed Harmonization

In the early EC securities directives, detailed harmonization was introduced. At that time, "the leading idea was to enact similar regulation, which would necessarily be very detailed so that double vetting of the prospectus and other disclosure documents would become unnecessary."[52] The purpose of detailed harmonization is to remove regulatory barriers by making rules equivalent. But it is not practical as the EC capital markets are not fully integrated and display national characteristics. In practice detailed harmonization proved unsuccessful because it had presented difficulties relating to over-regulation, cumbersome implementation and inflexibility. Therefore it is not surprising to see minimum harmonization has been used.

5.4.2 Minimum Harmonization

Compared with detailed harmonization, minimum harmonization is intended to remove significant differences between the regulatory systems of Member States and thereby to ensure that "basic public interests" are protected in a single market. It was designed to safeguard national autonomy and to keep open competition between legal orders.[53] It seeks to ensure the adoption of agreed essential standards into the domestic law of each member state, without seeking to achieve identical laws throughout the Community. Most EC directives seek to harmonize the laws of the EU Member States by providing minimum standards to be followed

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[52] Wymeersch, E, 'Regulating European Markets:The harmonization of Securities Regulation in Europe in the New Trading Environment' in Eilis Ferran and Charles A E Goodhart (eds), *Regulating Financial Services and Markets in the 21st Century* (Oxford, Hart Publishing, 2001), 189.
[53] Johannes Kondgen, 'Rules of Conduct: Further Harmonization?' in Guido Ferrarini (eds), *European Securities Markets: The Investment Services Directive and Beyond* (Kluwer Law International, 1998), 129.

by each Member State in the regulation of securities within its borders**.** [54] Minimum harmonization is a basic technique that been used by EC harmonization.

However, minimum harmonization is not perfect. According to the principle of minimum harmonization, member states are required to harmonize what are considered the essential areas of financial regulation while being free to surpass EU minimum standards and to maintain national regulation in areas not harmonized. It easier to cause implementation problems because it gives member states considerable discretion in applying the harmonized rules.

5.4.3 Mutual Recognition

This concept came from the *Cassis deDijon* judgment.[55] In the field of financial services the *Cassis* jurisprudence developed the concept of mutual recognition of Member States' rules on the right to provide financial services. The essence of mutual recognition is that compliance with the legal and regulatory processes in one Member State is recognized as being compliance with those in another Member States. After grappling with the immense difficulties posed by its ambitious harmonization program, EC securities regulation changed their technique from detailed harmonization to the mutual recognition. It represented a shift from commonality to reciprocity. Mutual recognition first appeared in the 1985 UCITS Directive.

The advantage of mutual recognition is that it generates a competitive process of regulation that may lead eventually (in theory) to convergence of regulatory standards. However, mutual recognition is widely regarded as having failed rather than having been successful. One reason is that the insistence of many Community competent authorities on full translation of the entire approved prospectus or listing particulars is particularly burdensome and restricts the mutual recognition regime in practice to only the largest issuers, while the requirement to include local information with respect to taxation, paying agents, and notification procedures can also represent a significant obstacle.

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[54] Samual Wolff, 'Recent developments in European Union Securities Law' (2002) 30 *Denver Journal of International Law and Policy*, 292.
[55] Case 120/78, *Rewe-Zentral AG* v *Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)* [1979] ECR 649.

5.4.4 Home Country Control

The 'home country control' principle concedes to the home Member State the primary role of authorizing and supervising an undertaking. In the White Paper of 1985,[56] it states that:

The principle of 'home country control'…means attributing the primary task of supervising the financial institution to the competent authorities of its Member State of origin… The authorities of the Member State which is the destination of the service, whilst not deprived of all power, would have a complementary role.

The 'home' State is essentially the State where the firm's true head office is located. The 'host' State is defined[57] as the State 'in which' a firm establishes a branch or provides services.

By now, none of the parties questioned that the principle of home Member State control constitutes the guiding principle, which has prevailed in the harmonization of the financial services sector.[58] The first financial services directive to adopt the 'home country control' approach was the UCITS Directive. Then it became the basis harmonization approach of the Investment Services Directive (ISD). However, the ISD also allocate regulatory responsibility to host member state which may exercise the rules can be characterized as general-good rules. Because inappropriate application of host-member-state conduct rules has the potential to impede integration of stock market, it led to move away from partially home/host-member-state control to a whole home-member-state control. In the new generation EC directives such as the UCITS Management Company and Prospectus Directive, the Prospectus Directive, the Markets in Financial Instruments (MiFID) Directive and the Transparency Directive, 'home country control' combined with 'single passport' have become the dominant harmonization approach. Comparing with the ISD, the new directives fulfil the real home-member-state control. For example, in the Prospectus Directive, it provides that a prospectus which is approved by the competent authority of one member state will be valid for the public offer or admission to trading of securities in any other member state (host member state). The host

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[56] Completing the Internal Market: White Paper from the Commission to the European Council, COM (85)310 final, paras 102-103.

[57] Article 1 of Insider Dealing Directive.

[58] Eva lomnicka, 'The home Country Control Principle in the Financial Services Directives and the Case Law' In Mads Andenas and Wulf-henning Roth (eds), *Services and Free Movement in EU Law* (Oxford University Press, 2002), 295.

competent authority is expressly prohibited from approving the prospectus for use in its own jurisdiction and therefore cannot require additional information to be included.[59]

Generally, the home country principle has functioned effectively in integrating EU markets. It is a useful concept in allocating prudential regulation over financial services undertakings to one State — the State where they primarily operate from. The concentration of regulatory competence in one primary regulator is sensible in that it avoids both regulatory gaps on the one hand, importantly from the point of view of establishing a single market, regulatory duplication with its unnecessary burdens on enterprise on the other.

5.4.5 Single Passport

The 'single passport' established by the Investment Services Directive (ISD), as the new constitution of the EC's securities markets, proved most influential in reshaping market structure in the European Union. The essence of the "single passport" concept in ISD is that issuers, investment firms and securities exchanges authorized in one host state can gain access to other Member States without the need for further, local regulatory approvals. In 2004, this "host state" rule has been reversed by Markets in Financial Instruments Directive (MiFID). The idea of a single passport in MiFID is that an investment firm, once authorized by the competent authority in its home member state, should then be able to operate through-out the EU under the continuing supervision of that home authority. MiFID requires compliance with rules of the member state in which business is done. Under MiFID, a company whether offering services in another member state through a branch or cross-border may follow the rules of the "home state" in which it is based. The passport concept was conceived as being crucial to the development of a properly integrated pan-European financial market in which issuers, investment firms and investors could operate freely and seamlessly, unimpeded by national boundaries.[60] In 2002, UCITS Management Company and Prospectus Directive establish a regulatory, home Member State passport for management companies. The 'single passport' for issuers is produced by the Prospectus Directive 2003 which introduces a full home Member State passport for the prospectus. When issuers place the prospectus, as long as it has been approved by one member state, it can be used without further adaptation in all

[59] See article 17 (1) of Prospectus Directive.
[60] Eilís Ferran, *Building an EU Securities Market* (Cambridge University Press, 2004), 4.

Member States. With respect to the secondary markets and investment services, MiFID supports a full regulatory passport for firms and exchanges.

The European passport for issuers is a unique opportunity to simplify regulatory compliance for issuers without their having to produce duplicative sets of documentation or respond to numerous additional national requirements.[61] The single passport regime reduces transaction costs for issuers and generates greater enthusiasm for pan-EC capital rising.

5.4.6 Maximum Harmonization

The opposite of minimum harmonization is maximum harmonization. According to the Green Paper,[62] maximum harmonization states that no member state could apply stricter rules than the ones lay down at Community level. It means that national law may not exceed the terms of the legislation. In practice, this prohibits gold-plating[63] of European legislation when it is transposed into national law. Traditionally it was fairly uncommon for European legislation to be drafted on this basis. The Prospectus Directive (PD) introduced the concept of 'maximum harmonization' which places more emphasis on home state supervision. This is a change from the prior EU financial service legislation which featured a 'minimum harmonization and mutual recognition' concept. PD is intended to create common disclosure standards for public issues of securities throughout the EU. As a maximum harmonization directive PD sets out the maximum limit of national regulation and individual member states are not permitted to impose content or disclosure provisions additional to those contained in the PD. Maximum harmonization could make free choice of the competent authority self-evident, as the standards will be the same in every jurisdiction. By imposing maximum harmonization the EU has deliberately forgone a mechanism that could alleviate deficiencies in its laws, namely intervention by member states to exceed the general EU-wide standards.[64] The maximum harmonization approach was also used in the recent MiFID. Since EU harmonization has been developing over time, maximum harmonization maybe the way forward.

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[61] Commission of the European Communities. COM (2001) 280 final.2001/aaaa (COD). Proposal for a Directive of the European Parliament and of The Council on the prospectus to be published when securities are offered to the public or admitted to trading (presented by the Commission).
[62] Green Paper on the Review of the Consumer Acquis COM (2006) 744 final (8 February 2007).
[63] Gold-plating refers to the practice of national bodies exceeding the terms of European Community directives when implementing them into national law.
[64] Ferran, *EU Securities Market*, above, n.58, 144.

5.5 The Scope of Harmonization

The breadth or scope of the harmonization effort is closely linked to the harmonization procedure. As the process of harmonization goes deeper the scope of harmonization is becoming wider and wider. Although harmonization has not fully covered all the aspects of securities regulation, the basic areas have already done. This section will pick some very important aspects to examine.

5.5.1 The Disclosure Regime

Disclosure is a core principle of securities markets regulation.[65] In the US, disclosure has been described variously as the 'bedrock'[66] and as 'a-if not the-defining characteristic'[67] of securities law. Disclosure regime also occupies a central position in the EC's efforts to build the regulatory framework for an integrated pan-European securities market. In undertaking global offerings involving simultaneous offers and sales in multiple jurisdictions, issuers must comply with the disclosure requirements in each such jurisdiction. These varying disclosure laws and regulations across jurisdictions remain an impediment to undertaking cross-border offerings and also are arduous burdens for foreign issuers. Very often, the offering and disclosure rules in foreign jurisdictions are not in harmony with, or even directly conflict with, the offering and disclosure rules in an issuer's home jurisdiction. There is a need for the development of common disclosure standards to be used uniformly in all securities markets The harmonization of disclosure rules may be the most significant change to affect the securities markets of many nations.

5.5.1.1 At National Level

The U.S. disclosure regime is one of the most rigorous regimes of the international securities markets. The premise underlying the Securities Act of 1933 and the securities Exchange Act

[65] Karel Lannoo, 'The emerging Framework for disclosure in the EU' (2003) 3 *Journal of Corporate Law studies*, 329.
[66] J.R. Macey, 'A pox on both your houses: Enron, Sarbanes-Oxley and the debate concerning the relative efficacy of mandatory versus enabling rules' (2003) 81 *Washington University Law Quarterly*, 329, 330.
[67] S.M. Bainbridge, 'Mandatory Disclosure: A behavioural Analysis' (2000) 68 *University of Cincinnati Law Review*, 1023.

of 1934 is that full disclosure of all material information is the best way to protect investors from fraud and manipulation and the best way to promote efficient and fair pricing of securities.[68] The enactment of the federal securities laws was simply a form of harmonization of the old state securities laws of the pre-1933 period. [69] Disclosure obligations are imposed on the issuers of securities. Firstly, the 1933 Securities Act requires that issuers selling securities in a public offering must disclosure important financial information through the registration of securities and thereafter comply with the periodic disclosure regime.[70] Second, the interplay of Sections 12, 13 and 15(d) of the Securities Exchange Act of 1934 provides, in general, that issuers whose securities are publicly traded become subject to an on-going obligation to provide information, commonly called the “continuous disclosure system”. It applies to information disclosed in conjunction with registration and public offering of securities, solicitation of proxy votes, tender offer and periodic public reporting. Finally, The Securities and Exchange Commission adopted Regulation FD (Fair Disclosure) that is a new issuer disclosure rule that addresses selective disclosure in 1999.[71] The regulation provides that when an issuer, or person acting on its behalf, discloses material non-public information to certain enumerated persons (in general, securities market professionals and holders of the issuer’s securities who may well trade on the basis of the information), it must make public disclosure of that information.

5.5.1.2 At Regional Level

U.S.-Canada Multi-Jurisdictional Disclosure System (MJDS) concept was originally released for public comment in a 1985 SEC release entitled “Facilitation of Multinational Securities Offerings.” [72] The MJDS was adopted in final form in June of 1991 and became effective in

[68] Robert Repetto, Andrew MacSkimming and Gustavo Carvajal Isunza, ‘Environmental Disclosure Requirements in the Securities Regulations and Financial Accounting Standards of Canada, Mexica and United States’(25 March 2002) is available at: http://www.cec.org/files/pdf/ECONOMY/env-disclosure-25-03-02_en.pdf (last visited, November 2007).
[69] See generally Joel Seligman, ‘The Historical Need for a Mandatory Corporate Disclosure System’ (1983) 9 *Journal of Corporation Law*.
[70] See section 7 of 1933 Act.
[71] The new rules and amendments were proposed in Exchange Act Release No. 42259 (Dec. 20, 1999) [64 FR 72590].
[72] Securities Act Release No. 6568, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) 83,743 (Feb. 28, 1985).

the United States and throughout Canada on July 1, 1991.[73] Prior to the MJDS, companies in US and Canada had to prepare two sets of disclosure documents, one according to U.S. securities laws and the other according to Canadian laws. MJDS was created to permit U.S. and Canadian issuers to conduct public offerings in both countries on the basis of their home disclosure standards.[74] The agreement was based upon the premise that "Canadian and U.S. accounting, disclosure, supervisory, and enforcement standards are so similar that each country's documents can be used in the other country without harm to investors." [75] The MJDS is comprised of two different sets of rules working together. The Canadian MJDS permits U.S. issuers who meet specified eligibility requirements to conduct public offerings in Canada, on the basis of disclosure documents prepared in accordance with U.S. disclosure rules, while the U.S. MJDS allows Canadian issuers who meet certain criteria to satisfy SEC registration requirements by complying with the disclosure rules of the Canadian authorities. Home country regulators have primary responsibility for reviewing disclosure documents, and host country regulators generally forgo review.[76] The respective regulatory authorities will only review the disclosure documents of the issuer from the other country to the extent necessary to ensure compliance with the specific requirements of the MJDS. The MJDS covers cross-border offerings, issuer bids, take-over bids, business combinations, and continuous disclosure and other filings. [77] The implementation of the MJDS is important because it has resulted in the significant harmonization of a substantial segment of securities regulation between two sovereign nations. The MJDS is the first truly multilateral response to internationalization of the securities markets and should be viewed as a significant first step towards greater internationalization of securities regulation.[78]

The EC harmonization plan serves as a good case study for the applicability and effectiveness of harmonized disclosure rules. At present, the new framework of issuer disclosure regime within the EC is divided into three parts: the regime for initial disclosure; periodic disclosure

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[73] Securities Act Release No. 6902; Notice of National Policy Statement No. 45, 14 OSC BULL. 2844 (June 28, 1991); National Policy Statement No. 45--Multijurisdictional Disclosure System, 14 OSC BULL. 2889 (June 28, 1991).

[74] See Edward F. Greene, Daniel A. Braverman & Jennifer M. Schneck, 'Concepts of Regulation--The US Model' in Fidelis Oditah, ed., *The Future for the Global Securities Market* (Oxford: Clarendon Press, 1996), 164

[75] David S. Ruder, 'Reconciling U.S. Disclosure Policy with International Accounting and Disclosure Standards' (1996) 17 *Northwestern Journal Of International Law & Business*, 1.

[76] 56 Fed. Reg. 30036 (1991); BCSC 71-101CP, The Multi-jurisdictional Disclosure System (Oct. 23, 1998) available at http:// www.bcsc.bc.ca/policy.asp?id=1299.

[77] Ibid.

[78] Anna T. Drummond, 'Securities law internationalization of securities regulation—multi-jurisdictional disclosure system for Canada and the US' (1991) 36 *Villanova Law Review*, 775.

and rules on market abuse and insider trading which are regulated by the Prospectus Directive, the Transparency Directive, and the Market Abuse Directive respectively. At the core of the Prospectus Directive is the obligation to publish a prospectus when making an "offer of securities to the public"[79] or "seeking admission to trading on a regulated market[80]." It sets out the disclosure requirements to be included in different models of prospectuses. According to the Directive, the prospectus must contain all information about the issuer, its securities and the offering.[81] The PD introduced a single prospectus passport, valid EC-wide, covering all listing and public offers of securities, whereby, once a prospectus is approved by the home member state's regulatory authority, it must be accepted throughout the EU for public offers of securities and admission to trading on a regulated market. The term "regulated market" encompasses both primary and secondary EC exchanges. Member States will each provide a list of regulated markets within their jurisdiction. The Prospectus Directive contains exemptions from the obligation to publish a prospectus upon an offer of securities (but note that these exemptions are irrelevant in determining whether a prospectus needs to be published to obtain the admission to trading on an EC regulated market of the offered securities) Disclosure is only regulated in principle in the Directive. Hence, most of the specific disclosure requirements were left to the Commission to determine through level 2 implementing measures.[82] Prior to the Directives, continuous disclosure of price-sensitive information by publicly traded corporations in the EU was largely governed by stock exchange rules, and price transparency of markets was left to the self-regulation of exchanges. Article 10 of the Prospectus Directive provides that issuers of securities traded on a regulated market of the EC have to disclose changes made to the information in their original prospectuses issued when their securities were first floated, on a yearly basis.[83] This is a form of periodic disclosure. Further, periodic continuous disclosure consists of yearly and half-yearly financial and non-financial information on the issuer's performance and operations specified in Articles 4, 5, and 6 of the Transparency Directive.[84] Under Article 6 of the Market Abuse Directive, issuers also must disclose, on an ad hoc basis, specific information about the

[79] Article 2(1) (d) of Prospectus Directive.
[80] Defined by reference to the Investment Services Directive (93/22/EEC).
[81] For more details see article 5 (1) of the Prospectus Directive.
[82] See Article 7 (1) of the Prospectus Directive.
[83] Article 10 of Prospectus Directive.
[84] Article 4,5,6 of Transparency Directive.

issuer or its securities that may materially affect the price of those securities in the market (i.e., inside information).[85]

5.5.1.3 At International Level

The International Organization of Securities Commissions (IOSCO), a group comprised of the securities regulators from countries around the world, has made efforts to harmonize international disclosure standards. Rather than focusing on mutual recognition of standards, IOSCO has attempted to develop a single set of non-financial statement disclosure standards. In September 1998, IOSCO issued its International Disclosure Standards (IDS) for Cross-Border Offerings and Initial Listings by Foreign Issuers.[86] IOSCO encouraged its members to adopt these standards by incorporating them in their domestic regulations. IDS is divided into two parts. Part I includes the introduction and sets out the disclosure standards (the "Standards") for use by companies in connection with cross-border public offerings. Part II discusses additional disclosure issues that are outside the scope of the Standards but that still may need to be addressed.[87] The IDS allow issuers to rely on a single disclosure document as an "international passport" to capital raising and listing in more than one jurisdiction at a time.[88] The I.D.S. was in turn to be implemented by the membership through domestic legislation, and it has garnered support from some key national regulators, including the U.S. SEC which has adopted it in relation to foreign issuers as part of U.S. federal securities laws.[89] The essence of the IOSCO's vision of an international passport is that an issuer seeking a cross-border share offering will only have to prepare a single prospectus reflecting the IDS which after being reviewed by a regulator of a country involved in the multinational offering, will thereafter be recognized by all other securities regimes in which the issuer subsequently seeks to sell its shares. The IDS is only to be used for multinational offerings, and the scope of

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[85] Article 6 of Market Abuse Directive.
[86] International Organization of Securities Commissions, 'International Disclosure Standards for Cross Border Offering and Initial Listings by Foreign Issuers (1998)' at IOSCO Document Library. available at: http://www.IOSCO.org/doc-public/1998-intnl_disclosure_standards_html.
[87] Ibid.
[88] International Organization of Securities Commissions, 'IOSCO Announces the Release of Four Documents of Vital Interests to Securities Regulators and Market Participants' IOSCO Press Release (May 1998), available at: http://www.iosco.org/news.
[89] See J. William Hicks, 'Harmonization of Disclosure Standards for Cross-Border Share Offerings: Approaching an 'International Passport' to Capital Markets?' (2002) 9 *Indiana Journal of Global Legal Studies*, 361.

the common standards does not apply to purely domestic issues.[90] The exceptions to the application of the Standards, including offerings between the U.S. and Canada that are governed by the Multi-jurisdictional Disclosure System between the two countries as well as offerings made within the EC.[91] Implementation of IDS standards by different jurisdictions appears to fall into four groups: adopted for foreign and domestic issuers; optional for foreign and domestic issuers; inapplicable to domestic, applicable to foreign issuers; inapplicable to domestic issuers, optional for foreign ones.[92] Duplicative disclosure costs must hence still be borne by issuers in having to comply with different standards for domestic and foreign markets. The IOSCO further suffers from the absence of a single arbiter for resolving disputes relating to the interpretation and enforcement of the common standards.[93] This can prove especially problematic because the test for deciding whether a particular piece of information needs to be disclosed under the IDS is that of materiality, a concept inherently vague and capable of diverse constructions. [94]

5.5.2 Accounting Standards

At the heart of many of the issues encountered in the harmonization of securities regulation has been the diverse accounting practices employed throughout the nations. In particular, the preparation of disclosure documents is burdensome due to the lack of universally accepted accounting practices. [95] As recognized in the IOSCO 1989 Report, [96] harmonization of international disclosure regulations through use of a single disclosure document cannot be achieved without establishing international accounting and auditing standards. The Report also recommended the development or recognition of internationally acceptable accounting and

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[90] IOSCO, 'International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers, Report of the Technical Committee' September 1998,
available at: http://www.iosco.org/library/index.cfm? whereami=pubdocs, (IOSCO—Documents Library) Singapore is the only country that uses the IOSCO standards for domestic issues.

[91] Ibid. Other exceptions include offerings by companies incorporated in New Zealand that are listed or seeking to be listed on an Australian Securities Exchange, certain offerings in Hong Kong, and companies organized in a foreign country wishing to make an offering in the U.S. who do not meet the SEC's definition of a "foreign private issuer".

[92] Samuel Wolff, 'Implementation of International Disclosure Standards' (2001) 22 *University of Pennsylvania Journal of International Economic Law*, 91.

[93] See Hicks, 'Cross-Border Share Offerings', above, n.87.

[94] Parikshit Dasgupta, 'Regulation of Cross-border Share Offerings: Trends towards Multi-jurisdictional Securities Laws' (2003) 3 *Global Jurist Advances*, Issue 3, Article 1 at 6.

[95] See Samuel Wolff, 'International Securities Regulation', above, n.47.

[96] International Equity Offers, Report of the Technical Committee of IOSCO 7 (September 1989) (manuscript on file with IOSCO).

auditing standards that would “greatly facilitate the development of the use of a single disclosure document”.[97]

5.5.2.1 At National Level

In the United States, under the Securities Exchange Act of 1934, the SEC has authority to establish accounting principles for businesses under its jurisdiction. Generally, the SEC permits the accounting profession and the private sector to self-regulate the accounting practice. Since 1973, the SEC has designated the Financial Accounting Standards Board (FASB), a private organization, as the standard-setter of accounting principles.[98] FASB sets the accounting standards to be used in preparing the financial statements for firms that are registrants with the SEC. Thus, domestic firms that are registrants with SEC must file financial reports using US Generally Accepted Accounting Principles (GAAP).[99] FASB establishes U.S. accounting standards by publishing several types of documents. The most important publication is the Statement of Financial Accounting Standard. The Statement of Financial Accounting Standard sets forth new accounting standards, the effective date and method of transition, background information, a brief summary of research done on the project, and the basis for the Board’s conclusions.[100] To further clarify the application of its Statements, FASB issues Interpretations. Interpretations modify or extend existing standards.[101] Finally, FASB publishes Statements of Concepts. Statements of Concepts do not announce new accounting standards; instead, they provide a general framework and agenda that FASB will follow to formulate new standards in the future.[102] Together, these various FASB pronouncements, along with non-superseded statements by FASB’s predecessors and certain SEC’s accounting rules, form U.S. GAAP.

Until 2002, Congress placed few restrictions on the SEC’s authority to delegate the power to establish accounting rules to a private entity. Then in 2002, Congress passed the Sarbanes-Oxley Act, which requires that before the SEC may recognize a private entity as the standard setter of accounting principles, it must verify that the private entity meets several

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[97] Ibid.
[98] See Financial Accounting Standards Board website, available at: http://www.fasb.org.
[99] 17 C.F.R. §§ 210-4.01(a) (2), 210.2-02(b) (2000).
[100] See Financial Accounting Standards Board website, above, n.96, Facts about FASB.
[101] Ibid.
[102] Ibid.

requirements.[103] The entity must (1) have a board of trustees, the majority of whom are not associated with any public accounting firm, (2) be funded as provided in section 109 of the Sarbanes-Oxley Act of 2002, (3) have procedures to ensure prompt consideration of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices, and (4) consider the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest. [104] In response to an ever-increasing number of accounting "restatements" (corrections of past financial statements) by public companies during the 1990s and record-setting bankruptcies by large public companies, notably those in 2002 involving WorldCom and Enron, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB). As an auditor oversight body the PCAOB is an independent, private-sector and non-profit corporation. The PCAOB's mission is to oversee the auditors of public companies, protect the interests of investors, and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB does this through its standards setting, inspections, enforcement, and outreach programs. Since the PCAOB opened its doors in January 2003, it has registered more than 1,750 accounting firms that audit, or wish to audit, U.S. public companies. [105] Once registered, these firms become subject to the PCAOB's supervisory oversight and must use PCAOB standards when they audit public companies.

5.5.2.2 At Regional Level

Before 2002, Europe lacked a set of continent-wide accounting rules; instead, accounting was the domain of national governments. It varies widely among the EC member states, running from sparse regulatory requirements to comprehensive, complex systems. [106] In 2002, the European Council and Parliament adopted IASB as the E.U. counterpart to FASB by passing the IAS Regulation, which required EC companies listed in the European Union to use IAS

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[103] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 108(a), 116 Stat. 745, 768 (2002).
[104] Ibid.
[105] Mark W. Olson (Chairman of Public Company Accounting Oversight Board), 'Global Risk and Regulation: the Role of the PCAOB' February 2, 2007,
available at: http://www.pcaobus.org/News_and_Events/Events/2007/Speech/02-02_Olson.aspx (last visited, September 2008).
[106] Peter E. Millspaugh, 'Global Securities Trading: The Question of a Watchdog' (1992) 26 *George Washington Journal of International Law & Economics*, 355, 359-60.

starting in January 1, 2005.[107] While the European Union recognizes IASB as the standard-setter, the European Union does not automatically defer to the IASB on accounting issues. When the IASB promulgates a new accounting standard, this standard undergoes an endorsement process in which the European Commission reviews whether the standard meets several requirements.[108] The proposed standard must (1) not be inconsistent with the requirement that annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss, (2) be conducive to the European public good, and (3) meet the criteria of understand ability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.[109] Only when the Commission is satisfied that an IASB standard meets these requirements may it adopt the standard by passing a new regulation. Hedge accounting under International Accounting Standard (IAS) 39 (Financial Instruments: Recognition and Measurement)[110] is currently the only area where there is a difference between EU IFRS and IASB IFRS.[111] Under EU IFRS, companies are permitted to "carve out" and not comply with certain requirements of IAS 39. Financial statements of companies that have chosen to rely on this carve-out are not in compliance with IASB IFRS. Recently, however, the European Union passed two Directives--the Prospectus Directive and the Transparency Directive--that require foreign companies listed in Europe to state their financial statements in IFRS as of January 1, 2007. Under the Prospectus Directive, non-E.U. issuers conducting a public offering within the European Union will need to publish a prospectus, which must include financial statements prepared in accordance with IFRS.[112] Under the Transparency Directive, non-E.U. issuers whose securities are traded on an E.U. market will have to provide annual and half-yearly financial statements prepared in accordance with IFRS.[113]

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[107] Council Regulation 1606/2002, 'On the Application of International Accounting Standards' 2002 O.J. (L 243) 1, 2 (EC).
[108] See Regulation 02/1606, art. 3(2), 2002 O.J. (L 243) 1-4 (E.C.).
[109] Ibid.
[110] IAS 39 deals with fair value and hedge accounting for certain financial instruments.
[111] See comment letter on the Adopting Release from the European Commission to the SEC, dated September 26, 2007, available at: http://www.sec.gov/comments/s7-13-07/s71307-111.pdf.
[112] See the Prospectus Directive, Council Directive 2003/71/EEC (OJ 2003 L345/64) of February 2003.
[113] See The Transparency Directive, Council Directive 2004/109/EEC (OJ 2004 L390/38) of 2004.

5.5.2.3 International Level

Before 2008 many of the foreign companies attracted to the international capital markets had basically three choices for their accounting reports: (1) to adopt the International Financial Reporting Standards (IFRS); or (2) to adopt the US GAAP; or (3) to reconcile their financial information with SEC requirements. IFRS is the product of the International Accounting Standards Board (IASB) which is the world's most influential accounting standards board. The IFRS has achieved the status of a worldwide accounting standard. Nearly one hundred countries around the world, including Australia, Russia and New Zealand, currently use or will use IFRS.[114] Due to the increased competition on capital markets, and given the global importance of US market, IFRS and US GAAP are competing to become the one who sets world standards.

The IASB has been trying to harmonize international accounting principles since 1973. IASB like FASB, is a private organization, but one difference is that IASB purports to be an international organization, which aims to set accounting standards for the world's capital markets. The IASB and the International Organization of Securities Commissions (IOSCO) have been jointly working on harmonization since July 1995, and in May 2000, the IOSCO finished its review of the IAS and recommended usage of certain IAS, supplemented with reconciliation, disclosure and interpretations.[115] Now IAS has been incorporated into the International Financial Reporting Standards (IFRS). IFRS is a set of international accounting standards that can be used by issuers in preparing their financial statements.

Since 2000, the IASB started to harmonize the differences between IFRS and US GAAP. The IASB continues to work on IFRS through their "Improvements Project", which focuses on improving the quality of IFRS and increasing compatibility with US GAAP.[116] A crucial landmark was reached in October 2002, when the Financial Accounting Standards Board

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[114] Use of IFRSs for Reporting by Domestic Listed Companies, by Country and Region Status as of 2005, IAS Plus (Deloitte Touche Tohmatsu), available at http://www.iasplus.com/country/useias.htm.

[115] See Press Release, Int'l Accounting Standards Comm., IOSCO Endorses IASC's Core Standards (May 17, 2000), http:// www.iasb.org/docs/press/2000pr14.pdf. In 2005, IOSCO reaffirmed its support for IFRS. Press Release, Technical Comm. of the Int'l Org. of Sec. Comm'n, Statement on the Development and Use of International Financial Reporting Standards in 2005, (Feb. 2005), available at: http://www.iasb.org/uploaded_files/documents/10_286_ioscopd182-100205.pdf.

[116] Sir David Tweedie & Thomas R. Seidenstein, 'Setting a Global Standard: The Case for Accounting Convergence' (2005) 25 *Northwestern Journal of International Law & Business*, 589, 596.

(FASB) of the USA and the IASB signed The Norwalk Agreement i.e. Convergence Agreement to create a set of key international standards.[117] The Norwalk Agreement was not an official agreement between the U.S. government and the EU government, but a private agreement between two nongovernmental entities. Nevertheless, it was an important development and was praised by U.S. and E.U. regulators. The two Boards have agreed on the following matters: to undertake a short-term project aimed at removing the various differences between US GAAP and International Financial Reporting Standards (IFRS) which include the IAS; to remove the other differences between the IFRS and US GAAP that will remain at January 1, 2005 through coordination of their future work programs. Consequently, differences in the accounting for inventory, asset exchanges, discontinued operations and many other areas are diminished. On July, 2007, revolutionary changes are occurred in accounting and financial reporting in the US. The SEC released a proposal to accept financial statements prepared in accordance with IFRS from foreign-private issuers without reconciliation to US GAAP.[118] On November 15, 2007, the SEC voted in favor of the proposal and issued the final rule release on December 21, 2007.[119] The new rules become effective March 4, 2008. Following the SEC's decision to accept the proposal, reconciliations are no longer required for the subset of foreign private issuers[120] that prepare their financial statements in accordance with IFRS. SEC's decision is intended to foster the use of IFRS as a set of high-quality, internationally accepted accounting standards. As the SEC Chairman Christopher Cox has indicated that "we have got to be able to demonstrate that IFRS is indeed a single set of international accounting standards and not a multiplicity of standards going by the same name**".**[121] Acceptance of IFRS by SEC was an important step towards the

[117] Financial Accounting Standards Board (FASB), Memorandum of Understanding: The Norwalk Agreement (September 18, 2002), available at http://www.fasb.org/news/memorandum.pdf.

[118] SEC Release No. 33-8818 (Proposed Rule: Acceptance From Foreign Private Issuers Of Financial Statements Prepared In Accordance With International Financial Reporting Standards Without Reconciliation To U.S. GAAP) (July 2, 2007) (the "Proposing Release"). Available at: http://www.404.gov/rules/proposed/2007/33-8818.pdf (last visited, September 2008).

[119] SEC Release No. 33-8879 (Final Rule: Acceptance From Foreign Private Issuers of Financial Statements Prepared In Accordance With International Financial Reporting Standards Without Reconciliation To U.S. GAAP) (December 21, 2007) (the "Adopting Release"),
available at: http://www.sec.gov/rules/final/2007/33-8879.pdf (last visited, September 2008).

[120] A "foreign private issuer" is defined in Rule 405 of the Securities Act of 1933 to mean any foreign issuer, other than a foreign government, except an issuer that meets the following conditions: (i) more than 50 percent of its outstanding voting securities are directly or indirectly owned of record by residents of the United States and (ii) any of the following: (a) the majority of the executive officers or directors are U.S. citizens or residents; (b) more than 50 percent of the assets of the issuer are located in the United States ; or (c) the business of the issuer is administered principally in the United States.

[121] Christopher Cox (SEC Chairman), 'Chairman's Address to the SEC Roundtable on International Financial Reporting Standards' March 2007,
available at: http://www.sec.gov/news/speech/2007/spch030607cc.htm.

harmonization of international accounting. Based on these efforts, acceptance of IFRS in virtually all countries, including the US, appears imminent, perhaps occurring within the next few years.[122]

5.5.3 Capital Adequacy Rules for Securities Firms

Capital adequacy has been defined as the "extent of capital that should be required of brokers or others carrying on the business of trading in securities."[123] The purpose of capital adequacy is limitation of client and systemic risks. Harmonizing international capital adequacy standards for securities firms will be critical so securities regulators may fulfil their key objectives: protect investors, protect fair competition and promote an efficient market.[124] Global banking supervisors have been successful in obtaining international capital adequacy standards, however, global securities regulators have not accomplished this goal although at a regional level have been gotten massive progress.

5.5.3.1 At Regional Level

The Capital Requirements Directive (CRD)[125] was adopted on 14 June 2006 within EC. The Directive is one of the measures required to complete the EU Financial Services Action Plan. The objective of the CRD is to have in place a comprehensive and risk-sensitive framework and to foster enhanced risk management amongst financial institutions. This will maximize the effectiveness of the capital rules in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting consumers. The framework under the CRD reflects the flexible structure and the major components of Basel II[126] rules on capital measurement and capital standards agreed by the Basel Committee on Banking Supervision[127]

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[122] L. Murphy Smith, 'Are International Financial Reporting Standards (IFRS) an Unstoppable Juggernaut for US and Global Financial Reporting?' (2008) *The Business Review, Cambridge*, 1
available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1125069

[123] Harold S. Bloomenthal & Samuel Wolff, *Securities and Federal Corporate Law* 2nd ed (Clark Boardman Callaghan,1998), 27.72.

[124] Elene Spanakos, 'Harmonization of international adequacy rules for securities firms: an argument to implement the value at risk approach by adopting Basle's internal model methodology' (2000) 26 *Brooklyn Journal of International Law*, 221.

[125] Directive 2006/48/EC and Directive 2006/49/EC.

[126] Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face.

[127] For more details about Basel Committee see 8.4.2, 'The Basle Committee on Banking Supervision'.

in 2004. It has been based on the three 'pillars', but has been tailored to the specific features of the EU market. In terms of scope of application, the CRD goes wider than the framework to incorporate investment firms and credit institutuions as well as banks.[128] This directive is making significant changes to two directives that were implementing Basel I[129] : The Banking Consolidation Directive and The Capital Adequacy Directive. Broader risk management, flexibility and greater risk sensitivity are key concepts of the CRD. The CRD applies to all credit institutions and those investment firms defined by Article 4(1), Market in Financial Instruments Directive.[130] By transposing internationally agreed capital standards into a common EU legal framework, the Directive ensures that all EU countries will be in line with Basel 2, thereby creating a level playing field for all banks, building societies and affected investment firms across the EU. This in turn will further deepen the Single Market in financial services.[131] Member States are to apply the Directive from the start of 2007. Institutions can choose between the current basic indicator approach and the Standardized Approach[132] that evaluates the business lines as a medium sophistication approach of the new framework. The most sophisticated approaches, Advanced IRB approach and advanced measurement approach for operational risk (AMA)[133] will be available on the beginning of 2008. From this date, all EU firms will apply "Basel II".

5.5.3.2 At International Level

It was international banking regulators who took the first step to harmonize international capital adequacy rules. Their successful experiences encouraged international securities

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[128] Article 1 of the Capital Requirements Directive.

[129] Basel I is the term which refers to a round of deliberations by central bankers from around the world, and in 1988, the Basel Committee (BCBS) in Basel, Switzerland, published a set of minimal capital requirements for banks. This is also known as the 1988 Basel Accord, and was enforced by law in the Group of Ten (G-10) countries in 1992, with Japanese banks permitted an extended transition period.

[130] Article 3 of the Capital Requirements Directive.

[131] 'Transposition of the Capital Requirements Directive: Consultation and Partial Regulatory Impact Assessment' available at:
http://www.europeansecuritisation.com/pubs/capital_requirements_directive280206.pdf.

[132] The standardized approach is a set of risk measurement techniques for banking institutions. The term may be used in the context of credit risk or operational risk.

[133]Under AMA, financial institutions can use their internal loss data in combination with external loss data and scenario analyses as input in the estimation of the capital required. The instituions must use the results of expert assessments to estimate exposure to very serious events (tail value at risk). Moreover, the approach specifies a number of qualitative requirements for the collection of data and internal controls that must be met by institutions that want to apply AMA. The AMA is the most sophisticated model for estimating operational risk. Banks who would like to use this method need an approval from their national FSA.

regulators to accelerate efforts to set forth harmonized capital requirement rules for securities firms. The first fruit of international capital adequacy rule making was Basle I. In July 1988, representatives of bank supervisory authorities from twelve countries meeting in Basle, Switzerland, agreed to uniform capital requirements as reflected in the Basle Accord on International Convergence of Capital Measurement and Capital Standards. Basle developed a “framework for assessing an institution’s capital adequacy by weighing its assets and off-balance sheet exposures on the basis of counterparty credit risk”.[134] The Basle I framework endorsed a risk-weighted approach to the assets denominator of the capital assets ratio.[135] Basle I deal with only on credit (counterparty) risk and much less on other important risks such as currency risk, interest rate risk, and market risk. The weaknesses of Basle I led to an extensive round of negotiations for the drafting of a new accord. The process of reforming the Basel Accord, begun in 1999, has been motivated by the goal of more closely matching regulatory capital to the risk profile of banks’ asset portfolios. In June 1999, the BIS issued a proposal that would significantly change the capital adequacy Accord through extensive revision and refinement of Basle I and by providing an alternative approach to measuring risk that would bring the capital framework closer to global market risk management practices.[136] Following several rounds of consultation, the revised Accord was finally published in June 2004[137] and further additions were released in 2005.[138] The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face.

The Basle II framework for the assessment of the capital adequacy of international credit institutions and monitoring of their compliance is based on three pillars: Pillar 1 provides minimum capital requirements; Pillar 2 describes the process for the supervisory review of capital adequacy; and Pillar 3 provides the mechanisms to facilitate and enforce market discipline through public disclosure. Under the revised capital adequacy framework (Basel II),

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[134] Risk-Based Capital Standards: Market Risk, 61 (1996) Fed. Reg. 47,358.
[135] Michael Malloy, ‘Emerging International Regime of Financial Services Regulation’ (2005) 18 *Transnational Lawyer*, 332-333.
[136] A New Capital Adequacy Framework, Basle, Bank for International Settlements, 1999, available at:http://www.bis.org/publ/bcbs50.pdf.
[137] BIS, Press Release, ‘G10 Central bank governors and heads of supervision endorse the publication of the revised capital framework’, 26 June 2004, available at www.bis.org/press/p040626.htm.
[138] Basle Committee on Banking Supervision, ‘International Convergence of Capital Measurement and Capital Standards, A Revised Framework’, Updated November 2005.

banks will be allowed to calculate regulatory capital using either a standardized approach to credit risk or a more sophisticated internal rating based (IRB) approach.[139] The IRB approach should bring capital requirements closer to credit risk profiles and all major banks can be expected to adopt it. As an international securities regulation organization, IOSCO is fully supportive of the Basel II Accord. This is particularly so with the joint working group which has been formed between the Basel Committee and IOSCO. In 2005, the group issued the paper the Application of Basel II to Trading Activities and the Treatment of Double Default Effects.[140] The paper particularly focuses on the treatment of counterpart credit risk for over-the-counter derivatives, repurchase agreements and securities financing transactions. Mr. Andrew Sheng, Chairman of the IOSCO Technical Committee and the Securities said “IOSCO fully endorses these new rules, which represent a significant step forward in the regulation of capital requirements for trading activities.”[141]

5.5.4 Clearing and Settlement Systems

Clearing and settlement systems have become an important component of the domestic and global financial infrastructure as securities markets have become an increasingly important channel for the flows of funds between borrowers and lenders, and investors have started managing their securities portfolios more actively. Thus, weaknesses in clearing and settlement systems can be a source of systemic disturbance for securities markets and for other payment and settlement systems. It is for this reason that the regional and international community has increasingly focused on the soundness, safety and resilience of the post-trading infrastructure, when assessing the strengths and vulnerabilities of the financial markets in various countries. The international debate on the regulation of the clearing and settlement industry has now a longstanding history, dating back to the Committee on Payment and Settlement Systems (CPSS) and IOSCO initiatives, and has recently culminated with the release of a Communication by the European Commission[142] and the final version of a joint

[139] See International Convergence of Capital Measurement and Capital Standards, available at:bis.org.
[140] Basle Committee press release, ‘Basel Committee and IOSCO finalize solutions for the application of Basel II to some trading-related exposures and the treatment of double default effects’
18 July 2005, available at: http://www.cnmv.es/publicaciones/IOSCOPD201_Nota_prensa.pdf.
[141] Ibid.
[142] Clearing and Settlement in the European Union – The way forward, Communication of the European Commission to the Council and the European Parliament, April 2004.

document by the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR).[143]

5.5.4.1 At Regional Level

Efficient and secure payment and settlement systems are crucial to the homogeneity and effectiveness of the EU internal market. EU institutions have therefore promoted developments in this area. Some success has been achieved in harmonizing rules for payment intermediation and payment systems in Europe. The main existing EU legislation in this area is the Settlement Finality Directive of 1998[144] and the Collateral Directive of 2002.[145] Further relevant provisions can be found in the Markets in Financial Instruments Directive of 2004.[146] The Settlement Finality Directive, which was required to be implemented by the Member States by 11 December 1999, has made a significant contribution to the reduction of systemic risk within designated EU payment and securities settlement systems. Originally, Settlement Finality Directive was drafted only with payment systems in mind, but it was later extended to cover securities settlement systems as well, due to the 'close connection between such systems and payment systems'.[147] The Directive has a rather narrow personal scope of application, being limited to qualifying payment and securities settlement systems. The second legal act which is relevant in clearing and settlement context is the Collateral Directive. Collateral is the provision of assets to secure the performance of an obligation, whereby there can either be transfer of the full ownership of the assets from a collateral provider to a collateral taker (e.g. under a repurchase or transfer of title arrangement) or the giving of rights over assets (e.g. pledge, charge or lien), where the ownership of the assets remains with the collateral provider.[148] Collateral is of particular importance in financial markets. Yet, as shown by various market studies, before the advent of the Collateral Directive the laws and practices on collateralization differed considerably between the EU Member States.[149] The Collateral Directive has established a largely harmonized framework for collateral in the EU that not only supports modern financial market needs, but at the same time facilitates the cross-border

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[143] Standards for Securities Clearing and Settlement Systems in Europe, ECB-CESR, October 2004.
[144] Council Directive 98/26/EC (OJ 1998 L166) of 19 May 1998.
[145] Council Directive 2002/47/EC (OJ L168) of 6 June 2002.
[146] Council Directive 2004/39/EEC (OJ 2004 L145/1) of April 2004.
[147] Recital 2 of the Settlement Finality Directive.
[148] The definitions also in article 2 (1) (a) to (c) of the Collateral Directive.
[149] International Swaps and Derivatives Association (ISDA), 'Collateral arrangements in EU financial markets', March 2000; European Financial Markets Lawyers Group (EFMLG), 'Proposal for an EU directive on collateralisation', June 2000, available at: www.efmlg.org.

use of collateral throughout the EU. The Collateral Directive pursues a number of complementary aims, all converging on the intention to create clear, effective and simple regimes for financial collateral arrangements. According to its recitals, the aims of the Collateral Directive are: first, the removal of the major obstacles to the (cross-border) use of collateral; second, the limitation of administrative burdens, formalities and cumbersome procedures; and third, the creation of a clear and simple legal framework.[150] The MiFID requires the Member States to harmonize their rules governing investment services and the pursuit of investment activities. The MiFID is a framework directive, in line with the comitology procedure. The MiFID seeks to establish, for the first time, a comprehensive regulatory framework governing the organised execution of investment transactions by exchanges, other trading systems and investment firms. While being aimed primarily at the trading of securities, a number of the MiFID provisions have a bearing on the clearing and settlement infrastructure. The provisions which may have the biggest effect in this respect relate to the safekeeping of client's assets and the access of investment firms to central counterparties and clearing and settlement facilities. MiFID requires Member States to ensure that investment firms from other Member States have non-discriminatory access to 'central counterparty, clearing and settlement systems in their territory for the purposes of finalizing or arranging the finalization of transactions in financial instruments.'[151] Furthermore, MiFID provides that, subject to certain qualifications, Member States must require regulated markets in their territories to offer all their members or participants 'the right to designate the system for the settlement of transactions in financial instruments undertaken on that regulated market'.[152]

In developing securities settlement systems, EU institutions aim in particular to strengthen the integration and functionality of European financial markets, reduce the costs and inefficiencies associated with securities settlements between member countries and enhance the international competitiveness of European exchanges. The Lamfalussy Report, published in February 2001, identified more efficient arrangements for securities settlements as a prerequisite for the successful harmonization of European securities markets.[153] Arrangements for cross-border settlements were then addressed in the first Giovannini Report published in November

[150] Recital of the Collateral Directive.
[151] Article 34 (1) of MiFID.
[152] Article 34 (2) of MiFID.
[153] Lamfalussy Report, pp. 16-17.

2001.[154] This report states that the widely divergent arrangements for securities settlements between individual member states make them complex, costly, time-consuming and risky. A second Giovannini report,[155] issued in April 2003, presented a road map for removing the barriers identified in the first report, and assigned action and follow-up responsibilities. Finally, the report contained a detailed description of possible consolidation models and policy responses. In 2004 October, The Governing Council of the European Central Bank (ECB) and the CESR have jointly approved the report entitled "Standards for securities clearing and settlement in the European Union", prepared by the joint the ESCB-CESR Working Group. The report contains 19 standards that aim to increase the safety, soundness and efficiency of securities clearing and settlement systems in the European Union. The standards are based on the CPSS- IOSCO Recommendations for securities settlement systems issued in November 2001, adapting them to the European context.

5.5.4.2 At International Level

At the international level, various bodies have responded to the challenges posed by the cross border clearing and settlement of financial instruments. In 2001, the CPSS of the Bank for International Settlements (BIS) and the Technical Committee of the IOSCO jointly prepared and released a report, the Recommendations for Securities Settlement Systems,[156] giving guidance on the reduction of legal and systemic risk in clearing and securities settlement systems. The recommendations were developed by the Task Force on Securities Settlement Systems that the CPSS and the Technical Committee of IOSCO created in December 1999. The Task Force comprises 28 central bankers and securities regulators from 18 countries and regions and from the European Union. In January 2000 the Task Force received input from central bankers and securities regulators who together represented about 30 countries, as well as from representatives of the International Monetary Fund and the World Bank. In January 2001 the CPSS and the Technical Committee of IOSCO released a version of this report for

[154] The Giovannini Group, 'Cross-Border Clearing and Settlement Arrangements in the European Union' Brussels, (2001) November, available at: http://ec.europa.eu/internal_market/financial-markets/docs/clearing/first_giovannini_report_en.pdf. (last visited, September 2008).

[155] See The Giovannini Group, 'Second Report on EU Clearing and Settlement Arrangements' available at: http://ec.europa.eu/internal_market/financial-markets/docs/clearing/second_giovannini_report_en.pdf(last visited, September 2008).

[156] Recommendations for Securities Settlement Systems, November 2001, available at: http://www.bis.org/publ/cpass46.phf.

public comment. Nearly 90 comments were received, and the commentary included a wide variety of interested parties, mostly from Europe, but also from Asia, Africa and the Americas. As a result of these comments, several recommendations have been changed significantly and a new recommendation on cross-border links between settlement systems has been added. The reports set out 19 recommendations for securities settlement comprise international standards that should be met by securities settlement systems and the markets in which they operate. The recommendations address three areas: (i) risk mitigation, (ii) efficiency, and (iii) governance and oversight. These recommendations have been included in the "Key Standards for Sound Financial Systems" highlighted by the Financial Stability Forum (FSF) and represent a "benchmark" for comparing and evaluating the degree of safety of SSSs around the world.[157] The recommendations are designed to cover SSSs for all types of securities, for securities issued in industrialized and developing countries and traded among domestic and cross-border counterparties. SSSs are broadly defined to include the full set of institutional arrangements for confirmation, clearance, and settlement of securities trades, and safekeeping of securities, and therefore the recommendations are applied broadly to various institutions, from central securities depositories, operators of trade confirmation systems, central counterparties, cash settlement agents, custodian banks, to other relevant parties. The CPSS-IOSCO reports emphasize that the recommendations are "minimum standards" (so stricter measures may be welcomed and in some cases warranted according to the specific environments in which the systems operate) and that various aspects would need to be further clarified by the relevant local authorities before the recommendations are implemented. In 2002, the CPSS-IOSCO document, Assessment Methodology for Recommendations for Securities Settlement Systems outlines how the standards should be applied and identifies the key requirements for meeting the standards. For each recommendation, it suggests the criteria necessary for the observance, broad observance, partial observance, or non-observance of each standard. The assessment methodology of the CPSS-IOSCO Recommendations leaves open the possibility for the relevant authorities to extend the scope of application of the recommendations beyond SSSs to other major providers of similar services. Securities custody and settlement services are offered by various categories of intermediary, depending on the business practice, legal tradition and history of the country concerned.[158] As a result, while a principle of

[157] Simonetta Rosati, 'Prudential and Oversight Requirements for Securities Settlement' *ECB Occasional Paper No.76*, 4.
[158] See paragraph 1.10 of the CPSS-IOSCO 2001 recommendations report.

specialization generally applies to financial intermediaries (e.g. banks and insurance companies), clearing and settlement services for securities can be provided by several entities. Furthermore, in January 2003, the Group of Thirty (G30) published its ‘Plan of Action’ for global clearing and settlement, [159] which basically confirmed the CPSS-IOSCO recommendations and identified some additional questions of substantive law that need to be tackled. These included the need for: effective protection against the risk of losing assets in the event of an intermediary’s insolvency; simplifying pledge formalities and the realization procedures relating to collateral; and harmonized rules of finality of settlement.

5.5.5 Regulation of Market Conduct

This is a major element in many securities regulation regimes. Systematic regulation against insider dealing is the result of SEC administrative and judicial interpretation in the USA. The regulatory stance against insider dealing toughened from the 1960s.[160] However, within the EC, as late as 1990, nine of the twelve member States failed to impose any criminal penalties for insider trading of securities.[161] But in light of the need to combat insider dealing in the interests of investor confidence, EC regulators recognized that harmonization is necessary, given the absence of insider-dealing prohibitions in some Member States and the divergences between those rules which have been adopted by Member States.[162]

5.5.5.1 At National Level

The US has a long history of regulating insider dealing. Statutory regulation was introduced in the United States by the Securities Exchange Act 1934, and even before then the common law in some states has already begun to control insider dealing.[163] However, no statutory definition of insider trading exists under the US securities law. It has only the general anti-fraud

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[159] The Group of Thirty, ‘Global Clearing and Settlement—A Plan of Action’ January 2003, available at: http:// www.group30.org/call.htm.

[160] Ben Pettet, *Company Law* 2nd edition (Harlow, Pearson Education Limited, 2005).

[161] Alexander B. St John, ‘The regulation of cross-border public offerings of securities in the European Union: present and future’ (2001) 29 *Denver Journal of International Law and Policy*, 239.

[162] Recital 7 and 8 of Insider Dealing Directive.

[163] Iain G MacNeil, *An introduction to the law on financial investment* (Oxford, Hart Publishing, 2005), 20.

provisions expressed in rule 10 b-5[164] which was promulgated by the SEC in 1942 under s.10 (b) of the Securities Exchange Act 1934. Rule 10 b-5 states that:

It is unlawful for any person, directly or indirectly, to: (a) employ any device or scheme to defraud, (b) make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

Specific types of insider trading are addressed by Exchange Act Section 16(b), which prohibits short swing profits by designated statutory insiders, and Exchange Act Rule 14e-3, which prohibits anyone other than a tender offeror from acquiring any securities while in possession of material information that he knows or has reason to know is non public and was acquired from the bidder, the target or any person associated with either one of these.

5.5.5.2 At Regional Level

By the time the EC 1989 Insider Dealing Directive (IDD) was adopted, the European Commission's programme of creating the EC-wide capital market was well advanced and it seemed possible to take some bold steps with insider dealing policy. In 2003, the Market Abuse Directive (MAD) replaced the limited 1989 Insider Dealing Directive with a view to a more detailed harmonization Europe-wide of regulation in this area. The MAD introduces for the first time an EC prohibition on market manipulation. It creates a harmonized framework for protecting the integrity of the financial markets by preventing insider dealing and market manipulation.[165] It defines and prohibits both forms of market abuse and provides for a number of preventive measures such as prompt disclosure of inside information and management transactions or safeguards of impartiality of investment research.[166] The MAD establishes extensive new definitions for insider dealing and market manipulation and without prejudice to the right of member states to impose criminal sanctions, requires member states to ensure that an administrative sanctions regime is in place, given the well-documented difficulties in policing market abuse through the criminal law. In addition, it would be "administratively simpler and reduce the number of different rules and standards across the EU" to treat both topics under the same directive.[167] MAD uses two main regulatory tools: ex-

[164] 17 CFR § 240.10b-5 (2002).
[165] Article 12 of Market Abuse Directive.
[166] See article 24, 25, 26 and 31 of Market Abuse Directive.
[167] See MAD, at Explanatory Memorandum.

post sanctions for those who engage in insider trading or manipulate the market and prophylactic rules to limit the risk that the prohibited conducts occur upfront.

5.6 The Road-block of International Harmonization

In many ways, international harmonization is a good thing. Harmonization can overcome piecemeal regulation of global securities problems and most importantly it can beget further harmonization and create an expanding zone of international cooperation. MJDS, EC harmonization Plan and the efforts of the IOSCO does give hope that harmonization on an international scale is possible. It can be seen that lots of hard work have been done but at the same time, it is still exist significant roadblocks in the path towards achieving the ideal international harmonization. Critics fear that harmonization could raise the threat of "regulatory imperialism" in which less regulated markets are forced to become more regulated.[168] Pessimists fear that the effort to achieve harmonization may itself encourage regulatory arbitrage as market participants aim to exploit differences between national regimes.

Firstly, although international regulators can usually agree on the basic goals and objectives of regulation, there exists fundamental differences in the regulatory approach taken, including the form and content of regulation.[169] These differences may be explained in large part by some or all of the following factors:

• differences in history, culture and national customs and practices;

• legal or juridical distinctions among jurisdictions, for example, common law versus civil code;

• universal banking and non-universal banking or mixed jurisdictions;

• differences in level of market maturity;

• differences in objectives of statutory framework, that is, market integrity, customer protection, or both;

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[168] OTA-BP-CIT-66, *Trading Around the Clock: Global Securities Markets and Information Technology* (Washington DC, Diane Publishing, 1990).

[169] Jane C. Kang, 'The Regulation of Global Futures Markets: Is Harmonisation Possible or even desirable?' (1996) 17 *Northwestern Journal of International Law & Business*, 242.

• differences in the role of markets, for example, public or private markets, and type of market and market participants, for example, physical delivery market with predominately commercial participation or market with significant retail participation;

• differences in market structure, for example, floor based or electronic.[170]

Therefore to find a single solution that will be viable for every country is an arduous task. The process of harmonization will require compromises among many domestic regulators that hold different views about securities regulation.[171] Such as MJDS, although this approach was promising for Canada, in most other foreign jurisdictions, this model will not work, precisely because of differences between the regulatory systems in the U.S. and those countries, particularly in the accounting and disclosure areas.

Secondly, the harmonization process is not cost free. It will entail substantial transition costs, both for regulators as well as market participants. Regulators will have to invest a great deal of resources and capital to develop the common standards. The MJDS rests on the substantial effort on the part of the securities regulators in both Canada and the United States in learning and understanding each other's system. It took six years to develop MJDS. Each of the U.S. and Canadian securities regulators took almost three years to review the other's rules, regulations and regulatory practices before agreeing to the system. One must keep in mind that this amount of time was required even though the United States and Canada have very similar securities regulatory systems. The prolonged period of negotiation and modification of existing rules even between two countries with strongly connected economies clearly highlights the difficulty associated with any harmonization project. It is not practical to assume that the international securities regulators would be willing to make such an investment. Investors and professionals such as lawyers and accountants may incur costs which arise due to the need to learn new rules, and such costs are especially high if they have relied upon old rules and had taken actions with long-term consequences. Issuers may also bear greater costs in having to prepare disclosure documents in accordance with new standards. This will prove particularly onerous for issuers from markets which traditionally imposed less stringent requirements than the uniform standards that are promulgated.

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[170] Ibid.

[171] Uri Geiger, 'The Case for the Harmonization of Securities Disclosure Rules in the Global Market' (1997) *Columbia Business Law Review*, 250.

Thirdly, another problem arises from the degree of flexibility permitted in the implementation of the common standards.[172] Within EC, although each member state must adopt EC harmonizing Directive into legislation; each member state retains the choice as to the form and method of implementation it wishes to employ to move the directive into national law.[173] Thus, the result is a wide variation in the degree of securities regulation from one member state to another. At the international level, the situation is same. The IOSCO proposal specifically states that each securities document is subject to host country review or approval process and contemplates that supplementary disclosure may sometimes be necessary for issuers from certain industries or for certain unusual forms of securities instruments.[174] It will be not surprising to see substantial modification of the IDS upon its implementation through domestic legislation. With such qualifications, one must surely doubt the extent of uniformity in standards that can actually be attained in practice.

Fourthly, perhaps the most important and difficult obstacle confronting the harmonization right now is that it lacks of absolute authority. The nearest entity approximating a formal, centralized regulatory authority in the world is the International Organization of Securities Commissions (IOSCO). In recent years, IOSCO currently serves as the principal forum for discussions of international securities issues.[175] Despite speculation, IOSCO's agenda has not indicated an intention to assume the role of a global securities watchdog.[176] IOSCO, and similar organizations, are special-interest groups with a narrow focus, lacking both the objectivity and credibility to serve effectively as an international regulatory authority.[177] Additionally, IOSCO lacks mandate authority to adopt and implement binding international regulatory principles.[178] IOSCO frequently finds it difficult to obtain a consensus amongst regulators.

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172 See Hicks, 'Cross-Border Share Offerings', above, n.87.

173 Andreas J. Roquette, 'New Developments Relating to the Internationalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community, and Germany' (1994) 14 *University of Pennsylvania Journal of International Business Law*, 588.

174 The IDS. Report states that companies engaged in specialised industries such as banking, insurance and mining may have to provide additional disclosure in certain countries. Similarly, it is acknowledged that additional information may need to be disclosed in respect of equity instruments like depositary receipts and voting trust certificates.

175 See Wolff, 'International securities regulation', above, n.47, 399-400.

176 See Millspaugh, 'Global securities trading', above, n.104,371.

177 See Millspaugh, 'Global securities trading', above, n.104, 373-374.

178 See Wolff, 'International securities regulation', above, n.47, 399.

Last but not least, even if an international regulatory authority did exist, it would still have problems. To create such a regulatory body, the nations must be willing to relinquish their sovereign authority over their market. Release of governmental control over economic markets is a precursor to the implementation of a harmonized securities market. Such a release of control by all nations, however, would require inconceivable diplomatic efforts and is extremely improbable, short of a market collapse or an event of extreme political embarrassment to demand such a change.[179] Thus, the threats to political sovereignty seem to be an insurmountable hurdle to achieving significant securities harmonization in international securities regulation.

[179] See Millspaugh, 'Global securities trading' above, n.104.

Chapter Six: Regulatory Competition

6.1 Introduction

Regulatory competition, apart from harmonization, has been said to be another regulatory answer in moving towards an integration system of international securities regulation. Different from harmonization which wants to unify the regulation, regulatory competition could yield a diversified set of regimes from which market players could pick and choose. Importantly, it can also be argued that regulatory competition produces superior standards in terms of investor protection when compared to the standards promulgated through international harmonization efforts because the international organizations responsible for the development of the uniform standards are not subject to political discipline and are potentially susceptible to rent-seeking.[1] Unfortunately, not every one agrees that it is necessary to have regulatory competition in international securities regulation. The reason is that the consequence of competition is not guaranteed as being positive. Competition can go in two different directions, a “race to the top” or a “race to the bottom”. The former approach argues that competition will produce a positive result; however, the latter argues that it has the opposite effect. The argument regarding which way competition is moving is on going. Whether regulatory competition leads international securities regulation to a race to the top, a race to the bottom, or somewhere in between is the basic question that will be explored in this chapter.

Firstly there is a brief analysis of the rationales for regulatory competition. Secondly, this chapter describes the feasibility of international regulatory competition. How regulatory competition works on an international level will be examined in section D. Since the main purpose of competition in international securities regulation is to attract more market participants, in other words, to attract more issuers to come to list, therefore these sections will concentrate not on the macrostructure but on the cross-listing competition among exchanges. Finally section E will explore the consequences of regulatory competition.

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[1] Roberta Romano, ‘The Need for Competition in International Securities Regulation’ (2001) 2 *Theoretical Inquiries Law*.

6.2 The Rationales for Regulatory Competition

Regarding the rationales of regulatory competition, many reasons can be mentioned, but some of them overlap. This section will just focus on two core reasons: first, it can correct market mistakes quicker; second, it can provide a superior regulatory regime.

Firstly, regulatory competition is argued to be the fastest means to correct market mistakes. In a competitive market, there is a built-in self-correcting mechanism, as the actions of numerous actors aggregate information efficiently.[2] A single regulator is not able to do it quickly. The flow of firms and investors into and out of particular regulatory regimes provides information concerning which rules are thought to be more desirable by investors. The result of competition will give regulators a good signal to show whether or not they need to improve their regulatory systems. When a regulator finds that its jurisdiction is subject to a net outflow, it will reassess its regulatory regime so as to stem the decline in its jurisdictional sphere. As national and regional markets lose liquidity and trading volume to international exchanges, usually a regulatory reaction has followed.

Secondly, regulatory competition among securities regulators would not only protect investors, both large and small, but also would provide a superior regulatory regime.[3] "Survival of the fittest" is the common principle for competition. Where there is competition, there must be failure. One direct result of competition is to purge out-of-date or inefficient regulation from the legal systems; this possible result will place pressure on regulators to tailor regulations for the needs of issuers and investors. On the contrary, regulatory monopolists have insufficient incentive and insufficient information to offer optimal regulation. In addition to the creation of competitive equilibrium, competition enables regulators to learn from the efficient regimes of other regulators and it fosters regulatory innovation. In those countries where the local market has been most adversely affected, legislative and regulatory reforms have been adopted to enhance governance and disclosure standards in the hope of stemming the flight of firms and trading to foreign markets.[4]

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[2] See Romano, 'The need for competition', above, n.1.

[3] See Romano, 'The need for competition', above, n.1

[4] John Barham, 'A Compromise Solution' (2001) Oct *Latin Finance*, 40, 41-42. Since late 2000, significant securities markets reforms have been adopted in Argentina, Brazil, Chile, and Mexico; in addition, Colombia has

6.3 Feasibility of International Regulatory Competition

After discussing the rationales of regulatory competition, the natural question is whether it is feasible to have regulatory competition in international securities regulation? This part tries to give an answer.

6.3.1 The New Structures of Securities Exchanges

As discussed in chapter one, the traditional model of an exchange is a locally organized mutual or membership association. Each exchange operated in isolation from the others.[5] Historically, the exchange's trading system was based on mutuality and floor trading which required physical location and verbal interaction. Access to the exchange had to be rationed to prevent overcrowding. Rationing access to the exchange was generally done through a combination of substantial initial and annual membership fees. As the trading system was so simple, stock exchanges were organized as not-for-profit organizations, founded and owned by brokers and dealers who managed "their" stock exchange like an exclusive club.[6] This kind of closed membership organization had high barriers to potential entrants and was sheltered from competition by national regulation and policies.[7] As such, they behaved more like sluggish monopolies than dynamic entrepreneurs.

This pattern, however, has changed due to the economics of automated trading. There is a big difference between automated trading and floor trading. The placement and matching of buy and sell orders can now be done on computer systems, access to which is inherently constrained neither by the location nor the members of desired access points.[8] Commission

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revised its regulations regarding pension funds to encourage more active participation in corporate governance by institutional shareholders. Chile approved a new tender offer law in late 2001, and Argentina and Mexico adopted new capital markets laws in 2001. Global Investing: Be Nice to Minorities in Latin America, Fin. Times, July 23, 2001, at 20. After a four-year struggle, Brazil also approved a compromise statute in 2001 that significantly revised its corporate governance standards, at least prospectively, in order to enhance the rights of minority shareholders.

[5] M. Pagano, 'The Changing Microstructure of European Equity Markets' (1997) Working Paper No. 4, Centre for Studies in Economics and Finance, revised version published in G. Ferrarini, *The European Securities Markets: The Investment Services Directive and Beyond* (London, 1998), 4.

[6] See Andreas M. Fleckner, 'Stock exchanges at the crossroads' (2006) 74 *Fordham Law Review*, 2541.

[7] See Mahmood Bagheri and Nakajima Chizu, 'Competition and integration among stock exchanges: the dilemma of conflicting regulatory objectives and strategies' (2004) 24 *Oxford Journal of Legal Studies*, 69.

[8] B. Steil, 'Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequences' (2002) Brookings-Wharton Papers on Financial Services, available at: http://fic.wharton.upenn.edu/fic/papers/02/0215.pdf (last visited, December 2007).

rates became unfixed, single capacity was eliminated, exchange floors disappeared and new marketplaces in the form of proprietary trading systems were launched.[9] In this new trading system the traditional concept of mutual or membership became economically untenable. The direct product of automation trading is to cause securities exchanges to become a for-profit public company with non-member ownership. With the membership gone there is no point for an exchange to continue to impose membership fees. Rather, only transaction-based charging is sustainable.

As a normal commercial enterprise, new securities exchanges are radically different from the traditional exchange floor, whose value derives wholly from the physical—presence of traders. New Exchanges attempt to exploit economies of scope and scale in securities trading by listing new firms and by attracting volume in existing securities.[10] Because exchanges profit from trading volume they do have a clear incentive to compete for listings, both domestic and foreign. Clearly the LSE wishes to take listings away from NASD, and vice versa. The emergence of commercial rather than mutualized trading operations has made competition a more tangible fact in the securities field. Competition between the world's exchanges is now a reality.

6.3.2 The Impact of Technological Advances

Today when we mention information technology, the words faster and cheaper are always coming to our mind. Technological advancements such as the Internet have had, and will continue to have, a tremendous impact on securities markets. First of all, trading is no longer tied to a physical location but takes place in a ubiquitous computer network. Internet trading lowers the costs of entry. Because it reduces the costs of performing transactions, the internet is expected to continue to cause the number of cross-border transactions to increase. Another obvious contribution of technological advances to the securities markets is to make information flows seamless and borderless, instantaneous and almost costless. Modern technology enables market participants to exploit simultaneous and multiple sources of

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[9] R.S. Karmel, 'The Case for a European Securities Commission' (1999) 38 *Columbia Journal of International Law*, 9 at 33; P. Arlman, 'European Equity Markets after the Euro: Competition and Co-operation Across New Frontiers' (1999) 2(1) *International Finance*, 139 at 141; M. Blair, 'Book Review; International Securities Regulation: London's "Big Bang" and the European Securities Markets' (1992) 26 (3) *The International Lawyer*, 840.

[10] T. Arnold, Ph. Hersh, J.H. Mulherin and J. Netter, 'Merging Markets' (1998) 54 *Journal of Finance*, 1083.

liquidity from remote locations. Such as through the internet, investors in China may obtain information on companies listed on the London Stock Market. Thirdly, in securities markets, a unified global capital market, working in real time, is emerging. A twenty-four hour global securities market is not impossible anymore.

As a result of advances in technology, securities markets can compete on a global basis which was previously infeasible. For example, in the past it was not easy to learn about competitive prices offered somewhere else. The wall between competitors, built by geographic boundaries and time zones that once dictated and furthered nationalistic views toward commerce will continue to fall because of better and lower-cost communications and analytics.[11] Rapid improvements in information technology and the creation of innovative financial instruments have paved the way for the international regulatory competition.

6.3.3 Cross-listing

So far, the principal mechanism that produces competition among market centers has been the issuer's decision to cross-list its stock on a foreign exchange, typically in the United States.[12] Cross-listing appears to be producing a new and desirable form of regulatory competition. This raises the question, why do companies have the desire to cross-list?

One reason is that the country in which a company is incorporated does not have the scale of capital market which is appropriate to the company's requirements.[13] To overcome this problem, issuers may seek the opportunity to gain access to a larger investor base with a larger pool of capital available for investment. Cross-listings were first thought of as a means to lower firms' cost of capital by enabling the firm to get more money from investors when offering its securities to the public.[14] By cross-listing its securities, a firm could expand its potential investor base more easily than if it traded on a single market. With cross-listing, firms can make their securities more liquid which will lead to more trading chances.

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[11] Steven M. H. Wallman, 'Information Technology & the Securities Market The Challenge for Regulators' (1998) 16 *The Brookings Review*, 26-29.
[12] John C. Coffee, Jr., 'Racing towards the top?: The impact of cross-listings and stock market competition on international corporate governance' (2002) 102 *Columbia Law Review*, 1757.
[13] Iain MacNeil and Alex Lau, 'International corporate regulation: listing rules and overseas companies' (2001) 50 *International & Comparative Law Quarterly*, 787.
[14] For a summary, see René M. Stulz, 'Globalization of Corporate Finance and the Cost of Capital' (1999) 8 *Journal of Applied Corporate Finance*, 30.

Secondly, the bonding hypothesis[15] offers another potential motivation for cross-listings. Essentially, the ‘bonding’ explanation for overseas listings predicts that high standards of regulation in one country will attract listings from countries with lower standards of regulation.[16] Issuers migration to superior capital markets, for example the U.S. market, is an evident signal to show the investors that they want to voluntarily subject themselves to the higher disclosure standards and greater threat of enforcement (both by public and private enforcers). Academic research suggests that foreign companies come to the United States in order to “bond” themselves to the rigorous legal standards of the United States, which include submitting to enforcement oversight by the SEC, opening themselves to civil litigation, preparing detailed disclosure of their operations and financial condition (in accordance with US GAAP), and providing guidance to investors.[17] By submitting to US requirements, these companies become more attractive to investors and are rewarded with higher valuations for their securities and a better market reputation. A 1999 study by Darius Miller found a positive 1.15 percent average abnormal return in a broad sample of ADR-listing announcement dates; even more interestingly, the stock market reaction was greater for emerging market firms (1.54 percent) and for firms listing on the major U.S. exchanges (2.63 percent).[18] Cross-listing on a foreign stock market can also serve as a bonding mechanism for corporate insiders to credibly commit to a better governance regime. This idea that foreign firms actually engage in cross-listing to improve their corporate governance is often attributed to Jack Coffee.[19] In this view, cross-listing firms import aspects of the corporate governance systems that they consider superior.

The putative benefit of increased visibility in the host country is another incentive to have cross-listing. In addition to greater demand for its stock, listing a corporation’s stock abroad provides the company with greater access to foreign product markets and facilitates selling

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[15] For more details see this chapter 6.6.2.

[16] See MacNeil and Lau, ‘International corporate regulation’, above, n.13.

[17] See René M. Stulz, ‘Globalization of Corporate Finance’, above, n. 446, 8–25; John C. Coffee, ‘The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications’ (1999) 93 *Northwestern University Law Review*, 641; See also Jordan Siegel, ‘Can foreign firms bond themselves effectively by renting US securities laws?’ (2005) 75 *Journal of Financial Economics*, 319-359 (arguing that the reputation bonding effect is stronger than the legal bonding effect).

[18]Darius Miller, ‘The Market Reaction to International Cross-Listing: Evidence from Depositary Receipts’ (1999) 51 *Journal of Financial Economics*, 103.

[19] See Coffee, ‘Racing towards the top’, above, n.12.

debt in the foreign country.[20] It also brings foreign securities closer to potential investors and increases their awareness of investment opportunities, which could increase expected returns.[21] New cross-listings in Western Europe, Australia, and Canada are consistent with firms pursuing increased visibility in growing overseas product markets. A company becomes more credible by providing information to the local capital market because the continuous flow of information allows the capital market to make quicker and more accurate decisions.[22]

6.4 The Regulation of Foreign Listing Companies

Securities exchanges as for-profit entities have natural incentives to compete and attract listings and orders from their rivals. The subject of competition among stock exchanges has two dimensions: competing for listings and for trading business. Internationalization and technological progress has dramatically increased foreign listing. Competition for listings is now more compelling. That is why only this kind of competition will be researched in this paper. How well the current policies of world exchanges regulators address this competition will also be discussed. This section will focus on four selected nations. They are United States, United Kingdom, Hong Kong and Singapore. These were chosen mainly because they are representatives of the international stock exchanges and cover the American, European and Asia areas.

6.4.1 United States

A foreign issuer contemplating the listing in the United States must make an initial choice between issuing its securities by means of a public offering on the Exchange, registered with the SEC pursuant to the Securities Act or by means of a non-public offering, pursuant to a private placement.

Foreign firms that list on U.S. exchanges have to register with the SEC and become subject to U.S. securities laws. When a foreign company makes an offering in the United States and lists

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[20] See Kent H. Baker, ‘Why U.S. Companies List on the London, Frankfurt, and Tokyo Stock Exchanges’ (1992) 6 *Journal of International Securities Markets*, 219, 221.
[21] See Robert Merton, ‘Presidential Address: A Simple Model of Capital Market Equilibrium with Incomplete Information’ (1987) 42 *Journal of Finance*, 483.
[22] See Edward B. Rock, Greenhorns, Yankees, and Cosmopolitans, ‘Venture Capital, IPOs, Foreign Firms, and U.S. Markets’ (2001) 2 *Theoretical Inquiries Law*, 711.

its equity securities on a US stock exchange, its shares are often sold and traded in the United States in American Depositary Receipt (ADR) form.[23] Therefore, foreign companies commonly offer equity securities in the United States through the issuance of ADRs which are negotiable receipts registered in the name of the holder that evidence underlying shares of non-U.S. equity securities. ADRs are issued by a U.S. depositary, usually a bank, against the deposit of a foreign company's equity securities with a custodian bank, usually located in the foreign company's home country that acts as agent for the U.S. depositary bank. The attitude of the SEC staff long has been that if a foreign issuer was going to tap the U.S. capital markets then it should play by the SEC's rules. However, the internationalization of the world's securities market has exposed the U.S. market to foreign competition and has posed new challenges to the SEC. The SEC has to balance its mandate to preserve investor protection with its responsibility to maintain the competitive position of the U.S. in the securities market. During the internationalist era, the SEC provided a number of accommodations to foreign issuers in order to entice them to register with the SEC and cross list on U.S. exchanges. In 1979, the SEC expressly adopted an integrated registration and annual reporting requirement embodied in Form 20-F, which was aimed at reducing the informational disclosure requirements imposed upon foreign issuers in certain key areas.[24] Subsequent to the adoption of Form 20-F, the SEC also adopted three simplified Securities Act registration forms F-1, F-2, and F-3, which collectively, alleviated the disclosure impositions on foreign issuers, to a large extent.[25] Based upon these forms, foreign issuers have the option not to disclose certain categories of information or to have less stringent disclosure obligations.[26] Similarly, in 1994, the SEC continued on with its mission to make U.S. securities markets more hospitable to foreign investors. In the 1994 "Simplification of Registration and Reporting Requirements for Foreign Companies" release,[27] the SEC adopted additional revisions designed to further streamline the registration and reporting process for foreign companies entering the U.S. securities markets. The SEC also permitted more flexible accounting standards for foreign issuers. Since 1994, first time registrants have been required to reconcile their financial

[23] See above, chapter three footnote 11
[24] Emmanuel U. Obi, 'Foreign issuer access to U.S. capital markets – an illustration of the regulatory dilemma and an examination of the securities and exchange commission's response' (2006) 12 *Law and Business Review of the Americas Summer*, 399.
[25] Exchange Act Release No. 6437 P 72407, 1982 SEC LEXIS 355 (Nov. 19, 1982).
[26] Marc I. Steinberg & Lee E Michaels, 'Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity' (1999) 20 *Michigan Journal of International Law*, 207.
[27] Securities Act Release No. 7053, [1993-1994 Transfer Binder], Fed. Sec. L. Rep. (CCH) P85,331 (April 19, 1994).

statements for only the last two years. Particularly, the SEC accepts a foreign issuer's cash flow statement without reconciliation if prepared in accordance with International Accounting Standard No. 7; and the widened use of both the short-form registration statement and the shelf rule.[28] The SEC characterized these actions as "part of [its] ongoing efforts . . . to ease the transition of foreign companies into the U.S. disclosure system, enhance the efficiencies of the registration and reporting processes and lower costs of compliance, where consistent with investor protection".[29] In 2002, with the enactment of Sarbanes-Oxley Act, the SEC utilizes a "unilateralist" approach in its treatment of foreign issuers, in that very few registration and disclosure exemptions are granted to foreign issuers. Traditionally, foreign listings have been exempt from many of the corporate governance requirements applicable to U.S. companies, both under exchange rules and federal securities law.[30] But after 2002, foreign issuers were shocked to discover that various corporate governance provisions of Sarbanes-Oxley applied to them. Sarbanes-Oxley's provisions impact the operation of internal corporate governance systems of foreign companies subject to U.S. regulation, and impact the relationships that these issuers have with their outside auditors.[31] The SEC presents foreign issuers with an all or nothing deal--either comply with Sarbanes-Oxley Act and the enumerated requirements or look to other securities markets.[32] Therefore, it is unquestionable that "the extraterritorial effects of [Sarbanes] burden foreign issuers with unjustified requirements and hinder the process of reciprocity and harmonization of international capital markets".[33]

A common method of selling securities in the United States without registration under the Securities Act is through a "private placement." Rule 144A, adopted by the SEC in April 1990, provides a non-exclusive safe harbor from the registration requirements of the Securities Act for resale's of certain securities issued in a non-public offering to "qualified institutional buyers" ("QIBs").[34] "QIBs" include insurance companies, banks, investment companies, employee benefit plans, savings and loans institutions, or an entity owned entirely by qualified

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[28] See Bevis Longstreth, 'A Look At the SEC's Adaptation to Global Market Pressures' (1995)33 Colum. J. Transnat'l L. 319, 329-30 (citing Exchange Act Release No 7053).
[29] See generally Exchange Act Release No. 7053.
[30] See, e.g., 15 U.S.C. § 78n (a) (limiting the application of proxy rules to U.S. public issuers).
[31] Irina Shirinyan, 'The Perspective of U.S. Securities Disclosure and The Process of Globalization' (2004) 2 *DePaul Business & Commercial Law Journal*, 515.
[32] Roberta S. Karmel, 'The securities and exchange commission goes abroad to regulate corporate governance' (2004) 33 *Stetson Law Review*, 849, 853-56.
[33] Ibid.
[34] Peter V. Darrow,Philip J. Niehoff and Michael L. Hermsen, 'U.S. Equity Markets for Foreign Issuers: Public Offerings and Rule 144A Placements of American Depositary Receipts' March 2007

investors. In contrast with listing on the exchange, foreign companies that list in the U.S. via Rule 144a are exempt from SEC registration[35] and many disclosure requirements and therefore face very few additional obligations when they list. Issuers relying upon Rule 144A may avoid compliance with the relatively burdensome obligations involved in the preparation of a Securities Act registration statement. They may also avoid compliance with SEC requirements concerning disclosure, accounting (including reconciliation of financial statements to U.S. generally accepted accounting principles) and ongoing periodic reporting requirements pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in addition to the disclosure and other requirements of the Sarbanes-Oxley Act. The existence of such a market enhances the attractiveness of the U.S. private market to foreign issuers that wish to avoid the burden of complying with the registration requirements of the Securities Act.

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6.4.2 United Kingdom

Foreign companies that wish to access the London capital market can list on the Main Market (London Stock Exchange) or on the Alternative Investment Market (AIM). There are different requirements for each listing type.

Foreign companies wanting to list on the London Stock Exchange (LSE main board) must seek admission to the official list of the UK Listing Authority (UKLA) and comply with the UKLA's disclosure requirements as set out in the Listing Rules of the UK Listing Authority.[36] Foreign companies also need be admitted to trading by LSE.

Companies not already listed on their home exchange may apply for a 'primary' listing in LSE, while companies which already have a listing on another exchange may apply for a 'secondary' listing. The Listing Rules apply in the normal manner to all listed companies irrespective of where they are incorporated unless exceptions or additional requirement are expressly created. Some concessions are made for overseas companies in the form of modifications to the listing rules (chapter 17). The most significant concessions are made in the case of overseas companies which seek a secondary listing, while the concessions for those

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[35] Under Section 4 (2) of the Securities Act 1933, the registration requirements of the Securities Act do not apply to "transactions by an issuer not involving any public offering."
[36] Section 3.1 of the Admission and Disclosure Standards of the UKLA Listing Rules

seeking a primary listing are relatively limited. Most foreign companies list in LSE seek a secondary listing or alternatively list on AIM which has lower entry requirements.

Foreign companies with a secondary listing are exempt from the more rigorous disclosure regime applicable to U.K. companies and overseas companies with a primary listing in the U.K. The exemptions most pertinent to foreign issuers are those concerning companies with either prior listings on an EC member's exchange,[37] or simultaneous listings on a EC member's exchange,[38] Securities that have been listed for at least three years on the exchange of a European Member state, in full compliance with the EC Directives, may supply abbreviated disclosures, rather than the full disclosures mandated for listing particulars.[39] Overseas companies that simultaneously seek a listing on a non-U.K. EC member's exchange may use the issuing documents prepared for that listing, provided that a series of conditions are satisfied.[40] The UKLA may also allow an overseas applicant to omit certain information otherwise required in its listing particulars, depending on the nature of the regulation to which the applicant is subject in its home country.[41] Although there are some exemptions, secondary listing are nonetheless obligated, among other things, to publish annual accounts[42] as well as an annual report, to publish a half-year report, to disclose major corporate developments, to inform of changes in their capital structure and to announce acquisitions and disposals as required by the stock exchange on which the companies have their primary listing. Different from other securities market, foreign companies with a secondary listing on LSE are not required to comply with the Combined Code on Corporate Governance.[43] But foreign companies with a primary listing on the official list must disclose significant ways in which their corporate governance practices differ from those set out in the Combined Code.[44] The main requirement for companies listing on the Main Market is to file financial information

[37] Listing Rules 5.23 (b).
[38] Ibid, 17.68.
[39] Ibid,5.23 (b).
[40] Ibid, 17.68 (a).
[41] Ibid, 17.6.
[42] These accounts can be prepared according to U.K. GAAP, U.S. GAAP, International Accounting Standards or another appropriate standard, approved by the UKLA and which "protect the interests of investors" (Section 17.3 of the Listing Rules).
[43]The Cadbury Report, published in 1992 included a "Code of Best Practice". In 1998, the Hampel Report led to the publication of the Combined Code of Corporate Governance ("Combined Code"). The Combined Code, which is annexed to the UKLA's listing rules, contains two sections, "Principals of good governance" and "Code of best practice." In 2003, the code was further revised. UK's Listing Rules make clear that the Combined Code on Corporate Governance applies only to companies incorporated in the United kingdom, with the result that it does not apply to foreign listed companies.
[44] FSA Handbook LR 9.8.7R

prepared in accordance with U.K. or U.S. GAAP or International Accounting Standards, although exceptions are made to this requirement in some cases. For example, the UKLA will accept local accounting standards from Japanese firms.[45]

AIM is a London based securities exchange that started in 1995. To gain admission to AIM foreign companies must in general produce an admission document that includes information about the company's directors, their promoters, business activities and financial position. Unlike most other markets, AIM does not stipulate minimum criteria in relation to company size, trading record, number of shares to be in public hands or market capitalization.[46] Instead, all prospective companies need a nominated adviser ('a Nomad') from an approved register who is responsible to the London Stock Exchange for ensuring that all applicants are suitable for admission to AIM and ready to be admitted to a public market. The admission document is not, however, pre-vetted by the Exchange nor UK regulatory authorities but rather by the Nomad. AIM has also created a streamlined admission process to make it even easier for international companies who have already been admitted to certain other major markets for at least 18 months to come to AIM.[47] These companies need not produce an admission document but simply need to make a detailed preadmission announcement. Existing published information can generally be relied upon although the latest annual audited accounts may not be more than nine months out of date.

6.4.3 Hong Kong

Cross-listings in HKSE are regulated under the Listing Rules of the Hong Kong Stock Exchange ('HKSE'). Chapter 19 of the HKSE Listing Rules applies to cross- listing companies generally and chapter 19A deals specifically with cross-listing companies incorporated in the People Republic of China. Both rules contain additional requirements and/or exceptions applicable to cross-listing companies. In addition, appendix 13 contains

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[45]London Stock Exchange, "A guide for Japanese companies listing on the London Stock Exchange", 2003, available at: http://fsahandbook.info/FSA/html/handbook/D85.

[46] London Stock Exchange website,
available at: http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new/About+AIM/whyjoin1.htm.

[47]This fast-track route is available for existing listings on the following stock exchanges: Australian Stock Exchange, Deutsche Börse, Euronet, Johannesburg Stock Exchange, NASDAQ, New York Stock Exchange, Stockholmbörsen, Swiss Exchange, Toronto Stock Exchange, UK Official List (as issued by the UK Listing Authority).m

additional provisions relating to cross-listing companies in Bermuda, the Cayman Islands, and the PRC. The HKSE controls admission to listing and admission to trading.

HKSE has no general exemptions for foreign companies in respect of its conditions for listing, irrespective of whether they seek to primary listings or secondary listings. On the contrary, cross-listing companies are subject to additional conditions for listing by comparison with Hong Kong incorporated companies.[48] Take the PRC as an example, in chapter 19A 01(2) of the HKSE Listing Rules it says that:[49]

To deal with the different markets in which a PRC issuer's shares may be traded as well as with the non-common law basis of the PRC legal system, certain additional requirements, modifications and exceptions to the Exchange Listing Rules are necessary in order for a PRC issuer to obtain and to maintain a listing of its securities on the Exchange.

The purpose of chapter 19 is to clarify that the Exchange Listing Rules apply as much to PRC issuers as they do to Hong Kong and overseas issuers, subject to the additional requirements, modifications and exceptions set out or referred to in this chapter.

In contrast to the UK, all listed companies in Hong Kong are expected to comply with the Code of Best Practice[50], the equivalent of the combined code in the UK. Companies are required to state in their annual reports whether they are in compliance with the Code and the SEHK can impose sanctions for non-compliance.

Another choice for foreign companies to cross-list in HK is the GEM, however, it is not open to every country. Only companies incorporated in Hong Kong, China, Bermuda and the Cayman Islands have a possible chance of being accepted.[51] GEM Listing Rules do not impose a profit requirement on listing applicants but the minimum market share capitalization cannot be less than 46 million H.K. dollars (about 5.94 million U.S. dollars) at the time of listing. In respect of corporate governance, GEM requires that the new applicants must have: appointed competent personnel; appointed at least 2 Independent Non-executive Directors; and established an audit committee.

[48] See ch 19A and Appendix 13 of SEHK Listing Rules.
[49] See ch 19A 01 (2) of SEHK Listing Rules.
[50] Appendix 14 of SEHK Listing Rules.
[51] See the Hong Kong Stock Exchange website, available at: http://www.hkex.com.hk/index.htm.

6.4.4 Singapore

Singapore Exchange (SGX) has two major equity trading boards: the SGX Main board and the SGX Dealing and Automated Quotation System (SESDAQ).

The foreign listing applicant who has a primary listing on the SGX must comply with the Listing Manual. There are altogether 7 Rulebooks issued and administered by SGX. These Rulebooks contain the various rules governing issuers (seeking a listing) and intermediaries (brokers/dealers trading on the securities futures market). The Rulebooks provide a framework for the listing, trading, clearing and the provision of depository services. Its adoption of international standards of disclosure and corporate governance policies has also provided a well-regulated trading environment for both local and international investors. For primary listings, the financial statements submitted with the listing application, and future periodic financial reports, must be prepared in accordance with the Singapore Statements of Accounting Standards (SAS), the International Financial Reporting Standards (IFRS), or the US Generally Accepted Accounting Principles (US GAAP). Accounts that are prepared in accordance with IFRS or US GAAP need not be reconciled to SAS. In March of 2000 The Stock Exchange of Singapore, adopted IOSCO Disclosure Standards for both foreign and domestic issuers. However, it modified the IOSCO Standards in several respects. For example, where the IOSCO requirements provide that five years of information should be furnished, the issuer making an offering in Singapore may provide the required information covering only the three most recent financial years.[52] Singapore also added a rider specifically permitted by the IOSCO Standards requiring disclosure of the "financial prospects" of the issuer.

In contrast to a primary listing, a foreign listing applicant with a secondary listing on the SGX need not comply with SGX's listing rules, provided that it undertakes to:[53]
(i) release all information and documents in English to the SGX at the same time as they are released to home exchanges;
(ii) inform the SGX of any issue of additional securities in a class already listed on the SGX and the decision of the home exchange; and

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[52]See Singapore Listing Rules, app. 3 (a)(1)(2).
[53] Singapore Stock Exchange website. www.sgx.com/general/disclaimer.shtml.

(iii) comply with such other listing rules as may be applied by the SGX from time to time.

SESDAQ is for newer companies and there are no quantitative requirements for listing. Listing applicants need not meet any minimum operating track record, profit or share capital requirements. Companies listed on the SESDAQ may apply to be moved to the main board if they have been listed for at least two years and meet the minimum quantitative requirements.

6.4.5 Summary

From the integrated comparison above among the different nations, it can be seen that there are many similarities in admission requirements. Regarding the main board, the underlying principles are broadly similar. In order to protect investors all the exchanges require an issuer to compile amounts of information, to provide their profitability record and to invest substantial company resources in the process. Although securities regulators share the broad goals of regulating securities markets, the means adopted to accomplish those goals differ. However, differences between the listing requirements among the exchanges are a matter of degree, rather than a matter of kind.

6.5 The Trends of Cross-listing

6.5.1 By Country

Firstly this paper will collect some statistics to show the performance of each exchange and their level of competition. The statistics include main board and second markets (or new markets). One thing that needs to be explained is that the numbers in table 1 and 2 do not include Chinese listing companies on HKSE. The HKSE's explanation is that the term foreign company[54] doesn't include any companies incorporated in mainland China. However, due to the special relationship between People Republic of China (PRC) and Hong Kong,[55] this paper views 'PRC' as one single legal jurisdiction. In order to get the whole picture, this paper will use particularly table 3 to show the numbers of Chinese companies listing on the world's stock

[54] A "foreign company" is a company not incorporated in the same country where the exchange upon which a listing is sought is located. In the context of the United Kingdom, foreign company, and "overseas company" are used interchangeably.

[55] On 1 July 1997, sovereignty over Hong Kong reverted to the PRC but their legal systems will remain separated for 50 years.

exchanges. Furthermore, a close look at the mainland's overseas initial public offerings (IPOs) over the past years reveals that competition for a slice of the mainland economy is intensifying among the world's stock exchanges.

Table 6-1: The numbers of foreign listed companies[56] (main board)

	2007[57]	2006	2005	2004
NYSE	421	451	452	459
LSE	699	343	334	351
HKSE	8	8	9	10
SGX	275	247	122	25

It is noticeable from table 1 that the competitive ability of SGX in attracting foreign listings has soared from 25 to 275 over the four year period. Whereas, that of NYSE and HKSE declined slightly over the same period. From 2004 to 2007, the trend of decline in NYSE continued. In contrast, the LSE experienced a decrease in 2005, but in 2006 it started to grow again, and by 2007 it achieved outstanding growth, it saw an almost 100% increase of foreign listings in that year. Also noticeable is the fact that up until 2006 NYSE was the leading market for foreign listings but it was well overtaken by LSE in 2007. It should also be noted that for HKSE the number of foreign listings is significantly smaller. This is due to the fact that it does not include the listings for mainland China. Thus compared to the other exchanges, it is not as popular with international companies outside mainland China.

Table 6-2: The number of new listed foreign companies[58] (main board)

	2006	2005	2004	2003	2002	2001	2000
NYSE	28	19	20	16	33	51	60
LSE	32	21	10	7	9	9	33
HKSE	1	0	0	1	0	0	1
SGX	49	44	0	10	4	8	12

[56] The data is from the website of World Federation of Exchange, available at http://www.world-exchanges.org
[57] Oct ,2007.
[58] The data are from the website of World Federation of Exchange, available at http://www.world-exchanges.org.

From 2000 to 2004, the average number of new listed foreign companies in the NYSE was greater than that of the other three stock exchanges. Its track record has been outstanding in its performances. However in 2005, this situation has been reversed, it is SGX rather than NYSE has the highest number of new listed foreign companies. LSE also pulled ahead of NYSE in the same period, having 21 new companies versus the 19 of NYSE. In 2006, although the number of new listed foreign companies in the NYSE increased, it did not regain its number one leading position. SGX and LSE continue to lead the race in attracting new listed foreign companies.

Table 6-3 [59] The number of new Chinese listed companies (main board)

	2004	2005
HKSE	43	35
SGX	31	26
NYSE and NASDAQ	10	8
LSE	1	0

In 2005, there were in total 69 new Chinese companies listed on Hong Kong, Singapore and United States markets. In contrast with table 1, HKSE is the first choice for Chinese overseas listings as 50% of Chinese companies listed their shares on the HKSE. SGX was the second choice. NYSE, NASDAQ and LSE were far behind HKSE and SGX.

Table 6-4: Average number of companies listed on global growth markets 2003-05[60]

	2006	2005	2004	2003
NASDAQ	3145	3187	3229	3335
AIM	1535	1232	875	713
GEM	200	203	198	175
SESDAQ	173	167	148	128

[59] 2004 and 2005 Chinese cross-listing companies research.
[60] Source: Grant Thornton's 2006 'Global new markets guide-insight into international capital markets'.

Throughout 2005 most of the world's markets displayed growth in the numbers of companies quoted, with the exception of NASDAQ. Despite a decline in year-on-year growth, NASDAQ continued to be the leader in each year, with 3145 companies listed in 2006. Compared with 2003, AIM has seen growth of 115%, with a peak of 1535 companies listed in 2006. Thus over the period AIM can be seen to be one of the star performers. During the 2003—2006 period, AIM attracted more new listings than NASDAQ, GEM and SESDAQ combined. Steady year-on-year growth has also been recorded for Singapore's SESDAQ. It supported 173 companies - an increase 35% on 2003. From 2003 to 2005, Hong Kong's GEM also experienced steady year-on-year growth, but it slightly declined in 2006.

6.5.2 Analysis

Competition inevitably implies that there will be winners and losers. Using the four tables mentioned above we can see that there are five outstanding things worth noting: firstly, the decrease in foreign listings on the exchanges in New York; secondly, LSE's outstanding growth in 2007; thirdly, SGX has become the new star of the main board; forthly, HKSE has a very strong position when it comes to attracting Chinese State Owned companies; and lastly AIM's fast growing performance on the growth market. From the above we might conclude that four of them look like "successful" stories and one of them is a "failure" story.

6.5.2.1 Successful Stories

In August 2006, California-based Napo Pharmaceuticals became the first US company to do an IPO on the London Stock Exchange's Main Market.[61] In 2007, the LSE had 699 foreign listed companies which meant for the first time, since 2004, it overtook NYSE. This figure is part of an important body of statistical data that shows London's lead over New York as a venue for international companies seeking to raise growth capital. The U.K. regulates the foreign issuer considerably less rigorously than does the U.S. and also less rigorously than it regulates its own domestic companies, that is, U.K. domestic companies are required to meet "gold-plated" standards to provide investor protector, but these same standards are not made applicable to foreign issuers. London also has a significant cost advantage. As a recent report

[61] London Stock Exchange Press Release (Feb. 8, 2006), available at http://www.londonstockexchange.com/NR/exeres/E968DB1D-BA29-4B2D-88FE-34924B2A4681.htm.

commissioned by the City of London governmental body and the LSE found, IPO underwriting fees in London are typically 3 to 4 per cent of funding proceeds, compared with 6.5 to 7 per cent in the US.[62]

During the four year period, the number of foreign listed companies increased 10 times on the SGX i.e. from 25 to 275. Additionally, in 2005 and 2006, SGX attracted more foreign listed companies than NYSE and LSE. In 2007, SGX senior executive vice-president and head of markets Gan Seow Ann said its listing platform currently hosted more foreign listing aspirants than domestic ones. “Overall, foreign listings accounted for about one-third of our total market in terms of number and market capitalisation and we expect this to enlarge, going forward”.[63] In its pursuit for more foreign listings, the SGX has introduced listing rules that are market-oriented. There are three different standards which apply to foreign companies. By satisfying any one of these standards a foreign company qualifies for listing. These rules provide greater flexibility for companies with diverse backgrounds to access public financing in Singapore, without compromising any regulatory standards. The SGX listing threshold is the lowest among NYSE, LSE and HKSE. Roughly speaking, companies who go to NYSE spend several million dollars, LSE costs at least £500,000 (around $ 0.94 million),[64] HKSE at least HKD 10 million (around $1 million), SGX around $0.1 million.[65] Although the numbers are not 100% accurate, it represents the outline.[66] It indicates that compared with NYSE, LSE and HKSE; listing on SGX is not a big financial burden. In the past listing rules required that foreign companies must have achieved in the previous three years a pre-tax profit of 15 million Singapore dollars, now it has been reduced to 7.5 million Singapore dollars. Therefore its profitability requirement has been reduced to half its previous value.

Regarding attracting Chinese Stated-Own companies to list, it can be said that HKSE is the absolute winner. In 2004, HKSE amended the Main Board Rules[67]to introduce 2 alternative

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[62]Clara Furse, ‘Comment: SOX is not to blame—London is just better as a market’ (2006) September 17, *Financial Times (London)* 17 September 2006.
[63] Leong Hung Yee, ‘More foreign firms drawn to Singapore exchange’ *Malaysia Star*, Monday December 3, 2007, available at: http://biz.thestar.com.my/news/story.asp?file=/2007/12/3/business/19616730&sec=business.
[64] See London Stock Exchange website, ‘A practical guide to listing’, available at: www.londonstockexchange.com.
[65]Xiaoqing, He, ‘Gongsi liyun 2000 wai, gai xuanze zai xinjiapo shangshi haishi zai xianggang shangshi hao?’ 2005-6-17 Chinese minying jingji newspaper. Available at: http://www.3009.cn/Article/200561714733-1.htm.
[66] See appendix.
[67] Hong Kong Stock Exchange, ‘Amendments to the Listing Rules’ HKEx News Release, Updated: 30 January 2004 available at: http://www.hkex.com.hk/news/hkexnews/0401303news.htm (last visited, December 2007).

financial tests[68] to provide more flexibility and cater for the wide variety of issuers seeking to list on the Main Board. Although the profit requirement has been maintained as one of the quantitative tests for assessing the track record financial performance of a listing applicant, the new rules eased the profit requirement. The purpose of this amendment was to attract the substantially larger sized Chinese Stated-Owned companies. The Semiconductor Manufacturing International Corporation (Shang hai) (SMIC) which listed its shares on the HKSE in 2004 became the first beneficiary of the new rules. SMIC was a money-losing company in 2003 and there were no profit records for the most recent years prior to its listing. It was impossible for it to have a foreign listing in any of the major world stock exchanges. Due to HKSE amended its listing rules, SMIC was able to fulfill its listing dream. SMIC was just the beginning of a wave of large Chinese companies who went to Hong Kong. Besides Hong Kong, Chinese companies are listed in Singapore, London and New York. But while Hong Kong has retained its primary importance, the other market options are fading or are being temporarily closed down.[69] There is no doubt that from 2005 HKSE, has sought to win over Chinese companies and it has achieved. NYSE or LSE, have historically been the top choice for companies who wished to raise large amounts of capital when listing. But now these seem to have no advantage over Hong Kong in luring large mainland IPOs. From the China Construction Bank to the Bank of China, China's newly super-large listing companies simply dropped their US plans and listed in Hong Kong instead. In 2006 HKSE hosted the US$ 16 billion IPO of the Industrial and Commercial Bank of China, the world's largest IPO to date. It is often said that its similar culture, language and convenient location are the reasons for HKSE's success, but its lower entrance requirements are a major important factor.

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[68] (1)Market capitalization / revenue test: The Exchange has amended the Main Board Rules to introduce a market capitalization / revenue test which is to apply to listing applicants with a market capitalization of at least HK$4 billion at the time of listing and revenue of at least HK$500 million for the most recent financial year comprising 12 months. This test caters particularly for those listing applicants that are of substantially larger size, are able to generate substantial revenue and can demonstrate that they are able to command significant investor interest (having at least 1,000 shareholders at the time of listing). They may or may not have a full 3-financial-year trading record. (2)Market capitalization / revenue / cash flow test: The Exchange has also amended the Main Board Rules to introduce a market capitalization / revenue / cash flow test which is to apply to listing applicants with a market capitalization of at least HK$2 billion at the time of listing, and revenue of at least HK$500 million for the most recent financial year comprising 12 months and a positive cash flow from operating activities that are to be listed of at least HK$100 million in aggregate for the 3 preceding financial years. Listing applicants under this test will still be required to comply with the trading record period requirement of not less than 3 financial years.

[69] AME information, 'China listings puts HKSE into top global bourses' (5 January, 2005) available at: http://www.ameinfo.com/61753.html (last visited, December 2007).

Another success story is AIM. Of the new markets AIM is the most successful growth market in the world. The number of listings on AIM has increased most dramatically in recent years: international companies listing counts increased from only 3 within one year of its launch in 1995 to 334 at the Oct of 2007.[70] It boasts a wide variety of countries including Australia, China, Germany, Japan and the United States. It is noticeable that as of October 2006, there were 36 US companies quoted on the AIM, of which 13 joined the AIM in 2006.[71] AIM out competed other international exchanges in part because it adopted a "zero" requirement policy. AIM's success is built on a simplified and flexible regulatory environment which has been specifically designed for the needs of smaller companies. It is well-known that listing requirements on AIM are minimal – there is no prior trading requirement, prior shareholder approval for transactions is not required, admission documents are not pre-vetted by the exchange or by the UKLA, there is no minimum market capitalization, and there is no minimum public float requirement. In fact, all that is required for a firm to be admitted to AIM is that it has the support of a nominated advisor ("Nomad") and subsequently the firm has to satisfy only the exchange's weak disclosure duty. AIM rules impose a "general duty of disclosure requiring information which it (the issuer) reasonably considers necessary to enable investors to form a full understanding of the financial position of the applicant." This flexible approach ensures appropriate quality control of AIM companies whilst making AIM as open as possible to a range of smaller, growing companies. This lowest listing requirement was extremely successful in attracting smaller Chinese companies in 2005. "Currently 28 Chinese companies (including Hong Kong companies) are listed on AIM. The first half of 2006 saw 12 Chinese companies list themselves there," Clara Furse, chief executive of LSE told China Daily.[72] By comparison, only nine small mainland companies were listed on Hong Kong's second market, the GEM in the same year. This number has fallen since 2003, when there were 27 mainland listings on GEM.

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[70] See London Stock Exchange website, 'AIM Market Statistics', available at: http://www.londonstockexchange.com/NR/rdonlyres/5FAB97C2-2D32-4700-B95C-D7E004A2B304/0/AIMMarketStatistics0710.pdf (last visited, December 2007).

[71] See London Stock Exchange website, 'Lst of AIM Companies', available at: http://www.londonstockexchange.com/NR/rdonlyres/98BE8920-8CFB-483F-8D37 4F006B12C663/0/LISTDATEAIMCOS.XLS (last visited, December 2007).

[72] Zhang Ran and Sun Min, 'Mainland companies weigh up exchanges' (2006) July 14 China Daily, available at: www.chinaview.cn.

6.5.2.2 Failure Story

The three most publicized reports—Interim Report of the Committee on Capital Markets Regulation, Report on Sustaining New York's and the US's Global Financial Services Leadership sponsored by Mayor Bloomberg and Senator Schumer and the Report and Recommendations of the Chamber of Commerce's Commission on the Regulation of the U.S. Capital Markets in the 21st Century—all concluded that the U.S. has lost ground in the increasingly global and competitive capital markets. The Committee on Capital Markets Regulation (better known as the "Paulson Committee") issued an "interim report" in late 2006 concluding that "the United States is losing its leading competitive position as compared to stock markets and financial centres abroad."[73] Similarly, Treasury Secretary Henry Paulson said the U.S. public-equity market has continued to decline in competitiveness.[74] Two sets of statistics document the US equity markets' growing unpopularity: a decrease in the number of foreign companies listed in the United States and an increase in the number of foreign companies expressing an interest in exiting the US markets.

It can be seen from the above table that cross-listings have been falling on U.S. exchanges. The diminishing market for American Depositary Receipts (ADRs) also provides evidence that foreign companies had less reason to do a public offering in the United States and list on a US stock exchange. As of June 2006, only 1.4 percent of the 34,800 companies listed on foreign exchanges had a registered ADR program in the United States; whereas in 2000 the percentage of international companies with registered ADR programs was 2.7 percent.[75] They're also losing out to overseas exchanges for initial public offerings (IPOs). In 2004, only three out of the twenty-five largest IPOs were listed on U.S. exchanges, in 2005 none of the twenty-five largest IPOs were listed on U.S. exchanges, and during the first half of 2006, only two of the largest twenty-five international IPOs were listed on U.S. exchanges. By contrast, in 2000, eleven of the twenty-five largest IPOs were listed on U.S. exchanges.[76] The decline in new non-U.S. listings is even starker when measured by volume. For example, in 2003, thirty-

[73] See Interim Report of the Committee on Capital Markets Regulation (November 30, 2006) at ix.
[74] Shanny Basar, 'More Non-U.S. Companies Ditch Their New York Listings' (2007) December 6 *Wall Street Journal*.
[75] Eric Pan , 'Why the World No Longer Puts Its Stock in Us' (2006) *Cardozo Legal Studies Research Paper No. 176*, available from the Social Science Research Network at http://ssrn.comb /abstract= 951705.
[76] Aaron Lucchetti, 'NYSE, via Euronext, Aims to Regain Its Appeal for International Listings' (2006) June 30 *Wall Street Journal*, at C1

one percent of the NYSE's initial public offering volume derived from non- U.S. issuers, compared to just eight percent in 2005.[77]

However, at the same period, the delisting of foreign companies from U.S. markets increased. A record show that 56 foreign companies have chosen to delist in 2007, up from 30 in 2006 and 12 a decade ago. Those 56 represented 12.4% of all listed foreign companies.[78] In one recent survey of 54 European companies with shares listed in US exchanges, 17 percent stated they would consider delisting their shares from the US exchanges.[79]

6.6 Sarbanes-Oxley Act and Bonding theory

One of the remarkable phenomena of the 1990s capital markets was the dramatic increase in cross-listed securities, particularly in the United States. The bonding theory was one of the more intriguing theories to surface which tried to explain the phenomenon. Cross-listing, the bonding theory suggested, might be a bonding mechanism by which firms incorporated within a jurisdiction with weak protection of minority rights or poor enforcement mechanisms could voluntarily subject them to higher disclosure standards and stricter enforcement of the US markets in order to attract investors.[80] However, by the 21st century, after the Sarbanes-Oxley Act of 2002 (SOX) was issued, new non-U.S. listings experienced a downward trend. Some scholars argue that the reasons postulated for this includes overly burdensome U.S. regulation and heightened litigation fears in a post-Sarbanes-Oxley world. This raises the questions: does overregulation threaten the competitiveness of the United States' capital markets? And does the bonding theory still work in practice? These questions need to be answered.

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[77] McKinsey & Co., Sustaining New York's and the US' global financial services leadership (2007) 46 [hereinafter Mckinsey Report] (report of McKinsey & Co. on the competitiveness of the U.S. capital markets).
[78] "Is Wall Street losing its competitive edge?" (2006) December 2 *Wall Street Journal*
[79] See Eric, 'In us', above, n.507
[80] See Coffee, above, n. 173, 11

6.6.1 The Sarbanes-Oxley Act

6.6.1.1 Overview

The Sarbanes-Oxley Act, comprised of eleven sections, was signed into law on July 30, 2002 by President George W. Bush. It was passed in response to high-profile business failures, such as Enron and WorldCom. The Sarbanes-Oxley Act is the public company accounting reform and investor protection act. It introduced highly significant legislative changes to the regulation of corporate governance and financial practice.[81] It established stringent new rules, to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws".[82] The legislation's intent is no less than to change American corporate culture by drawing a direct enforceable relationship between senior corporate management and the integrity and quality of their companies' financial statements. The former chairman of the SEC, Harvey Pitt, initially stated that the Act would apply equally to U.S. and non-U.S. issuers listed in the United States.[83] The Act applies to all corporations with a stock market listing in the United States, regardless of where they are incorporated, and specifically affects all companies filing periodic reports with the SEC. This includes non-U.S. companies that issue securities or have their securities traded in U.S. exchanges, and foreign issuers subject to the reporting requirements of section 13(a) or 15(d) of the Exchange Act. In many respects, the Sarbanes-Oxley represents the end of one era and the beginning of another.

[81] The Act impose new requirements on issuers are the following: (1) section 301 ("Public company audit committees") (mandating audit committees composed exclusively of directors meeting a statutory standard of independence); (2) section 302 ("Corporate responsibility for financial reports") (requiring sworn declarations from senior financial officers); (3) section 303 ("Improper influence on conduct of audits") (criminalizing actions to "coerce, manipulate, or mislead" the firm's auditors); (4) section 304 ("Forfeiture of certain bonuses and profits") (requiring forfeiture of incentive or equity compensation received, or stock trading profits made, during the initial twelve month period covered by an earnings restatement); (5) section 306 ("Insider trades during pension fund black-out periods") (restricting the ability of directors and executive officers to sell during certain "black-out" periods when holders of individual account plans are prohibited from trading); (6) section 307 ("Rules of professional responsibility for attorneys") (requiring securities attorneys to report "a material violation of securities law or breach of fiduciary duty or similar violation" to chief legal counsel, chief executive officer, and, under specified circumstances, to board of directors); and (7) section 402 ("Enhanced conflict of interest provisions") (barring most loans by firms to their corporate executives).

[82] The Sarbanes-Oxley Act Community Forum, 'Introduction and background' available at : http://www.sarbanes-oxley-forum.com/modules.php?name=Content&pa=showpage&pid=1.

[83] Anupama J. Naidu, 'Was its bite worse than its bark? The costs Sarbanes-Oxley imposes German issuers may translate into costs to the United States' (2004) 18 *Emory International Law Review*, 271.

6.6.1.2 The Influences of the Sarbanes-Oxley Act

Sarbanes-Oxley reflects a potential shift in the philosophy underlying the US securities laws from disclosure to substantive regulation of corporate governance.[84] With its fundamental corporate governance reforms,[85] the Act undoubtedly raises compliance costs for public firms. Many companies – especially foreign companies – believe that these new requirements are unduly burdensome and costly. One estimate suggests the largest firms will spend an average of $4.7 million in out-of-pocket costs in the first year of compliance just to implement required internal controls.[86] Other increased cost estimates range from $1 to 3 million, depending on the size of the firm.[87] Another survey of 70 UK-based companies estimates that the aggregate cost of Sarbanes-Oxley compliance for these companies may be as high as $860 million.[88] Not surprisingly, the higher costs of complying with all the provisions of Sarbanes-Oxley have encouraged foreign and US companies to consider other markets for their capital raising activities. Shortly after passage of the Sarbanes-Oxley Act, Porsche AG of Germany and Benfield Group Ltd. and a British insurance concern abandoned plans to list their

[84] Larry E Ribstein, ‘International Implications of Sarbanes-Oxley: Raising The Rent on US Law’(2003) *Journal of Corporate Law Studies*, 299.

[85] For example, the Sarbanes-Oxley Act authorizes the SEC to promulgate rules requiring issuers to disclose on a “rapid and current basis” such additional information concerning material changes as the SEC determines “is necessary or useful for the protection of investors and in the public interest.” 15 U.S.C.A. § 78m(l) (1997 & Supp. 2004). As part of this new rulemaking authority, the SEC required issuers making any public announcement about past earnings performance to furnish a report to the SEC within five business days of the public announcement. Conditions for Use of Non-GAAP Financial Measures, Exchange Act Release No. 34-47226, at 10, 2003 WL 16117 (Jan. 22, 2003). This requirement did not apply to foreign issuers. See Dixie L. Johnson & Karl A. Groskaufmanis, FFHSJ Client Memorandum: The Post-Enron Corporate Governance Environment: Where Are We Now?, PLI Order No. B0-01NM 938 (Apr.-June 2003) (noting that new disclosures required in revised Form 8-K inapplicable to foreign private issuers using Form 6-K). Similarly, concurrent with the passage of the Sarbanes-Oxley Act, the SEC considered and has since adopted a proposal significantly expanding the number of items considered to be material changes requiring disclosure under Form 8-K and requiring a filing within four business days of the event. S.E.C. Release No. 34-49424 3 (Mar. 16, 2004). See also Gary M. Brown, Reporting and Disclosure Under the Securities and Exchange Act of 1934; What a Public Company Should Know, PLI Order No. 3396 698 (Sept.-Dec. 2004) (describing new expanded Form 8-K disclosure requirements). This expanded disclosure also does not affect foreign issuers. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release No. 34-49424, at 3, 2004 WL 536851 (Mar. 16, 2004).

[86] Deborah Solomon & Cassell Bryan-Low, ‘Companies Complain About Cost of Corporate-Governance Rules’ (2004) February 10 *Wall Street Journal*, at A1.

[87] HighBeam research, ‘A (Going) Private Matter: To Be a Public Company, or Not to Be?’ (2003) March 22 *Economist (US)*, 58.

[88] Beth Carney, ‘Foreign Outfits Rue Sarbanes-Oxley’ (2005 December 15) *Business Week*, available at: http://www.businessweek.com/bwdaily/dnflash/dec2004/ nf20041215_9306_db016.htm (citing study conducted by Parson Consulting).

securities in the United States, citing specific concerns about the Act.[89] Daiwa Securities and Fuji Photo Film of Japan also delayed listing their securities in the United States because of the unsettled regulatory environment.[90] In each case, companies chose to make offerings outside the United States in part to avoid the requirements of Sarbanes-Oxley and related SEC and exchanged-based disclosure rules. Given China's notoriously poor corporate governance, the cost of producing accounts that comply with US accounting standards is prohibitive. Companies must provide three years of year-end financial data and in some cases five. Many of China's state-owned companies simply don't have that information, and the ones that do are rife with fraud. Additional the Sarbanes-Oxley Act requires that issuers rotate their auditor every five years poses significant difficulties for Chinese issuers.[91] In China, "there is approximately one certified public accountant per 13,000 [Chinese] persons."[92] In the U.S., however, there is "one certified public accountant per 1000 [sic] persons."[93] This leaves Chinese issuers scrabbling for certified public accountants. The result is that more and more Chinese firms have to say "no" to the United States stock markets.

Sarbanes-Oxley not only gives trouble to Chinese companies but also could block European companies as its new substantive requirements may conflict with their home-country law and contains no exemption for such firms. The most important and sweeping revision of Sarbanes-Oxley Act is its requirement of independent audit committees. Section 301 of SOx requires the SEC to direct the U.S. national securities exchanges and the NASD to prohibit the listing of any issuer's security if that issuer does not have an Audit Committee comprised entirely of independent members. Although this was not a major change for most U.S. companies, it represents a revolutionary reform for foreign issuers. The Sarbanes-Oxley Act requires all members of an issuer's audit committee to sit on the issuer's board of directors. This requirement is in direct conflict with "Section 85.6 of the Russian law governing joint stock companies . . . which prohibits members of the audit committee from serving on the board of

[89] Craig Karmin & Kevin J. Delaney, 'SEC's Exemption Gets Some Praise' (2003) January 13 *Wall Street Journal*, at C16.Even the SEC's subsequent exemption of foreign issuers from most of the Sarbanes-Oxley Act's corporate governance provisions has not satisfied some foreign issuers.
[90] Craig Karmin, 'Foreign Firms Lose Urge to Sell Stock in U.S.' (2003) July 24 *Wall Street Journal*, at C1.
[91] Jonathan Shirley, 'International Law and the Ramifications of the Sarbanes-Oxley Act of 2002' (2004) 27 *Boston College International & Comparative Law Review*, 501, 512.
[92] Tamara Loomis, 'Sarbanes-Oxley Act' (2003) 2 *New York Law Journal*.
[93] Ibid.

directors."[94] It also conflicts with corporations incorporated under civil law regimes, because civil law codes often require a two-tier board, with the lower or "managing board" having no independent directors and the upper or "supervisory board" being half composed of representatives of employees. As a result, because codetermination laws staff the supervisory board with employee and union representatives, civil law corporations have generally resisted giving the supervisory board significant substantive responsibilities.[95] Thus, the Sarbanes-Oxley Act is particularly threatening to many European firms precisely because it assigns to the audit committee all responsibility "for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting)."

6.6.1.3 The Sarbanes-Oxley Act can not Explains Everything

The blame for the United States' unpopularity does lie with the Sarbanes-Oxley Act. Anecdotal arguments for such a shift in listing activity abound. Both John Thain (CEO of the NYSE) and Bob Greifeld (CEO of Nasdaq) have expressed concern that foreign firms are bypassing U.S. exchanges as a result of the Sarbanes-Oxley Act.[96] However, Craig Doidge, G. Andrew Karolyi, and René M. Stulz latest academic research has found that after controlling for firm characteristics, there is no deficit in cross-listing counts on U.S. exchanges related to the Sarbanes-Oxley Act.[97] The loss of U.S public market competitiveness compared to global public markets results from a number of factors: the Sarbanes-Oxley Act is just one of them.

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[94] Sabyasachi Ghoshray, 'Impact of Sarbanes-Oxley on Multiple Listed Corporations: Conflicts in Comparative Corporate Laws and Possible Remedies' (2004) 10 *ILSA Journal of International & Comparative Law*, 447, 450-51.

[95] Under German law, for example, the supervisory board (or Aufsichtsrat) is expected to appoint and, if necessary, remove the corporation's managing board (or Vorstand), which consists of its principal executive officers, but the supervisory board does not make or review most business decisions. Under the Co-Determination Act of 1976, supervisory boards of companies with 2,000 or more employees must have an equal number of representatives of shareholders and labor. Thomas J. André, Jr., 'Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany' (1998) 73 *Tulsa Law Review*, 69, 84-85. Thus, the supervisory board is only half shareholder-elected and is not an organ necessarily committed to the shareholders' interests. Some critics have also reported that the "supervisory board has never been strong.... The board is not a serious monitoring mechanism inside the firm". Mark J. Roe, 'Political Preconditions to Separating Ownership from Corporate Control' (2000) 53 *Stanford Law Review*, 539, 548. Roe further suggests that shareholders do not wish to delegate enhanced powers to the supervisory board because to do so would only strengthen "labor's voice and authority inside the firm".

[96] Suraj Srinivasan and Joseph D. Piotroski, 'Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings' 2008 January available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=956987.

[97] C. Doidge, A. Karolyi, and R. Stulz, 'Has New York become less competitive in global markets? Evaluating foreign listing choices over time' (2007) April *Charles A. Dice Center Working Paper No. 2007-9* available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982193.

The Sarbanes-Oxley Act, however, is not the main reason for the loss of IPOs and increase in delistings. Many signs of foreign companies' diminishing interest in the US stock markets existed long before the passage of Sarbanes-Oxley. What has changed is that the US market is no longer unique – it is one market of many, and capital-raising and investing can now be conducted around the world. Marketplace developments in recent years also made a U.S. listing less attractive for foreign issuers. The European markets have matured to a point where capital can be raised there to meet the needs of most companies. Foreign, and even some U.S. companies, engaging in IPOs or stock exchange listings have done so in Europe, rather than in the United States. Moreover, Erica[98] found that the trend of Chinese issuers evolving away from U.S. listings and toward Hong Kong listings has more to do with the successful performance of the HKEx for China stocks and the receptiveness of Hong Kong investors rather than the desire to escape tougher regulations imposed by the U.S. Exchanges. As Hong Kong is now part of China and has always shared close cultural ties with the mainland, Hong Kong has many investors knowledgeable about and interested in investing in China. More importantly, unlike U.S. investors, Hong Kong investors understand the mainland business climate and perspective. As one person interviewed by Erica Fung succinctly put it, it is the "home country premium theory" at work, in that home markets tend to deliver the best valuations.[99] He cited China Telecom as an example: unlike investors in the Asia region who witnessed firsthand the popularity of SMS (mobile phone text-messaging), U.S. investors did not understand the company's business model, which depressed valuations.[100] He also recalled how the CEO of a major online gaming company in China commented in an interview that he had to educate American investors on how to do valuation of Chinese companies during road shows, and that listing in the U.S. often makes companies vulnerable to Wall Street dictating how they should run their companies.[101]

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[98] Erica Fung, 'Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005' (2006) 3 *NYU Journal of Law & Business*, 243.
[99] Ibid.
[100] Ibid.
[101] Ibid.

6.6.2 The Bonding Theory

6.6.2.1 What is Bonding Theory?

"Bonding"[102] is a term of art in modern institutional law and economics. It refers to the costs or liabilities that an agent or entrepreneur will incur to assure investors that it will perform as promised, thereby enabling it to market its securities at a higher price.[103] The paradigmatic example would be the surety bond purchased by the agent to protect the firm's shareholder principals. The idea of using stock exchange listing as a mechanism for bonding to a different, arguably better, governance regime first appeared in a fully domestic context in the United States. In a 1988 article titled "Ties that Bond", Jeffrey Gordon presented this argument with regard to listing on the NYSE.[104] Jack Coffee sets forth an argument known as the "bonding hypothesis." Coffee argues that foreign firms actually use a listing on an American market to bond their insiders to better governance standards:

> Large firms can choose the stock exchange or exchanges on which they are listed, and in so doing can opt into governance systems, disclosure standards, and accounting rules that may be more rigorous than those required or prevailing in their jurisdiction of incorporation . . . [T]he most visible contemporary form of migration seems motivated by the opposite impulse: namely, to opt into higher regulatory or disclosure standards and thus to implement a form of "bonding" under which firms commit to governance standards more exacting than that of their home countries. [105]

The notion that issuers may want to improve their corporate governance by subjecting themselves to a better regulatory regime through cross-listing is appealingly elegant. In contrast to the bonding hypothesis, an "avoiding hypothesis" proposes that stringent corporate governance requirements in destination markets actually deter insiders and may drive them to avoid cross-listing on these markets.[106]

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[102] The term was coined in Michael C. Jensen & William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics*, 305, 325.
[103] Cally Jordan, 'The chameleon effect: beyond the bonging hypothesis for cross-listed securities' (2006) 3 *NYU Journal of Law & Business*, 37.
[104] Jeffrey N. Gordon, 'Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice' (1988) 76 *California Law Review*, 3.
[105] See Coffee, 'The Future as History', above, n.17.
[106] Amir N. Licht, 'Legal Plug-ins: Cultural Distance, Cross-listing, and Corporate Governance Reform' (2004) 22 *Berkeley Journal of International Law*, 195.

6.6.2.2 Cross-listing Premium

A growing body of academic research has found that foreign corporations that do cross-list on a U.S. exchange seem to reap extraordinary benefits: (1) a valuation premium compared to otherwise similar firms that do not cross-list in the U.S., which at least one study finds to average 37% for foreign firms cross-listing on a major U.S. exchange,[107] and (2) a significant reduction in the cross-listing firm's cost of capital.[108] Craig Doidge, G. Andrew Karolyi, and René M. Stulz found that from 1990 to 2005, there was a significant premium for the U.S. exchange listings every year, the historical average listing premium for foreign firms cross-listing onto major U.S. exchanges have been 32.6%.[109] Their evidences support the theory that an exchange listing in New York has unique governance benefits for foreign firms. In 2006, another research found that when non-U.S. companies cross-list in the U.S. market, they incur a cost of capital reduction that averages 13% and ranges as high as 25%[110]. A variation on this basic theory has suggested that, as cross-listing increases the shareholder base, the firm's risk is shared among more shareholders which reduce the firm's cost of capital.[111] Coffee also found that greater intensity of enforcement action in the US contributes towards a lower cost of capital and this may attract some foreign issuers, even while it deters others from cross-listing.[112] The most plausible explanation for the existence of this premium is supplied by the "bonding hypothesis," which explains that by subjecting themselves to the SEC's higher

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[107] See C. Doidge, A. Karolyi, and R. Stulz, 'Why Are Foreign Firms Listed in the U.S. Worth More?' (2004) 71 *Journal of Financial Economics*, 205. These authors find that foreign companies with shares cross-listed in the U.S. had Tobin's q ratios that were 16.5% higher (as of the end of 1997) than the Tobin's q ratios of non-cross-listed firms from the same country. This figure rises to 37% when the foreign firm cross-listed on a major U.S. exchange (i.e., the New York Stock Exchange, Nasdaq, or the American Stock Exchange). In short, the valuation premium is twice as high over non-cross-listing firms when the foreign firm lists on a major U.S. exchange. In a later study, Doidge, Karolyi and Stulz find the historical average listing premium over 1997 to 2005 for foreign firms cross-listing onto major U.S. exchanges to have been 32.6% (but only 14.9% for all firms that cross-list in any way onto the U.S. market). See Doidge, Karolyi and Stulz, 'The Valuation Premium for Non U.S. Stocks Listed in U.S. Markets: 1997-2005' (January 3, 2007) at 1. This longer term study, showing a consistent listing premium over eight years, greatly enhances the robustness of their findings.

[108] See L. Hail and C. Leuz, 'International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?' (2006) 44 *Journal of Accounting Research*, 485 (finding that when non-U.S. companies cross-list in the U.S. market, they incur a cost of capital reduction that averages 13% and ranges as high as 25%).

[109] C. Doidge, A. Karolyi, and R. Stulz, 'The Valuation Premium for Non U.S. Stocks Listed in U.S. Markets: 1997-2005' (January 3, 2007).

[110] See Hail and Leuz, 'International differences', above, n.108.

[111] Stephen Foerster and G.Andrew Karolyi, 'The Effects of Market Segmentation and Investor Recognition on Asset Prices: Evidence from Foreign Stocks Listing in the United States' (2002) 54 *The Journal of Finance*, 981.

[112] John C. Coffee, Jr., 'Law and the Market: The Impact of Enforcement' (2007) April 4 *Columbia Law and Economics Working Paper No. 304*, 5.

disclosure standards and the greater prospect of enforcement in the United States, foreign firms thereby reduce their agency costs.

6.6.2.3 Beyond the Bonding Theory

The bonding hypothesis has its critics. Some researches argue that the bonding hypothesis offers only a partial explanation for the cross-listing phenomenon in the United States. One recent article focuses on the cross-listing by Israeli firms (which is a major subcategory of U.S. cross-listings) and argues that there can be little bonding because Israeli corporate law has essentially the same substantive provisions as U.S. law.[113] In this article the comparison between the Israeli and U.S. laws demonstrates that the Israeli law provides an adequate level of investor protection that is not significantly different from the level of investor protection offered by U.S. law. The bonding hypothesis also can not explain Canadian-based inter-listed corporations (CBIs) easily. CBIs form the largest single group of inter-listed foreign corporations in the United States, by a huge margin, representing over 25% all inter-listings on the NYSE, NMSNASDAQ and AMEX in 2004.[114] CBIs do not come from a “weak investor protection” jurisdiction and, for a variety of reasons and in a number of ways, tend not to “signal” their entry into the US market. Rather than “bonding”, CBIs have been adroitly exploiting what financial economists have described as the “home bias” of U.S portfolio investors.[115] Therefore, the bonding hypothesis should not be overstated. Furthermore, not all foreign firms will want to bond; many controlling shareholders of firms may prefer to enjoy the private benefits of control that they can obtain with relative legal immunity so long as they do not list in the U.S.

6.7 The Consequences of Competition

The trends in competition have lead to one obvious question: is competition producing greater laxity so that exchanges can attract more listings or greater liquidity from dealers (i.e., the race to the bottom)? Or producing greater transparency and more rigorous listing standards (i.e., a race to the top)? At least, from the appearances, the successful experiences of LSE, SGX,

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[113] Ariel Yehezhel, ‘Foreign Corporation Listing in the United States: Does Law Matter? Testing the Israeli Phenomenon’ (2006) 2 *NYU Journal of Law & Business*, 351, 393.
[114] See Jordan, ‘The chameleon effect’, above, n.103.
[115] Ibid.

HKSE, AIM and the failure of NYSE indicate that the result of competition is a race to the bottom. Although there is a decrease in the flow of new listings in New York and an increase in the flow of new listings in London, SGX and AIM, it not safe to make a definite conclusion that competition led to a race to the bottom.

On the one side, it is true competition may reduce the exchanges bargaining leverage in pushing for higher standards. SEC head Harvey Pitt noted that exchanges such as the NYSE and NASDAQ were reluctant to be the first to raise listing standards, "for fear of giving the other a competitive advantage."[116] The United State's standards became an upper limit rather than lower limit. Thus with this added protection foreign companies cannot meet the more stringent requirements of the U.S. market. Years later, the head of one US exchange put it: "By setting the bar so high in the US, the Sarbanes-Oxley Act has had the unintended consequence of triggering a 'race to the bottom' by stock markets and companies."[117]

On the other hand, there are evidences to show that competition could lead to a race to the top. Although the high standards of the Sarbanes-Oxley Act have generated much criticism, it has resulted in more global attention been given to corporate governance. A recent study by Ethiopis Tafara, director of the Securities and Exchange Commission's office of international affairs, showed that the major provisions of Sarbanes-Oxley "have not competitively disadvantaged U.S. markets, simply by virtue of the fact that they have been widely adopted elsewhere".[118] In the early stage maybe the exchanges took a more relaxed attitude to regulation, but latterly, in order to sustain the competitiveness in the market they have found that adhering to certain standards is necessary. LSE used to have significant concessions for foreign listed companies. But in the future, foreign listed companies will have to adhere to the Combined Code.[119] Likewise in France, pretty soon the vast majority of Sarbanes-Oxley will be applicable either at the European level or at the national levels.[120] Outside of the European Union, other countries have also closed the gap with the United States. More countries have adopted new rules improving the amount and frequency of disclosure and the oversight of

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116 Albert B. Crenshaw, 'SEC to Toughen Rule on Option Plans' (2001) December 20 *Washington Post*.

117 Clara Furse, 'Comment: SOX is not to blame—London is just better as a market' (2006) September 17 *Financial Times (London)*.

118 Greg Ip, Kara Scannell and Deborah Solomon 'In call to deregulate business, a global twist' (2007) January 26 *Wall Street Journal*.

119 Tony Tassell and Neil Hume, 'London Issues Guidelines for Foreign Listings' (2007) May 9 *Financial Times (London)*, 43.

120 See Ip, Scannell and Solomon, 'A global twist', above, n.118.

markets. For example, in 2004, Hong Kong's then-chief securities regulator, Andrew Sheng, told a Senate panel that Hong Kong has moved "closer to the U.S. SEC regulatory model", though without as much detail and prescription. Recently, the China Securities Regulatory Commission announced plans to adopt IPO regulations that conform to standards used in Hong Kong and other major international markets.[121]

Competition may also lead to increased specialization. Different markets will serve different clienteles, with some becoming more transparent and imposing higher listing standards in order to foster dispersed ownership, attract portfolio investors and maximize the share value of listed companies while others will persist as lower cost, relatively opaque exchanges which accommodate firms with concentrated ownership. For example, the AIM has focused on attracting smaller companies which more than likely would not have been listed in the U.S. because either they didn't meet U.S. requirements or they were too small to attract interest from U.S. underwriters and investors. "Many of the companies listed on AIM today wouldn't come anywhere close to meeting an NYSE listing standard", says Noreen Culhane, executive vice-president of listings at the NYSE.[122] HKSE has take advantage of its political and its location to attract large Chinese state owned companies. Some of them are impossible to list on other major exchanges. The U.S. might be the listing venue for higher quality issuers that wish to pursue strategic plans that require them to obtain low-cost equity financing or to bond with their shareholders, while London (and other markets) provide instead a comfortable refuge for firms with a control group intent on enjoying the private benefits of control (or a management pursuing other self-interested aims).[123]

[121] Zheng Jin, 'China Says It Intends to Adopt Major Overseas Standards for IPOs' (2006) September 13 *Wall Street Journal*, C4.
[122] See Ip, Scannell and Solomon, 'A global twist', above, n.118.
[123] See Coffee, 'Racing towards the top', above, n.12.

Chapter Seven: Cooperation

7.1 Introduction

As an incident of internationalization, there are two key viewpoints that have appeared in addressing the challenges associated with regulation of an international securities market. As discussed individually in chapter five and six, one is harmonization, the other is competition. However, Sykes argues that neither complete regulatory harmonization nor pure regulatory competition is feasible or desirable where important international cross border effects of regulation arise. Instead, a considerable degree of regulatory cooperation is always needed.[1] Whether the approach is harmonization or competition, enforcement of regulatory standards needs cooperation. Regulatory cooperation is another important reaction to internationalization evolution. As internationalization has accelerated, securities regulators are experiencing a corresponding rise in securities fraud originating from abroad. This has increased the incentives for domestic regulators to extend their reach abroad. In response, efforts to formalize cooperation among regulators have redoubled, to the point where "international cooperation...is blossoming among the world's regulators."[2]

This chapter is organized as follows: the first section describes the pre-period of cooperation which gives the background of why countries began to cooperate with each other. The second section analyzes the different methods of cooperation within the securities sector. Successful cooperation needs legislative support. Thus, the legislative basis for providing assistance will be explored in the third section. After this the next section catalogues the different scope of cooperation. The last section will discuss the influence of international cooperation.

7.2 The Pre-period of Cooperation

Internationalization makes the enforcement cooperation among securities regulators a high priority. These statements are almost axiomatic today, but this was not always the case. Until the 1990s, regulators in the world's major markets often lacked the legal and practical ability

[1] A. O. Sykes, 'Regulatory Competition or Regulatory Harmonization? A Silly Question?' (2000) 3 *Journal of International Economic Law*, 257

[2] David Zaring, 'International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations' (1998) 33 *Texas International Law Journal*, 281.

to share with their foreign counter-parts information vital to the resolution of cross-border investigations. The result was that, when the investigative trail crossed its jurisdiction's borders, it quickly became cold. In 1981, the SEC brought two civil enforcement actions alleging insider trading through foreign banks.[3] The first case filed, BSI/St. Joe, concerned the acquisition of call options and common stock of St. Joe Minerals Corporation ("St. Joe") through Banca Della Svizzera Italiana ("BSI"), prior to the public announcement of a cash tender offer for St. Joe by a subsidiary of Seagram Company Ltd. ("Seagram"). After commencing the injunctive action, the SEC tried unsuccessfully for eight months to determine the names of the BSI customers. The SEC moved for an order to compel BSI's New York branch to disclose its customers' names. BSI countered that such disclosure would violate Swiss secrecy laws and subjects it to civil and criminal liability in Switzerland.[4] Assertions of foreign secrecy laws frustrated SEC attempts to secure foreign-based evidence in several notorious insider trading cases, the SEC resorted to the federal courts to compel the production of the foreign-based information. That unilateral approach, however, was time consuming and expensive and strained international relations.

Partly because of the SEC's success in U.S. courts, the Commission was able to begin a dialogue with foreign securities officials and other law enforcement authorities to develop informal case-by-case understandings that facilitated the production of foreign-based information.[5] The ad hoc nature of that approach highlighted the need for more formal mechanisms that would provide greater assurance of assistance and foster cooperation. As a result, the SEC began focusing on using existing bilateral and multilateral agreements to satisfy its information needs. In some cases, the SEC found that because those mechanisms were not specifically tailored to its investigation and litigation needs, the existing agreements provided inadequate assistance. Accordingly, the SEC initiated discussions for its own formal understandings.

[3] SEC v. Banca Della Svizzera Italiana and Certain Purchasers of Call Options for the Common Stock of St. Joe Minerals Corp. ("BSI/St. Joe"), 92 FRD 111 (SDNY1981); SEC v. Certain Unknown Purchasers of the Common Stock of, and Call Options for the Common Stock of, Santa Fe Intl. Corp. ("Santa Fe"), [1983-1984 Transfer Binder] FedSecurLRptr (CCH) 99,424 (SDNY1983).
[4] Ibid.
[5] Michael D. Mann, Joseph G. Mari, and George Lavdas, 'International Agreements and Understandings for the Production of Information and Other Mutual Assistance', (1995) 29 *International Law,* 796.

The SEC is not alone in its ability or commitment to utilize unilateral measures to enforce final or ancillary provisional measures in connection with securities cases. In addition, U.K. courts have similarly faced issues involving the extraterritorial enforcement of court orders designed to preserve assets for return to defrauded investors. Nonetheless, the U.K. courts have also recognized that, in the absence of a better mechanism, it is crucial for a court with jurisdiction over the matter to act to preserve the availability of relief. Indeed, the internationalization of the world's securities markets and the increased frequency of cross-border trading activity have made reliance on domestic powers alone insufficient. Strong international cooperation is vital to the quick, thorough and accurate resolution of international enforcement investigations.

7.3 Methods of Cooperation

This section examines methods by which securities regulators could obtains information and evidence from abroad. Indeed, the method of cooperation has developed and expanded over time, from requests under the Hague Convention and pursuant to Letters Rogatory, to the implementation of Mutual Legal Assistance Treaties (MLATs) among governments and less formal bilateral and multilateral Memoranda of Understanding (MOUs) among securities regulators.[6] From the traditional Hague Convention method to develop new mechanisms, international regulatory authorities have enhanced their ability to investigate and prosecute activities that cross into another regulator's jurisdiction.

7.3.1 The Hague Convention

The traditional means of obtaining information abroad originated with the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters (Hague Convention or Convention).[7] Many countries are contracting nations to the Hague Convention. The Hague Convention enables signatories to request each other's assistance in obtaining evidence "for

[6] Michael D. Mann, William P. Barry, 'Developments in the internationalization of securities enforcement' (2005) 39 *International Lawyer*, 667.

[7] Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, opened for signature Mar. 18, 1970, 23 U.S.T. 2555, 847 U.N.T.S. 231 [hereinafter Hague Convention].

use in judicial proceedings, commenced or contemplated." [8] The Hague Convention encompasses three of the most common devices for foreign discovery: letters rogatory, evidence taking by a consular official, and private commissioners.

The traditional letter rogatory is a formal request from a court in one jurisdiction to a court in the jurisdiction in which the information or evidence is located. But the state from which assistance is requested may refuse if, under its laws, execution of the request falls outside the functions of the judiciary. [9] Many signatory states have exercised the Convention's Article 23 option, which enables signatories to declare that they will not execute letters rogatory for the purpose of pre-trial discovery of documents "as known in Common Law countries." [10] The letters rogatory method is unpredictable, however, because the court that receives the request has no obligation to provide assistance and needs no justification for denying the request.[11] Moreover, letters rogatory are complicated, time-consuming, and do not supersede bank secrecy laws.[12] Also they do not apply to supervisory procedures such as licensing.

Although the Hague Convention itself provides limited assistance to securities investigators, Article 27 states that methods of obtaining information other than those specified in the Convention are permissible.[13]Thus, when a national court exercises jurisdiction over a foreign national, principles of comity do not require the court to resort to the Hague Convention first; the court may instead employ its subpoena powers.[14]

7.3.2 Mutual legal assistance treaties (MLATs)

Mutual Legal Assistance Treaties (MLATs), negotiated through formal diplomatic channels, have the force of law and oblige signatories to provide assistance in a broad range of criminal

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[8] Hague Convention, art. 1, para. 2.

[9] Hague Convention. art 12, para. 1(a).

[10] Hague Convention, art. 23.

[11] Robert G. Morvillo, 'International Criminal Law Issues' (1994) 1 *New York Law Journal*, 3, 6. The effectiveness of letters rogatory generally depends on comity between nations. Bradley O. Field, 'Improving International Evidence-Gathering Methods: Piercing Bank Secrecy Laws from Switzerland to the Caribbean and Beyond' (1993) 15 *Loyola of Los Angeles International & Comparative Law Journal*, 691, 702.

[12] See John J. Tigue, Jr. & Bryan C. Skarlatos, 'Obtaining Evidence Abroad' (1994) 20 *New York Law Journal*, 3.

[13] Hague Convention, art. 27.

[14] Caroline A.A. Greene, 'International Securities Law enforcement: Recent Advances in Assistance and cooperation' (1994) 27 *Vanderbilt Journal of Transnational Law*, 635.

matters.[15] Under such treaties, parties may obtain information either in preparation for or during trial, regardless of whether charges have been filed in the requesting state. MLATs provide for direct communication between designated Central Authorities rather than between the parties' respective judiciaries. Thus, when an official of one state needs information or assistance, he or she must direct the request through the state's Central Authority. Communication between designated Central Authorities eliminates the impediment that the nation encounters under the Hague Convention, namely, the refusal of civil-law authorities to execute requests from non-judicial authorities, such as prosecutors. [16]

7.3.3 Memoranda of Understanding (MOU)

Today Memoranda of Understanding (MOU) is the leading example of international cooperation in securities regulation.[17] Professor Teixeira Dos Santos, the Chairman of the IOSCO Executive Committee and President of Portugal's Comissão do Mercado de Valores Mobiliários, said "The MOU truly reflects an international consensus among securities and derivatives regulators that effective regulation of globalized capital markets requires a high degree of cooperation among the world's regulators."[18]

The widespread use of MOUs as a cooperative tool largely arose from functional imperatives. Existing treaty arrangements "were seen as inadequate because they are too general and inflexible for highly technical and rapidly evolving securities markets in which intense surveillance of legal activities is needed to detect illegal activities."[19] MOUs evolved as an attempt to circumvent these obstacles and introduce a more flexible, lower-profile alternative. Unlike MLATs, MOUs are nonbinding statements of intent that target specific offenses. MOUs were described as "arrangements between like-minded regulators".[20] While they purport to address other types of securities law violations, they are chiefly intended to address

[15] See Morvillo, 'Criminal law', above, n.11.
[16] See Marian Nash (Leich): 'Contemporary Practice of the United States Relating to International Law' (1992) 86 *American Journal of International Law*, 547, 550.
[17] Stephen J. Choi, Andrew T. Guzman, **'**Portable reciprocity: rethinking the international reach of securities regulation' (1998) July *Southern California Law Review*, 903.
[18] 'IOSCO Strengthens International Cooperation to Fight Illegal Securities and Derivatives Activities' Press Release, 16 October 2003, available at: http://www.fsa.go.jp/inter/ios/20031016/01.pdf.
[19] Ibid.
[20] See Mann, Mari and Lavdas, 'International Agreements', above, n.5.

insider trading and secondarily intended to address other forms of securities fraud.[21] MOUs are expected to be more efficient and predictable than MLATs in obtaining information regarding securities violations because they are negotiated and implemented by parties with direct responsibility for regulating their respective securities markets.[22] MLATs, on the other hand, are negotiated through diplomatic channels. Such as, under the United States Constitution, they must be ratified by the U.S. Senate. With the United States MOUs, the SEC has established relationships of direct communication and assistance with foreign securities regulators. These relationships expedite the execution of requests and increase the reliability of the information received. A significant feature of the mutual assistance MOUs is the fact that they are bilateral. While unilateral measures such as court-ordered extraterritorial measures can be effective, they are subject to a case-by-case review by a court. MOUs provide bilaterally that each regulator will assist the other in the future by providing information and cooperation. Additionally, according to IOSCO principles, these MOUs should not require dual criminality--the subject matter under investigation need not constitute a violation of the requested country's laws.

7.4 Legislative Basis for Providing Assistance

When the national securities regulators began to use international cooperation as a primary vehicle for gaining access to foreign-based information, it became clear that the success of such an approach would depend on legislative changes. Indeed, at that time, most national regulators lacked the authority to use compulsory investigative powers unless there was an independent basis for suspecting a violation of domestic securities law. For example, if a foreign government needs US assistance with market investigation, it must ask for a court order to compel testimony or evidence.

The SEC sought specific legislation authorizing it to assist its counterparts and urged its counterparts to seek similar legislation in their countries. The SEC was among the first securities regulators to receive the legal authority to assist foreign counterparts in investigations of securities fraud. In 1988 the SEC proposed, and Congress enacted,

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[21] Joel P. Trachtman, 'Unilateralism, bilateralism, regionalism, multilateralism, and functionalism: a comparison with reference to securities regulation' (1994) 4 *Transnational Law and Contemporary Problems Spring*, 69.
[22] See Michael D. Mann et al., 'The Establishment of International Mechanisms for Enforcing Provisional Orders and Final Judgments Arising from Securities Laws' (1992) 55 *Law & Contemporary Problems*, 303, 317.

legislation authorizing the SEC to conduct investigations on behalf of foreign securities authorities, using subpoena authority if necessary.[23] Today, the SEC can assist foreign securities authorities in their investigations using a variety of tools, including exercising the SEC's compulsory powers to obtain documents and testimony, subject to the governing rules. Section 21(a) (2) of the Exchange Act, empowers the SEC to conduct a formal investigation upon the request of a foreign securities authority[24] without regard to whether the facts stated in a request would constitute a violation of the laws of the United States.[25] The SEC also has the ability to provide access to non-public information in its files with foreign persons. The Exchange Act provide that the Commission may, in its discretion and upon a showing that such information is needed, provide such non-public information in its possession to specified foreign persons.[26]

The Exchange Act requires that the SEC in deciding whether to provide the requested assistance, consider whether the foreign authority has agreed to provide reciprocal assistance.[27] It allows the SEC to refuse to process any request on the grounds that the request violates the public interest.[28] Further, it provides witnesses with all the protection and remedies afforded to witnesses in SEC proceedings.[29] Accordingly, witnesses could obtain access to a formal order identifying the basis and subject matter of an investigation. Further, they would be able to resist enforcement of an unnecessarily burdensome subpoena. In accordance with SEC practice, any challenge to a SEC subpoena would be reviewed by the SEC as part of the authorization process for a subpoena enforcement action.

The Exchange Act provides the SEC with flexibility, as it is not required to enter into a MOU before granting assistance to a foreign securities authority. In the absence of a MOU, the SEC may, if it receives all necessary confidentiality and use assurances, assist a foreign regulator and thereby demonstrate the value of international cooperation. This allows the SEC to use its

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[23] William G. Horton, Gerhard Wegen, *Litigation Issues in the Distribution of Securities* (Business & Economics, 1997), 561.

[24] Section 3(a) (50) of the Exchange Act broadly defines the term foreign securities authority to include "any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters." 15 U.S.C. § 78c(a)(50) (2005).

[25] Ibid, § 78u(a)(2).

[26] Section 24 (c) of the Exchange Act.

[27] 15 U.S.C. § 78u(a)(2).

[28] Ibid.

[29] Ibid.

powers to encourage the development of reciprocal assistance powers in countries that may not yet be able to enter into broad MOUs.

In December 1990, Congress enacted the International Securities Enforcement Cooperation Act (ISECA), which amended section 24 of the Exchange Act.[30] ISECA has improved substantially the SEC's ability to cooperate with the securities regulators of other countries. Sub-section 24(d) of the Exchange Act provides a basis for withholding disclosure under the Freedom of Information Act (FOIA) of certain records obtained from a foreign securities authority.[31] This exemption complements existing exemptions from disclosure under the FOIA. Therefore, information obtained from a foreign securities authority that does not satisfy the specific requirements of sub-section (d), also may be withheld if it is entitled to any other FOIA exemption. The exemption provided for in sub-section (d) could be claimed where the information requested was provided by a foreign securities authority, and the foreign securities authority has in good faith determined and represented to the SEC that the disclosure of such information would violate the laws applicable to the foreign securities authority.

ISECA also clarified the Commission's authority to provide foreign and domestic securities authorities with non-public information and authorized the SEC to obtain reimbursement from a foreign authority for expenses incurred in providing assistance to that authority. Finally, the SEC and US Self Regulatory Organizations (SROs) were authorized to impose sanctions on a securities professional found by a foreign court or securities authority to have engaged in illegal or improper conduct.

7.5 The Scope of Cooperation

As might be expected, cooperation tends to begin on a small scale, but over time it becomes more and more institutionalized, to the extent considered appropriate. Often this movement is gradual; perhaps beginning with a certain part of a sector, or perhaps beginning bilaterally, and expanding coverage after experience is gained and needs change. In fact engaging, even in disputes, can produce institutions for cooperation.

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[30] International Securities Enforcement Cooperation Act of 1990, H.R. 1396, 101st Cong. (1990).
[31] 15 U.S.C. § 78x (d).

7.5.1 Unilateral

As a temporal matter, unilateral initiatives might be expected to precede bilateral, regional, or multilateral initiatives, or to succeed the breakdown of such initiatives. Unilateral initiatives provide experience regarding what is acceptable and unacceptable to other countries and also set the stakes for bilateral or multilateral negotiations. For example, until 1988, insider trading was not a violation of Swiss law, and so was not subject to cooperation under the U.S.-Swiss mutual legal assistance treaty.[32] In response, the United States unilaterally sought Swiss legislation prohibiting insider trading in order to provide the predicate for more effective enforcement cooperation.[33] Thus, in this case, unilateral pressure worked, resulting in unilateral "harmonization" in order to enhance enforcement cooperation.

To regulate and police the U.S. securities markets the SEC has tried to obtain a wide variety of information from abroad. The SEC's attempts in the early 1980s to secure foreign-based evidence in several notorious insider trading cases often were frustrated by the assertion of foreign secrecy laws. Although the federal courts assisted the SEC by compelling the production of the foreign-based information, that unilateral approach was time-consuming and expensive. However, in part because of its success in U.S. courts, the SEC was able to begin a dialogue with foreign securities officials and other law enforcement authorities, and it developed informal case-by-case understandings that facilitated the production of information from other countries.

Unilateral initiatives may also be explained in terms of regulatory history. The United States has been a pioneer in business regulation generally and securities regulation in particular. It is a "standard-setter" [34] and a first-mover in the game of regulation.

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[32] Treaty on Mutual Assistance in Criminal Matters, This treaty relates only to criminal matters, and imposes a dual criminality requirement for compliance with requests. See Catherine F. Donohue, Comment, 'Swiss Law Prohibiting Insider Trading: Its Impact on Switzerland and the United States' (1990) 16 *Brooklyn Journal of International Law*, 379.
[33] Ibid, See Catherine, ' Swiss law'.
[34] James R. Doty, 'The Role of the Securities and Exchange Commission in an Internationalized Marketplace' (1992) 60 *Fordham Law Review*.

7.5.2 Bilateral

Cooperation between national securities regulators has traditionally taken place via MOUs. The SEC has led the way in establishing such regulatory arrangements. Securities regulators around the world now use cooperative arrangements modelled on those pioneered by the SEC as a significant means of enforcing domestic securities laws. The SEC entered into its first information-sharing arrangement to obtain evidence located abroad in 1982.[35] Since then, the SEC has made international evidence gathering a priority and has entered into more than thirty cooperative arrangements. MOUs form the basis of the SEC's ability to take enforcement action when the evidence is located overseas. The SEC may negotiate a MOU with its counterpart in a country where there is a great deal of cross-border business or where there is a broader U.S. government interest in establishing closer ties. In each case, the MOU must be crafted to fit the circumstances of the foreign market and the powers of the foreign authorities. Indeed, the actual texts of the documents reflect these differences in legal and regulatory authorities. Thus, before entering into a MOU with a foreign authority, the SEC and the foreign securities authority exchange information about their respective regulatory systems and thereby learn about each other's specific interests, needs, and capabilities. The SEC's bilateral understandings with foreign regulators and other formal and informal information-sharing arrangements provide a framework in which the SEC can seek and provide assistance for the purpose of enforcing the securities laws of the United States and foreign jurisdictions.

This paper will examine the Swiss MOUs and FSA MOU because they served as models for MOUs later negotiated with many other countries. The Swiss MOUs include three MOUs. The Swiss MOU of 1982 clearly recognized that both nations had an interest in cooperating on insider trading investigations and balancing the needs of such investigations with Swiss bank secrecy policies.[36] The 1982 MOU with Switzerland was effective in prosecuting insider trading cases involving trading through Swiss banks. In 1982 MOU, a separate private agreement among members of the Swiss Bankers Association was established. The agreement, known as Convention XVI, provided that, in cases involving takeovers, where insider trading

[35] See Mann and Barry, 'Securities enforcement', above, n.6.
[36] See Memorandum of Understanding to Establish Mutually Acceptable Means for Improving International Law Enforcement in the Field of Insider Trading, Aug. 31, 1982, U.S.-Switz., 22 I.L.M. 1.

was suspected, the signatory banks would disclose and furnish information to the SEC without violating Swiss bank secrecy laws.[37] The MOU of 1987 was designed to improve the exchange of information between the United States and Switzerland in the investigation of insider trading and other crimes.[38] In this MOU, the parties agreed to use their "best efforts" to notify each other when they seek information or evidence, to prevent the disclosure of information to anyone other than the officials involved in the case, and to refrain from using unilateral compulsory measures unless a request has not been answered within thirty days.[39] In cases in which a party employs unilateral compulsory measures, the parties must "exercise moderation and restraint." While the Swiss MLAT expressly excludes assistance with the prosecution of tax and customs laws violations unless the request includes an allegation of organized crime,[40] the second Swiss MOU authorizes assistance in cases involving duty or tax fraud, as defined under Swiss law.[41] In 1993, Switzerland amended its fairly restrictive 1987 MOU to include violations of law concerning securities, futures, or options, in other than penal proceedings, including cooperation with formal investigation that may lead to such proceeding. Thus, the three Swiss MOUs greatly expand the scope of assistance available to the SEC in insider trading cases relative to that authorized by the Swiss MLAT. The method of operation of MOUs facilitates this expansion. The three Swiss MOUs were negotiated through and are implemented by the parties' respective securities regulators, thereby enabling the SEC--through the Department of Justice--to tailor the agreements to its specific regulatory needs.

Based on its experiences under the Swiss MOUs, the SEC sought to develop more comprehensive relationships with other foreign securities authorities. On 14 March 2006, the FSA published a MOU entered into with the SEC in relation to the exchange of information regarding oversight and supervision of financial services firms carrying on business in both the UK and the US.[42] Through the MOU, the SEC and the FSA express their willingness to

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[37]Agreement XVI of the Swiss Bankers' Association with regard to the handling of requests for information from the SEC on the subject of misuse of inside information, 43 SEC Docket 155 (July 14, 1982).
[38]See Memorandum of Understanding on Mutual Assistance in Criminal Matters and Ancillary Administrative Proceedings, Nov. 10, 1987, U.S.-Switz., 27 I.L.M. 480.
[39] Second Swiss MOU, art. III, 27 I.L.M. at 483-84.
[40] Swiss MLAT.
[41] Second Swiss MOU.
[42] The name of MOU is Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms.

cooperate with each other in the interest of fulfilling their respective regulatory mandates, particularly in the areas of investor protection, fostering market integrity, and maintaining confidence and systemic stability.[43] According to the MOU, each regulatory agency will endeavour to inform the other in advance of: pending regulatory changes that may have a significant impact on the operations, activities or reputation of a firm in the other jurisdiction; and any material event that could adversely impact each other's markets or the stability of a firm, in the other jurisdiction.[44] In addition, upon written request, each agency will provide to the other the "fullest possible cooperation" in assisting with the oversight of a firm, and ensuring compliance with the laws and regulations of the requesting agency.[45] This assistance will include the provision of information based upon documents held in the files of the agency to whom the request is made covering, among other areas, a firm's financial and operational condition as well as information drawn from regulatory reports and filings. The MOU also contains a protocol dealing with on-site visits by one regulatory agency to persons located in the other's jurisdiction that are either regulated by both the FSA and the SEC, or are affiliates, branches or subsidiaries of a person subject to oversight in the other agency's jurisdiction.

The MOU between the FSA and the SEC is part of an increasing trend of transatlantic regulatory cooperation, the most recent public example of which was evidenced by the fines of companies in the Shell group (Shell) by both the SEC and the FSA in connection with Shell's overstatement of hydrocarbon reserves. In that case Shell paid US $120 million to settle the SEC case and was fined £17 million by the FSA following a joint investigation by both regulatory agencies. Significantly in its press release relating to the Shell case, the SEC stated that: "The degree of international and interagency cooperation in this case has been extraordinary and sets an important precedent for investors that regulatory efforts to police the financial markets will transcend national borders."[46] In light of the increased regulatory cooperation between the FSA and the SEC, financial services firms with operations in both the UK and the US will find it increasingly difficult to insulate the regulatory impact of a compliance breach occurring in the US from its UK operations and vice versa. Consequently, in seeking to address and mitigate such impact, firms will need to ensure that their response to

[43] See FSA MOU article two 12.
[44] See ibid, article three 20.
[45] Ibid, article three 21.
[46] 'FSA and SEC Publish Joint Memorandum of Understanding' available at: http://www.hunton.com/files/tbl_s10News%5CFileUpload44%5C12748%5CFSA_MoU_Client_Alert.pdf.

the discovery of a compliance breach is joined up and takes into account the likely regulatory consequences in both jurisdictions.

In addition to MOUs, the SEC actively seeks to identify and use other formal and informal information gathering mechanisms, most notably U.S. MLATs with foreign criminal authorities. The United States has signed MLATs with Argentina, the Bahamas, Canada, the United Kingdom concerning the Cayman Islands, Italy, Mexico, the Netherlands, Spain, Switzerland, Turkey, Belgium, and Thailand. Unless otherwise specified, the party addressed will carry out the request in accordance with its own laws. Most of the United States MLATs contain similar general provisions that detail the type of assistance available, the requisite elements of a request, the means by which requests will be executed, the permissible uses of information obtained, and the occasions for denying requests. MLATs between the United States and other countries are intended to enable U.S. authorities to obtain information that will be admissible in U.S. courts.[47] In particular, the MLAT between the United States and Switzerland has provided a useful mechanism for the SEC, working with the U.S. Justice Department, to obtain information located in Switzerland, including detailed banking information.[48] In addition, the Swiss authorities have been willing, in specific cases, to freeze profits traceable to illegal securities activities, thereby preserving the status quo pending further SEC action. Several mutual legal assistance treaties (MLATs) also provide that one country may request another, consistent with the requested country's domestic law, to (1) freeze forfeitable assets; (2) initiate a forfeiture action against property; (3) repatriate assets located abroad; and (4) enforce forfeiture judgments issued by a foreign court.[49] Through the U.S. Department of Justice, the SEC has used mutual legal assistance treaties to obtain provisional freezes of assets that it suspected were obtained in violation of U.S. federal securities laws.

Another important development in bilateral arrangements is the establishment of Regulatory Dialogues between particular countries that deal with areas of regulation of mutual concern. For example, the US and the EU have been engaged in such a dialogue since 2002. The U.S. is represented by the Treasury, the Federal Reserve Board and the SEC and the EU is

[47] See Marian Nash (Leich), 'Contemporary Practice', above, n.16, 550.
[48] See Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, U.S.-Switz., 27 U.S.T. 2019, 2050 (entered into force Jan. 23, 1977).
[49] See Mann et,al , 'The Establishment of International Mechanisms', above, n.22.

represented by the E.U. Commission. These meetings are supported by other bilateral meetings of technical regulators, for example meetings between CESR and the SEC. The meetings began due to EU concern with the foreign impact of US laws such as Sarbanes-Oxley that made it more costly to access US capital markets. The goals of the cooperation are to identify emerging risks in the US and EU securities markets and to engage in early discussions of potential regulatory initiatives in the interest of promoting convergence where possible. Today the dialogue is focused on several issues, including the US acceptance of international accounting standards, EU acceptance of SEC holding company regulation, and issues of financial privacy. One critical issue on the economic front is whether the US and the EU will seek to compete or collaborate. For example, the EU might respond to increasing US regulation by providing less regulated alternative, rather than pursuing efforts to relax US regulation and further the integration of the two markets.

The Dialogue also fulfills other functions. One important function is that it has allowed the US and the EU to reinforce their common ground. With respect to financial services regulation, the US and EU share the same fundamental goals — protecting investors, maintaining stability in our markets, and allowing free and unfettered competition among all market participants.

To date, the Dialogue has proven helpful in resolving potential problems, but it has also created the opportunity for the EU and US delegations to educate each other about existing laws and regulations and any changes thereto. This educative process allows the US and the EU to eliminate misunderstandings that may exist or that may arise with regard to regulatory changes being considered. It allows them to consider possible new avenues of regulation for their own markets, which ultimately enriches the regulatory rulemaking process and helps them each to better carry out their regulatory mandates.

7.5.3 Regional Level

The European Union serves as a good example of successful cooperation among member states. Although European securities regulators also have utilized MOUs extensively,[50] a

[50] See Bryan Thomas Shipp, ‘Filling gaps in European Union securities law: contractually organized supervision and the college of Euronext regulators’ (2008) 23 *American University International Law Review*, 407 (in his footnote stating that the FSA has approximately 150 MOUs with various regulatory authorities).

prime example is the Euronext Regulatory MOU.[51] Euronext merged the securities exchanges of Amsterdam, Brussels, and Paris in 2000 to take advantage of the increasingly harmonized regulatory regime for securities markets in E.U. Member States. But at the time of this merger there were gaps in EC securities legislation, particularly with respect to the harmonization of securities trading markets regulation. The Euronext College[52] responded to this regulatory challenge by creating a mechanism for the harmonization of trading markets rules in the jurisdictions in which Euronext operates. The mechanism employed in the Euronext Regulatory MOU parallels the harmonization framework of existing EC securities directives. The goals of the Euronext Regulatory MOU are identical to the goal of creating harmonized securities regulation in the EC. The Euronext Regulatory MOU provides for close cooperation between industry and the regulators in developing new rules for securities exchange regulation, the rules thus negotiated are better informed of the emerging structure of the industry. The primary concern of the Euronext Regulatory MOU is the establishment of a "coherent" regulatory framework for Euronext markets.[53] Under the terms of the Euronext Regulatory MOU, Euronext is obligated to cooperate with the Euronext College of the jurisdictions in which Euronext operates regulated markets. In general, Euronext's cooperation with the Euronext College encompasses the harmonization of domestic regulations pertaining to listing requirements, prospectuses, on-going obligations of listed companies, take-over bids and the disclosure of large shareholdings.[54] The Euronext College has authority under the Euronext Regulatory MOU to approve the modification and harmonization of Euronext Rulebooks.[55] Further, the Euronext Regulatory MOU does not state in terms that it is not binding,[56] as is the case with all MOUs to which the SEC is a party. As an instrument for cooperation the

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[51] Memorandum of Understanding on Supervision, Regulation, and Oversight of the Euronext Group, Mar. 22, 2001, available at
http://www.amffrance.org/documents/general/3622_1.pdf [hereinafter Euronext Regulatory MOU].

[52] The group of regulatory authorities that are signatory to the MOU is known as the College of Euronext Regulators, or Euronext College. See Prospectus Of NYSE EURONEXT, INC. 349-51 (Euronext, N.V., Nov. 27, 2006),
available at http://www.euronext.com/file/view/0,4245,1626_53424_979643772,00.pdf.
at A-15 (defining the Euronext College as the Committee of Chairmen of the AMF, the Netherlands Authority for the Financial Markets (Autoriteit Financiele Markten), the Belgian CBFA, the Portuguese Securities Market Commission (Comiss˜ao do Mercado de Valores Mobiliarios or "CMVM"), and the U.K. Financial Services Authority (FSA)).

[53] See Euronext Regulatory MOU, art. I (outlining the principles and objectives of cooperation by the College of Euronext Regulators).

[54] Euronext Regulatory MOU, article VII, 7.1.

[55] Euronext Regulatory MOU, article III, 3.1.1.

[56] Euronext Regulatory MOU, article X.

Euronext Regulatory MOU thus represents a significant evolution beyond the non-binding MOUs of the SEC and IOSCO.

7.5.4 International Level

International multilateral initiatives play an important role in raising the standard of information sharing on a global scale. Indeed, they can help securities regulators obtain the necessary domestic legal authority to share information with foreign securities regulators. The heads of state of the Group of Seven (G-7) countries (Canada, Japan, Germany, France, Italy, the U.K. and the U.S.) asked securities and banking regulators to cooperate in enhancing regulatory oversight and promoting stronger risk management and improved transparency in the markets. The G-7 Finance Ministers Report, which was issued at the G-7 Summit in June 1997, promotes continued information sharing and cooperation among financial regulators in connection with their oversight of globally active firms. IOSCO is the world’s leading forum for setting standards and cooperation on all matters concerning securities regulation. SEC officials note the importance of IOSCO as a forum for promoting cooperation and the spread and strengthening of securities law to new areas of the globe. IOSCO has fully endorsed information sharing among securities regulators worldwide. IOSCO has employed a variety of vehicles, such as core principles, resolutions and MMOU to establish a framework for information sharing on which its members can build in order to strengthen their securities laws.

In 1991, in light of the need for cooperation in enforcement matters, IOSCO adopted “Principles of Memoranda of Understanding.” The Principles represent a consensus among securities regulators about key tools that should be available to regulators for fighting securities fraud. These principles have been referred to time and again as IOSCO members developed bilateral and regional MOUs. They include core provisions on obtaining and sharing information, and on confidentiality and use of information that is shared. In particular, the MOU Principles endorse:

The provision of assistance without regard to whether the type of conduct under investigation would be a violation of the laws of the requested authority; Use of full domestic powers to execute requests for assistance, including obtaining documents, testimony, and conducting inspections; The importance of protecting the confidentiality of the information provided; and the right to use the information for enforcement investigations, actions and proceedings.

In addition to the MOU Principles, IOSCO members adopted a series of resolutions designed to affirm IOSCO members' commitment to cooperation in 1986, 1989 and 1994.

The 1997 Enforcement Resolution was a product of IOSCO members' recognition that there were significant differences in the ability of members to maintain, collect and share non-public information. The 1997 Enforcement Resolution thus addresses the importance of comprehensive record keeping and collection of information, as well as strong enforcement powers, in the context of mutual assistance and cross-border cooperation. In 1998, IOSCO's full membership incorporated the 1997 Enforcement Resolution into the IOSCO Core Principles.

On October 1, 1998, IOSCO adopted a Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws.[57] The resolution marked the first time that IOSCO's focus turned to improving the maintenance and collection of information as a critical part of international cooperation. The members recognized that "comprehensive record keeping, improved collection of information, strong enforcement powers and the removal of impediments to cooperation are fundamental to effective enforcement of securities and futures laws, market transparency and more generally the development of sound securities and futures markets." [58] The IOSCO Resolution first sets forth the principles that the participants agree are important for record keeping and enforcement and second focuses on the importance of information sharing among IOSCO members. The resolution suggests the creation of contemporaneous records of all securities and futures transactions, including information as to funds and assets transferred, beneficial ownership and details such as price, quantity of

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[57] The resolution derives from the 1994 IOSCO Resolution in which the members renewed their commitment to the principles of mutual assistance and cooperation and agreed to undertake self-evaluations. International Organization of Securities Commissioners, Resolution on Commitment to Basic IOSCO Principles of High Regulatory Standards and Mutual Cooperation and Assistance (Oct. 1994), available at http:// www.iosco.org/library/resolutions/pdf/IOSCORES11.pdf.

[58] International Organization of Securities Commissioners, Resolution of Principles for Record Keeping, Collections of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws (Nov. 1997), available at http:// www.iosco.org/library/resolutions/pdf/IOSCORES15.pdf.

securities and identity of brokers.[59] Record keeping as prescribed by the Resolution will provide a more complete document trail for transactions that will assist in monitoring and enforcement. IOSCO members also agreed in the Resolution that a competent authority in each member's jurisdiction should have the power to identify persons who own or control public companies, bank accounts, and brokerage accounts, emphasizing that domestic secrecy laws should not prevent or restrict the collection of such information.[60] As a result of the self-evaluations, IOSCO members recognized that the ability of members to implement the desired measures may vary significantly depending on many factors, including domestic legislation. Because of the importance of access to information, each IOSCO member agreed under the Resolution to "strive to ensure that it or another authority in its jurisdiction has the necessary authority to obtain [the relevant] information."[61] This provision suggests that, while the regulator itself may not have the power to provide assistance in some cases, another government authority in the jurisdiction--the criminal prosecutor, for example--may have such power to share information with foreign regulators. Because of the different legal structures among IOSCO members, this is an important alternative.

Equally important to effective enforcement, however, is the sharing of such information with other IOSCO members. The Resolution therefore provides that members will take appropriate efforts to ensure that such information may be shared among them.[62] Finally, members agreed generally to take efforts to remove such other impediments to cooperation as may exist under their domestic legislative and regulatory schemes.[63]

In the wake of the events of September 11, 2001, IOSCO undertook to further enhance the information sharing critical to the successful investigation and prosecution of cross-border securities violations. The result was the adoption of a Multilateral Memorandum of Understanding ("MMOU") in May 2002. Although a number of securities authorities have set up their own bilateral agreements over the past decade to cooperate with each other on cross-border securities fraud investigations, the IOSCO MMOU is the first global information-sharing agreement among securities regulators. It sets a new international benchmark for cooperation critical to combating violations of securities and derivatives laws. The MMOU

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[59] Ibid.
[60] Ibid.
[61] Ibid.
[62] Ibid.
[63] Ibid.

establishes a complex framework for cooperation to which IOSCO members can subscribe. The framework was agreed upon unanimously at IOSCO's 2002 Annual Meeting. To date, around 30 regulators have become signatories.[64] The key provisions of the MMOU focus on two essential elements of cross-border enforcement cooperation. First, the MMOU specifies the particular types of information a signatory may be asked to provide, such as client identification information, brokerage records, and information from a signatory's files. Second, the MMOU requires the confidentiality of information provided, while allowing information to be used for compliance with the securities laws, investigations and enforcement proceedings, surveillance or enforcement activities of self regulatory organizations, and assistance in criminal prosecutions.

The IOSCO MMOU provides for the exchange of essential information in investigating cross-border securities and derivatives law violations, including bank, brokerage, and client identification records. The MMOU also enables regulators to use that information to enforce compliance with securities and derivatives laws and regulations, including through civil and criminal prosecutions.

The MMOU is broad-based, authorizing regulators to obtain information and evidence from a variety of sources, including the following:

•Information and documents in the files of the requested authority;

•Information and documents regarding the matters set forth in the request for assistance. Upon request, the requested authority can require production from any person designated in the request or any person who may possess the requested information or documents. The types of information and documents subject to required production include:

[64] The following regulators are signatories to the IOSCO MOU: Australia--Australian Securities and Investments Commission; British Columbia-- British Columbia Securities Commission; France--Commission des operations de bourse; Germany--Bundesanstalt fur Finanzdienstleistungsaufsicht; Greece-- Capital Market Commission; Hong Kong--Securities and Futures Commission; Hungary--Hungarian Financial Supervisory Authority; India--Securities and Exchange Board of India; Italy--Commissione Nazionale per le Societa e la Borsa; Jersey--Jersey Financial Services Commission; Lithuania--Lithuanian Securities Commission; Mexico--Comision Nacional Bancaria y de Valores; New Zealand--New Zealand Securities Commission; Ontario--Ontario Securities Commission; Poland--Polish Securities and Exchange Commission; Portugal-- Comissao do Mercado de Valores Mobiliarios; Quebec--Commission des valeurs mobilieres du Quebec; Spain--Comision Nacional del Mercado de Valores; South Africa--Financial Services Board; Turkey--Capital Markets Board; United Kingdom--Financial Services Authority; United States--United States Securities and Exchange Commission and Commodity Futures Trading Commission.

• Contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to these transactions;

• Records that identify the beneficial owner and controller and for each transaction, the account holder, the amount purchased or sold, the time of the transaction, the price of the transaction, and the individual and the bank or broker and brokerage house that handled the transaction;

• Information identifying persons who beneficially own or control non-natural persons organized in the jurisdiction of the requested authority;

• Compelled, sworn testimony (where permissible) or the statement of a person regarding the matters set forth in the request for assistance. Where permissible under the laws of the jurisdiction of the requested authority, a representative of the requesting authority may be present at the taking of statements and may provide specific questions to be asked of any witness.

The MMOU also provides that each authority will make all reasonable efforts to provide unsolicited assistance to the other authorities in the form of information that it considers likely to be helpful to the other authorities in securing compliance with the laws and regulations applicable in their jurisdictions.

The IOSCO MMOU is an important contribution to cross-border enforcement cooperation and a public statement that the world's securities regulators are committed to assisting one another in preventing and prosecuting violations of our securities laws. In recognition of the importance which the IOSCO MMOU is now seen, the organization took the decision at last year's annual conference to set the deadline of 1 January 2010 for all IOSCO members to sign onto the MMOU. Setting such a deadline was a major milestone for IOSCO as an organization.

7.6 The Influence of Cooperation

In the last ten years, securities regulators have made substantial progress in developing cooperative relationships to reduce the value of international borders as barriers to the detection and prosecution of securities fraud. The obvious benefit of cooperation is that regulators are able to obtain enforcement-related information from numerous jurisdictions. Information is said to be the lifeblood of financial markets.[65] The exchange of information and other means for cooperation are critical components for the effective oversight of an expanding cross-border market. By obtaining a ready source of access to information, regulatory authorities will be in a better position to carry out their oversight functions. Depending on the applicable statutory and regulatory requirements, the exchange of information could facilitate the following regulatory functions:[66]

Obtaining information to assist in determining whether a foreign-based investment management person is eligible to do business in a member's jurisdiction; gaining an additional tool for ascertaining, through exchanging inspection reports and by conducting joint inspections, if an investment management person located abroad is operating in compliance with applicable domestic requirements; and obtaining an additional source of information to assist in making a determination whether a foreign-based fund should be permitted to market its shares or interests within a member's borders

Cooperating directly with peers in other jurisdictions also permits government officials to maximize their ability to fulfil their domestic mandates and more effectively enforces domestic law. The SEC believes cooperation serves important U.S. interests. SEC officials argue that cooperation enhances the ability of the U.S. to police fraud that undermines U.S. markets.

Another benefit of cooperation is that regulators could learn a great deal about their respective interests, needs and capabilities. Douglas Melamed of the US Department of Justice (DOJ) recently stated that cooperation can encourage the evolution of "common views and…understandings" about substantive and procedural issues, which facilitates shared enforcement responsibility and leads to deeper, more effective cooperation.[67] Similarly, a top US Federal Trade Commission (FTC) official stated that "the constant contacts [with foreign regulators] enable us to understand each other's analysis, lead to convergence in our approaches toward competition matters—in some measure due to an increasingly common

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[65] Onnig H. Dombalagian, 'Licensing the word on the street: the SEC's role in regulating information' (2007) 55 *Buffalo Law Review*, 1.
[66] See, Exchange Act Release No. IS-806, 59 SEC Docket 536 (May 3, 1995).
[67] A. Douglas Melamed, 'International Cooperation in Competition Law and Policy: What Can be Achieved at the Bilateral, Regional, and Multilateral Levels, Address Before the WTO Symposium on Competition Policy and the Multilateral Trading System' (1999) 2 *Journal of International Economic Law*, 423.

economic analysis—and benefit parties insofar as we are often able to arrive at complementary remedies."[68]

International cooperation is active and growing, with the SEC playing a critical and active role. The SEC began to actively cooperate with foreign agencies in the 1980s, by the late 1990s, the SEC was at the centre of international cooperation. A striking result of international cooperation is the diffusion of SEC style regulatory rules and practices around the world. Many jurisdictions replicate U.S regulatory approaches. This phenomenon is termed as the "regulatory gospel" of U.S. securities law.[69] SEC officials confirm that the SEC is far less interested in learning from its foreign counterparts than it is in imparting the wisdom it has accumulated regulating the world's largest financial markets. A statement by Richard Breeden, then Chairman of the SEC, "I'm interested in knowing the capital rules in other countries to know how big their buffers are. I'm not at all interested in what the French think US capital standards ought to be."[70] This gospel includes the following elements: strict insider trading rules; mandatory registration with a governmental agency of public securities issues; a mandatory disclosure system; issuer liability regarding registration statements and offering documents; broad anti-fraud provisions; and government oversight of brokers, dealers, exchanges, etc.[71] The SEC push for U.S.-oriented securities law also extends to advanced industrial democracies. The SEC has pressured Japan and Switzerland, for instance, to develop insider-trading regimes similar to that in place in the U.S. The encouragement of US style market structures and regulatory principles promotes open entry and competitive market conditions that may be enjoyed by US participants and service providers.

For the SEC, cooperation with foreign regulators is a conscious strategy aimed at enhancing its enforcement powers in a globalizing economy while at the same time promoting the institutionalization of U.S.-style securities laws abroad through its technical assistance

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[68] Debra Valentine, General Counsel of the FTC, Remarks at a 1998 American Bar Association panel, cited in David M. Knight, 'Global Antitrust Cooperation: The Role of Transnational Networks in Competition Policy Formation and Enforcement' (unpublished paper, Harvard Law School, 1998).

[69] Kal raustiala, 'The architecture of international cooperation: transgovernmental networks and the future of international law' (2002) 43 *Virginia Journal of International Law* The author quoted term from the Interviews with SEC officials, SEC Headquarters, in Washington, D.C. (Apr. 2000).

[70] Joel P. Trachtman, 'Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation' (1994) 4 *Transnational Law and Contemporary Problems Spring*, 69.

[71] Theodore Levine & W. Hardy Callcott, The SEC and Foreign Policy: The International Securities Enforcement Cooperation Act of 1988, 17 SEC. REG. L.J. 115, 123 (1989), cited in Kehoe: "The SEC raised foreign consciousness about the harmful effects of insider trading, and this directly led to legislation criminalizing insider trading or increasing enforcement in countries such as Switzerland, Japan, Canada, and England".

programs. This is even true of the SEC's cooperative efforts with regulators from other advanced industrial states. The SEC hosts a major training program each year for foreign securities regulators, the "International Institute for Securities Market Development," which is taught by SEC officials and outside experts. As of 2000, nearly 800 participants from 101 countries had taken part.[72] This training provides grounding in the basic principles and approaches employed by the SEC (such as the merits of disclosure-based versus merit-based regulation and the importance of transparency) and provide opportunities for regulators to share problems and solutions. The SEC also holds an International Institute for Securities Enforcement and Market Oversight, in which approximately 670 regulators from 65 countries have participated.[73] In 2000 alone, approximately 460 securities regulators from 71 countries were trained by the SEC.[74] These programmes are designed to benefit both the United States and recipient countries. Benefits to the US include an improved foreign investment climate and regulatory foundation for foreign offerings in the United States. SEC officials also argue that, aside from spreading the gospel and building the rule of law abroad, these sessions help to build important ties and contacts for future cooperation on concrete cases.[75] However, some argued that the SEC's efforts to export regulation, resulting in greater friction between the SEC and foreign regulators.

Opposition with SEC's export regulation, economically weak jurisdictions always embrace a substantial part of the regulatory models of the dominant powers. What incentives exist for weak jurisdictions to import the regulatory approaches of the advanced industrial democracies? In a complex, uncertain economic environment, the strategy of adopting successful foreign models can markedly reduce regulatory costs.[76] Importing jurisdictions do not bear the (often considerable) expense of creating the regulatory institutions they adopt.[77] While these institutions "may not match domestic conditions precisely . . .[they] are ready-made, pretested, and provide international compatibility." Foreign regulatory rules and

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[72] Practicing Law Institute, 'International Affairs: The SEC Speaks in 2001' 1235 PLI/Corp 977 (2001), 991.
[73] Ibid.
[74] Ibid.
[75] See Kal, 'International cooperation', above, n.621, The author quoted from Interview with former SEC official, in Washington, D.C., (Apr. 2000).
[76] Giandomenico Majone, 'Cross-National Sources of Regulatory Policymaking in Europe and the United States' (1991) 11 *Journal of Public Policy*, 79.
[77] Nancy Birdsall & Robert Z. Lawrence, 'Deep Integration and Trade Agreements Good for Developing Countries?' in Inge kaul et al (eds) *Global public goods: international cooperation in the 21st century* (Oxford University Press, 1999),128.

systems also may come “pre-interpreted”—with a body of case law and other decisions that have elaborated and improved the rules over time.

Chapter Eight: International Securities Regulatory Institutions

8.1 Introduction

As early as 1998, Eatwell and Taylor recommended establishing a World Financial Authority.[1] They argue that for efficient regulation the domain of the regulator should be the same as the domain of the market that is required.[2] Alexander is a supporter of this view. He contends that the changing structure of the international financial markets and in particular, the increased risk of systemic failure requires an efficient international financial regulator.[3] Ten years later, the securities market has changed even more, internationalization as discussed in chapter 3 has continued to grow. The risks involved have become more and more obvious and larger in scale. Chapter 3 has already argued that national securities regulations are not in harmony with this new situation. That is why it is necessary to call for international regulation. As discussed in chapter 4, there are three regulatory models in responding to international securities regulation: harmonization, competition and cooperation. Although they all have had in some way a degree of success in connection with international securities regulations, generally speaking it has not been very successful. One major reason for this is lack of an informal international regulator to coordinate things. Currently, many governments, committees, action groups, associations, etc., are involved in the regulation or governance of international securities trading, with each offering their own input on the various concerns associated with such regulation or governance.[4] However, to the contrary of international trade, which is formally and legally ruled by binding laws adopted at the WTO, there is a lack of leadership and central authority among the international securities regulatory institutions, which is worrisome. Clearly, "to create an effective system of regulation will mean overcoming turf-wars."[5] Regardless of all the regulatory parties involved their efforts to set universal standards results only in non-binding recommendations because they do not have regulatory authority.[6]

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[1] John Eatwell, 'New issues in international financial regulation' in Eilis Ferran and Charles A E Goodhart (eds) *Regulating Financial Services and Markets in the 21st Century* (Oxford, Portland Oregon, 2001), 235.
[2] Ibid.
[3] Key Alexander, 'The need for efficient international financial regulation and the role of a global supervisor' in Eilis Ferran and Charles A E Goodhart (eds) *Regulating Financial Services and Markets in the 21st Century* (Oxford, Portland Oregon, 2001), 273.
[4] Katharina Pistor, 'The Standardization of Law and Its Effect on Developing Economies' (2002) 50 *American Journal Comparative Law*.
[5] Alex Brummer, 'Saturday Notebook: Regulators Must Talk to Each Other' *The Guardian (London)*, Aug. 12, 1995, at 34.
[6] See Pistor, 'The Standardization of Law', above, n.4.

"There are simply too many trade associations and working parties, dissipating the force of their message and . . . needlessly duplicating effort."[7] Furthermore, "these groupings are further discredited by the fact that the same faces from the same firms almost inevitably appear on the roster of every new organization, and yet still fail to provide true leadership."[8] The issue thus arises, who should fulfil the international leadership position and set international securities standards? This chapter will try to answer this question.

Firstly, this chapter will examine what role the existing national regulator and international institutions play and what their objectives are. America and the EU are the representatives of national regulators; Banking Supervision Committee (the Basel Committee) of the Bank for International Settlements, the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Board (IASB) are the representatives of international institutions. Then the chapter will explore who is going to be an international securities regulator.

8.2 American Leadership

National governments are the principal regulators of international financial transactions and the formulators of international policies. The SEC has responded to the internationalization of markets by expanding its influence beyond U.S. borders. The United States now has, in the aggregate, the largest and most liquid securities markets in the world and possibly the most efficient, innovative, and fair markets in the world.[9] One of the SEC's goals in the internationalization of securities markets is to minimize discrepancies between different securities regulation schemes throughout the world.[10] This has led SEC regulators to believe that the SEC "has a responsibility to assume a leadership role in international securities regulation".[11] The SEC might believe that its policies are better than all others in the world and might want the world securities markets to benefit from its "superior" form of governance. Securities law practitioner Lee S. Richards, III summarizes the SEC's evolution into an international regulatory agency: For better or for worse, the internationalization of securities

[7] Richard Greensted, 'Committee Fails to Show Leadership' (September 11, 2000) *Financial News*.
[8] Ibid.
[9] OTA-BP-CIT-66, *Trading Around the Clock: Global Securities Markets and Information Technology* (Washington DC, Diane Publishing, 1990), 78.
[10] Peter E. Millspaugh, 'Global Securities Trading: The Question of a Watchdog' (1992) 26 *George Washington Journal of International Law & Economics*, 359.
[11] Ibid.

markets has encouraged the SEC to regard itself as an international policing agency. From the outside looking in, it would appear that internationalizing its efforts is now a major SEC priority. Indeed, the SEC now has a whole division devoted to this subject.[12]

8.3 The Special Case of the European Union

The Commission of the European Union, together with the European Parliament and Council of Ministers, is probably the most influential of all multilateral institutions, although it is often regarded as a quasi-national actor (representing the 27 member states of the E.U.). The Commission has formulated important Directives in many areas of finance that are implemented through national legislation, particularly measures seeking to enhance the operation of the E.U. "single market." Implementation of these Directives is coordinated through E.U.-wide functional regulators, such as the Committee of European Securities Regulators (CESR).

There are two committees related to securities regulation in the Europe Union. The European Securities Committee (ESC) is composed of Member State nominees representing their respective economic and finance ministries, and is chaired by a representative of the European Commission. ESC act in both "advisory" and "regulatory" capacities in the field of securities markets. In its advisory capacity, the ESC would advise the Commission on securities issues relating to the adoption of proposed Directives or Regulations under the Co-Decision process (Level 1). In its regulatory capacity, the ESC would vote on implementing measures proposed by the Commission (Level 2). The Committee of European Securities Regulator (CESR) is composed of senior representatives of national regulatory authorities designated by the Member States. CESR act as an independent advisory group. CESR now serves two distinct functions in the EC securities regime. As an advisory body under Level 2 of the Lamfalussy Process, CESR consults with the Commission during the drafting of securities legislation.[13]

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[12] See Lee S. Richards, III, 'Legal Representation in the International Securities Markets: Representing Client in Securities and Exchange Commission, Department of Justice or Self-Regulatory Organization Proceedings Involving Foreign Citizens or Foreign Trading' (1990) 683 *PLI/CORP* 145.

[13] See Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (Feb. 15, 2001) Available at: http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf , 31 (hereinafter Final Lamfalussy Report) (noting that CESR, also known as "ESRC," serves as an "independent advisory committee" during Level 2 of the Lamfalussy Process.

Under Level 3 of the Lamfalussy Process, CESR serves as a forum for collaboration among securities authorities to ensure consistent implementation of EC securities legislation.[14]

8.4 International Securities Regulatory Institution

Currently, there are many committees, action groups, associations, etc., involved in the regulation or governance of international securities trading. The most important of these are the Banking Supervision Committee (the Basel Committee) of the Bank for International Settlements, the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Board (IASB). This chapter focuses on these three organizations. In addition, before discussing these three organizations, it will also give a brief interdiction of other international organizations in order to get a clear picture of international securities regulatory organizations.

8.4.1 Briefly introduction of international organizations

The International Securities Association for Institutional Trade Communication (ISITC) is an industry association that collaborates to develop and promote market practice and shared standards in the global securities industry in order to reduce inefficiencies, lower risk, and build shareholder value. ISITC is an organization that develops invaluable recommendations for straight-through processing and other electronic trade and communications procedures — recommendations that are repeatedly adopted by the industry and become standards that have transformed trading processes. [15]

The International Capital Market Association (ICMA) is a unique self regulatory organization and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers amongst its 400

[14] Ibid, 31.
[15] See The International Securities Association for Institutional Trade Communication (ISITC) website, available at: http://www.isitc.org/ (last visited, September 2008).

member firms across almost 50 countries.[16] ICMA's market conventions and standards have been the pillars of the international debt market for 40 years, providing the self regulatory framework of rules governing market practice which have facilitated the orderly functioning and impressive growth of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants including regulatory authorities and governments.[17]

The Federation Internationale Des Bourses de Valeurs (FIBV) was formed in the 1930s in Paris with 57 member stock exchanges.[18] The aim is to facilitate exchange of information. Recently is concentrating on clearing and settlement, disclosure requirements, and listing procedures.

The International Councils of Securities Associations (ICSA) formed in 1988, membership includes four SROs (Canada, Japan, the United Kingdom, and the United States) and three Securities Dealers Associations (Canada, Japan and the United States).[19] Aims to aid and encourage the sound growth of the international securities markets by promoting and encouraging harmonization in the procedures and effective regulation of those markets, thereby facilitating international securities transactions and by promoting mutual understanding and the sharing of information among the members.[20]

International Swaps and Derivatives Association (ISDA), which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. It is headquartered in New York. ISDA was chartered in 1985, and today has over 850 member institutions from 56 countries on six continents. [21] Since its

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[16] See The International Capital Market Association (ICMA) website, available at: http://www.icma-group.org/ (last visited, September 2008).
[17] Ibid.
[18] See John Reed, 'Globalization and the Group of Thirty'
available at: http://www.capital-flow-analysis.com/investment-essays/globalization2.html (last visited, September 2008).
[19] See the International Councils of Securities Associations (ICSA) website, available at:
http://www.icsa.bz/html/about_icsa.html (last visited, September 2008).
[20] Ibid.
[21] See International Swaps and Derivatives Association (ISDA) website, available at: http://www.isda.org/ (last visited, September 2008).

inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.[22]

The Committee on Payment and Settlement Systems of the central banks of the Group of ten countries (CPSS) was established in 1990. Its functions are to monitor and analyze developments in domestic payment, settlement and clearing systems as well as in cross-border and multicurrency systems. It has also increasingly focused on standard setting activities. All its 15 members come from rich countries, two of them, the Hong Kong Monetary Authority and the Monetary Authority of Singapore being representatives of new financial centers in Asia. [23]

8.4.2 The Basle Committee on Banking Supervision (Basle Committee)

The Basel Committee established by the central-bank Governors of the Group of Ten countries at the end of 1974, consists of representatives of twelve central banks that regulate the world's largest banking markets.[24] The Basle Committee meets regularly four times a year seeks to create common standards of banking oversight. The Basel Committee is widely recognized as the principal international forum for developments in international banking supervision. However, the standards developed by the Basel Committee are of direct relevance to the capital requirements imposed on investment firms (such as investment banks) operating in securities markets.

The Basle Committee works informally. Its operations are distinguished by an emphasis on personal contacts, insistence on the nonbinding nature of the agreements it concludes, and an

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[22] Ibid.
[23] CPSS Publications, 'CPSS history, organization, cooperation' available at: http://www.bis.org/cpss/cpssinfo01.htm (last visited, September 2008).
[24] The institutions represented on the Committee are as follows: from Belgium, the National Bank of Belgium and the country's Banking Commission; from Canada, the Bank of Canada and the Office of the Inspector General of Banks; from France, the Bank of France and the country's Banking Commission; from Germany, the Deutsche Bundesbank and the Federal Banking Supervisory Office; from Italy, the Bank of Italy; from Japan, the Bank of Japan and the Ministry of Finance; from Luxembourg, the Luxembourg Monetary Institute; from the Netherlands, the Netherlands Bank; from Sweden, the Sveriges Riksbank and the Royal Swedish Banking Inspectorate; from Switzerland, the Swiss National Bank and the Swiss Federal Banking Commission; from the United Kingdom, the Bank of England; from the United States, the Federal Reserve Board, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; and, serving as the Committee's Secretariat, the Bank for International Settlements. See David Zaring, 'International Law by other Means: The Twilight Existence of International Financial Regulatory Organizations' (1998) 33 *Texas International Law Journal*, 281.

interactive and decentralized method of ensuring compliance. The Committee makes decisions by consensus. It operates through a rotating chair and makes recommendations based on consensus.[25] The Basle Committee operates in secret and has sought throughout its existence to maintain an unpublicized existence and a low profile.[26] The Committee has declared that "the development of close personal contacts between supervisors in different countries has greatly helped in the handling and resolution of problems affecting individual banks as they have arisen. This is an important, though necessarily unpublicized, element in the committee's regular work".[27] The Committee pursues those contacts within its membership and has sought to develop others with outside banking regulators. This quest for common ground is the Committee's substitute for binding agreements.

The Basle Committee characterizes its "key objectives" as "strengthen[ing] international cooperation, improv[ing] the overall quality of banking supervision worldwide, and ensur[ing] that no foreign banking establishment escapes supervision." [28] The Committee has developed principles of "consolidated supervision" over the past decade and created a multinational framework for bank capital adequacy requirements, among other regulatory efforts. [29] Although the Basle Committee has strong background of banking regulation, it is also an important player in international securities regulation, as exemplified by its Capital Accord Basel I and Basel II. The Basel I was published in 1988 laid down universal minimum capitalization standards (ultimately pegged at eight percent of assets) for international banks under the regulatory aegis of the members' central banks.[30] While a non-binding, non-official document, this Accord soon (through a complex, informal and uncoordinated transmission matrix) became the international benchmark for bank capital adequacy within the developed and then-developing world.[31] The Basel II which was initially published in June 2004 is the second of the Basel Accords, which are recommendations on banking laws and regulations.[32] The purpose of Basel II is to create an international standard that banking regulators can use

[25] Ibid, see Zaring, 'International law by other Means', p288.
[26] Ibid.
[27] Basle Committee on Banking Supervision, Annexure C para. 7 (September 1995) (hereinafter Annexure C).
[28] Ibid, para. 3.
[29] See William A. Lovett, 'Conflicts in American Banking Regulation: Renewed Prudence, Retrenchment, and Struggles over Growth Potential' (1993)12 *Annual Review of Banking Law*, 443, 458.
[30] Basel Committee, International Convergence of Capital Measurement and Capital Standards (July 1988), available at http:// www.bis.org/publ/bcbsc111.pdf.
[31] See Joseph Jude Norton, 'Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?' (1989) 49 *Ohio State Law Journal* 1299, 1342.
[32] Basel Committee, International Convergence of Capital Measurement and Capital Standards (Basel II, June 2004), available at http://www.bis.org/publ/bcbs128.pdf.

when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Generally speaking, the Basel II rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability. The Basel II has already been implemented by Capital Requirements Directive in the EU.[33]

The Basel Committee's does not have legislative authority. As Peter Cooke, a former chair of the Committee, has observed that "[t] he committee does not undertake a formal super-national supervisory role; its conclusions do not have, and were never intended to have, legal force." [34] Usually, the committee has allowed for some flexibility in how local authorities implement recommendations, so national laws vary. The Committee has agreed that it possesses no such formal authority; rather, it formulates broad supervisory standards, practices, and guidelines which individual authorities use to implement the detailed arrangements-- statutory or otherwise--which are best suited to their own national systems. Because the Basel Committee has no enforcement authority, implementation of its proposals and standards are dependent on the member's cooperation in implementing national regulations. In this way, the Committee encourages convergence toward common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.[35]

8.4.3 The International Organization of Securities Commissions (IOSCO)

The birth of IOSCO dates back to 1974. In 1974, several Western nations organized the Inter American Association of Securities Commissions today known as IOSCO. IOSCO was initially formed in order to provide a setting in which representatives of the member countries could meet to discuss securities regulation matters. Despite its western origins and headquarters in Canada, in 1983, the organization had become a worldwide organization. At the same year it was incorporated by an act of the Quebec Parliament as a non-profit corporation under Quebec law.[36] In an effort to facilitate discussion among a broader base of

[33] For more details see chapter five: Harmonization, 5.5.3.1.
[34] See Zaring, 'International law by other Means', above, n.24, 289.
[35] See Annexure C, above, n. 27, para.2.
[36] The charter members of IOSCO are the countries of the North American continent, Quebec and Ontario. The non-charter members are the other countries that have since joined the organization. See Samuel Wolff, 'Recent

securities regulators, IOSCO expanded its membership to include regulators from all over the world, and currently has 189 members, together accounting for more than 90% of the world's securities markets.[37] IOSCO is a consensus-based organization, its principles and standards reflect the collective wisdom of regulators worldwide.

The organizational structure of IOSCO includes the General Assembly, a General Secretary (and General Secretariat located at the Quebec Securities Commission), and various committees. IOSCO is governed by and its work done through a network of committees. There are four main committees, a president committee, an executive committee, a technical committee and an emerging markets committee.[38] The Presidents Committee is the most powerful committee and consists of the presidents of all of the regular and associate members.[39] The Presidents Committee meets once a year at the annual conference. It is responsible for approving all resolutions; such resolutions then become policies and pronouncements of IOSCO. The Presidents Committee also elects members of the Executive Committee.[40] The Executive Committee is the principal governing body and consists of twelve representatives elected by the Presidents Committee; the chairs of the Emerging Markets and Technical Committees; and a representative from each of the regional standing committees.[41] The Executive Committee meets throughout the year, focusing primarily on governance and management issues.[42] The Technical Committee is responsible for the promoting of "regulation which facilitates the process whereby world class issuers can raise capital in the most cost effective and efficient way in all capital markets."[43] Its members are the representatives of sixteen securities agencies of the larger and more developed markets in the world.[44] The Technical Committee operates through five Working Groups, each of which is responsible for reviewing issues related to international securities regulation in a defined area and for making recommendations to the Technical Committee. The Technical Committee

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Developments in International Securities Regulation' (1995) 23 *Denver Journal of International Law and Policy,* 400.

[37] See IOSCO website, available at: http://www.iosco.org/ (last visited, May 2007).

[38] Ibid.

[39] International Organization of Securities Commissions (IOSCO), 1995 Annual Report (1996) [hereinafter 1995 Report].

[40] Ibid.

[41] Ibid.

[42] Ibid.

[43] International Equity Offers, Report of the Technical Committee of IOSCO 7 (September 1989) (manuscript on file with IOSCO) [hereinafter International Equity Offers]. It was intended that the Technical Committee primary objective was "to summarize the key problems in regard to a number of regulatory frictions ... affecting international equity offers."

[44] See 1995 Report.

in turn forwards the recommendations to the Presidents Committee and Executive Committee for approval and promulgation.[45] The defined areas for which the Working Groups are responsible include: (1) multinational disclosure and accounting; (2) regulation of secondary markets; (3) regulation of market intermediaries; (4) enforcement and exchange of information; and (5) investment management.[46] The Emerging Markets Committee (formerly the Development Committee) is concerned with the problems of emerging markets.[47] IOSCO describes its mission in this manner: The Emerging Markets Committee endeavours to promote the developing and improvement of efficiency of emerging securities markets by establishing principles and minimum standards, preparing training programs for the personnel of members and facilitating exchange of information and transfer of technology and expertise.[48] Like the Technical Committee, it does its work through working groups assigned to areas paralleling those established by the Technical Committee. The defined areas for which the Emerging Markets Committee Working Groups are responsible include: disclosure and accounting, regulation of secondary markets, regulation of intermediaries, enforcement and the exchange of information and investment management.[49] In addition, there are four Regional Committees which meet to discuss problems in their geographical areas. These are the Africa-Middle East Regional Committee, the Asia-Pacific Regional Committee, the European Regional Committee and the Inter-American Regional Committee.[50] The geographic areas least represented in IOSCO are Africa, the Middle East and former parts of the Soviet Union (other than Russia).

Before 1994, IOSCO did not limit membership to prosperous countries as the Basle Committee does, and even offers membership to non-government regulators. In 1994, IOSCO took steps to limit new membership. It resolved that future applicants for membership would be required to confirm that “they will be able and willing to adhere to IOSCO’s principles.”[51] IOSCO has three classes of membership: ordinary, affiliate and associate which has 109, 69 and 11 members individually.[52] Ordinary members consist of either governmental regulators

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[45] Ibid.
[46] Ibid.
[47] Ibid.
[48] Ibid.
[49] Ibid.
[50] Ibid.
[51] Jonathan Shirley, ‘International Law and the Ramifications of the Sarbanes-Oxley Act of 2002’ (2004) 27 *Boston College International & Comparative Law Review*, 501.
[52] See IOSCO website (last visited, May 2007).

of securities markets, or a self-regulatory agency, such as a stock exchange.[53] Associate members are made up of associations of public regulatory bodies having jurisdiction in the subdivisions of a country when the national regulator is a member, such as the North American Securities Administrators Association.[54] Affiliate members include international organizations whose goal is the regulation or the development of capital markets, or any other organization recommended by the Executive Committee.[55] While affiliate members are not given voting privileges and may not attend meetings of the Presidents Committee or the Executive Committee, they are allowed to be members of the Technical Committee and its working parties.

IOSCO has no charter and was not formed by treaty; instead, it was incorporated by a private bill of the Quebec National Assembly. Although the organization has continued to amend and develop its bylaws, the formal statement of purpose has not changed. The members committed: to cooperate together to ensure a better regulation of the markets, on domestic as well as on the international level, in order to maintain just and efficient markets; to exchange information on their respective experiences in order to promote the development of domestic markets; to unite their efforts to establish standards and an effective surveillance of international securities transactions; and to provide mutual assistance to ensure the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.[56]

In the course of IOSCO history, it has had a number of significant achievements. One of the most prominent was the adoption of its Objectives and Principles of Securities Regulation in 1998.[57] In the same year, another impressive achievement was the adoption of International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (International Disclosure Standards).[58] Then in 2002 the adoption of its Multilateral

[53] See 1995 Report.
[54] Ibid.
[55] Ibid.
[56] See 1995 Report.
[57] For more details see chapter five: harmonization, 5.3.3.
[58] For more details see chapter five: harmonization, 5.5.1.3.

Memorandum of Understanding Concerning Regulatory Cooperation and the Exchange of Information[59] was also a significant.

In 2005 the Presidents Committee set a new strategic direction. That decision had two aims: to raise the standard and consistency of securities market regulation world-wide, and to increase the number of jurisdictions signed on to the IOSCO multilateral MOU. The direction set itself four key priorities.[60] The first of these strategic priorities is its aim to confirm and develop IOSCO's role as the global leader in regulatory standards setting. That means the organisation must be proactive in identifying and analysing issues as they emerge, and responding promptly in the most appropriate ways. As a second strategic priority IOSCO promotes the full implementation of its 30 broad Principles for securities regulation in the regulatory framework of every member jurisdiction. A third strategic priority for IOSCO relates to improving enforcement related cross-border co-operation. And the last of the four priorities is about engagement with industry, in other words IOSCO's commitment to further develop and strengthen relationships with stakeholders.

8.4.4 The International Accounting Standards Boards (IASB)

The International Accounting Standards Board (IASB) founded on April 1, 2001 is the successor of the International Accounting Standards Committee (IASC) founded in June 1973 in London. The roots for IASC establishment can be traced back to the first international accounting conference in St Louis, Missouri, in 1904.[61] However, the momentum towards its establishment actually began in 1966 when a three nation study group - the Accountants International Study Group - was set up, comprising the UK, Canada and the United States.[62] Six years later, at the tenth International Accounting Congress, in Sydney, Australia, definitive plans were drawn up for establishing the IASC. This was duly done in June 1973.

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[59] For more details see chapter seven: cooperation, 7.5.4.
[60] Jane Diplock AO (Chairman, Executive Committee IOSCO), 'IOSCO - Global Strategic Issues in Securities Regulation' (Speech on International Investment Funds Association Annual Conference, Sydney, 1 November 2007) available at: http://www.seccom.govt.nz/speeches/2007/jds011107.shtml. (last visited, September 2008).
[61] Samuels, J M and A G Piper , 'International Accounting: A Survey' (1986) 61 *The Accounting Review*, 359.
[62] IASC Insight 'Lord Benson - IASC's Creator' (1995) The Newsletter of the International Standards Committee, March 31.

Between 1973 and 2000, international standards were issued by the IASC. During that period, the IASC's rules were described as "International Accounting Standards" (IAS). After nearly 25 years of achievement, IASC concluded in 1997 that to continue to perform its role effectively, it must find a way to bring about convergence between national accounting standards and practices and high-quality global accounting standards. To do that, IASC saw a need to change its structure. In late 1997 IASC formed a Strategy Working Party to re-examine its structure and strategy. At their November 1999 Meeting, the IASC board unanimously supported a resolution that would radically change its structure and its standard-setting machinery in the future. A new IASC constitution is expected to move the organization even closer to its goals. The new structure and due process are somewhat similar to the structure of the U.S. Financial Accounting Standards Board. A new constitution was adopted in May 2000. New structure includes two main bodies, the Trustees and the Board, as well as Standing Interpretations Committee and Standards Advisory Council.[63] A board of trustees has 19 members. The trustees appoint the IASC board members, exercise oversight, and raise the money needed to operate the IASC. The IASC board is to be geographically diverse. Twelve of the 14 members of the board will be full-time. To achieve a "balance of perspectives and experience," IASC has mandated that at least five members shall have been auditors, at least three shall have a background in the preparation of financial statements, at least three shall have a background as users of financial statements, and at least one shall have an academic background.[64] In addition, seven of the IASC board members are expected to have direct liaison responsibility with one or more national standard setters. A simple majority of voting members is required to approve new IASC accounting standards.

Since April 2001, rule-making function has been taken over by a newly-reconstituted IASB.[65] IASB is an independent, privately funded accounting standard setting body. The IASB describes its rules under the new label "International Financial Reporting Standards" (IFRS), though it continues to recognize (accept as legitimate) the prior rules (IAS) issued by the old standard-setter (IASC). The IASB is better-funded, better-staffed and more independent than

[63] See Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities Act Release No. 8818, 72 Fed. Reg. 37962, 37964. (July 11, 2007).

[64] 1995 report.

[65] The International Accounting Standards Committee (IASC) Foundation was incorporated in 2001 as a not-for-profit corporation in the State of Delaware, US. The IASC Foundation is the legal parent of the International Accounting Standards Board.

its predecessor, the IASC. Nevertheless, there has been substantial continuity across time in its viewpoint and in its accounting standards. IASB's mission is to develop, in the public interest, a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements.[66]

Officially, the IASB cannot force anyone to follow its standards. Compliance is totally voluntary. During the past years, actions taken by the SEC, the European Commission of the European Union (EU), and the International Organization of Securities Commissions (IOSCO) contributed significantly to the acceptance and prestige of the IFRS. SEC involvement has been a key factor. On 2007, the SEC issued two significant documents. The first document, a final rule,[67] would affect foreign private companies whose securities are listed in the US. The final rule would eliminate the current requirement that the foreign private issuers which use IFRS must provide reconciliations of the differences in net income and shareholders' equity under IFRS and U.S. GAAP.[68] The second document is a concept release on allowing US companies the choice (equivalent to that available to non-US issuers) of preparing their financial statements using either IFRS or U.S. GAAP.[69] Before the SEC had accepted the IFRS, the EU from 2005 onward had already required that all listed companies in the EU adopt IFRS (as approved by the EU).[70] In 2005, IOSCO announced that it would be recommending that its members allow multinational firms to use IFRS standards supplemented, where necessary, by reconciliation, disclosure, and interpretation--to address outstanding substantive issues at a country or regional level.[71]

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[66] International Accounting Standards Board (IASB) website, available at: http://www.iasb.org/Home.htm. (last visited, September 2008).

[67] SEC Release No. 33-8879 (Final Rule: Acceptance From Foreign Private Issuers of Financial Statements Prepared In Accordance With International Financial Reporting Standards Without Reconciliation To U.S. GAAP) (December 21, 2007) (the "Adopting Release"),
available at: http://www.sec.gov/rules/final/2007/33-8879.pdf (last visited, September 2008).

[68] Ibid.

[69] United States Securities and Exchange Commission (SEC), 'Concept Release On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards' Concept Release No. 33-8831, issued August 7, 2007, available at:
http://www.sec.gov/rules/concept/2007/33-8831.pdf.

[70] The EU Regulation of the European Parliament and the Council of the European Union on the application of international accounting standards was adopted in June, 2002.

[71] In 2005, IOSCO reaffirmed its support for IFRS. Press Release, Technical Comm. of the Int'l Org. of Sec. Comm'n, Statement on the Development and Use of International Financial Reporting Standards in 2005, (Feb. 2005), available at: http://www.iasb.org/uploaded_ files/documents/10_286_ioscopd182-100205.pdf.

8.5 Who is going to Supervise International Securities Markets?

Some consider an international regulatory agency to be the answer to the dilemmas posed by the internationalization of markets and proliferation of cross-border trading. [72] The international body would design regulatory policies to govern international transactions, police the international securities marketplace, and effectively enforce the rules.[73] Most importantly, international enforcement would alleviate home country resistance to submitting to a foreign country's domestic regulatory regime. The question is who should become the international regulatory agency?

8.5.1 The SEC

The groups that favour the SEC's expanding role in international regulation tend to be those who will benefit from the increase in foreign market investment that the SEC predicts will result from its policies.[74] The major supporters of the SEC's regulation are securities lawyers, accountants, and others who prepare documents, and financial analysts, portfolio managers and other securities market professionals who benefit from these efforts.[75] Foreign regulators' cool reception of the SEC's plan to regulate foreign broker-dealers implies that some major disagreements between the U.S. and other countries over international securities regulation are on the horizon. Other countries will continue to object to the SEC's erosion of their sovereignty.

Unfortunately for the SEC, its policies do not enjoy worldwide support. Critics argue that extensive U.S. securities regulation actually disadvantages U.S. issuers and markets[76] and that duplicative regulation causes "positive transaction costs"[77] to all investors. The assumption of this role becomes problematic when the SEC imposes its regulatory regime on foreign markets. Critics argue that "more uniform regulation of international markets would benefit

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[72] See Lewis D. Solomon & Louise Corso, 'The Impact of Technology on the Trading of Securities: The Emerging Global Market and the Implications For Regulation' (1991) 24 *John Marshall Law Review*, 338
[73] Ibid.
[74] See Regulation of Exchanges, SEC Concept Release No. 34-38672, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P85,942, at 89,684 (May 23, 1997).
[75] Matthew F. Gorra, 'ON-Line Trading and United States Securities Policy: Evaluating the SEC'S Role in International Securities Regulation' (1998) 32 *Cornell International Law Journal*, 232.
[76] James D. Cox, 'Rethinking U.S. Securities Law in the Shadow of International Regulatory Competition' (1992) 55 *Law & Contemparative. Problems*, 157.
[77] Gorra, 'On-Line Trading', above, n.75.

investors……, [but] the uniform system the SEC advocates is one patterned on the American model". [78] Once the SEC is permitted to promulgate rules that infringe upon foreign sovereignties, it violates norms of international law. Under the non-intervention doctrine, each state has a duty not to intervene in the internal affairs of other states. [79]

Furthermore, the efficient regulation requires that the domain of the regulator should be the same as the domain of the market that is regulated. [80] The SEC, however, is a US federal agency; thus, it is dependent upon and at the mercy of the US Congress. It conducts itself in the best interest of US markets, not global markets. As a national regulator, SEC obviously is not the best candidate for international regulator.

8.5.2 The IOSCO

Both the rules of the Basle Committee and the IASB in the international securities regulation are limited and narrow. The Basle Committee more likely is an international banking institution which provides a forum for regular cooperation on banking supervisory matters. IASB is just focused on harmonizing international accounting standards. It is not realistic to expect them to take full responsibility to cover the whole international securities field. IOSCO is the international organization of stock exchanges supervisors. In this sense it complements the Basle Committee and IASB that are more specialized in banking and accounting. In comparing them, IOSCO is better suited as a leader in international securities regulation. There are three specific reasons: its global commitment, its independence, and its reputation. First, unlike the SEC, IOSCO is not committed to one specific market. Although many organizations have been formed in response to the globalization of the capital markets, IOSCO's membership includes the securities regulators of scores of countries,[81] thus making it the most important of these organizations. IOSCO's focus is specifically international securities trading and the international market. Second, IOSCO lacks self-interest because it holds no allegiance to one specific country or market. As a result, IOSCO can exercise independence in making decisions in the best interest of the global market. Finally, regardless

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[78] Paul G. Mahoney, 'Securities Regulation By Enforcement: An International Perspective' (1990) 7 *Yale Journal on Regulation*, 306.
[79] Ian Brownlie, *Principles of Public International Law* 5th ed (Oxford, Clarendon Press 1998), 293.
[80] See Eatwell, 'New issues', above, n.1.
[81] For more details see IOSCO website, it states that IOSCO expanded its membership to include regulators from all over the world, and currently has 189 members, together accounting for more than 90% of the world's securities markets.

of periodic struggles, IOSCO is successful in setting international securities regulation standards. For example, IOSCO's Objectives and Principles of Securities Regulation is recognized today by the world financial community as international benchmarks for all markets. Furthermore, IOSCO Multilateral Memorandum of Understanding Concerning Consultation and the Exchange of Information (IOSCO MMOU) is the first global information-sharing arrangement among securities regulators; it sets a new international benchmark for cooperation critical to combating violations of securities and derivatives laws. IOSCO MMOU is an attractive and respected option for countries looking to partake in a global market. SEC officials note the importance of IOSCO as a forum for promoting cooperation and the spread and strengthening of securities law to new areas of the globe. The SEC is not the only group or individual following IOSCO. At the IOSCO's annual conference, large numbers of persons in the securities industry, lawyers, and others interested in international financial matters attend as observers. This "following" suggests that IOSCO is a regulatory body that commands the attention of groups and individuals who hold an interest in the international securities industry. For these reasons, IOSCO would best serve as the lead governing body for international securities regulation.

Although IOSCO has many advantages, that are its size and diversity, there are some problems. IOSCO has not been recognized as an international organization by international law. On a basic level, international law defines international organizations by state membership, tangible manifestations of organizational bureaucracy, and an adequate legal pedigree.[82] All three attributes are lacking in the IOSCO. Moreover, IOSCO do not meet the standards for international organizations set by legal literature and settled practice.

First, IOSCO does not look like a traditional international organization as defined by the Restatement (Third) of the Foreign Relations Law of the United States. The Restatement suggests that an international organization "is created by an international agreement and has a membership consisting entirely or principally of states" [83]and that "statehood . . . is generally a minimum qualification for membership in international organizations". [84] One leading

[82] Restatement (Third) of the Foreign Relations Law of the United States § 221, cmt. b reporter's note 6 (1987) [hereinafter Restatement]

[83]Ibid.

[84] Restatement, § 222 cmt. a. The Restatement recognizes that some international organizations may include non-state participants, but suggests that those participants would include "territories and possessions of member states that are not themselves states", such as in the Universal Postal Union, or "delegations of member states

casebook defines international organizations as “organizations composed entirely or mainly of states and usually established by treaty”. [85] The members of IOSCO do not act as representatives of national governments, but as substate actors. The members explicitly view themselves as representatives of their bureaucratic employer, rather than their national government. In addition, IOSCO are not created by a treaty but by a less formal promulgation of bylaws. IOSCO similarly derives its legal existence from a private bill passed by the Quebec National Assembly. [86]

Secondly, IOSCO has flexible internal organization. The casual beginnings of IOSCO are matched by an informal approach to internal rules and restrictions. IOSCO has promulgated bylaws, but those laws are permissive and open-ended, rather than restrictive and definitive. IOSCO’s bylaws grant the Presidents Committee “all the powers necessary to achieve the purpose of the Organization”, [87] while its Executive Committee “takes all decisions necessary to achieve the purpose of the Organization . . . .”[88] The enabling tenor of the bylaws of both organizations, comparable to bylaws a business might pass for itself, suggests that the organizations should be viewed as conduits for ongoing and flexible relationships.[89] By contrast, other international organizations have much more formal rules of order. The UN General Assembly, for example, has promulgated over 160 rules of procedure.[90] These flexible internal arrangements suggest that IOSCO is not concerned with a carefully delineated power-sharing arrangement. It focuses on the content of the resulting promulgations, rather than a sense that fair, or at least acceptably clear, procedures were used to create the supranational standard. Observers have concluded that this flexibility has also enabled the

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includ[ing] representatives” from bodies of private citizens, such as the International Labor Organization. Id. § 221, cmt. c.

[85] See Louis Henkin et al., *International Law*: *Cases and Materials* 3rd edition (1993),344.

[86] See An Act Respecting the International Organization of Securities Commissions, ch. 143, 1987 S.Q. 2424, 2437-38 (Can.).

[87] IOSCO By-Laws, pt. 4, para. 15.

[88] Id. pt. 5, para. 26.

[89] To be sure, the bylaws IOSCO do impose some limitations on their operations--a maximum number of members on the management committees is specified in both cases, for example, as are broad aims such as to “enhance the ability of insurance supervisors to better protect insurance policyholders,” IAIS By-Laws, pmbl., or to “cooperate...in order to maintain just and efficient markets”. IOSCO By-Laws, pmbl. Generally, majority votes effect changes of policy for both organizations, although IOSCO requires a two-thirds vote to amend its bylaws. See IOSCO By-Laws,, pt. 4, para. 21(l). However, the existence of majoritarian processes in IOSCO and IAIS distinguishes both organizations from the Basle Committee, which apparently relies on consensus among its 12 members. Consensus may have helped to drive the effectiveness of the implementation of Basle’s capital accord, while IOSCO’s resolutions have been less likely to be enacted by its members. See IOSCO Annual Report 1994, at 8.

[90] See Rules of Procedure of the General Assembly, reprinted in Basic Documents of the United Nations 41-67 (Louis B. Sohn ed., 1968).

most important financial regulators to have a central role in IOSCO. "The United States, European Union, and Japan control" IOSCO, according to Gary Klieman.[91] And Tony Porter believes that the SEC plays an overwhelmingly influential role in IOSCO.[92]

Finally, the Restatement suggests that international organizations, once constituted, possess "status as a legal person, with capacity to own, acquire, and transfer property, to make contract", and the like.[93] IOSCO lack much in legal status, it does not have legislative and enforcement authority. Most of the international standards, rules, principles, guidelines, codes of conduct, best practices, and other arrangements governing cross-border financial relations can be characterized as 'soft law'.[94] The international standards of securities regulation which promulgated by IOSCO are not an exception to soft law. Different from 'hard law' which is formal and enforceable, soft law expresses a preference and not an obligation that states should act, or should refrain from acting, in a specified manner.[95] Although soft law is not legally enforceable, they have often proven to be effective in finding their way into national law. In a sense, IOSCO has indirect force through mechanisms such as the Financial Sector Assessment Program (FSAP). FSAP, a joint International Monetary Found (IMF) and World Bank effort introduced in May 1999, aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries.[96] FSAP will assess a country's compliance with and observance of IOSCO's standards. In October 2003, IOSCO released the Methodology for Assessing the Implementation of the IOSCO Objectives and Principles of Securities Regulation.[97] This Methodology is intended to provide guidance on the conduct of a self-assessment or third party assessment of the level of implementation of the International Organization of Securities Commission's Objectives and Principles of Securities Regulation.[98] IOSCO Methodology provides a comprehensive

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[91] Gary N. Klieman, 'Better Forum Needed to Negotiate Terms of Foreign Competition' *American Banker*, Jan. 4, 1996, at 5.

[92] See Tony Porter, *States, Markets, and Regimes in Global Finance* (1993) 66, at 122-23.

[93] Restatement, supra note 23, § 223(a). See also Certain Expenses of the United Nations, 1962 I.C.J. Pleadings, at 151, 168 (July 20, 1962) (discussing fiscal powers and responsibilities of the General Assembly of the United Nations). On the legal rights of international organizations generally, see Henkin et al., above, n.85, at 344-68.

[94] Mario Giovanoli, 'A New Architecture for the Global Financial Markets: Legal Aspects of International Financial Standard Setting' in Mario Giovanoli (ed), *International Monetary Law. Issues for the New Millennium* (Oxford: Oxford University Press, 2000), 33.

[95] Joseph Gold, *Interpretation: The IMF and International Law* (The Hague: Kluwer Law International, 1996), 31.

[96] International Monetary Fund, 'Financial Sector Assessment Program' available at: http://www.imf.org/external/np/fsap/fsap.asp.

[97] See IOSCO website, http://www.iosco.org/library.

[98] Ibid.

framework for analyzing implementation of the principles.[99] Furthermore in order to help achieve implementation IOSCO provides technical assistance, advice and training to members. It is also concerned to see regulators who can effectively enforce international securities regulation standards through co-operation and information exchange. In today's global capital markets cross- border enforcement cooperation is essential. SEC Chairman William Donaldson said, "The SEC has long recognized that international cooperation is vital to an effective enforcement program. The IOSCO MOU is an important contribution to cross-border enforcement cooperation and a public statement that the world's securities regulators are committed to assisting one another in preventing and prosecuting violations of our securities laws."[100] But soft law is soft law. The key element for distinguishing between hard and soft law is enforcement.[101] IOSCO promulgations have less force than do those of a traditionally defined international organization. When states violate legal obligations to international organizations as covered by the Restatement, they are obligated to provide redress.[102] But the promulgations of the IOSCO considered here is in theory not binding on member states. Regulators have claimed that nothing they do in the organizations is legally binding. "We can't bind the United States", observed one SEC regulator who has participated in IOSCO.[103] The lack of effective enforcement is the eternal problem of international financial soft law.[104] This is also the foremost disadvantages of IOSCO.

IOSCO, therefore, cannot create the legal obligations to which traditional international organizations are entitled. IOSCO thus do not qualify as traditional international organizations under the definition of the Restatement or other leading texts, and are not subject to the rights and duties of international organizations. It has not authority to impose its recommendations on regulators and frequently finds it difficult to obtain a consensus amongst regulators. Solutions are often worked out informally before being drafted as agreements between the concerned parties. Discussions at IOSCO conferences often can result in bilateral or multilateral solutions to regulatory problems.

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[99] World Bank and International Monetary Found, *Financial Sector Assessment: A Handbook* (Washington, 2005), 145.
[100] SEC, 'SEC Announces IOSCO Unveiling of Multilateral Agreement on Enforcement Cooperation', available at: http://www.sec.gov/news/press/2003-145.htm.
[101] Rosa M. Lastra, *Legal Foundations of International Monetary Stability* (New York, Oxford University Press, 2006), 454.
[102] See Restatement, § 901 cmt. a.
[103] See Pistor, 'The Standardization of Law', above, n.4.
[104] See Lastra, *Legal Foundations* above, n.101, 460.

8.5.3 Lessons Learned From the EU

Within the EU, at a member state level there are many powerful regulators who do excellent work promulgating listings and offering rules for the national markets, but there is little coordination at the EU level. As a result, there exists a regulatory vacuum for cross-border offerings. The EU needs a single regulator to create a single securities market. It needs a single regulator to coordinate and to impose the necessary regulatory reforms to develop a well-functioning, cross-border securities market and to represent the interests of European issuers and investors in international forums. This situation of the EU is very similar to that of the international securities regulation. Both regulatory domains are composed of member from various states. Much can be learned from the experience gained within the EU. This would include lessons learned from their failures. EU efforts are not only important in their own right but have offered a model, and an experimental laboratory, as to how regulation might be formulated and implemented in the international system at large.

The idea of a European Securities and Exchange Commission (ESEC) is not new: Hopt argued in 1976 that such an institution should be considered and Walter recently stated that it would be unavoidable if Europe is serious about having a single financial market.[105] The support for the creation of an ESEC is growing.

The ESEC is likely to differ from the current EU institutional structure in three important ways. First, neither representatives of Member State governments nor the European Commission will have direct control over the ESEC, and in that sense it will be independent and autonomous. Second, it will have decision-making powers going beyond those currently obtained by either the ESC or CESR. Finally, the ESEC will have some enforcement powers.

Its role could initially be relatively limited, with further developments subject to a step-by-step approach. The most likely way to effect the transition from the Lamfalussy structure towards an ESEC, will be via the ESC or CESR obtaining progressively more powers. Indeed, CESR is already the front-runner to take on a transition role to form the basis for the ESEC for several

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[105] Hopt, Klaus J., 'Third Theme: The Necessity of Co-ordinating or Approximating Economic Legislation, or of Supplementing or Replacing It by Community Law - A Report' (1976) 13 Common Market Law Review 245 Walter, Norbert, 'The Banking Supervision Issue in Europe' (2001) Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament.

reasons. CESR is independent of Member States, in the sense that representatives on CESR are mostly not part of their respective governments. The members of CESR have an expertise in regulating securities markets, whereas the representatives of the ESC are highly placed bureaucrats in Member States' economics or finance ministries. The creation of the ESEC will similarly only be possible if it too obtains wide political support. However, universal support throughout the EU will not be necessary for its creation.

Opponents for an ESEC have doubled the viability of such a body on constitutional grounds and also fear the enormous costs required in setting up and operating it. ESEC sceptics have furthermore argued that the notion of supra-national supervisor is not a pragmatic solution.[106] It is argued that given the fragmented nature of Europe's securities markets, it is untenable since such an idea presupposes that Member States are willing to make political concessions as well as complete harmonized regulation, technologies and infrastructure. There is an immediate need first for more harmonization of securities market regulation. However, often the same opponents see the benefits of a single national regulator for various market segments, as it offers 'one-stop shopping' for market participants with improved economies of scale as a result of pooled resources and management, lower supervisory costs and more transparent to consumers than with a fragmented system. Already this rationale has been entrenched in various European countries (e.g. United Kingdom, Germany, Sweden, Denmark, Norway, Iceland, Finland) as well as far a field as Japan and South Korea[107] more recently. If this reasoning is correct at a national level, it should logically apply at the European level, in the context of a single currency, a single market, free capital flows and an increasingly global market place.

The barriers to establishing a pan-European single regulator are numerous. Support for subsidiary remains strong in Europe. Very few countries are willing to give up regulatory control of their capital markets, even though the evidence shows they already have. The challenge for Europe is to create a single European regulator that has the authority and resources to drive the formation of a single European securities market is another challenge. The single European securities regulator needs powers similar to those of the SEC, including

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[106] See for example, Karel Lannoo, ' A European SEC? (Part II)' (march 2000) FRR, p.1; James W F Walson, 'International Co-operation in the Field of Financial Regulatory Enforcement, Part 2—the EU Services Regulator' (2000) JIBFL 15 (1), p.13; Clive Briault, 'The Rationale for a Single National Financial Services Regulator' Financial Services Authority Occasional Paper Series No. 2, (May 1999).

[107] Ibid, See Clive Briault, 'Single Regulator', 11-12.

rule-making powers. The single regulator cannot rely on member states to implement its rules but must have direct rule-making authority over the entire European market. The single regulator must also have enforcement powers. Without enforcement powers, the regulator will not be able to ensure that issuers carry out its regulations effectively. The EU institutions lack the legislative and regulatory tools they need to act as, or to create, a successful securities regulator. Even if a regulator surmounts the political and institutional hurdles, it must develop common regulations and policies for all countries in the European Economic Area, countries divided by culture and legal tradition. Member states must be willing to give up their desire for documents translated in their local language and agree on common definitions of professionals and retail investors. At the same time, new regulations must be understandable and effective in both the common law and civil law traditions, particularly with regard to legal issues such as fiduciary duty, enforceability of contract, and corporate control. By no means will these barriers be easy to overcome.

Just as is true of the EU, there is no doubt that there is a need for an international securities regulator. However, there are many barriers to be overcome. Therefore, before establishing a formal international regulator, the intermediary step of regional integration could be employed, this would offer an alternative to going directly to international securities regulation. Regional integration also gives developing countries the opportunity to build their own governance according to their needs and stage of development.

Chapter Nine: Conclusion

This thesis has assessed the concept and history of the securities market, the securities exchange, securities regulation and the securities regulator. This thesis does not view the securities markets and the securities exchanges as one and the same thing, although quite often the terms are used interchangeably in the academic articles. The reason for this is discussed in Chapter 1. A securities exchange has different roles: it can be viewed as a firm, as a regulator and as a regulated entity. In this respect the securities market and securities exchange are different. Building on this theory, the paper has examined the characteristics and developments of securities markets and securities exchanges separately.

The history of the securities market proves that it is very important to have both securities regulation and regulators in order for the system to operate successfully. The securities market is an ‘engine’ of general financial development. It plays a crucial role in economic growth and financial stability. The securities market’s strong relationship with economic growth underlines the importance of the need for regulation. However, unfortunately, initially the securities market was in essence unregulated. After financial crises and scandals occurred, government regulation was called for and introduced. It has obviously taken some time to develop a proper independent securities regulation. Until the 1930s modern securities regulation in a systematic and sophisticated form first started in the US. Furthermore, the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk became the core objectives of securities regulation. In order to function effectively, securities regulation would logically require a regulator. In the past securities exchanges were used as the main regulator but as time moved on, it was proven that relying solely on securities exchanges as regulators brought more risks. It is now widely accepted that the existence of a public entity charged with the regulation and supervision of the market and market participants is key to the healthy development of markets. But this does not mean that securities exchanges loose their regulator identification completely, they still undertake some responsibilities. A national financial regulator has five main tasks: (1) authorization of market participants; (2) the provision of information to enhance market transparency (3) surveillance to ensure that the regulatory code is obeyed; (4) enforcement of the code and disciplining of transgressors and (5) the development of policy that keeps the regulatory code up to date. Three distinct models of allocation of regulatory powers can be identified: Government-led Model, Flexibility Model and Cooperation Model.

In the past the most difficult task of the financial regulator has been to keep up with the changing market place that he or she is supposed to be to regulating. As discussed in Chapter 3 the effect of internationalization was to change the world we live in completely, therefore even the securities markets could not avoid its influence. Securities markets are closely linked and work in a systemic way therefore no market can function in isolation from others. Today securities markets around the world are more connected than ever before. The direct benefit of the internationalization of securities markets is access to markets, which would be otherwise inaccessible. Starting in the 1980s, many firms chose to raise capital or list their shares in foreign markets. Today many securities transactions have cross-border elements therefore an entirely domestic transaction is likely to become increasingly less common. Internationalization has also made the competition stronger and as a result that competition has brought many changes to the securities exchange. Traditionally, securities exchanges were member-owned and self-regulatory. Most major exchanges have now converted into for-profit companies and develop corporate strategy to expand their activity at international level in order to become more profitable. In most cases they have become public, i.e. listed on their own Exchange. By October 2006, 19 Exchanges or holding companies had obtained public listings. The result of demutualization is that the commercial nature of the exchange becomes more evident. When securities exchanges convert to for-profit businesses this also results in an increase of conflicting interests. These for-profit exchanges have become the dominant providers of securities markets the world over. International securities markets have also already witnessed the consolidation of different markets from different regions in the world. NYSE Euronext is the first international Exchange to operate in both Europe and the United States. Following NYSE Euronext, is Nasdaq OMX, another international consolidation. The tides of consolidation clearly show that the securities exchanges of the world are uniting. The economic benefit of exchange consolidation is to concentrate trading on a single platform. They have several potential benefits: cost savings; increased liquidity; reducing the transaction costs of purchasing foreign securities; and diversification of the exchange's business into new product areas. Benefits or opportunities, however, are always accompanied with risks. Trading in securities markets, whether carried out domestically or across national boundaries, always involve risks. Compared with trading in a strictly domestic setting many of these risks are heightened at international level. There are several kinds of risks involved: credit risk, liquidity risk, position risk, operational risk, legal risk and systemic risk. The most important is system risk, particularly in the field of international securities regulation. If a large productive firm goes bankrupt, it naturally affects its employees and the economy, however, it does not trigger an economic crisis. On the other hand, if a large financial intermediary fails, the “domino effect” can lead to the collapse of the whole financial system, which can then ripple through the whole economy. A recent example of this was the Federal Reserve Rescue of AIG, the world’s largest insurer, which had links to all major securities markets. It follows that in an international market economy the effect of a systemic run down or failure would be massive.

Following the above discussion, it becomes necessary to consider the role and position of the regulatory body in an international securities market. In a competitive marketplace, regulators cannot afford to be either insular or parochial in the way they go about making public policy decisions regarding what constitutes prudent regulation and what are acceptable levels of risk. Regulatory diversity should not be endorsed without a firm commitment by International Regulators to cooperatively ensure that the agreed rules of the game, which may need to evolve, are understood, accepted and observed. The development of comprehensive, global securities regulation is essential and would achieve two main objectives: (1) the enhancement of international economics through capital formation; and (2) the avoidance of an international economic crisis

In response to the need for effective regulation, three approaches have been explored in this paper, namely: harmonization, competition and cooperation. It has to be acknowledged that these three very different regulatory approaches all have produced some successful results in the jurisdictions where they have been employed. Regarding harmonization, as discussed in Chapter 5, both the European Union and the International Organization of Securities Commission have made significant progress in adopting general disclosure and accounting standards for various public companies. For example, international accounting standards, now serve as a universal language for investors to help them better compare their investment options. International disclosure norms help establish a universal expectation for market participants around the world. Chapter 6 discussed competition. There is ample evidence indicating that competition could lead to both a race to the top and to increased specialization. A more likely possibility, however, is that regulatory competition will lead to a spectrum of varying standards. The simple reason for this is that different issuers and investors may have different preferences. High quality issuers and investors willing to pay a premium may select countries that supply strong regulatory standards and stringent disclosure rules, while investors who are less risk-adverse and issuers wanting a relatively inexpensive means to raise capital may be drawn to more lenient regimes. One thing for certain is that as the world financial system becomes more multi-polar, the United States will gradually lose its superior position within that system. With regard to cooperation which was explored in Chapter 7, a considerable progress has been made similar to that of harmonization. SEC has entered into more than thirty cooperative arrangements. European securities regulators also have utilized MOUs extensively; a fine example is the Euronext Regulatory MOU which has been adopted in 2001. The following year 2002, the Multilateral Memorandum of Understanding ("MMOU") was adopted. It is the first global information-sharing agreement among securities regulators. It sets a new international benchmark for cooperation critical to combating violations of securities and derivatives laws. Through cooperation, the various nations learned from each other's experiences about what works, and what hasn't.

But there is no one system which will work in all jurisdictions. Of the three securities regulatory models this paper has analyzed, none is perfect. As long as there are regulations, there will be abuses and room for improvements. They all have disadvantages. In the regional level, reforms of the EU legislative framework for constructing a single market in financial services are still underway. Progress towards an effective international standard, which is meaningful, specific and that applies to all aspects of securities regulations, has been slow. Little has been done to harmonize enforcement. The directives provide for cooperation among authorities, but it is likely that some member states will have stronger enforcement than others and some will have almost none. The opposite view asserts that harmonization could lead to excessive regulation without sufficient corresponding regulatory benefits. The main problem with harmonization is that although international regulators can usually agree on the basic goals and objectives of regulation, there exists fundamental differences in the regulatory approaches taken, including the form and content of regulation. Therefore, to find a single solution that will be viable for every country is an arduous task. Additionally the harmonization process is not cost free.

The "race to the bottom" phenomenon is perhaps the most well known criticism of the regulatory competition model. It is said that regulators in competing for multinational offerings will have an incentive to lower their regulatory standards and offer lax disclosure rules so as to attract foreign issuers into their markets by lowering their compliance costs. The result is a race to the bottom in regulatory standards. In Chapter 6, statistics showed that the United States' securities markets were losing its leading competitive position when it was compared to other securities markets abroad. In contrast to its failure AIM seems to be the complete success story. It has a lower entrance level and a more flexible regulatory environment. This has resulted in the thinking that there is a race to the bottom, but this is based on appearances only.

Opponents for cooperation argue that efforts on the part of countries to construct workable international cooperation into securities regulation, although fine in theory, are most likely to fail. Although the SEC has met with some success in gaining cooperation from other countries regarding insider trading laws, international cooperation remains limited.

In international securities regulation, apart from the approach itself, there are common problems that exist among all three regulatory approaches. One problem is that international securities regulation as it exists today is biased in favour of the most powerful countries, in particular the US. The US securities regulation became the "regulatory gospel". A striking result of international cooperation is the diffusion of SEC style regulatory rules and practices around the world. The US promotes a regulation that protects and improves the interests of their own securities markets. The SEC regulators believe that the SEC has a responsibility to assume a leadership role in international securities regulation. They believe their form of regulation is the best in the world and want the world securities markets to benefit from its superior form of governance. Therefore, the SEC is very positive about exporting their regulation model. This kind of unilateral approach may impede any attempt at harmonization and cooperation with regard to regulation.

Another problem is that contrary to international trade, which is formally and legally ruled by binding laws adopted at the WTO, there is no official international securities regulation institution providing formal governance and defining of official laws by which international securities regulation can be ruled. Instead of a formal international securities regulator there is a set of international institutions, which include a limited number of countries, which produce standards and norms that are then adopted by national authorities on a voluntary basis. All the international securities regulation institutions lack legislative authority. Because of the diversity, complexity, and universality of issues likely to continue to arise over the next decade, a single international body with legislative authority should be considered to facilitate world cooperation in addressing these issues.

In the light of previous experience, an international securities regulator should be established. The new international regulator could be a brand new institution or could be a radical reform of the IOSCO. Before establishing a formal international regulator, regional integration offers an alternative to international securities regulation. The experiences of the EU offer a model for international securities regulations. It has long ago established common institutions and regulations to create a single European financial market. Regional integration also gives developing countries the opportunity to build their own governance according to their needs and stage of development.

Appendix

6-1 The Main board listing requirements (1)[1]

	NYSE	LSE
Shares market capitalization	$40 million	Not less than £700,000
Financial record	N/A	3 years
Financial performance	Pre-tax income (the latest year)$2.5million, every year $2 million for two years; every year has profit for preceding three years, total pre-tax income is $6.5 million, the latest year>=$4.5million	a sound well-managed business a relatively consistent record of revenues and profits
Accounting standards	US GAAP	UK GAAP, US GAAP, IFRS
Periodic Disclosure requirements	Quarterly, half-year and yearly report	Half-year and yearly report
Corporate Governance	The requirements of NYSE new rules, Sarbanes-Oxley Act	The requirements of The Combined Code on Corporate Governance[2]
Listing fees	High	High

[1] Source: the website of NYSE, LSE, HKSE, SGX: available at: http://www.nyse.com/; http://www.londonstockexchange.com/en-gb/; http://www.hkex.com.hk/issuer/listhk/glossary.htm; http://www.sgx.com/

[2]Not apply for foreign companies seconary listing.

6-2 The Main board listing requirements (2)[3]

	HKSE	SGX
Shares market capitalization	Not less than HK$100 million	Alternative3[4]:Singapore$80milion alternative 1 and 2 there is no requirement
Financial record	3 years	3 years (Standard 3, Standard 1 and 2 there is no requirement)
Financial performance	3 years>= HK$50 million, the most recent year>=HK$20million	pre-tax profit> alternative 1: Singapore$7.5 million over three years; at least S$1million each year; alternative 2: S$10million in 1 or 2 years; Alternative 3 there is no requirement
Accounting standards	HK GAAP, IFRS, UK GAAP, US GAAP	US GAAP,IFRS,SAS
Periodic Disclosure requirements	Half-year and yearly report	Half-year and yearly report
Corporate Governance	The requirements of Hong Kong Companies Ordinance	Similar to UK Combined Code
Listing fees	High	Low

[3] Source: The website of NYSE, LSE, HKSE, SGX: available at: http://www.nyse.com/; http://www.londonstockexchange.com/en-gb/; http://www.hkex.com.hk/issuer/listhk/glossary.htm; http://www.sgx.com/

[4] A company may apply for a Main Board listing based on any one of the three alternative criteria.
Alternative 1 criterion
- cumulative consolidated pre-tax profit of at least S$7.5 million for the latest three years, and a minimum pre-tax profit of S$1.0 million for each of those three years;
- applicant must be under substantially the same management throughout the last three years.
Alternative 2 criterion
- cumulative consolidated pre-tax profit of at least S$10 million for the latest one or two years;
- applicant must be under substantially the same management throughout the one year or two years, as the case may be.
Alternative 3 criterion
- market capitalisation of at least S$80 million based on the issue price and post-flotation issued capital.
- continuity of management is not required. Management should, however, have the appropriate experience and expertise to manage the group’s business.

6-3 Second markets listing rules (1)[5]

	AIM	GEM	SESDAQ
Minimum public float	No minimum requirement	Minimum of 100 or 300 shareholders with 20% to 25% of shares with a minimum market value of US$3.8m or US$128m held by the public (depending on circumstances)	Greater than 0.5m issued shares or 15% of issued shares held by a minimum of 500 public shareholders
Initial equity required	No minimum requirement	No minimum requirement	No minimum requirement
Market capitalization	No minimum requirement	Minimum of US$5.9m or US$64m (depending on circumstances)	No minimum requirement
Trading history	No minimum requirement	Minimum of 24 months (reduced to 12 months if additional requirements are met)	If no track record, new projects must be fully researched and costed
Financial performance	No minimum requirement	No minimum requirement	No minimum requirement but business is expected to be viable and profitable, with good growth prospects
Accounting standards	UK GAAP/IFRS/US GAAP	HK GAAP/US GAAP/IFRS	Singapore FRS/US GAAP/IFRS
Interview with exchange	No	No	Yes

[5] Source: Grant Thornton's 2006 Global new markets guide-insight into international capital markets, Available at: http://www.gti.org/publications/markets.asp

6-4 Second markets listing rules (2)[6]

	NASDAQ National Market	NASDAQ Capital Market
Minimum public float	Minimum of 400 shareholders Minimum of 1.1m shares publicly held with a minimum market value of US$8 - 20m depending upon listing route	Minimum of 300 shareholders
Initial equity required	US$0 - 30m depending upon listing route	US$5m
Market capitalization	Minimum of US$75m	Minimum of US$50m
Trading history	0 - 2 years depending upon listing route	1 year
Financial performance	No minimum requirement	No minimum requirement
Accounting standards	US GAAP	US GAAP
Interview with exchange	No	No

[6] Source: Grant Thornton's 2006 Global new markets guide-insight into international capital markets, Available at: http://www.gti.org/publications/markets.asp.

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