BUILDING A TRANSATLANTIC SECURITIES MARKET

By Benn Steil

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Benn Steil

December 2002

CHAPTER 1: INTRODUCTION AND EXECUTIVE SUMMARY

1.1. The Agenda

This report aims to jump-start the integration of the US and EU securities markets through a mutual recognition agreement on transatlantic exchange access. Under this agreement, securities exchanges on each side of the Atlantic would be permitted to provide direct electronic access to brokers and institutional investors on the other side, for the purpose of trading listed equities and derivatives based on equities. We argue that this initiative will reduce trading costs, increase investment returns, lower the cost of capital, and increase economic growth on both sides of the Atlantic. The success of such an initiative will, over time, encourage its expansion to cover all forms of debt securities, primary issues, and other national markets.

1.2. Why Focus on Securities Markets?

Economic performance is ultimately determined by the efficiency with which scarce resources are allocated among competing ends. The centerpiece of this allocation process in modern economies is the market for corporate securities. The liberalization of cross-border capital flows and the shift in securities trading from physical floors to networked computers over the past two decades has contributed enormously to the internationalization of this market. Yet, as we detail in this report, significant regulatory barriers to cross-border market integration remain. Many of these barriers play little or no role in the protection of investors, and should be reconsidered in light of what we now know about how this market actually works.

Three observations in particular stand out:

- Reducing trade intermediation through the expansion of automated trading networks reduces trading costs and increases investment returns.[1]
- Reducing trading costs reduces the cost of capital for public companies, and thereby stimulates investment.[2]
- The development of more liquid and more highly capitalized equity markets increases economic growth.[3]

Transatlantic capital market integration is therefore a worthy economic goal, but one which has the outstanding additional benefit of being one of the simplest items on the transatlantic economic agenda to accommodate politically. Not surprisingly, capital markets are at the top of the list of 2002 priority issues for the Transatlantic Business Dialogue. In particular, the TABD stresses the importance of "Highlighting impediments to capital flow and suggesting better coordination for the US-EU financial architecture."[4] We take up their challenge in this report.

1.3. What's New Here?

The United States, in particular, places significant and costly regulatory barriers between its citizens' capital and foreign companies seeking to access it. Others before us have argued that many of these barriers are unnecessary or counterproductive from the perspective of protecting investors. Previous proposals have sought to address this problem by making it easier for foreign companies to list on a US stock exchange – for example, by making required financial disclosures prepared according to International Accounting Standards (IAS) an acceptable substitute for disclosures based on US Generally Accepted Accounting Principles (GAAP). But this accommodation to foreign

[1] See Domowitz and Steil (1999, 2002) and Conrad *et al* (2001).

[2] See Domowitz and Steil (2002).

[3] See in particular Rousseau and Wachtel (2000) and the survey by Wachtel (2001).

[4] www.tabd.org/about/about.html

issuers only addresses a *symptom* of a more costly and fundamental problem.

The problem is regulatory barriers which raise the cost to US investors of buying and selling the shares of companies listed overseas. Either US investors must pay multiple redundant intermediaries to trade these shares, or the companies must pay lawyers, accountants, and a US exchange to produce costly substitutes for these shares (American Depositary Receipts, or "ADRs") in the United States. As we discuss in chapter 2, both options inflate the cost of equity capital and reduce investment returns without any offsetting benefit either to the companies or to the investors.

Rather than merely making it less costly for foreign companies to list ADRs in the US, we advocate eliminating the necessity of ADRs entirely. By allowing European exchanges to expand access to their electronic trading technology, US brokers and institutional investors could buy and sell the actual shares of the companies already listed on those exchanges more simply and cheaply than they currently buy the substitute ADRs on the New York Stock Exchange or Nasdaq.

In fact, European derivatives exchanges have been providing direct electronic trading access in the United States since 1997, under authority granted by the US Commodity Futures Trading Commission (CFTC), with great success both for the exchanges and the American trading houses which have become members. Eurex, Europe and the world's largest derivatives exchange, recently expanded trading hours for its Dow Jones Stoxx 50 European blue-chip index futures specifically to accommodate growing order flow from the US.[5]

The US Securities and Exchange Commission (SEC), while never endorsing the more liberal CFTC approach to foreign exchange access, has long maintained that regulatory issues related to corporate financial disclosure necessitate a more restrictive approach in dealing with foreign stock exchanges than derivatives exchanges. We address the SEC's concerns at length in chapter 4.

A further significant advantage of a mutual recognition regime aimed at exchanges, rather than one aimed merely at making cross-listing cheaper, is that it exempts EU-listed companies from US legislation and regulation intended to apply to US companies, but which catches foreign companies in their net by virtue of their being listed on a US exchange. In particular, the Sarbanes-Oxley Act of 2002 imposed sweeping new corporate governance requirements on all companies listed in the US. Although passed by Congress in direct response to accounting and governance scandals uncovered solely within American companies, the Act applies to *all* companies listed on US exchanges. These include all 188 EU companies listed on the New York Stock Exchange (NYSE) and 111 listed on Nasdaq.

The Act has not only raised concerns among foreign companies, regulators and governments over the legitimacy of the "extra-territorial" scope of the legislation, but has placed many foreign companies in an untenable position whereby they must violate their home country laws in order to obey US law. German companies listed on the NYSE, for example, cannot comply with the Act's requirements for board and audit committee independence. German companies have separate management boards and supervisory boards. Only the management board has responsibilities comparable to those of a US board of directors, yet it has no outside members. Whereas the supervisory board does have outside members, it is also required to have employee representatives, thus running afoul of the US requirement that the certifying officers report on internal controls to an "independent" body.

As our proposal would greatly assist European companies in attracting US shareholders without requiring the companies to seek a US exchange

[5] e*FinancialNews* (June 12, 2002).

listing, it allows them effectively to swim in American waters without getting entangled in American legal nets.

What about the nearly 300 EU companies already listed in the US? There can be little doubt that, once European exchanges are permitted to provide trading access in the US, cross-listed companies will find much of the existing NYSE and Nasdaq trading of their stocks migrating back to the home exchange in Europe. Over time, many of these companies can be expected to drop their redundant US listings. We have clear evidence from within the EU itself that the removal of regulatory barriers to cross-border trading leads to repatriation of trading to the home exchange, and delisting from secondary exchanges.

Some prominent European commentators – among them, Judith Mayhew, Head of Policy at the Corporation of London – have called for mutual recognition of European standards in the Sarbanes-Oxley Act.[6] But, however desirable, this is again treating a symptom rather than the actual problem. There will *always* be "Sarbanes-Oxley Acts" to reckon with. Unless mutual recognition is applied to *the exchanges themselves*, we will merely have recurring conflict of standards crises and serial proposals for mutual recognition to resolve them.

1.4. Does Market Integration Require Regulatory Integration?

Achieving transatlantic market integration does not imply a need for prior harmonization of rules, standards, or institutions. On the contrary, harmonizing in advance of liberalizing may eliminate successful business practices in different jurisdictions without producing any offsetting benefits in terms of investor protection or market efficiency. Given that regulatory standards are comparable across the Atlantic, and that the public authorities on each side would appear to have no basis for doubting the competence or integrity of the authorities on the other, a transatlantic market liberalization agreement based on mutual recognition and home country control is preferable to one based on national treatment or the prior creation of common regulations.

1.5. Liberalizing EU Market Access

The current wide-ranging initiative to reform securities markets legislation and regulation across the EU is part of a much broader economic and, importantly, political integration process in Europe, one which dates back to the signing of the 1957 Treaty of Rome. As such, the so-called Lamfalussy process is quite naturally geared towards the internal integration of securities markets across EU member states; markets which are still in many ways *de facto* and, in some important areas (such as pension investments), *de jure* segmented along national lines.

Yet when viewed from the perspective of European investors seeking higher investment returns and better diversification opportunities, and European companies seeking cheaper access to capital, further reducing market access barriers within the EU is a poor alternative to achieving a freer flow of capital across the Atlantic. US companies represent nearly 60% of the top 100 global companies by market capitalization, and should form a major part of any sensibly diversified investment portfolio. And US investors represent the dominant foreign investor group in most major EU national equity markets. Any initiative which significantly lowers transatlantic investment costs is bound to have a significant positive economic effect in Europe.

Of course, European integration does not preclude transatlantic integration. Yet an uncoordinated approach is apt to raise *further* barriers to the integration of the transatlantic market, given that rules and standards are likely

6 *eFinancialNews* (August 19, 2002).

to diverge. This is why the processes should proceed in tandem.

The European Commission has expressed unreserved support for the concept of a transatlantic mutual recognition agreement on exchange access. This is not entirely surprising, for two reasons. First, the major EU exchanges, all of which operate automated trading platforms, believe strongly that US market access will bring them significant new order flow from US investors, and have therefore lobbied intensively for such access. Second, these exchanges foresee no imminent competitive threat from US exchanges, the largest of which, the NYSE, is floor-based and currently uninterested in European expansion. Protectionist pressures are therefore minimal.

The legal structure of the EU makes it impossible for any one body, such as the European Commission, to guarantee market access rights in every Member State. We therefore make the following primary recommendations for accommodating US exchange access across the EU:

- In discussions with US authorities, the EU should be represented by the European Commission, in consultation with the Committee of European Securities Regulators (CESR).
- There being no legal concept of a "European Exchange," US exchanges wishing to provide direct trading access throughout the EU will necessarily be required first to obtain recognition in any Member State as a "regulated market," as defined by the Investment Services Directive (ISD).
- US exchanges should be specifically authorized to provide direct electronic trading access to registered EU broker-dealers or institutional investors for the securities of non-EU domiciled issuers which make their required periodic financial disclosures in accordance with either US GAAP or IAS.
- Such exchanges will be regulated by the US SEC, which will be required to have in place a "memorandum of understanding" with the designated regulatory body of the authorizing Member State regarding information sharing and cooperation in investigations of suspect trading practices.
- As all US registered exchanges already meet the broad requirements laid out in the ISD for designation as a "regulated market," European finance ministers should, through ECOFIN, produce a formal statement expressing their firm commitment to allowing US exchanges to acquire this status in any Member State without the imposition of additional legal or regulatory requirements.
- In this statement, the finance ministers should also express their firm commitment to allowing any US exchange so designated in any Member State to operate throughout all other Member States under the "single passport" rights enumerated in Article 15.4 of the Directive, and should foreswear the use of Article 15.5 as a means of denying them such rights. We further recommend the elimination of Article 15.5 during the current process of revising the Directive.

1.6. Liberalizing US Market Access

Although outgoing SEC Chairman Harvey Pitt expressed a willingness to accommodate foreign exchange access in the US based on "reciprocity," numerous stumbling blocks to an agreement exist in the form of "investor protection" standards. In particular, the SEC has repeatedly expressed concern about one aspect of investment risk borne by US investors transacting in overseas securities: accounting risk. Such risk is believed to derive from the application of foreign accounting standards which are considered to be less rigorous than US GAAP.

The 2002 "summer of discontent" in the US equity markets, in which broad stock price indices fell sharply as large listed companies announced egregious "errors" in their published financial statements, should serve as a warning that GAAP accounting represents no bar to the willful dissemination of misleading or even patently false financial figures. In evaluating whether to make it easier and less costly for Americans to buy foreign shares, the SEC should reconsider whether adherence to IAS, as opposed to GAAP, by foreign companies is truly a material source of risk for US investors. The studies which we discuss in chapter 4 suggest strongly that it is not. In fact, the evidence suggests that GAAP can, under certain circumstances, present a demonstrably distorted view of the financial performance of companies operating primarily outside the US legal and tax environments.

Given that the recent US corporate financial scandals generally revealed major lapses in corporate governance and external auditing to be primarily at fault, it would be wise to refocus regulatory attention on those areas. As this is done, we believe that any reasonable analysis would conclude that US investors are no more at risk from potential European governance and auditing failures than they are from such failures at home.

In the three Council on Foreign Relations study group meetings held over the past year, participants rightly emphasized the need to ensure that any cross-border market access liberalization proposal adequately addresses the implications for retail investor protection. Whereas direct retail participation in exchange and quasi-exchange trading systems may well become the norm in many national markets in the not so distant future, the proposal put forth in this study does not entail *any* liberalization in the way in which retail investors currently access markets, either domestically or abroad. There is, therefore, no diminution of retail investor protection implied in our agenda.

This does not mean, however, that retail investors will not benefit from the proposal. On the contrary, it should make it considerably cheaper for individuals in the US to buy European stocks, and vice-versa.

The cost savings to an individual US investor will come from the elimination of current regulations, wholly unrelated to retail investor protection, which effectively prohibit the investor's US broker from buying or selling European stocks directly and electronically on the European exchanges where the stocks are traded. Currently, the investor's US broker must pay a *second* broker – one which is based in Europe and a member of the relevant European exchange – to trade the stocks on behalf of its client. That cost is ultimately borne by the client, as is the cost of the greater front-running possibilities created by multiple intermediaries and the time lag implied in such an indirect trading process. Our proposal would allow European exchanges to extend membership – and therefore direct, electronic trading access – to brokers in the United States, thereby eliminating all costs associated with the involvement of redundant brokers in Europe. The reverse, of course, holds as well: if US exchanges are willing and able, legally, to offer remote membership to European brokers, then individual European investors will no longer have to bear the cost of their brokers having to pass on their orders to redundant intermediaries based in the US.

On the basis of our analysis of the SEC's role and investor protection concerns in chapter 4, we derive the following primary recommendations for accommodating EU exchange access in the United States:

- The US government should be represented by the Department of the Treasury, which would negotiate the terms of EU exchange market access rights in the United States in consultation with the SEC. The SEC should not directly represent the interests of US exchanges during or subsequent to negotiations on mutual market access, as this would conflict with its statutory role as a regulatory body.

- EU exchanges should be authorized to provide direct electronic trading access to US "qualified institutional buyers" for the securities of "foreign private issuers" which make their required periodic financial disclosures in accordance with either US GAAP or IAS.
- Such exchanges will be regulated by their designated home country authority, which will be required to have in place a "memorandum of understanding" with the SEC regarding information sharing and co-operation in investigations of suspect trading practices.
- As this access agreement will apply directly to foreign *exchanges* rather than foreign *issuers*, in contrast with the US-Canada Multi-Jurisdictional Disclosure System, the companies whose securities are traded on these exchanges should be considered immune to US civil and criminal liability under Rule 10b-5 of the 1934 Exchange Act.

CHAPTER 2: WHY INTEGRATE THE TRANSATLANTIC SECURITIES MARKETS?

2.1. Scope of the Project and Contrast with Other Proposals

This proposal is focused on integrating the secondary equity markets of the United States and the European Union via a system of mutual recognition of exchange and trading regulations combined with home country control and minimal harmonization of corporate financial disclosure rules. It contrasts with a number of other prominent proposals for facilitating the internationalization of markets in both its scope and its methods.

Scott (2000) focuses on the primary securities markets, advocating the establishment of an "offshore free zone" (OFZ) as a means of achieving "optimal standardized issuance" across borders. Subject only to minimum disclosure requirements where US investors are to participate, the OFZ would allow the market discovery process to operate in determining a set of optimal common distribution procedures across the major national markets. Our proposal avoids the issue of primary market distribution for two reasons.

First, as Scott himself emphasizes, the primary markets involve more complex issues of investor protection than the secondary markets: "Investors purchasing in primary markets, as opposed to secondary markets, cannot necessarily rely on prices set in deep liquid markets where rational expectations of the value of the securities have been incorporated into the price", (p71). This makes it less likely that the US Securities and Exchange Commission would be willing to place its faith in foreign distribution and disclosure rules, much less rules still to be determined by market practice in some future offshore jurisdiction.

Second, one of our major objectives – minimizing the cost of capital to US and European companies – can be substantially achieved through secondary market internationalization. This is because the very presence of a deeper, more liquid international secondary market must necessarily increase the value of participating in a primary distribution, even if access to primary distributions remains restricted across jurisdictions. The wider and deeper the secondary marketplace for trading stocks, the more the investors in the initial distribution will be willing to pay for those stocks, and the lower the cost of raising equity capital for the companies issuing those stocks.

Scott, furthermore, is highly skeptical about the utility of mutual recognition agreements. While explicitly acknowledging the problems which Scott identifies in the operation of a limited mutual recognition regime involving the SEC and Canadian provincial regulators (the "Multi-Jurisdictional Disclosure System," see chapter 4), we are much less critical of the operation of mutual recognition within the EU – at least in the limited area of secondary market trading, the subject of our proposal (see chapter 3).

Romano (1998) focuses on the secondary markets, as do we. She advocates what is in effect a mutual recognition regime for issuers, which would allow them to apply their home country disclosure rules when listing on a US exchange. Our proposal has a subtle but highly significant difference. In advocating mutual recognition for issuer disclosures based on the issuer's country of incorporation, Romano seeks to encourage non-US companies to list on US exchanges. We, on the other hand, advocate the application of mutual recognition to the *exchanges* rather than to the *issuers*. This would have the same effect of allowing foreign securities to trade freely in the US under their home market disclosure rules, but would *not oblige foreign companies to dual-list on US exchanges*. Allowing foreign exchanges to operate in the US under their home market rules, including those applying to listed company disclosure, will, we argue, offer US investors lower trading costs, and non-US companies lower capital costs, than would prevail under Romano's regime.

2.2. "Mutual Recognition" as a Tool of Market Access Liberalization

Economists and trade negotiators tend to address issues of trade and investment liberalization from very different premises. Broadly speaking, economists evaluate liberalization proposals on the basis of anticipated domestic consumer benefit, whereas trade negotiators focus on domestic producer benefit. The latter perspective, for example, pervades every aspect of World Trade Organization operations. These are premised on the assumption that member governments will actively seek foreign market access on behalf of domestic producers, using political control over producer access to domestic consumers as bargaining leverage.

Whereas economists may lament the fact that mercantilism drives international trade and investment liberalization, they cannot hope to improve outcomes without explicitly acknowledging the political process through which policy is generated. In the context of our proposal, then, it is important to see mutual recognition as nothing more than the most politically tractable and the least economically damaging of the mercantilist policy tools available to bring about transatlantic market integration.

To be sure, unilateral market access liberalization on both sides of the Atlantic would be the quickest and most effective way to proceed, assuming that political considerations could be ignored. The US CFTC has already undertaken significant unilateral market access liberalization in the derivatives area, with demonstrable effect (see section 2.5.2). As a matter of economics, reciprocity agreements as a precondition for transatlantic market access liberalization are neither necessary nor desirable. However, both the US and EU authorities have displayed a predictable tendency to paint the issue as a traditional trade matter, meaning that they believe that market access liberalization on one side should be made conditional on equivalent liberalization on the other. As outgoing US SEC Commissioner Harvey Pitt explained:

> "Our ultimate goal is to provide investors with the opportunity to purchase different investments, provided that we maintain and improve investor protections. We also want real reciprocity, so that US markets can offer the world's investors the chance to participate in our vigorous and unparalleled markets"[7]

EU Internal Market Commissioner Frits Bolkestein shares Pitt's view on the importance of reciprocity, although he sees the need for access liberalization being wholly on the US side:

> "The transatlantic community should become one big financial market. They trade here, we want to trade there."[8]

As we illustrate in chapter 3, this characterization is substantially accurate, but not meaningful. US exchange activity in Europe is currently trivial, although the demand for more direct access to European traders is likely to increase in the coming years.

The common thread between the two views is the classic trade negotiator's focus on domestic producer interests; in this case, those of exchanges. As we argue in some detail below, such interests are naturally quite different from those of the consumers of exchange services: that is, investors and listed companies. Fortunately, the dynamics of trade negotiations tend to bring consumer interests to the fore by

[7] Reuters (January 30, 2002).

[8] *Irish Times* (March 1, 2002).

requiring each side to foreswear protectionism in return for the foreign market access that the other desires.

The classic trade policy tool for liberalizing foreign direct investment regimes is the application of the principle of "national treatment" across the parties. National treatment requires that the host country treat foreign services or service providers no less favorably than comparable domestic services or service suppliers.[9]

A US-EU exchange access accord based on national treatment would be ineffective for two reasons. First, there exist costly market access barriers - particularly in the US, in the form of national financial disclosure standards for listed companies not used elsewhere in the world (see section 2.4.1). Second, exchanges need a common set of rules across all participating traders in order to operate effectively. Trying to run a transatlantic exchange according to rules which differ depending on the location of the trader is costly at best, infeasible at worst.

The extreme alternative of attempting to harmonize exchange regulations on both sides of the Atlantic is entirely impracticable. Even within the EU, attempts to establish a single set of rules across the Member States were abandoned two decades ago. But the EU developed a radical alternative to both national treatment and regulatory harmonization which has, to date, performed well, and could form the basis of a transatlantic market integration initiative. This is to carve out a sphere of activities for which each side would apply "mutual recognition" and "home country control."

This is a much more aggressive form of integration policy than national treatment. National treatment requires national authorities to treat foreign firms like domestic firms. Mutual recognition of regulations, combined with home country control, means that foreign firms must be given access equivalent to domestic firms, but with the right to apply *the rules and regulations of their home market*. Home country control harnesses the natural advocacy instinct of governments towards their nationals in the service of greater cross-border access, while simultaneously neutralizing the protectionist tendencies of host state authorities.[10]

The SEC has in the recent past, under limited circumstances, been willing to waive some US regulations when US investors deal in certain foreign securities (in the form of Rule 144A and the Multi-Jurisdictional Disclosure System, reviewed in chapter 4). In chapter 4, we argue that it is both appropriate and, given such precedents, feasible for EU exchanges to be granted US market access under a home country control regime. Whether the SEC is the appropriate authority to negotiate reciprocity abroad on behalf of US exchanges, however, is a matter on which we take a much more skeptical stance.

As regards American exchange access in Europe, the European Commission has expressed enthusiastic support for accommodating it formally as part of a reciprocity arrangement with the US. Legally guaranteeing such access is, however, a technically difficult matter, given the legal structure of the EU. We address this issue in some detail in chapter 3.

2.3. A Profile of Transatlantic Portfolio Investment

2.3.1. Foreign Portfolio Investment in the US

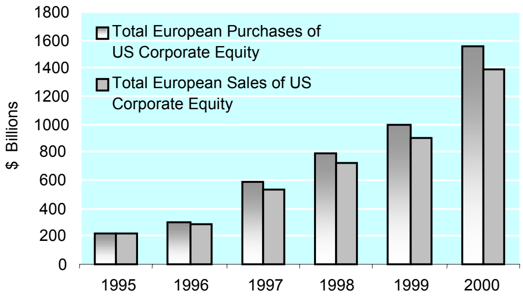
Figure 1 illustrates the tremendous growth in European purchases and sales of US equities between 1995 and 2000. Figure 2, going back to 1985, reveals how much of the growth in

[9] The most important papers on the use and limitations of national treatment and market access provisions in financial services trade agreements are Key (1997) and Key and Scott (1991).

[10] The methods and performance of the EU regime are probed in depth in Steil (1998). See also Key (1989).

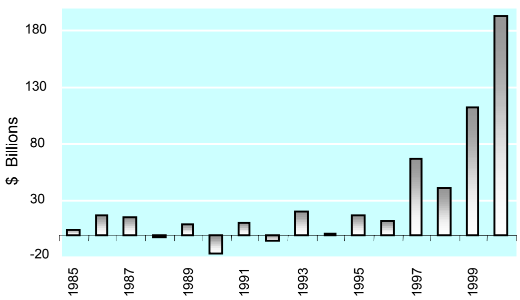
foreign holdings of US equities has been concentrated in the period since 1996.

Figure 1 - European purchases and sales of US corporate equity



Source: Table CM-V-5, US Treasury Bulletin

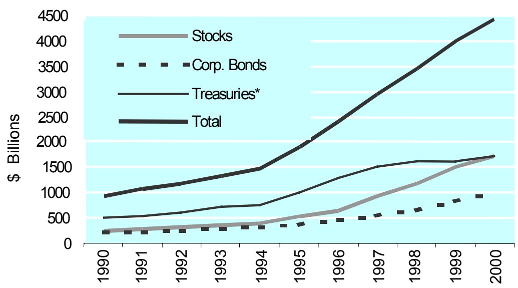
Figure 2 - Rest of the world's holdings of US corporate equities



Source: Federal Reserve, Flow of Funds Accounts

Figure 3 shows that this dramatic rise brought the level of such equity holdings up to that of US Treasury issue holdings in 2000.

Figure 3 - Foreign holdings of US securities



*Includes agency issues

Source: Federal Reserve, Flow of Funds Accounts

Figure 4 provides gross transactions in US equities across a subset of major foreign investors, and agglomerated for the EU and wider Europe.

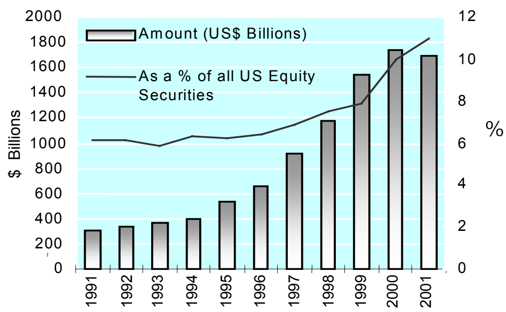
Figure 4 - Gross transactions in US equities by foreign investors in $ billions

	1990	1992	1994	1996	1998	2000
Canada	38	53	78	110	154	307
France	13	16	17	41	393	383
Germany	12	12	20	29	102	213
Netherlands	6	11	23	32	55	119
Switzerland	28	35	51	85	163	292
UK	93	122	197	318	629	1410
European Union	144	184	292	498	1356	2631
Total Europe	178	226	353	587	1535	2958

Source: US Treasury Department

Figure 5 shows how foreign holdings of US equities as a percentage of total holdings rose rapidly after 1996.

Figure 5 - Foreign holdings of US equity securities

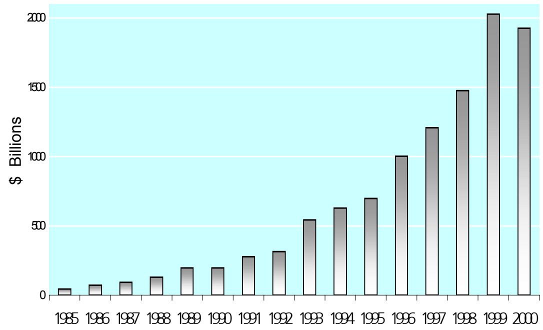


Sources: White (2002); Federal Reserve, Flow of Funds Accounts

2.3.2. US Portfolio Investment Abroad

Figure 6 shows the tremendous rise in the value of foreign equities owned by US residents between 1985 and 2000.

Figure 6 - Market value of foreign equities held by US residents (includes American Depositary Receipts)



Source: Federal Reserve, Flow of Funds Accounts

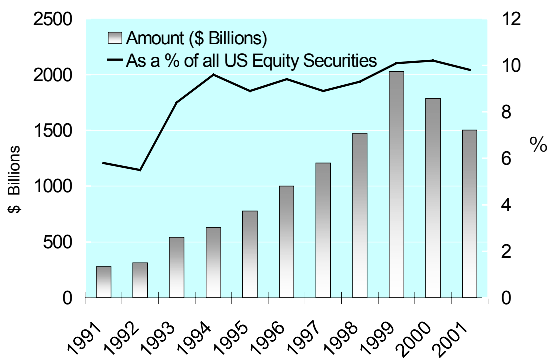
Figure 7 - Gross transactions in foreign stocks by US investors in $ billions

	1990	1992	1994	1996	1998	2000
Canada	10	14	35	64	107	172
France	12	17	23	26	47	92
Germany	14	12	34	33	84	148
Netherlands	8	9	18	25	49	80
Switzerland	9	10	23	21	58	35
UK	93	134	279	373	787	1350
European Union	141	182	387	492	1057	1937
Total Europe	154	199	436	536	1155	2063

Source: US Treasury Department

Figure 7 reveals that the growth in US investor gross transactions in foreign stocks since 1996 parallels the growth of foreign investor gross transactions in US stocks over that period. Figure 8 shows the rise in US holdings of foreign equities relative to domestic equities between 1991 and 2001; a trend that was sustained even during the tremendous bull market in US stocks in the latter half of the 1990s.

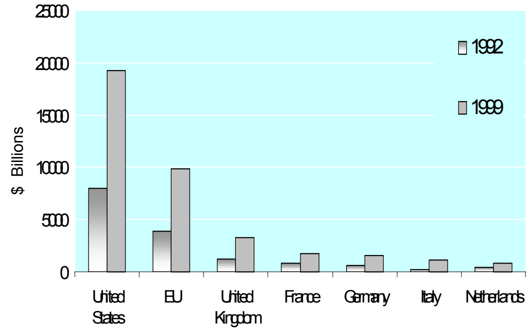
Figure 8 - US holdings of foreign equity securities



Sources: White (2002); Federal Reserve, Flow of Funds Accounts

2.3.3. Institutional Investment

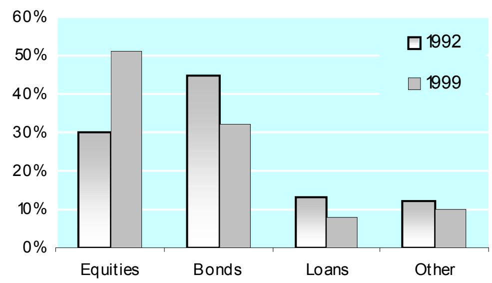
Figure 9 - Growth in institutional investor assets: 1992-1999



Source: Conference Board 2002, compiled from OECD data

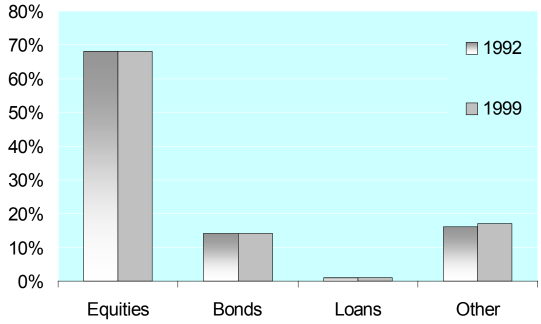
Growing institutional dominance of the equity markets has driven the growth in cross-border investment. Figure 9 reveals the marked growth in US and EU institutional investor assets between 1992 and 1999.Figures 10(a)-10(e) show how institutional asset allocation has shifted significantly from debt to equity over this period. Figures 11(a)-11(e) illustrate the general trend towards greater international equity holdings over this period. The UK and the Netherlands (specifically, their investment companies) are notable exceptions, owing mainly to the fact that they were already well diversified relative to the size of their domestic capital markets in 1991.

Figure 10(a) - Asset allocation by institutional investors (United States)



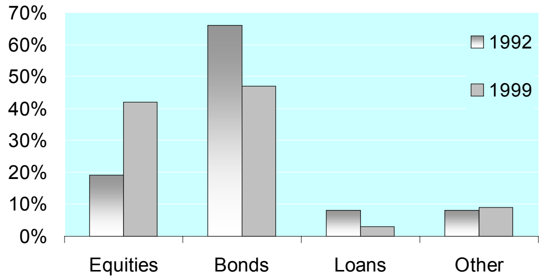
Source: Conference Board 2002, compiled from OECD data

Figure 10(b) - Asset allocation by institutional investors (United Kingdom)



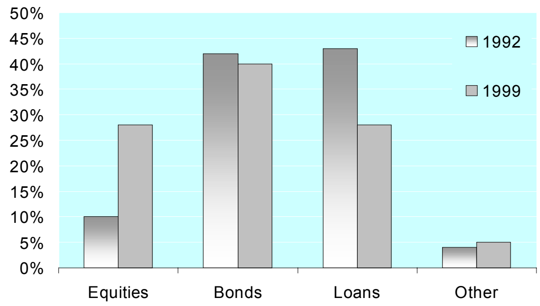
Source: Conference Board 2002, compiled from OECD data

Figure 10(c) - Asset allocation by institutional investors (France)



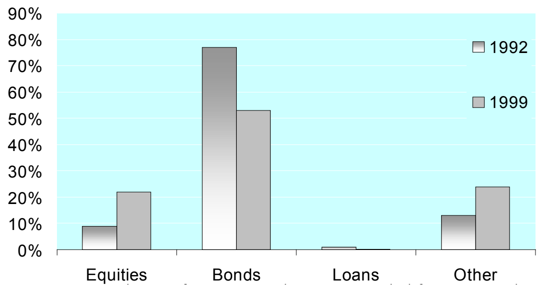
Source: Conference Board 2002, compiled from OECD data

Figure 10(d) - Asset allocation by institutional investors (Germany)



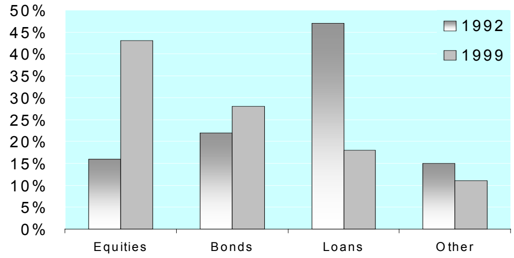
Source: Conference Board 2002, compiled from OECD data

Figure 10(e) - Asset allocation by institutional investors (Italy)



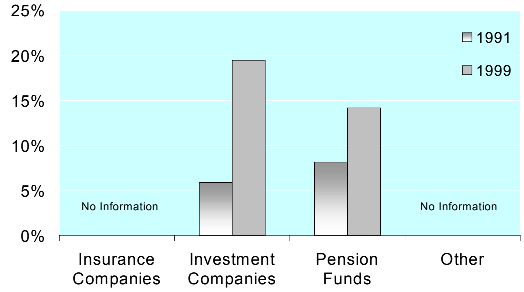
Source: Conference Board 2002, compiled from OECD data

Figure 10(f) - Asset allocation by institutional investors (Netherlands)



Source: Conference Board 2002, compiled from OECD data

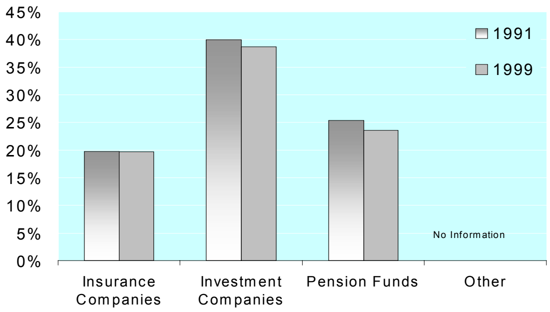
Figure 11(a) - Foreign equity holdings of financial institutional investors (United States)



Note: estimated from Pensions & Investments: Pension funds – Top 200 defined benefit funds only as of 9/30. For investment companies top 500 money managers, year-end data.

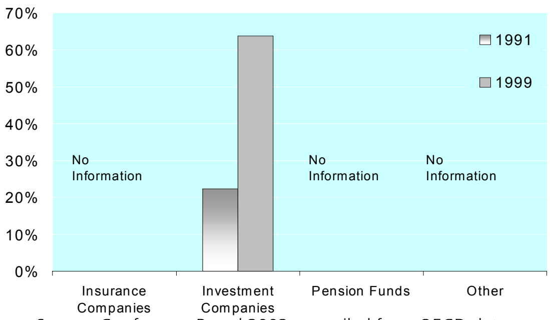
Source: Conference Board 2002, compiled from OECD data

Figure 11(b) - Foreign equity holdings of financial institutional investors (United Kingdom)



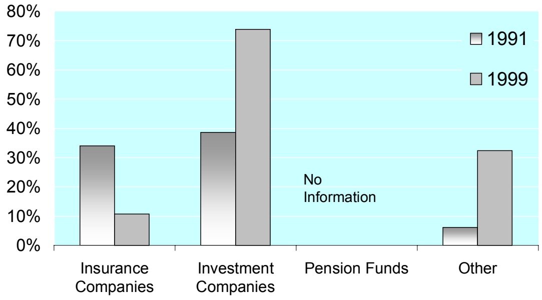
Source: Conference Board 2002, compiled from OECD data

Figure 11(c) - Foreign equity holdings of financial institutional investors (Germany)



Source: Conference Board 2002, compiled from OECD data

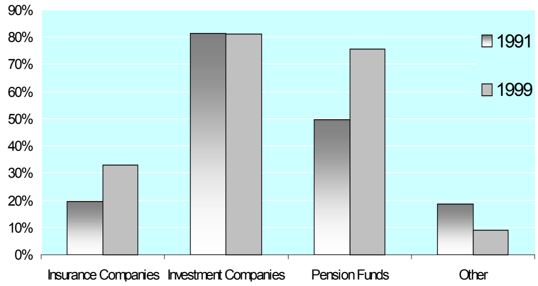
Figure 11(d) - Foreign equity holdings of financial institutional investors (Italy)



Note: for insurance companies, data reflect 1994 and 1999

Source: Conference Board 2002

Figure 11(e) - Foreign equity holdings of financial institutional investors (Netherlands)



Source: Conference Board 2002, compiled from OECD data

Figures 12, 13 and 14 focus on the largest individual fund managers, charting the considerable growth in their international equity holdings.

Figure 12 - International equities held by the 34 pension funds with the largest foreign portfolios

		1993		1995		1996		1997		1999		2000	
		Int. Equities	% of Tot. Assets	Int. Equities	% of Tot. Assets	Int. Equities	% of Tot. Assets	Int. Equities	% of Tot. Assets	Int. Equities	% of Tot. Assets	Int. Equities	% of Tot. Assets
1	California Public Employees	9,292	12.0%	14,000	15.1%	17,409	16.9%	24,300	19.0%	30,675	19.7%	32,389	18.9%
2	TIAA-CREF*	10,197	8.2%	12,963	8.4%	13,482	7.6%	15,677	7.4%	35,190	20.6%	30,799	19.1%
3	California State Teachers	2,223	4.6%	6,418	11.0%	13,133	19.3%	16,240	20.6%	24,698	25.1%	26,314	23.6%
4	New York State Common	-	-	-	-	-	-	-	-	13,142	11.8%	15,747	12.6%
5	New Jersey Division	-	-	-	-	-	-	-	-	11,434	15.5%	12,915	16.0%
6	Florida State Board	898	2.5%	3,605	7.6%	-	-	5,871	8.2%	8,011	8.6%	11,909	11.2%
7	Ohio Public Employees	-	-	-	-	-	-	-	-	8,969	17.0%	11,624	19.8%
8	Wisconsin Investment Board	2,089	7.1%	4,069	11.4%	4,528	11.4%	5,706	11.4%	9,231	16.0%	11,566	17.8%
9	Ohio State Teachers	-	-	-	-	2,336	6.5%	8,354	19.0%	11,462	22.3%	11,300	19.9%
10	New York City Retirement	2,986	8.2%	3,971	9.5%	3,645	8.1%	5,920	10.8%	9,649	15.3%	10,580	15.4%
11	Penn. Public School Employees	-	-	-	-	-	-	-	-	8,463	18.0%	10,209	19.2%
12	IBM	5,781	17.1%	-	-	4,409	10.1%	10,534	19.8%	9,741	23.0%	9,273	20.0%
13	Texas Teachers	1,636	4.5%	2,809	6.1%	-	-	5,252	8.2%	8,176	10.3%	9,238	10.6%
14	UN Joint Staff Pension	-	-	-	-	-	-	-	-	8,010	35.0%	8,432	34.0%
15	New York State Teachers	317	0.8%	4,364	8.8%	2,599	4.7%	6,019	8.8%	7,419	9.1%	8,379	9.3%
16	General Electric	2,833	7.5%	4,081	10.2%	3,543	7.8%	6,265	11.0%	7,672	17.0%	8,266	16.0%
17	Washington State Inv. Board	-	-	-	-	-	-	-	-	7,042	17.7%	7,867	17.2%
18	Bell Atlantic	-	-	-	-	-	-	-	-	7,559	20.3%	7,782	19.3%
19	Maryland State	519	3.0%	2,984	15.5%	4,555	21.6%	5,697	21.9%	6,154	21.0%	7,360	23.0%
20	Oregon Public Employees	2,400	14.1%	3,100	15.5%	2,900	12.6%	5,421	19.3%	6,462	19.0%	6,619	16.0%
21	SBC	-	-	-	-	-	-	-	-	-	-	6,339	14.0%
22	Minnesota State Board	1,130	5.9%	2,062	9.4%	1,860	7.2%	4,721	15.2%	5,816	14.8%	5,964	14.2%
23	New York City Teachers	-	-	-	-	-	-	4,466	12.7%	-	-	5,922	16.0%
24	Pennsylvania State Employees	-	-	-	-	2,886	16.0%	3,899	10.0%	5,363	21.3%	5,867	20.2%
25	Virginia Retirement	1,074	6.5%	1,790	9.0%	-	-	3,866	13.4%	5,677	16.3%	5,718	14.0%
26	Du Pont	2,194	9.6%	3,222	12.5%	4,051	14.6%	4,449	13.8%	-	-	-	-
27	Los Angeles County	1,069	6.9%	2,342	11.5%	2,117	9.6%	4,100	16.6%	4,998	18.5%	-	-
28	Lucent	-	-	-	-	1,987	5.0%	5,547	11.4%	-	-	-	-
29	Massachusetts PRIM	-	-	-	-	-	-	-	-	4,558	17.0%	-	-
30	New Jersey	-	-	-	-	4,593	9.9%	7,848	13.1%	-	-	-	-
31	New York Common	2,651	4.6%	4,283	6.0%	5,422	6.9%	7,382	7.7%	-	-	-	-
32	NYNEX	2,150	11.7%	3,043	15.1%	2,777	13.0%	4,194	15.9%	-	-	-	-
33	Teamsters Central States	-	-	-	-	-	-	4,508	24.1%	-	-	-	-
34	Washington State Board	-	-	-	-	2,256	8.4%	5,232	15.4%	-	-	-	-
	Total Top 25	64,334	7.7%	98,359	10.4%	110,816	11.2%	181,468	12.9%	265,571	18.0%	288,378	17.5%

Note: Dash (-) indicates data not available
Note: Data on defined benefit plans for 1999 and 2000 only as of 9/30 of each respective year
*Estimated for CREF accounts for 1999 and 2000 only as of 12/31 of each respective year
Source: Pensions and Investments, issues from selected years: The Conference Board

Figure 13 - The top 20 largest managers of actively managed international equity: 2000 - $ millions

	Managers	1993	1994	1995	1996	1997	1998	1999	2000
1	Capital Guardian	9,193	13,889	16,563	26,885	32,849	42,651	78,243	74,710
2	Morgan Stanley	-	-	10,267	16,065	30,519	33,157	40,906	39,243
3	Putnam Investments	9,238	11,636	3,973	7,430	10,440	14,270	32,257	32,044
4	Schroder Investments	-	-	13,721	17,335	20,494	26,296	33,849	27,254
5	Bank of Ireland	6,639	6,799	3,719	7,383	10,895	15,378	23,970	23,580
6	Templeton Worldwide	-	-	6,148	5,713	9,209	11,559	26,099	22,659
7	Janus	1,168	2,299	-	-	-	9,673	27,200	21,960
8	TIAA-CREF	6,928	6,908	13,631	-	9,700	13,199	20,274	18,858
9	T. Rowe Price Int'l	-	-	8,432	10,557	11,421	16,334	20,817	15,718
10	Zurich Scudder	-	2,604	7,885	11,740	13,563	14,076	20,580	15,086
11	Oechsle Int'l	3,189	2,989	6,055	8,731	7,431	9,250	15,927	14,428
12	Brandes Investment	6,938	7,862	-	-	-	7,066	12,842	12,990
13	Lazard Asset	-	-	4,088	5,841	7,534	10,856	12,462	12,516
14	Alliance Capital	4,250	4,891	-	-	-	-	-	12,412
15	GE Asset	3,349	2,662	4,418	5,269	5,969	7,423	11,923	12,228
16	Fidelity Investments	-	-	-	-	-	-	-	11,677
17	American Express	-	-	-	-	-	-	7,507	11,329
18	UBS Asset	-	-	-	-	-	-	-	10,298
19	J.P. Morgan Fleming	-	-	-	-	-	-	12,503	9,701
20	Grantham, Mayo v. Otterloo	-	-	10,566	12,599	11,565	10,699	11,146	9,679
	Total Top 20	88,735	99,117	153,553	193,068	181,589	241,887	408,505	408,370

Note: Dash (-) indicates data not available

Source: Pension and Investments, May 14, 2001; The Conference Board

Figure 14 - The top 20 largest managers of indexed international equity: 2000 - $ millions

	Managers	1993	1994	1995	1996	1997	1998	1999	2000
1	State Street Global	15,086	19,551	26,869	35,600	44,201	56,752	81,701	75,000
2	Barclays Global Investors	12,499	13,566	20,053	29,914	34,827	40,243	48,500	47,500
3	Deutsche Asset	6,719	7,532	8,902	12,637	18,110	21,324	23,040	9,869
4	Munder Capital	-	506	1,543	2,302	3,008	3,135	4,130	3,252
5	Alliance Capital	504	884	1,782	2,085	2,261	2,695	3,848	2,892
6	Mellon Capital	568	570	1,428	1,363	2,035	1,208	2,966	2,856
7	Axe-Houghton	1,272	904	1,379	1,480	1,624	1,974	2,036	2,052
8	Vanguard Group	737	1,427	486	644	590	1,053	1,335	1,310
9	Northern Trust Global	209	350	-	-	-	394	464	1,152
10	Prudential Insurance	473	520	600	839	970	1,036	1,028	1,019
11	Banc One	-	-	-	-	-	623	900	801
12	PanAgora Asset	-	-	1,098	1,480	1,116	1,331	490	441
13	First Quadrant	-	-	-	-	-	-	-	438
14	Merrill Lynch	-	-	-	-	-	-	23	367
15	Parametric Portfolio	-	-	-	-	-	-	386	291
16	Trusco Capital	-	-	-	-	-	-	-	247
17	GE Asset	-	-	-	-	424	456	578	135
18	New York Life	-	-	-	-	-	-	202	133
19	Fidelity Investments	-	-	-	-	-	-	-	95
20	Bridgewater Associates	-	-	-	-	-	80	104	67
	Total Top 20	42,833	50,512	69,858	93,706	109,166	132,304	171,731	149,917

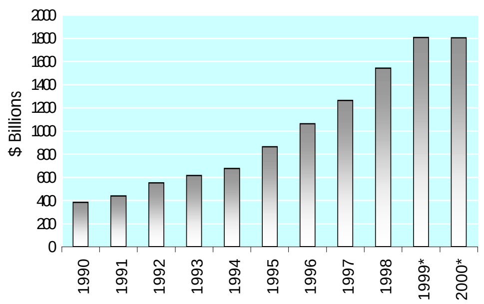
Note: Dash (-) indicates data not available

Source: Pension and Investments, May 14, 2001; The Conference Board

2.3.4. Pension Fund Investment

The growth of tax-advantaged private pension funds over the past decade has contributed not only to the tremendous growth of the US and European equity markets, but to a rapid rise in cross-border trading as a means of diversifying investment portfolios. Figure 15 plots the growth of so-called 401(k) US private pension fund assets between 1990 and 2000.

Figure 15 - Total 401(k) plan assets

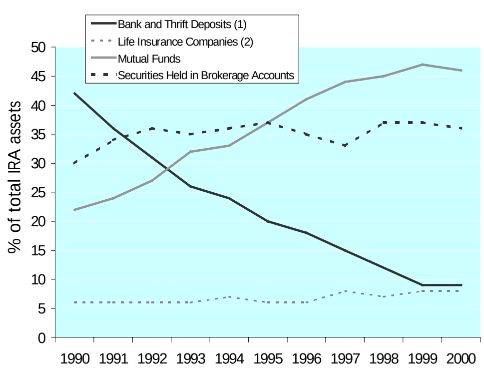


*estimated

Source: Investment Company Institute

Figure 16 reveals the dramatic rise in mutual funds, and the dramatic fall in bank deposits, as a percentage of total US Individual Retirement Fund (IRA) assets over this period.

Figure 16 - Distribution of individual retirement account (IRA) assets by financial institution

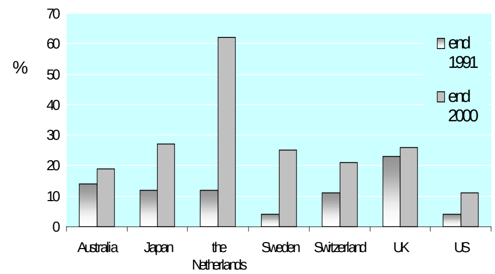


(1) Bank & thrift deposits include Keogh deposits
(2) Annuities held by IRAs excluding variable annuity mutual fund IRA assets

Sources: Securities Industry Association (2001); Investment Company Institute; Federal Reserve Board; American Council of Life Insurers and Internal Revenue Service

Figure 17 shows that the percentage of pension fund investments allocated to foreign assets rose considerably from end-1991 to end-2000 in those countries with well-developed private pension regimes. Figure 18 provides year-by-year data on equities.

Figure 17 - Pension fund allocation to international assets



Sources: Securities Industry Association (2001); Phillips and Drew

Figure 18 - Percentage pension fund asset allocation to international equities, 1991-2000

	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00
Australia	12	12	14	12	14	15	14	13	16	16
Japan	5	5	5	6	6	6	11	12	19	19
Netherlands	9	10	12	13	15	16	20	24	38	39
Sweden	4	5	7	9	12	13	14	15	16	15
Switzerland	3	4	4	5	6	8	9	10	11	11
UK	20	21	24	23	22	22	20	20	24	22
US	3	3	6	7	9	10	11	12	10	10

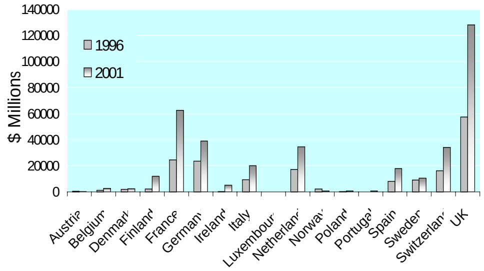
Sources: Federal Reserve, Flow of Funds Accounts; Phillips & Drew

Figure 19 illustrates the tremendous rise in US tax-exempt equity investments[11] in EU (and Swiss and Norwegian) national markets between 1996 and 2001.[12]

[11] These are investments by pension funds, foundations, and endowments.

[12] We are grateful to Carol Parker and Intersec for providing these custom-specified data.

Figure 19 - US tax–exempt cross-border equity investment



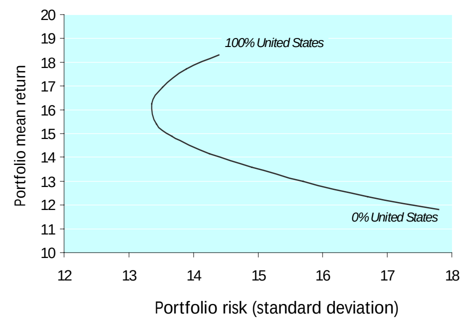
Source: Intersec

The development of private retirement funds throughout most of Europe is still in its infancy, although UK, Dutch, Danish, and Irish funds are substantial, and equity investment has been growing in recent years. Anticipated further moves at the national level to develop private pension regimes in continental Europe, as well as EU-level initiatives to liberalize their investment restrictions, will undoubtedly fuel greater growth in transatlantic portfolio investment in the coming years.

2.3.5. "Home Bias" in Equity Investments

In spite of the significant growth observed in transatlantic portfolio investment, there is overwhelming evidence that American and European investors still remain much less than optimally diversified internationally. Even over a bull market period such as 1987-1997, a global capital asset pricing model (CAPM) analysis of the risk and return performance of US and non-US equity portfolios would have suggested a 40% weighting in non-US stocks for US investors (see figure 20). Yet US investors only held about 10% of their equity portfolios in foreign stocks at the end of this period. Focusing solely on holdings of US long-term mutual funds, the results hardly vary: about 12% of net assets (stocks and bonds) were foreign in 1997 (up from 4.4% in 1988). Similar international under-diversification has been noted for European investors[13] who, in any event, generally hold a smaller proportion of their wealth in equities.

Figure 20 - Risk return trade-off: portfolio of EAFE and US indices, January 1987 – August 1997



Note: EAFE = Europe, Asia, Far East. Means and standard deviations are based on annualized monthly returns.

Sources: Tessar and Werner (1998); Morgan Stanley Capital International.

This "home bias" in investment is well documented, and remains a puzzle for economists seeking "rational" explanations based upon standard assumptions regarding investor risk aversion.[14] Whereas Tesar and Werner (1998) argue that the additional transaction costs associated with buying and selling foreign assets are not sufficient to explain the home bias finding, they note that the marked rise in international portfolio diversification following the 1987 US stock market crash corresponded with a period of declining cross-border transaction costs. Furthermore, Ahearne *et al* (forthcoming), using actual data on transaction costs and cross-border holdings unavailable to Tesar and Werner, provide compelling evidence that the latter significantly underestimate the impact of transaction costs on observed home bias. In particular, they find that US investor home bias drops markedly for firms from high-transaction-cost countries which list on the NYSE. Since, as we discuss in section 2.5.1, the major European exchanges have significantly lower implicit costs

[13] See Tesar and Werner (1998).

[14] See, for example, Frankel (1996).

than US exchanges,[15] however, European firms would see a greater reduction in the total cost of trading their stocks from having their home exchanges operate in the US, rather than from cross-listing on a US exchange. We believe, therefore, that our proposal, in significantly accelerating the decline in transatlantic trading costs, will correspondingly serve to erode home bias in portfolio investment.

What would the benefits of such erosion be? They are twofold. First, underdiversified investors receive lower returns at the same level of risk, and suffer higher risk at the same level of expected returns. Removing barriers to transatlantic investment can therefore be expected to improve investor welfare on both sides. Second, underdiversification leads directly to the misallocation of productive resources across countries, meaning in essence that the wrong firms produce the wrong products at excessive cost. If capital could flow to its most productive uses internationally, costs would decline, products and services would improve, and living standards would rise.

2.4. Cross-Border Investment Without Cross-Border Exchange Access

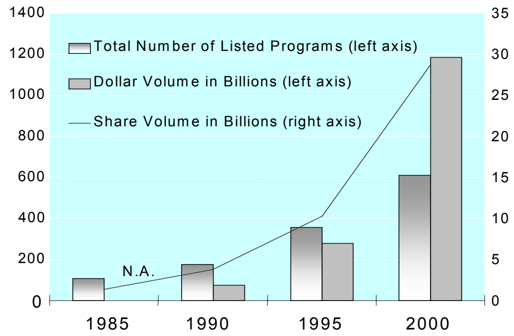
2.4.1. Trading Foreign Securities in the US

Shares of nearly 300 EU-based companies are traded on US exchanges in the form of American Depositary Receipts. Figure 21 illustrates the rise of ADR programs on the major US exchanges since 1985.

Accessing US capital via a US exchange can involve significant costs to a foreign company. There are three primary components of such costs.

First, the SEC requires foreign companies wishing to be publicly traded in the United States to prepare their financial statements according to, or reconcile their statements to, US GAAP. This can be a costly proposition, and has deterred many large non-US companies from listing on a US exchange.

Figure 21 - American depositary receipts (ADRs) listed on the NYSE, Amex and Nasdaq.



Sources: Securities Industry Association (2001); Bank of New York

Legal fees associated with an initial SEC filing by a foreign company generally amount to about $250,000, but frequently run to well over $1 million for large European companies (like Daimler-Benz, now DaimlerChrysler). The one-off initial accounting translation cost then typically amounts to between two and three times the legal bill. Accounting costs can easily run to over $2 million for a large German company, given the significant differences in accounting rules.[16] Once listed, the company's annual cost of preparing GAAP statements in addition to home market or IAS statements is itself significant. The Chief Financial Officer of Nokia estimates that his company would save approximately $500,000 annually if the SEC would allow his company to maintain its NYSE listing on the basis of disclosure statements prepared according to IAS.[17]

Second, US exchange-imposed listing fees are themselves significant: in the case of the New York Stock Exchange, up to $250,000 initially and $500,000 annually thereafter.

[15] See Domowitz *et al* (2001) and Domowitz and Steil (2002).

[16] I thank Sara Hanks at Clifford Chance for providing these estimates.

[17] Email correspondence with Olli-Pekka Kallasvuo, February 26, 2002.

Third, trading via ADRs can be more costly than trading in the underlying shares, and may be discounted by investors owing to reduced shareholder rights.[18] Depository banks charge up to five cents per share for the creation or issuance of ADRs, and for the release of the underlying shares back into the local market. These costs must ultimately be passed on to investors. Depositories delay dividend payments by five to fifteen days beyond the local payment date, and can choose to apply the least favorable foreign exchange rate over this period.[19] ADRs are also frequently less liquid than the underlying shares, inflating the cost of trading in institutional block sizes.

In short, cross-listing of shares is not a substitute for cross-border exchange access. Cross-listing involves significant additional legal, accounting, and administrative costs, and inflates capital costs by artificially segmenting the liquidity pools for corporate securities. Whereas nothing in our proposal would in any way restrict the ability of non-US companies to issue ADRs, we would anticipate much less use of ADRs by companies whose primary exchanges were granted the legal authority to provide direct electronic trading access to broker-dealers and institutional investors in the United States.

2.4.2. Trading Foreign Securities Outside the US

US investors can also trade European stocks on the European exchanges where the companies are listed. This involves European brokerage commission rates which tend to be much higher than US rates on ADRs. According to recent data from the Plexus Group, European institutional commissions are, on average, 46% higher than those prevailing in the US. However, we would expect European rates to converge to US levels rapidly if European exchanges were permitted to operate in the US. Furthermore, transatlantic exchange access would provide valuable new competition among trading structures and encourage the elimination of redundant and costly trade intermediation practices; a dynamic process which we describe below.

2.5. The Benefits of Transatlantic Exchange Operation

The most immediate benefit of transatlantic exchange operation lies in the potential for eliminating unnecessary layers of trade intermediation. Trade brokerage – the passing of investor buy and sell orders to further layers of intermediaries or to an exchange – is costly, both in terms of the explicit commission fees involved and the impact on market prices when intermediaries use investor order information to trade before them (*i.e.* front-running).

2.5.1. Evidence of the Benefits of Disintermediation

Domowitz and Steil (1999, 2002) studied the impact of trade disintermediation through the analysis of five years of trading data, from 1992 to 1996, of a large US mutual fund. They found that, on average, brokers *subtract value* in the trading process, even after trade difficulty is accounted for. Total trading cost savings achieved through non-intermediated electronic trading systems (such as Instinet and Posit) were 32.5% on Nasdaq trades, and 28.2% on trades in NYSE-listed stocks. Focusing just on commissions, they found that automated execution fees were, on average, 70% less than those levied by traditional institutional brokers in the sample. Their findings are corroborated by Conrad *et al* (2001), who examined Plexus Group trade data from 1996 to 1998.

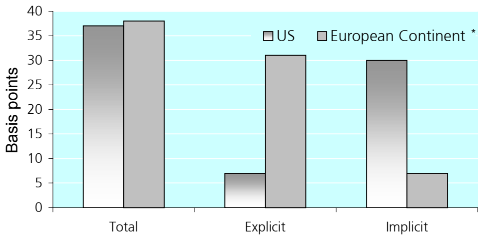
What is the relevance to transatlantic trading? First, one or more layers of brokerage can be cut out of the transatlantic trading process if the exchanges are able to operate directly on both sides. Second, more direct competition among

[18] ADR holders frequently have diminished privileges in terms of voting and proposing shareholder resolutions (*Wall Street Journal*, August 20, 2001).

[19] St. Goar (1998).

US and European exchanges should spread best practice to each. Based on trading data from Domowitz *et al* (2001), 1996-1998, Domowitz and Steil (2002) present the following trading cost comparisons.

Figure 22 - Trading costs: US vs. Europe



* France, Germany, Italy, Netherlands, Spain, Sweden, Switzerland

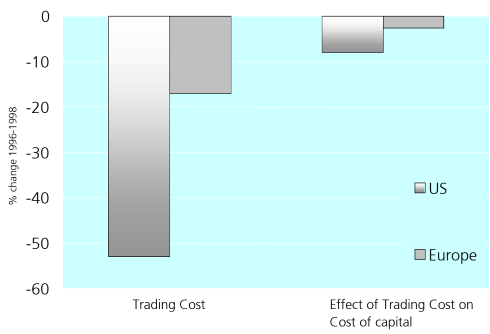
Sources: Domowitz, et al (2001); Domowitz and Steil (2002)

As illustrated in Figure 22, total trading costs in the US were 0.38% of principal traded, compared with 0.37% in the seven largest continental European markets. Yet when trading costs are decomposed into explicit costs (brokerage commissions) and implicit costs (or "market impact," measuring the efficiency of the trading system), we find that European explicit costs are three to four times the level of US explicit costs, but that European implicit costs are 1/3 to 1/4 the level of US implicit costs.[20] This suggests a more efficient brokerage industry in the US, but more efficient exchange trading systems in Europe, where structures are fully automated. To the extent that transatlantic exchange operation enables more direct competition between US and European exchanges, and US and European brokerage, relative efficiency advantages on each side are spread to the other, resulting in increased returns to investors and a lower cost of capital to listed companies.

How significant would this effect be? The above findings imply that a true integration of the transatlantic market has the potential to lower explicit costs in Europe to US levels (0.07%) and implicit costs in the US to European levels (also 0.07%). Lowering total trading costs on both sides to 0.14% would mean an extraordinary 60% decline in trading costs on both sides of the Atlantic.

But the benefits would not cease at lower trading costs, and therefore higher investment returns, for US and European investors. Listed companies would see a lower cost of raising capital in the equity markets. Using US and European trading and market data over the period 1996-1998, Domowitz and Steil (2002) estimated that every 10% decline in trading costs resulted in a 1.5% decline in the cost of equity capital to blue-chip listed companies (see figure 23). A 60% decline in trading costs, only slightly higher than the 53% decline in US trading costs they documented between 1996 and 1998, is therefore worth approximately 9% off the cost of equity capital to US and European listed firms. Domowitz and Steil (2002) further found that each 10% decline in trading costs yielded an 8% increase in trading volume. A 60% decline in trading costs may therefore also be expected to translate into a massive 50% increase in US and European trading volumes.

Figure 23 - Trading cost and cost of capital



Source: Domowitz and Steil (2002)

Yet even this analysis is likely to be too static, and therefore conservative. Greater inter-exchange competition should accelerate the process of trading automation and disintermediation. Both are intimately linked with the internationalization of securities markets. The London Stock Exchange, for example, witnessed a 16% surge in the

[20] Calculation of these costs is explained in detail in Domowitz *et al* (2001).

proportion of trading accounted for by overseas clients (to 25%), overwhelmingly US based, in the two years following the replacement of its SEAQ dealer market structure with the automated SETS platform for FTSE 100 stocks in late 1997. US institutional investors appeared much more willing to trade in the London market under an automated structure which afforded them greater speed, anonymity, and price transparency, all of which contributed to lowering UK trading costs.

As exchanges continue to demutualize, the commercial interests of exchanges and brokers will continue to diverge. Exchange profits are highly sensitive to trading volumes, which are themselves highly sensitive to trading costs. Demutualized exchanges (*i.e.*, those not controlled by brokers) therefore have a powerful incentive to minimize those costs of trading that do not accrue to them as revenue; in particular, brokerage commissions. This incentive is even more compelling when exchanges face more direct foreign competition for listings and trading volumes. There is therefore good reason to believe that exchanges will use transatlantic trading rights not only to sign up new foreign brokers as members, but to bypass brokers entirely and to sell transaction services direct to foreign institutional investors. Such initiatives will reduce transatlantic trading costs even further.

2.5.2. Evidence of the Effectiveness of Deregulation in Promoting Transatlantic Trading

In 1996, the US CFTC provided its first "no-action letter" to a non-US exchange, allowing it to operate in the United States. Deutsche Börse's screen-based DTB derivatives exchange (now Eurex Deutschland) was permitted to sign up US-based trading members for a single product: the 10-year bund future. At the time, DTB had been stuck on a bund futures market share of about 35% for four years, with London's then-floor-based LIFFE the dominant exchange. DTB's ability to place trading screens in Chicago had an enormous competitive impact, boosting their market share to over 95% after only a half-year of US trading, as London-based bund futures traders transferred their activity from LIFFE to DTB in response to the surging US flows. This prompted a 180 degree turnaround in LIFFE's market structure strategy, with a crash program to automate the market as its centerpiece.

At the end of 2001, US-based members accounted for 13% of total Eurex bund futures trading, indicating the enormous impact which direct transatlantic trading can have on the structure and composition of the markets. It further struck fear in the hearts of the floor-based Chicago derivatives exchanges, all of which launched automated trading initiatives as well as governance reforms to allow them to respond more quickly to competitive developments. LIFFE and the Paris-based Matif derivatives exchanges, both now owned by Euronext, also have CFTC "no-action letters" allowing US market access.

2.6. Other Structural Barriers to Efficient Cross-Border Trading

Removing regulatory barriers to transatlantic exchange operation will not in itself be sufficient to realize the full economic potential of the transatlantic securities market. There are structural barriers to achieving an optimal level of trade and post-trade transaction disintermediation; barriers which may persist at some level for some time. The three major ones derive from the ownership and governance of securities exchanges, the manner in which institutional traders choose to fund their research and trading activities, and fragmentation of the post-trade clearing and settlement infrastructure in Europe. As each of these barriers may be significantly influenced by policy intervention, it is important that we encompass them in our analysis.

2.6.1. Exchange Ownership and Governance

The traditional model of an exchange as a locally organized mutual association is a remnant of the era before trading system automation. As trading required visual and verbal interaction, exchanges were necessarily designated physical locations where traders would meet at fixed times. Access to the exchange had to be rationed to prevent overcrowding and, when single-price periodic call auctions were prevalent, to ensure that simultaneous full participation was physically feasible.

As trading "systems" were simply rules governing the conduct of transactions, exchanges were naturally run by the traders themselves as cooperatives. Organizing trading floors as companies selling transaction services would have been infeasible, as there was no "system" distinct from the traders themselves - only an empty room. Rationing access to the exchange was generally done through a combination of substantial initial and annual membership fees, in order to ensure self-selection by high-volume users. Non-members naturally wished to benefit from the network externalities of concentrated trading activity (commonly referred to as "liquidity"), and therefore paid members to represent their buy and sell orders on the exchange floor. This is how exchange members came to be intermediaries (or "brokers") for investor transactions.

The economics of automated auction trading are radically different. 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 numbers of desired access points. In a fully competitive "market for electronic markets," the traditional concept of membership becomes economically untenable. As the marginal cost of adding a new member to a trading network declines towards zero, it becomes infeasible for an exchange to impose a fixed access cost, or membership fee." Rather, only transaction-based (*i.e.*, variable cost) charging is sustainable.

Indeed, we see this trend towards reducing or eliminating membership fees clearly among automated exchanges faced with significant competition. The transactors on electronic networks, therefore, come to look much more like what are normally considered "clients" or "customers" of a firm than "members" of an association. And since an electronic auction system is a valuable proprietary product, not costlessly replicable by traders, it is feasible for the owner to operate it, and sell access to it, as a normal for-profit commercial enterprise. This contrasts with a traditional exchange floor, whose value derives wholly from the physical presence of traders.

The fact that an automated exchange can be operated as a commercial enterprise, unlike a traditional floor-based exchange, does not in itself make an economic case for a corporate rather than mutual governance structure. However, such a case emerges naturally from an analysis of the incentive structures under which a mutualized and corporate exchange operate.

Exchange members are the conduits to the trading system, and they thereby derive profits from intermediating non-member transactions. They can therefore be expected to resist both technological and institutional innovations which serve to reduce demand for their intermediation services, even where such innovations would increase the economic value of the exchange itself. If the members are actually *owners* of the exchange, they will logically exercise their powers to block disintermediation where the resulting decline in brokerage profits would not at least be offset by their share in the increase in exchange value.

Two factors in particular have driven a number of European exchanges to "demutualize" – meaning to separate exchange ownership and membership, and to extend ownership to non-members. The first is a high level of direct competition with other European exchanges (particularly relevant to Stockholm, Helsinki, and Amsterdam), and the second is the rapid internationalization of exchange membership. Greater competition reduces the ability of exchange members to block trading reforms which facilitate disintermediation, and greater internationalization of exchange membership encourages larger international banks to use exchange governance reform as a means of reducing the strategic control of smaller domestic banks and increasing their own voting rights.

Demutualization is still very much a work in progress. In the United States, only the newly minted Archipelago exchange (ArcaEx) and the International Securities Exchange, a derivatives exchange created in 2000, would currently qualify as demutualized. Our contention is that the greater the degree of broker control over an exchange, the less economic benefit from the removal of regulatory barriers to transatlantic exchange operation. This is because brokers have an incentive to use their ownership stake to block the extension of membership to remote foreign traders, and a particularly strong incentive to prevent their customers – the institutional fund managers – from gaining direct, non-intermediated trading access to the exchange. Since the economic benefits of transatlantic exchange access ultimately derive from the expansion of direct trading access to foreign brokers and fund managers, exchange demutualization is an important component of transatlantic market integration. As we have advocated elsewhere, we also believe that regulators should actively facilitate the demutualization process as a means of better aligning the interests of exchanges with those of investors.[21]

2.6.2. Commission Bundling

As we discussed above, the traditional role of brokers as intermediaries between investors and exchanges is an historical anomaly – a remnant of the era before trading system automation. Yet not only do institutional investors continue to trade overwhelmingly via brokers (particularly in Europe), but commissions rates have hardly fallen in recent years despite huge increases in trading volumes.

US weighted average agency institutional commission rates fell only 16% from 1994 to 2001, from 6.1 cents per share to 5.1 cents per share,[22] in spite of trading volumes rising nearly tenfold over this same period.[23] This compares with nonintermediated electronic trading commissions of 0.25 to 2 cents per share currently prevailing in the US market. Yet there has been no mass institutional migration to electronic platforms: institutional ECN executions actually declined from 24% of Nasdaq volume in 1996 to 19% in 2001,[24] even as *total* ECN executions rose to nearly 40% of Nasdaq volume. What accounts for the persistence of both traditional institutional trade intermediation and commission rates in the face of proliferating low-cost electronic competition?

Institutional investors typically pay for services wholly unrelated to trade execution – such as company and macro research, trading systems, portfolio analytics and (illegally) access to initial public offerings (IPOs) – via brokerage commissions. In fact, they have an incentive to cover as much of their operational expenses as possible via brokerage commissions, as these payments are made out of *fundholder assets*, rather than the assets of the fund management firm itself. This practice of "commission bundling" – or "soft commissions," when it is part of an explicit agreement with a broker – is extremely widespread in both the US and Europe, which explains why brokers remain part of the trading process even where it can be documented that the use of brokers results in more costly trades.

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21 See Steil (2002).

22 Greenwich Associates (2002a).

23 The value of shares traded in the US rose from $3.56 trillion in 1994 to $32 trillion in 2000 (Securities Industry Association, 2001).

24 Greenwich Associates (2002b).

To the extent that commission bundling persists, the full economic benefits to investors and corporate issuers will not be realized via the removal of regulatory barriers to transatlantic exchange operation. This is because such benefits, as we discussed above, rely fundamentally on the expansion of direct trading access. If US investors, for example, continue to use broker-members to trade on European exchanges, even if the SEC allows them to bypass such brokers, then trading costs will not come down as much as they could. Schwartz and Steil (2002) analyze the economics of commission bundling, and discuss how a combination of market forces and regulatory intervention can assist in ending the practice.

2.6.3. Clearing and Settlement

Necessary post-trade operations – in particular, clearing and settlement - can have a significant effect on the cost of trading. "Clearing" (or "clearance ") comprises the calculations of the obligations of transacting parties, and often utilizes the services of a "central counterparty," which facilitates the netting of transactions and credit risk management among participants. "Settlement" refers to the legal transfer of securities against funds.

Cross-border trades tend to have much higher clearance and settlement costs than wholly domestic transactions. It is nonetheless extremely difficult to compare costs across different settlement systems precisely, given that the nature of the services provided varies widely from one provider to another. The Giovaninni Report (2001) for the European Commission addressed the issue by comparing the per-transaction income of international central securities depositories (ICSDs) with that of the EU domestic CSDs, estimating the former to be 11 times higher.

Deutsche Börse Group and Clearstream International (2002) ascribe 40% of the cost premium on cross-border trades to "regulatory translation," resulting from different national laws, taxes, rules for corporate actions and the like. They estimate total cross-border transaction costs to be 30% higher for wholesale trades, and 150% higher for retail trades. Others put the average cross-border premium at a much higher level, typically around 600%.[25]

The proportion of the cost premium which can be ascribed to non-regulatory industry structure factors which the exchanges and CSDs themselves control is a matter of considerable dispute. Deutsche Börse Group and Clearstream International estimate it at 20%, but a number of prominent proposals for applying EU competition policy to CSDs appear to imply a belief that this figure is actually much higher. The European Shadow Financial Regulatory Committee (2001) has proposed that the EU bar exchanges from owning controlling stakes in CSDs, arguing that the creation of so-called "vertical silos," integrating trading system operators and CSDs (like Deutsche Börse and Clearstream), limits effective competition between exchanges and precludes the achievement of significant economies of scale and network externalities which would otherwise derive from the horizontal integration of CSDs (of which there are currently 21 in the EU, including two ICSDs). London Stock Exchange Chairman Don Cruickshank proposes a much more radical solution, requesting the European Commission to "explore how it might force Europe to use a single CSD" (2001:331).

Clearing and settlement in the US equity market takes place through a single industry utility, the Depository Trust & Clearing Corporation (DTCC). The degree to which US clearing and settlement is more efficient than that in Europe is a matter of enormous dispute: its estimation is subject to the same problems associated with comparing such costs across Europe. Nonetheless, it is widely accepted that cross-border consolidation of European CSDs would narrow the gap considerably.

[25] This widely cited figure is used by the *Financial Times* (June 3, 2002), for example.

Our proposal would not have a direct impact on the structure of the CSD industry in Europe, although it would undoubtedly result in greater pressure from new US-based participants for a consolidation of trading, clearing, and settlement platforms for widely traded European blue-chip equities. The degree to which EU competition policy and national regulatory and taxation reforms work to limit, accommodate, or force such consolidation will, however, influence the future structure of the industry enormously. The European Commission formally launched a consultation process on clearing and settlement policy on May 28, 2002, requiring all comments to be submitted by August 31.

CHAPTER 3: EU MARKET ACCESS POLICY

3.1. EU Dramatis Personae

Numerous government, inter-governmental, and supranational bodies are involved in EU securities markets regulation. We review their respective roles below.

Each Member State has its own securities market regulator or regulators, responsible, among other things, for the regulation of national exchanges. As of February 2001, there were over 40 such regulatory bodies operating in the EU. The national treasury in each Member State is responsible for designating exchanges in its country which, meeting the requirements of the Investment Services Directive, are entitled to a "single passport" to solicit remote trading members legally based in other EU countries, and to apply home country rules to their participation.

The list of exchanges having single passport rights, designated "regulated markets" by the 1993 Investment Services Directive, is maintained by the European Commission in Brussels. The Commission's Internal Market Directorate-General ("DG Market") is responsible for proposing - and, in certain limited cases, determining - EU-wide financial market regulations, which are then applied at the national level.

After receiving a formal proposal from the Commission, the Council of Ministers is responsible (according to a co-determination procedure involving the elected European Parliament) for determining the final text of EU-wide "directives," which are then transcribed into national law and implemented at the national level. The Council is comprised of representatives of the national governments. Matters related to financial markets are discussed within ECOFIN, a Council subset comprised of national economic and finance ministers.

A major drawback of this approach to EU-wide regulation is that the procedures involved can be very time-consuming, typically requiring five years between initial proposal and implementation. To address this problem, the so-called "Committee of Wise Men," (see section 3.5.1) recommended a four-level approach to European securities regulation, using existing Treaty rules. This approach was endorsed by the Council in February 2001 and by the Parliament in February 2002.

"Level 1" in the new hierarchy involves directives, as before, although the aim is now to establish only broad "framework" principles rather than detailed rules. These principles require specific approval by the Council and the Parliament.

A new EU Securities Committee, staffed by national experts and chaired by the Commission, assists the Commission in the determination and implementation of so-called "Level 2" technical measures necessary to operationalize and keep current Level 1 directives. In preparing such measures, the Commission is also advised by a new Committee of European Securities Regulators (CESR, pronounced "Caesar"), established in June 2001, comprised of national securities regulators

CESR is the focal point of "Level 3" in the new regulatory approach, being responsible for ensuring consistent and timely implementation of Level 1 and 2 acts.

Finally, "Level 4" represents a call for Commission and Member State cooperation in strengthening the enforcement of EU law. Although Level 4 is still ill-defined at this early stage of implementation, such strengthening is clearly necessary to avoid protracted legal action, which must ultimately be settled through a final judgment rendered by the European Court of Justice.[26]

[26] See Steil (1998: 19-20) on the case of discriminatory Italian "SIMS" law, which took five years to eliminate through EU legal channels.

3.2. Principles of EU Financial Regulation

The EU legislative framework for financial markets is grounded in a concept widely referred to as "competition among rules," which takes the continuing reality of separate and distinct national legal and regulatory systems as given. The principle outlined in the European Commission's 1985 White Paper supporting competition among rules is that of *mutual recognition*, according to which all Member States agree to recognize the validity of one another's laws, regulations and standards, and thereby facilitate free trade in goods and services without the need for prior harmonization. Directly derived from this principle is the Second Banking Coordination Directive provision for a single license, colloquially referred to as a "*single passport,"* under which credit institutions incorporated in any EU Member State are permitted to carry out a full range of "passported services," detailed in the Directive's annex, throughout the EU.[27] Similar guidelines are laid down for the provision of cross-border investment services in the Investment Services Directive.

Reinforcing the market-opening effect of mutual recognition is the assignment of *home country control*, which attributes the primary task of supervising a given financial institution to its home country authorities. Home country control should, in theory, provide some assurance that foreign EU firms will not be put at a competitive disadvantage by host country authorities seeking to protect domestic firms. However, a major exception to the home country control provision exists for "rules of conduct," which remain the province of the host country.

A second major principle enshrined in the White Paper is *harmonization of minimum standards*, which acts to limit the scope for competition among rules by mandating Member State conformity with some base-level EU-wide requirements. The principle is intended to ensure that "basic public interests" are safeguarded in a single market with different national rules and standards. Whether this principle facilitates or inhibits the free movement of goods, capital, and labor depends wholly upon the manner in which it is applied. It can, on the one hand, facilitate free competition by stopping Member States from erecting "standards barriers" against one another's products and services, while on the other it can inhibit free competition by barring certain products or practices from the market altogether.

Prior to the formal launch of the Single Market initiative in 1985 the harmonization approach was predominant in the drive for political and economic integration. Mutual recognition, as the Commission's White Paper made clear, was considered an inferior integration mechanism, made necessary only by Council obstructionism in the Commission's pursuit of common rules.[28]

Given that mutual recognition was therefore chosen as the basis for Single Market legislation primarily on pragmatic grounds, it is perhaps not surprising that neither the Commission nor the Council has ever enunciated a conceptual framework for determining where one approach was likely to result in more efficient market outcomes than the other.[29] However, the

[27] The institution must be authorized to carry out an activity in its home state before it can invoke its passport rights to do so in other Member States.

[28] "The harmonisation approach has been the cornerstone of Community action in the first 25 years and has produced unprecedented progress in the creation of common rules on a Community-wide basis. However, over the years, a number of shortcomings have been identified and it is clear that a genuine common market cannot be realised by 1992 if the Community relies exclusively on Article 100 of the EEC Treaty. There will certainly be a continuing need for action under Article 100; but its role will be reduced as new approaches, resulting in quicker and less troublesome progress, are agreed. . . . Clearly, action under this Article would be quicker and more effective if the Council were to agree not to allow the unanimity requirement to obstruct progress where it could otherwise be made. . . . In principle, . . . mutual recognition could be an effective strategy for bringing about a common market in a trading sense." (Commission of the European Communities, 1985:18)

[29] "I have to confess," wrote a former director-general of DG Market, "that I find myself cheerfully unrepentant in face of the criticism that the Commission has not made any serious

political dynamics of the Council have since illustrated that harmonization of rules and standards generally operates to curtail liberalization, whereas the combination of mutual recognition and home country control has proven reasonably effective in muting the influence of protectionist lobbies. The evolution of the ISD from its initial 1988 Commission draft to its 1992 approval by "qualified majority" in the Council[30] provides an excellent case study in the interplay between the harmonization and mutual recognition approaches.[31]

3.3. The Performance of the EU's Mutual Recognition Regime

A technical evaluation of the EU's "Single Market Program" (SMP) in financial services is a difficult undertaking. Basically, it requires an estimation of performance *trajectories* both before and after implementation of the relevant directives. In other words, one must estimate how the markets would have developed had it not been for the directives. In this context, distinguishing SMP effects from non-SMP regulatory effects, as well as wider technological and competitive developments, is an exceptionally difficult task. Acknowledging these important caveats, the available evidence still suggests that the SMP has not materially aided the creation of an integrated retail banking market in Europe, whereas modest success can be detected in the wholesale sector.

The most interesting survey data on the performance of the SMP in the EU banking sector come from Economic Research Europe (1997). An evaluation of the findings and critique of the study can be found in Steil (1998). Broadly, the SMP has performed poorly where it has relied on a combination of limited rule harmonization and host state control, as in the retail banking sector, and relatively well where it has relied on a combination of mutual recognition and home country control, as in the wholesale sector – particularly corporate deposit taking, corporate lending, and off-balance sheet activities.

Within the EU, a host state can legally retain jurisdiction over a foreign EU financial services provider when it considers the provider's services to be rendered "within the territory" of that host Member State. In the case of retail services, host states have claimed wide discretion in declaring services to be within their territory, rather than cross-border. This has meant, in practice, that there has been very little in the way of liberalization or cross-border competition initiated by the SMP directives covering retail financial services, and thus little in the way of EU market integration in this area. Mutual recognition is ineffective as a tool of liberalization where host states retain the right to control the core activities of foreign firms on the same basis as domestic firms.

At the other end of the financial services spectrum is wholesale securities trading. As most such business among firms domiciled in different national jurisdictions is conducted via electronic means, there is less scope for host states to exercise jurisdiction. Home state authority has therefore come to dominate cross-border securities transactions. The result has been a steady and significant rise in such activity. This is because home state control harnesses the natural advocacy tendencies of national authorities on behalf of their national financial institutions when such financial institutions seek to expand their activities cross-border. Host state authorities are typically lobbied by, and responsive to, their domestic institutions seeking protection against foreign competition. EU law provides far more scope for such protection, in the form of granting host state control, in the case of retail services.

attempt to develop a theory of harmonisation" (Fitchew 1991:1).

[30] Italy and Spain voted against the final compromise text.

[31] See Steil (1998) for a detailed account of the Directive's creation.

3.4. Mutual Recognition for EU Exchanges

Article 15.4 of the ISD provides for a "single passport" for EU trading systems, allowing a system authorized by the competent authority in one national jurisdiction to provide remote services in all the others. This single passport is a manifestation of mutual recognition and home country control, as outlined above.

The ISD single passport for trading systems, however, only applies to so-called "regulated markets." Harmonizing a definition of such markets was a source of enormous controversy within the Council of Ministers during the original ISD negotiations, which began in 1988. If an exchange or trading system was not legally a "regulated market," then it was obliged to seek explicit authorization to operate in each and every national jurisdiction in which it wished to provide services, even if only by remote cross-border electronic link. Local protectionism was therefore a real threat to any trading system operator which could not satisfy the "regulated market" criteria.

The London Stock Exchange's SEAQ International trading platform was the primary target for protectionist manipulation of the "regulated market" definition in the ISD negotiations. A significant competitor to the continental exchanges in the late 1980s, it had nonetheless been overtaken by the time of the ISD implementation deadline in 1996. Cross-border expansion of electronic trading systems proceeded rapidly in the late 1990s, but as the exchanges generally refrained from competing in each other's products there were few opportunities for testing the protectionist potential of the "regulated market" definition. This is now set to change dramatically, as evidenced by the emergence of pan-European blue-chip platforms such as virt-x[32] and initiatives by Deutsche Börse to target specific foreign stocks with high international trading interest (such as Nokia and "Dutch Stars").

[32] The author is a non-executive director of virt-x.

A significant example of the potential for protectionism has emerged in electronic bond trading. Italian regulations controlling what type of trading system operator can and cannot utilize central counterparty services for Italian government securities, and what type of institution can and cannot have access to the Italian settlement system, Monte Titoli, have given an effective monopoly in electronic trading of Italian government securities to the Italian MTS "telematico" system.

As reported in May of 2000, the Italian Treasury was interpreting a domestic regulation on the clearing of repurchase (or "repo") transactions in Italian government securities such that central counterparty services for these transactions could only be provided to "regulated markets" in Italy, as designated by the Treasury.[33] MTS is the sole operator so recognized for Italian government securities. Aspiring foreign competitors, such as eSpeed and Brokertec Global, were therefore barred from using the services of the London Clearing House, or other central counterparty service providers, to clear Italian government securities trades and to provide trading anonymity to their users. This precluded their ability to compete effectively with the Italian operator, MTS.

More recent soundings from the Italian Treasury have revealed conflicting interpretations of the current status of this particular restriction. However, there remains a separate regulatory barrier to the trading of Italian government securities, in the form of a restriction on the ability of central counterparty service providers to access the Italian settlement system, either directly or through an agent bank.[34] Despite

[33] *Wall Street Journal* (May 10, 2000).

[34] The following is part of a recent draft order from the Governor of the Bank of Italy:

"Those participating in settlement services may not settle operations for entities which, in the operation of systems referred to in paragraph 1, letter f) and paragraph 2, letters b) and c) of the present article, perform the role of central counterparty or which in any way intervene between the members of the same systems themselves, and take over in their own name the relative contractual positions."

demand to utilize their services by non-Italian bond trading system operators going back to at least 2000, the London Clearing House has yet to secure regulatory approval in Italy for any form of settlement system access.

3.5. Recent Market and Policy Initiatives

3.5.1. Report of the Committee of Wise Men

Mandated by the EU's Economic and Finance Ministers in July 2000, a "Committee of Wise Men" under Belgian central banker Alexandre Lamfalussy published a major report on the regulation of European securities markets in February 2001.[35] The primary task of the Committee was to identify policy tools to remedy the sources of "fragmentation" in the European securities markets, deriving from a legacy of nationally based market organization and regulation. The report postulated significant economic benefits to be reaped from European market integration, referring in particular to greater capital and labor productivity, which would enhance the potential for greater growth in gross domestic product (GDP) and job creation.

The report identified barriers to market integration along five dimensions: differences in legal systems, differences in taxation, political barriers, cultural barriers, and external barriers. The last of these is particularly interesting, given that the report, in conformity with its mandate, focused almost exclusively on eliminating European-based barriers to internal European market integration. The Committee specifically pointed to the fact that "EU trading screens are not authorized in the US" (p14) as its sole example of external barriers to European market integration. Whereas US trade and investment barriers are not obviously a barrier to internal European market integration as such, the Committee made clear its view that the removal of "the most pernicious trade barriers hampering the global expansion of the EU's securities industry" was itself necessary "if the full potential of an integrated European financial and securities market is to be captured" (p14).

Placing aside the obvious political dimension of European economic and monetary union, it is clear that transatlantic market integration holds vastly more promise of significantly lowering the cost of capital to European enterprises, and improving the risk-return profiles of European investors, than intra-European market integration. US investors are a major investor group in EU national markets,[36] and US companies a major component of European private pension fund holdings.

3.5.2. IAS Disclosure for Listed Companies

In March 2002, the European Parliament approved the European Commission's proposal for a "Regulation" – a form of EU-wide law binding in all Member States even without national legislation – which would require EU-domiciled listed companies to apply International Accounting Standards beginning in 2005. US GAAP would not be acceptable as a substitute. The Commission supported the Parliament's amendments to their draft Regulation, and approved the final text in June 2002.

The Commission clearly sees international political significance in the adoption of IAS throughout the EU. Commenting on the Parliament's supporting vote, DG Market Commissioner Frits Bolkestein said:

> "This crucial vote gives a strong political signal not only that the European Union is serious about achieving an integrated capital market by 2005, but also that it is ready to lead the development and

[35] European Commission (2001).

[36] Among the largest 100 non-US companies operating in the US, of which European companies comprise the majority, US investors control 20% of the total market capitalization (Glassman, 2001).

acceptance of International Accounting Standards. EU publicly-traded companies must start preparing for IAS in earnest. I hope the United States will now work with us towards full convergence of our accounting standards. Recent events, especially the Enron affair, mean there has never been a more appropriate time." (March 14, 2002).

3.5.3. Revision of the Investment Services Directive

The Commission is currently drafting significant amendments to the Investment Services Directive, which is the primary piece of European legislation governing the operations of securities exchanges and investment firms. In the process, the Commission is wrestling with many of the same issues which confront the SEC, in particular:

- How to distinguish "exchanges" from non-exchange trading systems, and how to regulate both.
- How to regulate the "internalization" of client order flow within broker-dealer firms.[37]
- How to determine the appropriate "transparency" requirements to be imposed on both on-exchange and off-exchange trades.

Furthermore, the widely noted high cost of clearing and settling cross-border securities transactions within the EU has become the focus of a major public policy debate. The Commission's current strategy, with regard to ISD reform, is to liberalize access for both investment firms and exchanges to clearing and settlement facilities in foreign EU jurisdictions. Some, however, are calling for more aggressive Commission action, such as the imposition of a single European CSD[38] or the imposition of a ban on exchanges owning controlling stakes in CSDs.[39]

The SEC has expressed a keen interest in the ISD revision process, and has been in consultation with the European Commission over its progress. In section 3.7.2 we identify one aspect of the current ISD regime (Article 15.5) which should be of concern to US exchanges seeking pan-EU market access.

3.6. The Current EU Regime Applying to Non-EU Exchanges

There are currently four ways in which non-EU exchanges can offer trading services in the EU:

1. joint venture with a European exchange;
2. takeover of an EU exchange;
3. application to an EU national authority to provide services within that national jurisdiction; or
4. application to an EU national authority to operate a subsidiary throughout the EU under the "single passport" provisions of the Investment Services Directive.

Each of these options is explained and illustrated below.

3.6.1. Joint Ventures

Euronext Paris and the Chicago Mercantile Exchange (CME), together with the Singapore International Monetary Exchange (SIMEX), operate the GLOBEX Alliance, which facilitates trading of each exchange's products on the same trading platform and cross-margining of positions. The technology platforms of Euronext Paris and the CME have been consolidated, with

[37] Internalization refers to the matching of client buy and sell orders within a broker-dealer firm, rather than through an exchange or other authorized trading system.

[38] See Cruickshank (2001).

[39] See European Shadow Financial Regulatory Committee (2001).

trading taking place on the Paris NSC system and clearing on the CME's Clearing 21 system.

3.6.2. Takeover

Currently, one US market operator, Nasdaq, offers pan-EU trading services through a European subsidiary, Nasdaq-Europe. So named after Nasdaq purchased a 58% stake in the Belgium-domiciled Easdaq exchange, a dealer-oriented market competing with the incumbent national EU exchanges for young company listings, Nasdaq-Europe is able to operate throughout the EU under the single passport provisions of ISD Article 15.4. The exchange trades both European stocks which it lists, in competition with other European exchanges, as well as US Nasdaq stocks.

3.6.3. National Authorization to Operate Nationally

Nasdaq was also given authorization back in 1988 to offer US stock trading services to intermediaries in the UK, as a "Recognized Overseas Investment Exchange", but has never made use of this right. Other major EU national jurisdictions operate comparably liberal regimes. Germany, for example, does not currently require foreign exchanges to become licensed as German exchanges by virtue of their having German members and a limited presence in the country.

3.6.4. National Authorization with ISD Single Passport

The experience of Nasdaq in Europe indicates that it is already feasible for a US market operator to establish European operations, either through the purchase of an already licensed European exchange or through an application to an EU national authority to extend US trading operations to intermediaries in that country. The latter does not necessarily require changes to any of its trading or regulatory procedures, but its scope is strictly limited to the legal jurisdiction of the country providing the authorization.

US exchanges may also attempt to establish pan-European operations in the same manner as an aspiring EU exchange: through application to an EU national authority to be designated as an EU "regulated market," according to the provisions of the ISD. This is the same sort of "national treatment" which applies, in principle, to EU exchanges which might wish to establish operations in the US: that is, they are free to apply to the SEC to be registered as a US exchange.

No US exchange has to date expressed an interest in establishing an EU exchange *de novo*. As long as the NYSE continues to operate a trading floor with a fixed number of memberships (or "seats"), remote foreign access to the exchange is not a viable business proposition.

3.7. Problems Associated with a US-EU Mutual Recognition Agreement

3.7.1. Nationally Based Exchange Licensing

As there is no legal concept of a "European Exchange," meaning that all exchanges wishing to operate throughout the EU must be authorized by an individual EU Member State national treasury, the EU as such cannot guarantee US exchange access in Europe without a major change in EU law. This would require individual EU Member States to implement national legislation allowing US exchanges to provide services within their territory. In order to ensure that the scope and terms of such legislation were fundamentally identical across Member States, an EU directive would first have to be agreed among them by qualified majority in the Council of Ministers, and approved by the European Parliament. Drafting, ratifying, and implementing such legislation across the EU would most likely require at least three years to complete.

As a practical matter, then, the US may be obliged to accept a version of a mutual recognition agreement which is less legally watertight than it might like – at least for a given period of time. At the very least, the US should want to ensure that after an American exchange were designated a "regulated market" under the ISD for the purposes of acquiring single passport rights to operate throughout the EU, all other EU Member States would accept such a designation.

The reason for this is as follows. Whereas it should not be difficult for a US exchange to secure a "regulated market" designation in a major Member State – such as the UK, which has consistently expressed its willingness to allow US exchanges to provide access within its territory – it is another matter to ensure that this designation will be respected outside that particular Member State. The logic is that exchanges in other Member States may view a given US exchange as a competitor in a given securities product, or as a potential competitor, motivating them to lobby for protection from their national treasuries. The ISD, in fact, contains conspicuous loopholes that may provide effective legal cover for protectionism against foreign, including other EU, exchanges.[40] Below we identify the clause that is potentially most troubling for US exchanges which would seek to exercise acquired single passport rights within the EU.

3.7.2. The ISD's "New Markets" Clause

Article 15.5 of the ISD states that Article 15 "shall not affect the Member States' right to authorize or prohibit the creation of new markets within their territories." This clause is redundant if its actual intent was merely to reinforce home state discretion in designating "regulated markets." But the intent appears to have been to furnish host states with an escape clause from the single passport provision for screen-based trading systems (Article 15.4). By declaring a foreign trading system to be a "new market," a host state could deny it single passport rights.

Indeed, an early sign of the potential for abuse of the new markets clause came in 1995, when the Dutch Ministry of Finance opined that a foreign screen-based system wishing to provide for remote access in the Netherlands might be considered as intending to create a "new market" in the Netherlands.[41] The Dutch position provoked considerable criticism from other EU Member States, and was never applied. If its validity were to be upheld, however, the single passport would be entirely negated. With the recent establishment of new trading platforms for equities and bonds, the potential for abuse is now considerable.

US exchanges could potentially become the first victims of this clause. Even if the European Commission were to support the designation of a US exchange as an EU "regulated market" with full single passport rights, the Commission does not have the legal authority to make this designation. Member States, therefore, would not be legally obliged to respect it. There are three ways in which this problem could be effectively addressed:

1. The Commission could propose a formal "Level 1" revision to the ISD, most likely as part of their current initiative to make a number of significant amendments to the Directive. This could require several years to gain the approval of the Council and the Parliament, to be followed by several more before ratification by all the Member States.
2. The Commission could invoke the "comitology" process vis-à-vis the Securities Committee, and treat the amendment or elimination of Article 15.5 as a "technical" change not

[40] These are explained in depth in Steil (1996, 1998). Steil (2001) proposes precise revisions to the ISD text to mitigate their protectionist potential.

[41] Steil (1995).

requiring the approval of the Council or the Parliament. This approach may provoke objections from Member States and/or the Parliament that the Commission is exceeding its authority.

3. ECOFIN could produce a formal statement affirming that no Member State would invoke Article 15.5 to prevent US exchanges from operating in the EU. Such a statement would have a dubious legal status, but would clearly pose a reputational threat for any Member State which would violate it. The European Court of Justice would be the ultimate arbiter in the case of an internal EU dispute over the applicability of Article 15.5.

3.8. Conclusions: A Blueprint for EU Action on US Exchange Access

The European experience with mutual recognition in financial services suggests strongly that host country regulatory control must be strictly circumscribed in order for it to be effective, and that focusing exclusively on wholesale market participants is the most reliable means of keeping host state authorities at bay. Limiting the scope of a transatlantic agreement to *secondary trading* (and not primary market offerings) and to *exchanges* (and not intermediaries with retail clients) is the best way to ensure that investor protection is not invoked, either as a genuine regulatory concern or a pretext for protectionism, to justify SEC interference in EU exchange operations or EU regulator interference in US exchange operations.

Technical legal barriers to establishing a regime guaranteeing US exchange access in Europe will be difficult to eliminate quickly. As a practical matter, however, such barriers are not currently inhibiting the immediate expansion plans of any US market operator. The NYSE's present trading technology and governance structure give it little reason to pursue remote foreign access strategies. Nasdaq and the CME have chosen to pursue transatlantic alliance and merger strategies which have thus far circumvented any legal snafus that might accompany unilateral expansion initiatives. Further, more substantial, transatlantic exchange mergers are clearly in the offing.

Nonetheless, the continuing trend towards trading automation and disintermediation suggests that direct unilateral transatlantic access will become a higher strategic priority for US exchanges in the not too distant future. In negotiating transatlantic access rights with US authorities, the European Commission, backed by ECOFIN, needs therefore to be able to provide credible guarantees that US exchanges will be able both to secure "regulated market" (or equivalent) status within any EU national jurisdiction, at least for the trading of securities of non-EU-domiciled issuers, and to utilize the accompanying "single passport" effectively in all other EU jurisdictions.

Guaranteeing effective EU market access requires, in particular, the elimination of ISD Article 15.5, or an effective means of exempting US exchanges from its purview. As US GAAP disclosure will, under current regulations, continue indefinitely to be permitted for non-EU companies listed on EU exchanges, disclosure standards are not currently, and should certainly not be made into, an entry barrier for US exchanges.

Below we summarize the primary policy conclusions on US exchange access which emerge from our analysis.

- In discussions with US authorities, the EU should be represented by the European Commission, in consultation with the Committee of European Securities Regulators (CESR).
- There being no legal concept of a "European Exchange," US exchanges wishing to provide direct trading access

throughout the EU will necessarily be required first to obtain recognition in any Member State as a "regulated market," as defined by the Investment Services Directive.

- US exchanges should be specifically authorized to provide direct electronic trading access to registered EU broker-dealers or institutional investors for the securities of non-EU domiciled issuers which make their required periodic financial disclosures in accordance with either US GAAP or IAS.
- Such exchanges will be regulated by the US SEC, which will be required to have in place a "memorandum of understanding" with the designated regulatory body of the authorizing Member State regarding information sharing and cooperation in investigations of suspect trading practices.
- As all US registered exchanges already meet the broad requirements laid out in the ISD for designation as a "regulated market," European finance ministers should, through ECOFIN, produce a formal statement expressing their firm commitment to allowing US exchanges to acquire this status in any Member State without the imposition of additional legal or regulatory requirements.
- In this statement, the finance ministers should also express their firm commitment to allowing any US exchange so designated in any Member State to operate throughout all other Member States under the "single passport" rights enumerated in Article 15.4 of the Directive, and should forswear the use of Article 15.5 as a means of denying them such rights. We further recommend the elimination of Article 15.5 during the current process of revising the Directive

CHAPTER 4: US MARKET ACCESS POLICY

4.1. The SEC's Position on Foreign Market Access

In 1997 the SEC issued a "Concept Release" on the "Regulation of Exchanges."[42] This document contains a large segment detailing the SEC's thinking on the regulation of foreign market activities in the United States. While presented in the context of the need to "revise" such regulation, the release makes clear that there is much foreign market trading activity already going on in the US over which there is no clear regulatory regime in operation.

The SEC notes a 4,700% increase in the trading of foreign securities by US residents in the fifteen years to 1995. The Commission further notes the role of "advanced technology" in facilitating such trading, as evidenced by the ability of US investors to trade directly on overseas exchange trading systems via so-called "pass-through" electronic linkages provided by both US and foreign broker-dealers and other access providers. Instinet, for example, a US-registered institutional agency broker, operates electronic linkages to 17 exchanges outside the United States, making those exchanges' electronic trading systems directly accessible by the firm's clients. Such activity, however, has never been explicitly authorized by the Commission:

> "The Commission to date has not expressly addressed the regulatory status of entities that provide US persons with the ability to trade directly on foreign markets from the United States. While some access providers may be registered as U.S. broker-dealers because of their other activities, the lack of regulatory guidance in this context has discouraged other parties from offering US persons foreign market access. Similarly, foreign markets have been reluctant to permit US persons to become members of their markets without assurance from the Commission that they would not be required to register as national securities exchanges." (pp78-79)

The Commission recognizes, however, the benefits which could accrue to US investors from allowing foreign exchanges to provide more direct access into the United States, deriving from the ability of investors to cut one or more layers of brokerage, or "pass-through" linkage, out of the trading process:

> "Direct U.S. investor access to foreign markets could provide significant benefits to US investors. Such access may provide these investors with entirely new investment opportunities, and may significantly reduce their transaction costs." (p93)

The Commission's stated concern, however, is that direct access implies certain risks:

> "Although these are positive developments, they also raise concerns that the activities of foreign markets in the United States could adversely affect not only U.S. investors, but also the U.S. securities markets." (p94).

The risks to US investors, in the Commission's view, derive from three primary sources:

1. a "lack of comparable information" about foreign companies which do not meet SEC reporting and disclosure requirements,
2. risks related specifically to the act of trading on foreign markets, and

[42] Securities and Exchange Commission (1997).

3. the inability of the SEC effectively to "enforce the antifraud provisions of the U.S. securities laws," (p8).

The Commission never specifies how "the US securities markets" as such may be adversely affected, but does refer several times in the document to the ability of trading technologies to eliminate long-standing distinctions between domestic and foreign trading markets. One can therefore infer a Commission concern over the impact of blurring regulatory jurisdictions on how and where US securities are traded.

4.1.1. The SEC's Proposals for Regulating Foreign Market Activities in the US

The SEC indicates that its aim is "to develop a consistent, long-term approach that clarifies the application of the US securities law to the U.S. activities of foreign markets. Any such approach," it continues, "must not impose unnecessary regulatory costs on cross-border trading and, at the same time, *must allow the Commission to oversee foreign markets' activities in the United States and protect US investors under the US regulatory framework*" (p79, italics added).

Whereas the Commission explicitly acknowledges the necessity not to impose "unnecessary regulatory costs," it insists on a particularly costly standard for determining necessary regulation; that is, explicit oversight of foreign market activities by the Commission itself, and protection of US investors "under the US regulatory framework." This standard is reflected in the Commission's evaluation of the merits and limitations of the three regulatory options it poses:

1. to rely on home market regulation;
2. to require foreign markets to register as US "national securities exchanges;" or
3. to regulate trade access providers, rather than the foreign markets themselves.

We discuss each of these options in turn.

4.1.1.1. Home Market Regulation

The SEC lists three "advantages" to relying on a foreign exchange's home market regulator:

1. greater "regulatory certainty" for foreign market operators;
2. provision of services to US investors at lower cost; and
3. consistency with "principles of international comity," which support home country regulation of trading in securities of that country's issuers.

The Commission then alleges "significant drawbacks" to this approach; drawbacks which would appear to indicate that the SEC will not accept home market regulation. The SEC notes that "trading on a foreign market through an access provider is often indistinguishable from trading on a domestic market," and that "these similarities could lead many investors to expect that such trading would be subject to the same protections provided by the U.S. securities laws," (p79).

In the case of institutional investors, it would appear implausible that they would be unaware that they were trading on foreign markets, or that trading on foreign markets is subject to different regulations and standards than apply in the US market. These investors are already well versed in the enormously different trading rules and protections which apply *within* the US market, between the NYSE and Nasdaq in particular, not to mention those between the US and non-US markets.

Within the EU, the ISD's mutual recognition regime is fundamentally premised on the notion that professional investors fully comprehend that trading on different national marketplaces implies that different rules will be in operation. Rule differences across national markets have, in fact, been a lesser source of public criticism among institutions than alleged inconsistency in the application of rules *within* national markets. The salience of the latter was well illustrated by the reaction of UK domestic and international fund managers to the UK government's role in triggering the collapse of Railtrack shares.[43]

Individual investors are certainly less likely than institutional investors to be aware of legal and regulatory differences across markets. While it might seem a simple matter to require brokers to inform investors where US legal and regulatory jurisdiction does not apply, the SEC does not appear apt to accept "caveat emptor" as the guiding principle for such investors.

Foreign markets, according to the SEC, frequently do not provide US investors with "the same protections;" a fact which it deems unacceptable. It defines such protections in terms of "disclosure of trading rules, transparency, timely transaction reporting, and T+3 clearance and settlement" (p82), with additional references to bans on insider trading and legal requirements for "market makers and specialists to have firm quotes, and to display certain customer limit orders (p80)." We deal with each of these items below:

- **Disclosure, transparency, and reporting.** All EU markets have statutory rules related to trade publication and reporting. The SEC makes much of the fact that 90 second public dissemination of trades is a requirement for most stocks traded in the US, whereas many foreign markets permit delayed publication of large block trades when the agent is acting in a dealership, or risk-taking, capacity. Yet this does not represent a proper basis upon which to characterize US markets as being more "transparent" than other markets. First, it ignores the fact that the 90 second rule is effectively unenforceable, and flouted widely as a matter of standard industry practice for large risk trades. In an international survey of institutional fund managers accounting for 15% of world mutual and pension funds, Schwartz and Steil (2002) found that 41% of North American institutions reported that their dealers "regularly" or "very frequently" (*i.e.*, over half the time) intentionally delayed publication of risk trades over $5 million in size. The comparable figure in Europe, where delayed publication is generally accommodated in the regulations, was only 8%. Second, the majority of EU market trades take place on automated public limit order books, and are therefore electronically disseminated to the market within several seconds, rather than "within 90 seconds."

- **T+3 clearing and settlement.** "T+3" refers to the fact that cash and securities legally change hands three days after a trade. All EU markets settle on a T+3 cycle or shorter.

- **Insider trading.** Trading on all EU exchanges is subject to national insider trading rules and sanctions, which are themselves in accordance with the 1989 EU Insider Dealing Directive. The European Commission proposes to update the rules on insider trading and market manipulation, taking account of the potential growth of non-exchange trading systems, through a new Market Abuse Directive. Given the number of high profile investigations of possible insider trading rule violations in the United States over the past year, it would be difficult to identify a reasonable basis upon which to maintain that European markets were systematically more prone to such abuse.

- **Mandatory display of quotes and limit orders.** This benchmark has elements which are not relevant and others which do not favor the US markets. First, the prevalence of "market makers

[43] See, for example, *Financial Times* (March 6, 2002).

and specialists" in the US markets makes the US an outlier among world markets. Most other markets around the world have replaced market-maker and specialist-based trading systems with automated trading platforms, where such intermediaries are unnecessary and therefore generally not built into the trading structure. Second, the fact that market makers and specialists are required to make firm quotes does not constitute a "protection" for investors: exchange members do not provide quotes as a *pro bono* public service obligation. On the contrary, in each US marketplace where market makers or specialists are used, such as the NYSE and Nasdaq, the rules have traditionally operated to protect them from disintermediation by investors who might not wish to pay for their services, or who do not believe that such intermediaries act in investor interests. Finally, regarding public display of investor limit orders, the automated European markets have this built into their trading technology, whereas the NASD and the SEC itself found that Nasdaq dealers frequently - and some dealers, systematically – illegally flouted the market's manual limit order display rule.[44] Furthermore, EU exchanges and regulators generally consider strict "price-time priority"[45] for limit orders to be an essential investor protection tool, yet neither the NYSE floor auction structure nor the Nasdaq SuperMontage trading system provide such protection.

[44] See, for example, this National Association of Securities Dealers (2000) press release entitled "NASD Regulation Fines J. P. Morgan $200,000 for Limit Order Violations": www.nasdr.com/news/pr2000/ne_section00_131.html.

[45] "Price-time priority" indicates that limit orders at the highest bid and lowest offer price are executed in strict accordance with the order in which these bids and offers are entered into the market.

In short, there is simply insufficient evidence to support a claim that EU markets operate according to lower standards than US markets – and certainly not with regard to the specific items of concern raised by the SEC.

4.1.1.2. Requiring Registration as "National Securities Exchanges"

The option to apply for recognition as a US national securities exchange has existed since 1934, and has never been taken up by a foreign securities exchange. This is because of the enormous legal and regulatory costs involved in establishing what is, in effect, an entirely new US entity; not to mention that the fact that its listed securities could not actually be traded without the issuers fulfilling SEC registration and GAAP financial disclosure requirements.

Deutsche Börse, the German exchange, formally commented on this regulatory option as follows:

> "Deutsche Börse does not . . . believe that requiring foreign exchanges to register with the Commission as a national securities exchanges would, as [a] practical matter, allow foreign exchanges to provide US members with efficient direct access to their trading facilities. Even with the benefit of any exemptive relief the Commission may choose to grant pursuant to its new authority under Section 36 of the Exchange Act, the procedural burdens and costs of submitting to a second regulatory regime, with different information disclosure standards and recordkeeping and other regulatory requirements, will deter foreign exchanges that contemplate only limited activities in the United States

> from offering membership to registered broker-dealers and highly sophisticated investors in the United States." (Franke and Potthoff, 1997).

The SEC has only conferred national securities exchange status on two entities in its entire 68-year history: the International Securities Exchange, a derivatives exchange, in 2000; and Archipelago, also a Nasdaq ECN, in 2001.[46] The latter waited over two years from its August 1999 filing date to secure SEC approval. As a strategy to speed up the process, Archipelago had bought the commercially unviable equity floor trading operations of the Pacific Stock Exchange in March 2000 (closing the floor two years later), giving the Exchange a 10.8% stake in the company valued at about $40 million. In buying an existing "self-regulatory organization" (SRO), Archipelago had hoped, apparently without justification, that the SEC would look more favorably on their ability to regulate a market, and therefore confer exchange status on them quickly. The $40 million price tag on the SRO and the 27-month approval period, however, give an idea of the cost and time commitment a foreign exchange might be obliged to bear in order to become a registered US exchange.

There is a "loophole" in the exchange registration regime which the SEC has used to permit two exchanges to operate in the US without meeting the full requirements of registration. This loophole is to be found in Section 5 of the 1934 Exchange Act, which allows the SEC to exempt an exchange from the registration requirement where "in the opinion of the Commission, by reason of the limited volume of transactions effected on such an exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration." This low-volume exemption was conferred on the (now-defunct) Arizona Stock Exchange in 1991 and on UK-based Tradepoint in 1999.

At the time of its application to the SEC in 1997, Tradepoint was trading UK stocks in competition with the London Stock Exchange (LSE). Its volume was less than 1% of the LSE's. The SEC exemption stipulated that Tradepoint could offer its trading services direct to US members under the condition that its volume remained under 10% of the LSE's. Bids and offers in non-US-registered shares traded on the system would be "available only to QIBs [qualified institutional buyers],[47] non-US persons, and international agencies."

Although the meaning of the word "available" is ambiguous, consistency with the 1997 Concept Release would suggest a liberal interpretation: that is, whereas individual investors and those institutions smaller than QIBs could only trade on Tradepoint via a US-registered broker-dealer, electronic "pass-through" access provided by the broker-dealer would satisfy the intermediation requirement. Our report is advocating the extension of precisely this such regime to all EU exchanges, although without any "limited volume" criteria.

Tradepoint subsequently changed its business strategy twice: offering pan-European blue-chip trading in 1999, and becoming the dominant market for Swiss SMI index stocks through the sale of a 40% stake in the company to the Swiss Exchange in 2001. The latter transaction involved changing its name to virt-x. The SEC allowed virt-x to inherit the Tradepoint exemption, but prohibited it from trading Swiss securities in the United States, under the logic that its Swiss volume was not "low." The SEC continued to apply the trading barrier of 10% of LSE turnover to virt-x's non-Swiss volume,

[46] The other primary US exchanges pre-dated the SEC.

[47] As defined under Rule 144A of the 1933 Securities Act (see section 4.3.2). To be recognized as a QIB, the investor must own and invest on a discretionary basis at least $100 million in securities not associated with the QIB. The eligibility threshold for broker-dealers is $10 million. Banks and savings and loan associations must have a net worth of at least $25 million, in addition to meeting the $100 million investment requirement.

despite the fact that virt-x, unlike Tradepoint, has never focused on UK shares. Owing mainly to internal financial resource constraints, Tradepoint never made significant use of the right to operate in the US, and virt-x has never made any use of it.

The low volume exemption is, logically, a perverse basis upon which to confer access rights to foreign exchanges. All else being equal, investors are clearly better protected trading on a long-established, well-capitalized, and liquid market than on a new, financially constrained, and illiquid one. Given the SEC's primary mission of protecting US investors, it cannot be sensible to continue to confer access rights on foreign exchanges on the basis of whether their trading volume is sufficiently "low." Such a policy further raises the question of what the SEC would do were an exempted exchange to achieve "high" volume on the basis of enthusiastic US participation. Presumably, the Commission would be obliged to repeal its exemption, thus requiring the exchange to cut off its satisfied American clientele.

Finally, there is a vast inconsistency in the way the "exemption" approach is applied to foreign stock exchanges by the SEC and derivatives exchanges by the CFTC. US access rights for foreign derivatives exchanges have been subject to tremendous regulatory volatility since 1997. Access rights were first granted to one exchange (DTB, now Eurex) for one product (10-year bund futures) in 1997, partially suspended (US membership was frozen) after effective lobbying by the Chicago derivatives exchanges in 1998, opened up to all qualifying foreign exchanges for most foreign derivative products after a change in CFTC chairman in 1999,[48] and explicitly withheld for single stock futures and "narrow" index derivatives after the Treasury mandated joint SEC-CFTC regulation of such products in 2001. The inconsistency of approach over time and across products undermines the integrity of US market regulation, and encourages wasteful regulatory arbitrage activity to avoid restrictions which serve no purpose related to investor protection.

4.1.1.3. Regulating Trade Access Providers

The third option proposed by the SEC is to impose specific new regulatory requirements on those entities providing electronic access to foreign markets, rather than trying to regulate the foreign markets themselves. The obvious benefit to foreign exchanges of such an approach is that they would not need to adapt their rules or structures to SEC requirements, nor would they themselves be directly subject to SEC regulation. The approach would, however, raise the cost of accessing these exchanges, and may involve significant restrictions on the securities to which intermediaries could offer US investors direct trading access.

The SEC suggests that foreign market access providers can be divided into two general classes for regulatory purposes: broker-dealers and everyone else. Both classes would be required to meet regulatory requirements related to their foreign market access activities, such as recordkeeping, reporting, disclosure, and antifraud undertakings.

Many of these requirements already apply to broker-dealers, but a new one would be significant: "disclosure [to clients] of the specific risks relating to the trading on foreign markets,"(p86). Needless to say, it is exceedingly difficult to determine precisely what "risks" are uniquely related to trading on a specific foreign market, rather than trading on, say, the New York Stock Exchange. Such a requirement is likely, therefore, to subject brokers which are already providing such access, such as Instinet, to new legal risks deriving from client trading activity. Furthermore, foreign broker-dealers which are currently exempted from registration under Rule 15a-6 would either lose their exemption if they wished to provide foreign exchange access, or would be made subject "to

[48] European derivatives exchanges Eurex, Matif, and LIFFE operate in the US under "no action" letters from the CFTC.

a regulatory framework tailored to their access provider activities," (p87).

The SEC suggests that non-broker-dealers providing electronic access services to US members of foreign exchanges could be required to register as "Securities Information Processors" (SIPs), a specific category of regulated institution defined in Section 11A of the Exchange Act. This would involve a significant expansion of the SIP registration requirement and the regulatory purview of the SEC, as, to date, only so-called "exclusive processors" – five major US market institutions[49] - have been required to register.

Both of these new regulation requirements have the potential to raise the cost of trade intermediation on foreign exchanges and to deter the participation of intermediaries which do not wish to bear the fixed cost and legal risk of registration and compliance. It would further limit the power of foreign exchanges to reduce trade intermediation costs by offering their own access service direct to US QIBs. Finally, it would impose these costs and legal risks without the SEC having provided any evidence that the foreign market access services currently provided to US investors are failing adequately to protect the interests of these investors.

More significantly, the SEC suggests that this approach may need to be accompanied by a requirement that both broker-dealers and access providers should have their activities on foreign markets restricted to those securities registered with the Commission in accordance with Section 12 of the Exchange Act. This is because non-registered securities are issued by companies which may not meet US disclosure and accounting standards. As this is the most serious concern which the SEC expresses about US investor access to foreign markets, we address it in detail below.

[49] The Consolidated Tape Association, the Consolidated Quotation System, the Securities Industry Automation Corporation, Nasdaq, and the Options Price Reporting Authority.

4.2. Financial Disclosure Issues

At the heart of the SEC's emphasis on financial disclosure as the most essential element in investor protection is the belief that the application of US GAAP by listed companies is itself the only effective guarantor of such protection. This belief needs to be scrutinized on two separate grounds. First, there are multiple dimensions along which investor protection can be assessed, and the impact of financial disclosure standards must be measured along each. Second, regulatory barriers to the trading of non-GAAP securities may not merely protect investors against trading losses associated with insufficient financial disclosure: such barriers may increase the risk or reduce the expected returns on their investment portfolios. These effects must also be considered.

Below we examine the justification for and the impact of disclosure-related trading barriers in detail. We focus first on issues related directly to investor protection, and then examine the use of disclosure standards to protect other constituencies.

4.2.1. Disclosure Standards and US Investor Preferences

The SEC's insistence on GAAP reconciliation presumes that GAAP disclosure is more informative than disclosure based on standards used anywhere else in the world. Yet studies of the relative efficiency of US and European securities prices provide no support for this view.[50] This finding may reflect the fact that disclosure variations across countries are not always a sign of more rigorous and less rigorous requirements, but rather an appropriate reflection of differences in the underlying legal and business environments: for example, differences in patterns of business ownership (including cross-shareholdings) and financing, taxation practices, employment obligations, and

[50] See the excellent surveys by Edwards (1993) and Baumol and Malkiel (1993).

legal systems.[51] Reconciliation to US GAAP may in some cases, therefore, provide a misleading "veneer of comparability"[52] across US and non-US company disclosures.

A compelling recent example of the dangers of such a "veneer" are Deutsche Bank's second quarter 2002 GAAP financial figures. For its 2001 Annual Report, released in March 2002, Deutsche Bank applied GAAP accounting (changing from IAS) for the first time. Deutsche Bank explained the switch as having been necessitated by its NYSE listing, although reconciliation would have been sufficient.

Owing to a wholly inappropriate synthetic tax charge mandated under GAAP rules, and not under IAS, Deutsche Bank's net income figures are not only hugely distorted for 2002, but will likely be so through 2004, as Deutsche Bank continues to dispose of industrial holdings and incur GAAP tax accounting charges without incurring any actual tax liability. Hein (2002) explains that:

> ". . . the reason behind this strange tax rule variation under US GAAP is that US financial companies simply do not have industrial holdings (they are not allowed). The US GAAP rules are not designed for German banks with their huge industrial holdings. However, they considerably distort net income and EPS from 1999 onward (the period that has been restated under the US GAAP rules) and in our view, do not really help to give a 'true and fair view' of Deutsche Bank's profit development,"(p5). "Taking all this into account, we would suggest that Deutsche Bank reconsiders its US GAAP experiment and returns as soon as possible to IAS accounting before its confuses investors even more," (p7).

There is simply no evidence that US investors value GAAP disclosures more highly than IAS disclosures, at least for European companies. The reverse appears to be the case. A recent survey of major US institutional investors in European equities found that 71% considered the use of IAS by European companies to be very important, whereas only 42% considered the use of US GAAP to be very important.[53]

What about the quality of markets generally under GAAP and IAS regimes? A recent study focused on the relevance of the choice between GAAP and IAS for two prominent measures of market quality: bid-ask spreads and trading volume. Examining stocks listed solely on the Neuer Markt small-cap section of Deutsche Börse, where firms were required to choose US GAAP or IAS in preparing their financial disclosures, Leuz (2001) found no economically or statistically significant difference in spreads or turnover between GAAP and IAS firms.

Finally, materially inadequate or inaccurate financial disclosures are far more likely to be a result of improper internal accounting controls or lax external audits than, say, the application of IAS rather than US GAAP. The collapse of Enron in 2001 provided a particularly vivid illustration of this, as its GAAP-mandated disclosures earned it the ranking of America's seventh largest company by market capitalization only months before it filed for Chapter 11 bankruptcy protection. Subsequent SEC and, in some cases, Justice Department investigations into the accounting practices of WorldCom, Tyco, Global Crossing, Qwest, Adelphia Communications, AOL Time Warner and other "blue chip"

[51] See, for example, Choi and Levich (1996).

[52] Baumol and Malkiel (1993:21).

[53] Brunswick Group (2002). The study is based on research carried out in August 2002 by Rivel Research Group. Interviews were conducted on a non-attributable basis with analysts at 72 institutions and portfolio managers at 54. In aggregate these accounted for $674bn in European equities.

companies provide further evidence that the focus on GAAP disclosure standards in discussions with the Europeans is not consistent with a focus on protecting US investors.

4.2.2. Disclosure Standards and Foreign Issuer Preferences

The SEC presumes that investors value quality corporate financial disclosures, yet in *mandating* GAAP reconciliation for foreign issuers it seems further to presume that investors will not actually reward foreign companies with higher valuations when they bear the additional costs of GAAP compliance. Otherwise the mandate would be unnecessary.

In fact, studies indicate that non-US firms which cross-list in the US appear, on average, to benefit from a higher share price, and therefore a lower cost of capital, after the cross-listing.[54] As Coffee (2001) explains, there are two competing explanations for this effect. The first is the "segmentation hypothesis," which holds that cross-listing increases share value by allowing firms to overcome investment barriers, such as regulatory restrictions and taxes. The second is the "bonding hypothesis," which holds that cross-listing increases share value by allowing firms to "bond" themselves to a regulatory regime which is more attractive to investors, possibly because of more informative financial disclosure rules or superior minority shareholder protection.

If the US were to allow European exchanges to provide for direct QIB access in the United States, under home country control, then the segmentation logic for cross-listing would disappear: that is, any European firms which would continue to cross-list in the US would clearly be doing so because of the positive anticipated bonding effect. The disappearance of the segmentation effect should logically be very welcome by the SEC, provided that the bonding hypothesis holds, since this would indicate that non-US firms will adopt US standards of their own accord where investors demonstrate a demand for such voluntary compliance.

Several recent studies lend support for the bonding hypothesis. Doidge *et al* (2002) find compelling evidence that the valuation premium that has been widely detected for non-US firms listing in the US is correlated with proxies for investor protection in their home market. In particular, they suggest that companies which choose to list in the US are specifically looking to signal a high level of minority shareholder protection, with its attendant guarantees that controlling shareholders are limited in their abilities to extract private benefits from their control.

Another recent empirical analysis, examining the costs and benefits to non-US companies of raising capital via privately placed and publicly placed American Depositary Receipts, lends support for the intuition that there is no economic benefit in obliging foreign firms to meet GAAP disclosure requirements.[55] Firms are shown to self-select, with those that derive net benefits from higher disclosure choosing to meet the requirements and to list publicly, and those which do not choosing to use private placements instead. Further, companies from countries with lower accounting standards are more likely than those from countries with higher standards to list in the US,[56] and on average outperform their local market returns benchmarks in the three years after a US listing by a much greater degree.[57] This is further evidence of a bonding effect, as well as evidence that European firms derive relatively little benefit from it. They would therefore benefit significantly from an elimination of the segmentation effect via removal of US regulatory barriers to cross-border exchange access.

[54] See Coffee (2001) for a summary of these studies.

[55] Sarr (2001)

[56] Hargis (2000)

[57] Foerster and Karolyi (2000)

4.2.3. Disclosure Standards and Insider Trading

Allegations of greater insider trading, and more lax insider trading regulation, outside the US have greater or lesser merit depending upon the national market in question. Yet whereas insider trading in non-US stocks may harm US investors, its occurrence is not mitigated by GAAP reconciliation.

4.2.4. Disclosure Standards and Regulatory Arbitrage

Since US investors are free to trade non-GAAP securities abroad, and do so with greater and greater frequency, they cannot logically be afforded greater protection by a ban on trading them in the US. As Romano has argued,

> ". . as long as investors are informed of the governing legal regime, if promoters choose a regime that exculpates them from fraud, investors will either not invest in the firm at all or will require a higher return on the investment (that is, pay less for the security), just as bondholders charge higher interest rates to firms bearing greater risk of principal non-repayment," (1998:2366).

In fact, experience with the SEC's imposition of Section 12 registration requirements on Nasdaq stocks in 1983 indicates that investors are *less* protected when companies are subjected to an excessively costly disclosure regime. These requirements clearly promoted the trading of previously eligible securities in less regulated and less transparent foreign jurisdictions, as well as over-the-counter markets (the Electronic Bulletin Board and "pink sheets") operated by Nasdaq.[58]

4.2.5. Disclosure Standards and Mutual Fund Costs

Even if SEC disclosure requirements could somehow be lauded for making it more difficult for small investors to trade foreign securities, these requirements unnecessarily increase the cost of their professionally managed mutual and pension funds. Institutional investors, for whom the SEC does not believe that its disclosure requirements are necessary, must obviously pass on the higher costs of trading securities abroad, and through redundant intermediaries, to their individual fundholders.

Institutional control of equity holdings in the United States has grown dramatically over the past two decades. US institutional holdings of US stocks rose from 29.3% in 1980 to 47.5% in 1990[59] to 58.9% in 2000,[60] and that figure is higher still for non-US stocks. By continuing to premise its investment restrictions on a putative need to protect (generally wealthy and better educated) retail traders, the SEC reduces diversification opportunities and lowers investment returns for an increasingly large majority of the US population year on year.

4.2.6. Disclosure Standards and the Protection of US Issuer Interests

Assume that the SEC preference for US GAAP turns out to be justified, in that US investors lose money investing in non-US companies because such companies failed to make GAAP-quality financial disclosures. US companies would then clearly benefit from blanket GAAP compliance, and the entire burden of disclosure risk would be borne by non-US companies. US issuers cannot logically be harmed, therefore, if the SEC is correct in its belief that US investors are hurt by inferior foreign disclosure standards.

[58] See Edwards (1993)

[59] Securities and Exchange Commission (1994).

[60] Securities Industry Association (2001).

4.2.7. Disclosure Standards and the Protection of US Exchange Interests

Now assume that the SEC preference for US GAAP turns out to be justified in another sense: that US companies seek to exploit a transatlantic mutual recognition agreement by threatening to de-list in the US and re-list in the EU, where the financial disclosure regime is supposedly less costly. Thus, the GAAP requirement for US exchange listings will threaten the survival of US exchanges, as mutual recognition will trigger mass de-listing.

This argument, although widely raised, has no practical merit. A firm with a substantial US presence, as measured by business activity and investor residence, is subject to US securities law regardless of where its securities are listed.[61] US firms, for better or for worse, cannot choose to opt out of US financial disclosure rules. Such regulatory arbitrage is thus not possible without a major change in US securities law.

A "level playing field" argument is frequently made against allowing foreign exchanges to offer more efficient trading links into the United States so long as US exchanges are obliged to enforce a US disclosure regime. Yet as former SEC officials Edward Greene and Linda Quinn concluded:

> "…concerns not to disadvantage the NYSE and the Nasdaq by allowing foreign exchanges to establish linkages in the United States which would facilitate US investors' trading in offshore securities has seriously impeded SEC market efficiency initiatives," (2001:5-6).

"Level playing field" concerns are an inappropriate basis on which to continue impeding such initiatives, particularly given that few European issuers would actually wish to bear the costs of a US exchange listing once their home exchanges were able to provide efficient US market access for trading in their securities.

This is well illustrated by the failure of the EUROLIST initiative of the Federation of European Securities Exchanges (FESE). Launched in September 1995 and shut down a year later, the scheme allowed a company to be listed on all FESE member exchanges on the basis of a single listing fee. Although 65 companies from 11 countries had signed up by June 1996, trading remained concentrated on the home exchange, where the shares were liquid. More recently, EU firms have been *de-listing* from EU exchanges on which they had secondary cross-listings, as liquidity has frequently all but dried up outside the home exchange. As reported recently on *eFinancialNews:*

> "The decision by Fineco, the Italian asset management firm, to delist from Germany's Neuer Markt has cast further doubt on the benefits of European companies being listed outside their domestic market," (August 29, 2002).

4.2.8. Disclosure Standards and the Protection of the SEC

The rhetoric of investor protection aside, the SEC has historically shown a willingness to waive financial disclosure requirements only where its own authority has come under competitive threat from alternative jurisdictions.[62] This is most evident in the area of domestic debt issuance, where the creation of the Eurobond market in the 1960s offered US corporations a highly cost-effective means of bypassing US regulation. In contrast, the SEC has not relaxed requirements in areas where its jurisdiction is exclusive; in particular, domestic equities. The "extra-legal" expansion of cross-border electronic brokerage, and the increasing role of CFTC-regulated

[61] See, for example, Romano (2001:392).

[62] See Romano (1993).

derivatives as a substitute for cash products, however, may over time push the SEC toward mutual recognition as a means of retaining some nominal authority over the trading of foreign equity products by US investors.

The fact that the SEC has, for many years, been formally considering allowing foreign issuers to list on US exchanges under the IAS disclosure regime should be seen in this light. Under enormous pressure from its fellow national securities agencies within the International Organization of Securities Commissions (IOSCO) to agree to IAS use by foreign issuers, the SEC has undoubtedly come to see the risks of isolation. IAS could become the global accounting standard, outside of the US, without the SEC having any influence over IAS or the firms applying it. Thus the SEC has an incentive to accommodate IAS for foreign issuers as a means of retaining influence over the future development of IAS and the institutions which trade IAS securities.

4.3. The SEC's Existing Home Country Control Arrangements

Below we review past experience with mutual recognition and home country control of foreign securities trading in the US, and draw implications for the drafting of a US-EU agreement on transatlantic exchange access.

4.3.1. The US-Canada Multi-Jurisdictional Disclosure System

The SEC's most significant experiment with mutual recognition and home country control has been the Multi-Jurisdictional Disclosure System, the result of a bilateral agreement with Canada[63] which came into effect on July 1, 1991. Whereas the stated aim of the agreement was to facilitate reciprocal access for US and Canadian companies to each other's national capital market, in reality MJDS represented a unilateral concession on the part of the SEC to assist Canadian securities issuers seeking to raise capital in the US.

The system permits Canadian companies with a market capitalization of at least $75 million to utilize Canadian disclosure documents in lieu of a separate, and more detailed, US filing when listing on a US exchange. Although the system cannot be used for initial public offerings, it can, in principle, save a Canadian company hundreds of thousands of dollars annually in legal and other fees related to ongoing disclosure filings. Of the more than 220 Canadian companies listed on the NYSE or Nasdaq, about 100 of them make use of MJDS.

The effectiveness of MJDS in lowering the cost of US capital to Canadian issuers is of great interest because the SEC had always intended MJDS to be a test case. If judged successful, it was envisioned that similar arrangements could be concluded with the UK, Japan, and other major national equity markets.

By and large, the results have not been encouraging. A statistical examination of Canadian listings on US exchanges between 1987 and 1995 yielded no evidence of a post-MJDS boost.[64] The major reason would appear to be that MJDS is not a pure mutual recognition agreement. In particular, a 1993 SEC amendment to MJDS reinstated the requirement to reconcile Canadian company financial reporting to US GAAP.

90% of Canadian cross-listers surveyed by Houston and Jones (1999) indicated that the preparation of US GAAP information is both costly and time consuming. Non-US listers surveyed indicated the cost and difficulty of US listings and GAAP reconciliation as the primary reasons for not utilizing MJDS.

Furthermore, Foerster, Karolyi and Weiner (1999) found that 42% of total cross-listers surveyed, and 62% of Nasdaq cross-listers, cited US legal considerations as a factor in the way they

63 Technically, the agreement was concluded with four Canadian provincial regulatory authorities.

64 Houston and Jones (1999).

conducted business subsequent to a US listing. In particular, concern has been widely reported among Canadian cross-listers over the potential liability from US civil court action, particularly class-action suits, related to inadequate or inaccurate disclosure. This is a critical gap in the mutual recognition regime, as it implies that Canadian companies can satisfy all the requirements of their home authorities and still be subject to major damage assessments in US courts. Jordan (1995) concludes that: "The original principle of reciprocal recognition, i.e., the ability to use a Canadian prospectus to do a public offering in the United States, has been distorted by one of the asymmetrical aspects of the regime, the retention of U.S. civil liability by the SEC for the prospectus document."

In spite of the fact that the SEC chose Canada as the first partner for MJDS because of the significant similarities between the US and Canadian accounting, auditing, and regulatory environments, the agreement took over six years to conclude, and has been subject to unilateral SEC revision and repeated threats of revision and annulment over the course of its ten-year existence. This has a number of implications for trying to conclude a transatlantic mutual recognition agreement.

First, as with MJDS, a US-EU exchange access agreement will involve asymmetric interests: EU exchanges are far more anxious for US market access reforms than US exchanges are for European reforms. Part of this is a function of the state of market automation: all EU exchanges are operating automated auction systems which could be transplanted in the US almost as quickly as servers could be installed. Nasdaq has moved in this direction with the recent launch of its new generation of trading platform, SuperMontage, although the floor-based NYSE is currently not in a position to avail itself of EU access rights. The other part, however, is directly analogous to the MJDS scenario: US investors hold more EU stock than vice-versa. If the SEC behaves as a traditional mercantilist trade negotiator – and signs point clearly in this direction[65] – then SEC concerns, both prior to and after an agreement, will have a significantly disproportionate effect over the terms for mutual access, and these terms may change over time.

Second, and more specifically, if the agreement should center around the "quality" of EU corporate disclosure, auditing, regulatory, and listing standards – or, more accurately, the degree to which they approximate US standards – there is a significant risk that negotiations will be prolonged and any agreement reached short-lived.

Third, the EU needs to guard against the possibility that EU issuers or exchanges will be subject to US civil liability on such matters as corporate financial disclosure or exchange trading rules. The EU needs to ensure that the legal jurisdiction for resolving investor disputes is the same whether US investors are trading "in the EU" (as now), or EU exchanges are offering trading services "in the US."

Fourth, the SEC is not necessarily the party with which the EU should seek to reach agreement. EU exchanges may find enforcement of their US access rights more effective if the agreement is concluded with the US Treasury, rather than with the SEC. Furthermore from the perspective of ensuring that "mission creep" does not lead the SEC into adopting a trade negotiator's role - which involves playing advocate for US producer interests, quite possibly at the expense of proper investor protection - the idea of the Treasury taking responsibility for concluding and enforcing an exchange access agreement with the EU is attractive. Finally, although the SEC will undoubtedly claim exclusive competence

[65] As Harvey Pitt told Reuters (January 30, 2002), "We also want real reciprocity, so that U.S. markets can offer the world's investors the chance to participate in our vigorous and unparalleled markets." The call for "reciprocity" indicates that the former SEC chairman considers more direct access for US investors to European exchanges to be primarily a privilege accorded to these exchanges (as a *quid pro quo* for US exchange access in Europe), rather than a means of expanding investment opportunities for US investors.

over this matter, on the basis of its substantial exemptive powers, such a claim can and should be carefully scrutinized. As Romano (2001) has suggested:

> ". . . ceding a territorial jurisdictional rule is not a matter that is unambiguously within an agency's purview. In the United States, for example, such rules are legislative or judicial in origin. Mutual recognition of statutory securities domicile would therefore have to be effectuated by a treaty or other executive agreement approved at a higher governmental level than the securities agency,"(p398).

4.3.2. Rule 144A

Since 1990, the SEC has operated a liberalized regulatory regime which exempts privately traded securities, both debt and equity, from the registration requirement of the 1933 Securities Act, provided that offers and sales are made only to "qualified institutional buyers." Known as Rule 144A, this regime was created to ease access to capital for all firms, but was particularly intended as a means of reducing the time and cost involved in selling foreign securities to US investors for whom the SEC did not believe that the normal financial disclosure requirements were necessary.[66] QIBs, unlike retail investors, were assumed to be sophisticated enough to determine and demand the information they needed to make informed investment decisions. The SEC was motivated to implement the regime by the growth of offshore markets, which were increasingly being used by issuers to avoid what they saw as overly onerous disclosure requirements (particularly reconciliation to US GAAP).

Foreign issuers are attracted to the 144A regime because of the greater flexibility in disclosure, the absence of periodic reporting requirements, and the speed with which the offering can be completed without the standard Commission review of documents required for a public offering. The downside comes with the strict limitations on who can buy 144A issues, and the restrictions imposed on the resale of such securities, which limit their liquidity. These restrictions are still much less onerous than those placed on non-144A private issues. Although 144A issues are technically private placements, the rules regime actually makes them more similar to public offerings.

Rule 144A applies to both debt and equity issues. Whereas the two markets were of comparable size a decade ago, the 144A debt market is now much larger.

In 1992, there were 25 144A private placements of depositary receipts by non-US companies, raising $3.8 billion in equity capital. 1994 saw the highpoint in such placements, as 102 were made for a total volume raised of $8.3 billion. By 2000, filings were back down to 28, and capital raised was only $2.1 billion.[67]

Total capital raised via debt is nearly eight times that raised via equity.[68] 144A non-convertible debt issues grew from $3.39 billion in 1990 to $235.17 billion in 1998, while the traditional private placement market shrank from $109.94 billion to $51.10 billion over this period.[69] The volume of foreign 144A debt grew from $378 million in 1991 to $12.1 billion in 1997. From 11% of total debt issued by foreign firms in 1991, 144A issues rose to 65% in 1997. Foreign firms have therefore reacted to the 144A regime by shifting the bulk of their US debt issues from the public market to the 144A market. 144A high yield debt rose from 50% for foreign high yield debt issues in 1991 to 91% in 1997. In 1996-1997, foreign firms issued twice as much

[66] Chaplinsky and Ramchand (2000).

[67] Conference Board (2002).

[68] Chaplinsky and Ramchand (2000).

[69] Livingston and Zhou (2001).

debt in the 144A market as they did in the public market.[70]

The rapid growth and huge size of the 144A (particularly debt) market has raised questions about the appropriateness of the SEC's registration and disclosure regime for public offerings. After all, if so many issuers prefer the 144A regime, they would appear to be adequately meeting US investors' information requirements. An analysis of the impact of Rule 144A on foreign debt issuance in the US concluded that the regime had brought significant economic benefits to foreign firms, owing mainly to reductions in disclosure costs which were not fully offset by higher yield spreads.[71]

The SEC may interpret the substantial and growing use of 144A as reflecting a general preference by issuers for low disclosure standards. This would be unwarranted, as we explained in section 4.2.2, but may still influence its policy thinking. This is particularly the case given that the NYSE is likely to lobby intensely against EU exchange access, owing to its concern that it will lose foreign company listings. It may even claim that there is a risk that US companies will avoid listing, or de-list, in the US in favor of listing abroad, where costly GAAP disclosure requirements do not apply. As we argued in section 4.2.7, such a strategy is not legally tenable, as US-domiciled companies cannot escape US securities law by listing abroad. Nonetheless, the Commission's 1997 Concept Release does appear to reflect this concern, as it solicits public commentary as to whether foreign market access providers should be prohibited from transmitting orders in US securities.[72] Given that the red herring of US issuers migrating abroad has the potential to block or delay EU exchange access, the EU would be politically wise to agree up front to limit trading under such a scheme to non-US-domiciled issuers.

[70] Chaplinsky and Ramchand (2000).

[71] Chaplinsky and Ramchand (2000).

[72] See question 126 on page 89.

4.4. Conclusions: A Blueprint for US Action on EU Exchange Access

In this chapter we have discussed the policy context in which foreign securities currently trade in the US, and have analyzed the SEC's recent practice and thinking related to access to US markets for foreign securities exchanges. We believe that the case for liberalizing access rights for EU exchanges along the lines we suggest is compelling on economic, prudential, and political grounds.

First, as we detailed in chapter 2, American investors – and, in particular, pension fund holders – stand to benefit significantly from the anticipated rise in their portfolio investment returns and the decline in risk associated with greater diversification.

Second, our proposals involve no dilution in the current US retail investor protection scheme. US investors trading on US exchanges can only do so via US-registered, SEC-regulated broker-dealers. Equivalently, EU exchanges operating in the US under our scheme will only be permitted to accept US retail order flow via US-registered, SEC-regulated broker-dealers.[73]

Third, every component of our liberalization agenda has already been accepted and implemented by the SEC under an existing liberalization scheme, such as the US-Canada MJDS and Rule 144A. Therefore, no political or

[73] Under US securities law, a US investor is free to purchase foreign securities through either a US or foreign broker, although neither is permitted to "solicit" trades in unregistered securities from an individual US investor. Wang (2002) analyzes the dimensions and impact of the ban on solicitation. He concludes that "The complexity of the brokers' solicitation rule does not appear to have any significant effect on the behavior of the market. As a matter of practice, most US investors will contact a registered broker when interested in a foreign security. These brokers are allowed to advertise their brokerage services and usually do not advertise specific securities unless they are market makers" (p386). Wang suggests that the global expansion of internet use will make it increasingly difficult to restrict advertisement and information flows generally, but it remains the case that, even under our scheme, US brokers will not be able to "solicit" trades in unregistered European securities the way they solicit such trades in registered securities.

legal innovations are required in order to realize our agenda.

Below we detail the policy conclusions on EU exchange access which emerge from our analysis:

- **The Role of the SEC.** Consistent with Romano's view that "mutual recognition of statutory securities domicile" (2001:398) should be considered beyond the powers of a securities agency, an agreement with the EU should formally be effectuated by the US Department of the Treasury, in consultation with the SEC. Although the technical details of an agreement on transatlantic exchange access must necessarily involve the SEC, its position as a neutral market regulator would be compromised if it were placed in a position of representing the commercial interests of US entities wishing to operate in Europe. If reciprocity is to be the basis for transatlantic exchange access, then the rights granted to EU exchanges by the US should be guaranteed by the Treasury. Likewise, to the extent that the interests of US exchanges in the EU should require US government representation, this should also be provided by the Treasury, which is not directly responsible for regulating these entities.
- **The Scope of US Access Rights.** EU exchanges should be permitted to establish certain limited operations (such as the installation of user terminals, network access devices, and communications servers) in the United States for the purpose of offering trading services in the securities of so-called "foreign private issuers," and derivatives based on such securities, to US "qualified institutional buyers." It should be noted that trading in broad-based stock index futures is under the exclusive jurisdiction of the CFTC, which is already operating a "no-action" regime allowing foreign exchanges to offer trading in such contracts within the US.
- **Home Country Regulation.** EU exchanges should be permitted to operate in the US under the regulatory control of their home country authority, provided that the authority already has in place a "memorandum of understanding" with the SEC regarding information sharing and cooperation in investigations of suspect trading practices.
- **Disclosure Standards.** Issuers of securities traded by EU exchanges pursuant to this arrangement should be permitted to make their required financial disclosures in accordance with IAS rather than US GAAP. Provided that US broker-dealers continue to make US investors fully aware when they are trading foreign securities on a foreign exchange, there is no logic in imposing new GAAP disclosure requirements on the issuers. US investors *are already* free to trade foreign securities outside the US, and in an electronic trading environment no practical distinction can be drawn between transacting "inside" and "outside" a given territory.
- **Broker-Dealer Registration Requirements.** No new registration requirements should be imposed on US registered broker-dealers, or foreign broker-dealers already exempt from registration pursuant to Rule 15a-6 of the 1934 Exchange Act, as a pre-condition for providing trade intermediation services to US investors who wish to effect transactions on EU exchanges operating in the US. Consistent with existing SEC practice,

foreign broker-dealers should be allowed to provide direct electronic "pass through" access to US institutional investors, provided that all transactions continue legally to be intermediated by a US registered broker-dealer in accordance with the requirements of Rule 15a-6(a)(3).

- **US Civil and Criminal Liability.** In contrast with the US-Canada MJDS, this proposal should not subject non-US issuers to US civil and criminal liability under Rule 10b-5 of the 1934 Exchange Act.[74] The issuers themselves would not be a party to this arrangement. American investors purchasing securities traded on EU exchanges do not currently have legal recourse in the US for fraud or deceptive practices by non-US-domiciled issuers, and our proposal has no implications whatsoever regarding the legal domicile of issuers. Unlike Romano's (2001) proposal - which would empower foreign *issuers* to list in the US under foreign disclosure rules, and therefore subject them to US civil and criminal liability[75] – our proposal only empowers foreign (specifically EU) *exchanges* to offer trading in foreign issuers' securities in the United States. As our proposal does not attempt to encompass primary market offerings in a transatlantic mutual recognition regime, and does not require any changes in EU or US exchange listing regulation, issuers should remain entirely immune to "extraterritorial" legal challenges. The importance of such immunity has been underscored by Greene and Quinn:

> "One of the most significant considerations for foreign issuers considering a US listing or registration is whether they are willing and prepared to manage the risk of class action litigation. The risk associated with US liability laws and the use of class actions in the United States may drive issuers seeking to raise capital to other markets, for example the European market, especially if the European market is reformed in line with current proposals," (2001:13).

- **Avoiding Regulatory Arbitrage by US Exchanges.** In order to ensure that EU exchange access is accorded only to

[74] Rule 10b-5 -- Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

To employ any device, scheme, or artifice to defraud,

To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

[75] Romano (2001:401) proposes a major rule change exempting foreign issuers on US exchanges from US civil and criminal liability, and requiring US brokers to inform their clients of this fact prior to any transaction. She suggests, however, that foreign issuers "can be expected" to agree contractually in their offering and disclosure documents to be sued in the United States (2001:408). The MJDS experience for Canadian issuers strongly suggests otherwise, which represents a major advantage of our proposal to extend mutual recognition to *exchanges* rather than *issuers*.

bona fide EU exchanges, and not to US entities organizing outside the US for the purpose of evading US exchange registration requirements, access rights should be limited to those exchanges recognized by the European Commission as "regulated markets" under the Investment Services Directive. The SEC could scrutinize subsequent additions to this list to vet their legitimacy as EU operations before conferring US access rights on them.

CHAPTER 5: REFERENCES

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