EXCHANGE CONSOLIDATION AND MODELS OF INTERNATIONAL SECURITIES REGULATION

BO HARVEY*

INTRODUCTION

In recent years, globalization and a growing demand for capital have increased competition within the capital markets for the business of issuers and investors.[1] This has led stock and derivatives exchanges to change their business models from mutual business entities, run for the benefit of their members, to demutualized corporations, run for the benefit of shareholders.[2] Consequently, as for-profit corporations, exchanges have looked to position themselves more competitively in an internationalized securities market. Part of such positioning has included increasing exchange alliances and acquisitions on a global scale. This is highlighted by the recent merger between the New York Stock Exchange (NYSE) and Euronext (the new entity to be known as NYSE-Euronext). With financial markets now spilling across national borders, demutualized exchanges see opportunities for growth and expansion by consolidating internationally.

However, these changes have put securities regulators in the position of trying to stay ahead of the curve, as exchanges—often seen as once historic landmarks of national pride—push the limits on cross-border consolidations. Traditionally, "[f]inancial exchanges

* Bo Harvey is a J.D./M.B.A. candidate at Duke University School of Law and The Fuqua School of Business. Special thanks is extended to Professor Steven L. Schwarcz for serving as advisor during the writing of this note.

1. *See generally* Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,258 (Dec. 8, 2004); Irina Shirinyan, *The Perspective of U.S. Securities Disclosure and the Process of Globalization*, 2 DEPAUL BUS. & COM. L.J. 515, 515-16 (2000).

2. For an in-depth explanation of the exchange demutualization process, see generally Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?*, 21 NW. J. INT'L L. & BUS. 657 (2001).

come with a lot of political, cultural, and emotional baggage."[3] Yet, the current activity of exchanges is challenging traditional models of securities regulation. This note highlights the role demutualized exchanges are playing in the convergence of international securities regulation and evaluates the extent to which exchange consolidation fits within one traditional theoretical framework applied to international securities regulation. In practice, cross-border exchange consolidation is largely shaping the path regulators are taking with respect to cross-border securities regulation. However, securities regulation will always remain bound by national borders in certain important respects.

Part I of this article will provide some background to exchange demutualization and explain the driving factors behind an increased competition among capital markets. Part II will introduce the traditional theoretical models of international securities regulation. It will focus on the idea of international "convergence" of regulatory standards and set forth examples of convergence (or the lack thereof) within, and between, the United States and the European Union. Part III will analyze how exchanges have recently influenced international regulatory coordination as illustrated by the merger between NYSE and Euronext.

I. DEMUTUALIZATION AND COMPETITION FOR CAPITAL MARKETS

A. Brief History of Exchange Demutualization

The first stock exchange demutualized in 1993.[4] Prior to this, exchanges were run as mutual businesses. Mutual businesses consist of private members rather than shareholders and are run by managers for the benefit of members, not for public profit.[5] In demutualizing, exchanges take on the form of a "public corporation—the most efficient organizational form for large enterprises."[6] In doing so, exchanges seek the benefits of responding to competition, basing

3. *Flying in Formation*, ECONOMIST, Feb. 3, 2007, at 76-77.

4. *See* Shamshad Akhtar, *Demutualization of Asian Stock Exchanges- Critical Issues and Challenges*, *in* DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES 3, 5 (Shamshad Akhtar ed., 2002). The first exchange to demutualize was the Stockholm Exchange. *Id.*

5. Bradley, *supra* note 2, at 661.

6. Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2542 (2006).

decision-making on shareholder value, pursuing new business strategies, unlocking members' equity values, and facilitating business partnerships.[7] Since 1993, over twenty-one stock exchanges have demutualized.[8] This trend is not limited to stock exchanges; derivatives exchanges have also demutualized.[9] By 2006, several major exchanges worldwide had demutualized or changed their business structure to allow for shareholders. These exchanges include, among others, Euronext (itself the result of a consolidation of five exchanges in England, Belgium, France, the Netherlands, and Portugal),[10] NYSE, Chicago Mercantile Exchange, Chicago Board of Trade, London Stock Exchange, Tokyo Stock Exchange, Deutsche Boerse, Australian Stock Exchange, and Hong Kong Stock Exchange.[11]

B. Factors Driving Exchange Demutualization and Competition

Exchange demutualization, among other things, facilitates increasing competition within the "exchange business;" in other words, the business of providing a market where issuers can raise capital and investors can buy and sell securities. In response to recent competition, alliances and consolidations have emerged as exchanges look to increase profitability.[12] Generally, the forces driving demutualization are also those driving exchange consolidation, and fall into one of two broad categories: changes in the business and financial landscape and changes in the regulatory environment.

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7. Bradley, *supra* note 2, at 668-69 (listing the Chicago Mercantile Exchange's five major objectives for its demutualization).

8. Akhtar, *supra* note 4, at 5.

9. *See, e.g.*, Bradley, *supra* note 2, at 668-69; Akhtar, *supra* note 4, at 6 (listing derivatives markets that have formed alliances).

10. *See* Euronext, http://www.euronext.com/editorial/wide/editorial-1994-EN.html (last visited May 1, 2007).

11. Reena Aggarwal & Sandeep Dahiya, *Demutualization and Public Offerings of Financial Exchanges*, 18 J. APPLIED CORP. FIN. 96, 98 tbl.1 (Summer 2006), *available at* http://faculty.msb.edu/aggarwal/183final.aggarwal.pdf.

12. *See Flying in Formation*, *supra* note 3; Robert Daniel, *NYSE, TASE Meet with Eye To More Dual Listings*, MARKETWATCH, Jan. 20, 2007, http://www.marketwatch.com/news/story/nyse-tel-aviv-exchange-tout/story.aspx?guid=%7BB8906DED%2DEB14%2D4620%2D972D%2D30C9C0DC72F4%7D; *see generally* David Weidner, *NYSE Allies with Tokyo Stock Exchange*, MARKETWATCH, Jan. 31, 2007, http://www.marketwatch.com/News/Story/nyse-forms-working-alliance-tokyo/story.aspx?guid=%7BCBDCBE78-B20A-4CED-A3AD-E3C27977D302%7D (discussing the alliance between the NYSE and the Tokyo Stock exchange). For an example of the intensity of the bidding war between exchanges, see Norma Cohen, *Nasdaq in Last-Gasp Move to Win Bid*, FIN. TIMES, Jan. 29, 2007, at 20 (discussing Nasdaq's attempt to purchase a controlling stake in the London Stock Exchange).

These categories are not meant to be airtight independent causes; factors in one category may correlate with factors in another as, for example, regulatory changes produce changes in the financial landscape and vice versa.

1. Changes in the Business Environment that Affect Exchanges. First, exchanges are reacting to the increasing technological capabilities of alternative trading systems (ATSs), also known as electronic communication networks (ECNs), which have put pressure on the traditional role of exchanges as an order-matching intermediary. ECNs can match orders transparently, efficiently, and anonymously, and offer lower transaction costs for investors.[13] ECNs have also lowered barriers of entry into the exchange business, as a physical trading floor becomes unnecessary.[14] Thus, there has been downward pressure on profit margins resulting from order-matching, and exchanges are looking to diversify into other lines of business, such as clearing and settlement.[15] Adding to this pressure has been an increase in the amount of order-flow large that brokerage houses are crossing internally (particular for institutional clients trading large blocks of shares), which obviates the need for sending orders to an exchange.[16] Moreover, these technological innovations facilitate the trading of securities regardless of where the issuer is listed.[17] "Today's technology enables market participants to tap simultaneous and multiple sources of liquidity from remote locations," so investors can obtain real-time information about securities trading on foreign exchanges, and execute orders on those markets electronically.[18]

13. *See* Akhtar, *supra* note 4, at 5-6; *see also* John G. Moon, *The Dangerous Territoriality of American Securities Law: A Proposal for an Integrated Global Securities Market*, 21 NW. J. INT'L L. & BUS. 131, 156-62 (2000) (detailing the specific trading advantages that ECNs have compared to physical trading floors).

14. Akhtar, *supra* note 4, at 7.

15. *Battle of the Bourses*, ECONOMIST, May 27, 2006, at 65-67.

16. *Id*.; Larry Tabb, Tabb Group, *NYSE / Euronext: The Age of Global Exchange Consolidation Begins* (2006), http://www.tabbgroup.com/thought/NYSE_EuroNext.pdf. For example, POSIT, Liquidnet, and Pipeline are few computerize order-crossing systems that allow anonymous execution of large blocks of shares, which many institutional investors consider desirable. *See* Nina Mehta, *Internal Crossing*, TRADERS MAG., June 2006; *UBS Taps Dark Pools*, SEC. INDUSTRY NEWS, Feb. 12, 2007.

17. *See* Moon, *supra* note 13, at 153-55.

18. Roberta Karmel, *Will Convergence of Financial Disclosure Standards Change SEC Regulation of Foreign Issuers?*, 26 BROOK. J. INT'L L. 485, 519 (2000). *See also E-Trade to Handle Foreign Stocks*, LATIMES.COM, Feb. 20, 2007, http://www.latimes.com/business/la-fi-wrap20.1feb20,1,7505449.story?coll=la-headlines-business&ctrac (describing possibility of online trading of foreign equities).

Collapsing national and technological barriers have thus had the effect on stock exchanges that these lowered barriers would have on any other industry, increasing global competition for the listings of securities issuers and for the trading activity of investors buying and selling those securities.

Second, the boom in financial innovation and derivatives trading has caused exchanges to look for ways to enter these markets.[19] Able to offer investors access to a wide array of financial products,[20] exchanges can differentiate themselves in a competitive environment. NYSE-Euronext, for example, expects derivatives to be the biggest source of new revenue for the combined entity.[21] Euronext traded forty percent of Europe's $16 trillion in outstanding (notional) derivatives contracts,[22] and represents a significant addition to the NYSE's traditional strength in providing a liquid market for stocks.

Third, in recent years the U.S. financial markets have not experienced the same increased growth in market value as certain foreign markets.[23] In conjunction with a declining dollar over the last few years, this relatively slower growth than other international markets has prompted U.S. exchanges to expand into better-performing and increasingly active international markets, either by forming alliances or through mergers.[24]

2. Changes in the Regulatory Environment. Recent regulatory changes have also increased competition among stock and derivatives exchanges. Two important regulations passed by the Securities and Exchange Commission (SEC) that are widely seen as enabling stronger competition are the Regulation of Exchanges and Alternative Trading Systems (Regulation ATS),[25] and the recently

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19. *See* Richard Beales, *Equity Derivatives Tipped for Dramatic Growth*, FT.COM, Apr. 10, 2007, http://www.ft.com/cms/s/ecd19150-e790-11db-8098-000b5df10621.html.

20. *See* Richard Beales, *Exchanges Try to Offer Instruments that Align with OTC Credit Derivatives*, FT.COM, Mar. 22, 2007, http://cachef.ft.com/cms/s/0d95433e-d8a8-11db-a759-000b5df10621.html (reporting on new exchange-traded instruments).

21. Aaron Luccheti and Peter A. McKay, *NYSE Cranks up Derivatives Machine*, WALL ST. J., June 6, 2006, at C1.

22. Telis Demos, *What's Driving the Stock Exchange Merger Binge?*, FORTUNE, June 12, 2006, at 32.

23. *See, e.g.*, Tony Tassell, *Europe Tops US in Stock Market Value*, FT.COM, Apr. 2, 2007, http://search.ft.com/ftArticle?queryText=%22Europe+tops+US+in+Stock+market+value%22&aje=true&id=070402010807.

24. *See Battle of the Bourses*, *supra* note 15, at 65-67.

25. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844 (Dec. 22, 1998).

amended, controversial Regulation National Market System (Regulation NMS).[26] Regulation ATS was adopted in 1998 in response to the growing number of ECNs, which were not "exchanges" in the traditional sense but were systems that "otherwise perform[ed] with respect to securities the functions commonly performed by a stock exchange."[27] The purpose of Regulation ATS was "to more effectively integrate the growing number of alternative trading systems into the national market system, accommodate the registration of proprietary alternative trading systems as exchanges, and provide an opportunity for registered exchanges to better compete with alternative trading systems."[28] Regulation ATS lowered entry barriers by allowing ECNs to compete directly with registered exchanges for the matching of orders.[29]

Regulation NMS was adopted in 1975, in order to connect the various stock markets so that orders could be routed on a national scale.[30] One express purpose of Regulation NMS is to allow for exchange competition. Regulation NMS, recently amended in 2005, is "premised on promoting fair competition among individual markets, while at the same time ensuring all of these markets are linked together." It sets forth the objective of promoting "vigorous competition" among both individual markets and individual orders.[31] Together these regulations provide strong incentives for exchanges to reorganize as corporations, in order to partner or consolidate with emerging, demutualized competitors.

The changing regulatory regime in Europe has also fostered competition and consolidation among exchanges in attempting to create an integrated pan-European capital market. The European Commission has explicitly stated that "any remaining capital market fragmentation should be eliminated, thereby reducing the cost of capital raised on E.U. markets."[32] The Markets in Financial

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26. Regulation National Market System, Exchange Act Release No. 34-51808, 70 Fed. Reg. 37,496 (June 29, 2005).

27. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. at 70,847 (citing 17 C.F.R. § 242.300(a)-(a)(1) (2005)).

28. *Id*. at 70,844.

29. *See* Fleckner, *supra* note 6, at 2566.

30. *Id.* at 2554.

31. Regulation National Market System, Exchange Act Release No. 34-51808, 70 Fed. Reg. at 37,498.

32. Roberta Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANSNAT'L L. 9, 15 (1999).

Instruments Directive (MiFID),[33] seen as trying to stimulate competition,[34] rests on the notion that "market participants and investors [are] able to compare the prices that trading venues . . . are required to publish. To this end, it is recommended that Member States remove any obstacles which may prevent the consolidation at a European level of the relevant information and its publication."[35] With these obstacles removed, several E.U. exchanges, such as Euronext, have consolidated, creating a liquid, efficient, interconnected financial infrastructure that has attracted issuers and investors, and challenged the traditional dominance of the U.S. capital markets. More closely interlinked European financial markets have provided a viable alternative for international issuers as a source of capital.

Moreover, the recent gap between standards in the United States and European regulatory environments, combined with the cross-border, mobile nature of capital, have had a secondary (and perhaps unintentional) effect of intensifying the consolidation trend among exchanges. The passage of the Sarbanes-Oxley Act (SOX) in 2002,[36] in response to a wave of corporate accounting scandals, enhanced accounting and disclosure requirements of publicly traded companies. Several commentators have suggested that the burdens of SOX compliance may have caused a decline of foreign issuers choosing to raise capital in the United States.[37] For example, a report commissioned by New York City Mayor Michael Bloomberg and Senator Charles Schumer notes that E.U. capital market revenues are growing by twenty percent per year, compared with seven percent in

33. Council Directive 2004/39/EC, 2004 O.J. (L 145) 1 (EC).

34. Tabb, *supra* note 16.

35. Council Directive 2004/39/EC, *supra* note 33, at 4.

36. *See* Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C. §§ 7201-7266).

37. Robert G. DeLaMater, Speech, *Recent Trends in SEC Regulation of Foreign Issuers: How the U.S. Regulatory Regime is Affecting the United States' Historic Position as the World's Principal Capital Market*, 39 CORNELL INT'L L.J. 109, 114-16 (2006); Hong Zhu & Ken Small, *Has Sarbanes-Oxley Led to a Chilling in the U.S. Cross-Listing Market?*, CPA J., Mar. 2007, *available at* http://www.nysscpa.org/printversions/cpaj/2007/307/p32.htm. *See also* Jenny Anderson, *New York Leaders Warn of Wall Street Decline*, INT'L HERALD TRIB., Jan. 22, 2007, *available at* http://www.iht.com/articles/2007/01/22/business/wall.php (reporting on a McKinsey study commissioned by Mayor Michael Bloomberg of New York and Senator Charles Schumer of New York, addressing a "burdensome legal and regulatory environment" as one reason, among others, that the U.S. global financial services market could decline in light of European and Asian competition).

the United States.[38] Also, the U.S. share of global initial public offerings (IPOs) has fallen from fifty-seven percent in 2001 to sixteen percent in 2006 while E.U. IPOs have increased from thirty-three percent to sixty-three percent during the same period.[39] Some of this decline can be attributed to a period of deflation in the U.S. stock market value since 2000. Yet, even controlling for this period of market value deflation, many foreign companies are choosing not to list in the United States, and are in fact de-listing from U.S. exchanges at an increasing rate relative to U.S.-based companies.[40] These events have led some in Congress to re-evaluate the global competitiveness of U.S. capital markets.[41] While the idea that foreign companies are prevented from listing on U.S. exchanges because of a strict U.S. regulatory regime is not new.[42] SOX may have hastened American exchanges' search for overseas markets as a way to diversify away from a single regulatory environment.[43] In essence, for-profit exchanges are responding as corporations are intent on maximizing shareholder value by seeking to establish diverse sources of revenue and footholds in markets with growth opportunities. Thus, the tighter standards of SOX may have been one factor contributing to the global exchange consolidation trend.

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38. MCKINSEY & CO. AND NEW YORK CITY ECON. DEV. CORP., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP, at 41, 44 (Jan. 23, 2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

39. *Id.*

40. Zhu & Small, *supra* note 37, at 32. Zhu and Small's study focuses on the 2002-2005 period.

41. *See* DeLaMater, *supra* note 37, at 118; *China's Strategy and Objectives in Global Capital Markets: Hearing Before the U.S. – China Economic and Security Review Comm.*, 109th Cong. 19-27 (2005) (testimony of Robert G. DeLaMater). For example, several of the biggest IPOs in the last few years have been listed in Hong Kong or Shanghai. *See* MCKINSEY & CO. AND NEW YORK CITY ECON. DEV. CORP., *supra* note 38.

42. *See* James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58 *passim* (1994) (arguing for easing access to U.S. capital markets for foreign issuers so as to maintain the "international stature of our financial markets.").

43. *See generally* Demos, *supra* note 22, at 14 (positing that U.S. exchanges are searching overseas for new sources of revenue); MCKINSEY & CO. AND NEW YORK CITY ECON. DEV. CORP., *supra* note 38.

II. MODELS OF INTERNATIONAL SECURITIES REGULATION

A. Background

Mobile capital and porous borders between national financial markets have highlighted the disparities between different regulatory models, enlivening an ongoing spirited debate that reevaluates the territorial conception of securities law.[44] The traditional territorial-based approach to securities law is being challenged by the globalization of finance.[45] For example, U.S. securities law has a history of wrestling with the issue of determining the outer boundaries of its extra-territorial reach, as seen, for instance, in the exemptions the SEC carves out to accommodate foreign issuers, such as the attempt to restrict the territorial scope of registration requirements through the passage of Regulation S.[46] Regulation S[47] provides safe harbors for issuers in response to the question of whether it is appropriate to require an issuer to register its securities under the Securities Act of 1933—even though there would be jurisdiction to do so—when it offers those securities exclusively to non-U.S. citizens in offshore transactions.[48] Regulation S "declared the SEC's explicit embrace of a territorial approach to Securities Act registration."[49] Like Regulation S, the reach of anti-fraud provisions of the Securities and Exchange Act of 1934[50] implicates a territorially-focused inquiry, as reflected in the "conduct" and "effects" tests that the courts have developed to determine—sometimes not without difficulty—the proper subject-matter jurisdiction in securities fraud cases.[51] With these territorially-focused inquiries firmly established,[52]

44. Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WIS. L. REV. 1363, 1367 (2002).

45. *Id.* at 1369-71.

46. Kellye Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927, 955 (1994).

47. 17 C.F.R. § 240.901 (2006).

48. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 242-43 (rev. 5th ed. 2006).

49. Tung, *supra* note 44, at 1375.

50. *See, e.g.*, 17 C.F.R. § 240.10b-5

51. *See* Schoenbaum v. Firstbrook, 405 F.2d 200, 206-08 (2d Cir. 1968), *rev'd in part en banc*, 405 F.2d 215 (2d Cir. 1968). *But see* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 988-89 (2d Cir. 1975), *cert. denied*, 423 U.S. 1018 (1975) (limiting the scope of effects that can be successfully invoked); *see also* HAZEN, *supra* note 48, at 730-31 (describing the conduct and effects tests); James D. Cox, *Choice of Law Rules for International Securities Transactions?*, 66

unless regulators clarify and coordinate their oversight of securities markets, determining the outer boundaries of national securities law will only become more difficult as financial exchanges begin to operate through cross-border mergers and alliances.

Due to the conflict between territorially-based law and borderless capital flows, various theoretical alternatives have been proposed to accommodate the decreasing importance of national borders in capital markets. As a general matter, alternatives to conventional territorially-based regulation fall somewhere along a spectrum of models of international securities regulation, with the concept of harmonization at one end, and regulatory competition at the other.[53] Some commentators have set forth finer, more detailed descriptions of the various possible approaches to international securities regulation,[54] but for the purposes of this article, identifying the two conceptual poles in this debate, harmonization and competition, is sufficient. As will be discussed, convergence (sometimes called "equivalence") is a third approach that falls somewhere between the two extremes of harmonization and regulatory competition.[55]

1. Harmonization. Harmonization is defined as the idea that there should be a single, uniform, international regulatory standard.[56] Benefits of such a standard would be reduced transaction and administrative costs for issuers and investors, and thereby increased efficiency and liquidity.[57] Reducing duplicative and even conflicting regulatory standards would lower the cost of capital, benefiting both

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U. CIN. L. REV. 1179, 1181-82 (1998) (stating that "the reach of the U.S. securities laws is territorial" and specifically that the conduct of the parties more frequently establishes territoriality).

52. *See* Cox, *supra* note 51, at 1181.

53. *See* Tzung-bor Wei, *The Equivalence Approach to Securities Regulation*, 27 NW. J. INT'L L. & BUS. 255, 255-56 (2007).

54. *See generally* Shirinyan, *supra* note 1, at 526-38; Hal S. Scott, An Overview of International Finance: Law and Regulation (Dec. 15, 2005) [hereinafter Scott, International Finance] (unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=800627).

55. Arguably convergence may be an apple in a bucket of oranges. It is possible to argue that convergence is not easily comparable to harmonization and competition because it is, to a greater degree than the models of harmonization and competition, descriptive and grounded in the practicalities of the financial and regulatory environments; whereas the concepts of harmonization and competition are more prescriptive in nature.

56. Hal S. Scott, *The Future Content of U.S. Securities Laws: Internationalization of Primary Public Securities Markets*, 63 LAW & CONTEMP. PROBS. 71, 78 (2000).

57. Wei, *supra* note 53, at 255-56.

investors and issuers. Regulators themselves would also benefit by being able to allocate their investigative and auditing resources more efficiently. Moreover, some argue for harmonization because "competitive regulation inevitably means more regulation,"[58] as different jurisdictional standards lead to regulators from each jurisdiction jostling to exert authority over particular transactions or parties. A national example of a harmonized system would be the Financial Services Authority (FSA) in the United Kingdom, which replaced eighteen other U.K. regulators when it was formed under the Financial Services Act.[59] The FSA acts as a "super-regulator," overseeing the securities, commodities, insurance, and banking industries.[60] At least one prominent scholar has noted that a unified regulatory arrangement is a "sound idea."[61]

However, there are several potential drawbacks to harmonization. First, although it might promote efficiency, it does not guarantee that the most optimal regulatory standards will be implemented.[62] Like a monopoly, a single regulator can be efficient but suboptimal. Moreover, it may stifle regulatory innovation.[63] Having several competing regimes can provide a useful signaling device to regulators, as companies choose to issue securities where regulation is neither overly burdensome nor so light that investors require a higher return on their investments to compensate them for additional risk.[64] This signaling function is entirely absent when issuers and investors have no choice but to adhere to a single set of standards. Lastly, there are practical problems associated with actually implementing a harmonized regulatory system. A completely harmonized system would require that states cede power, to some extent, to an international body.[65] This is likely to be politically unacceptable, as "each nation would have to forswear its

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58. Jerry W. Markham, *Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319, 414 (2003) (arguing for competitive regulation within the American domestic setting).

59. *See* Financial Services Act, 1986, c. 60, § 8, (Eng.); Financial Services and Markets Act, 2000, c. 8, § 2 (Eng.).

60. Markham, *supra* note 58, at 520.

61. *Id.* at 410.

62. Scott, *supra* note 56, at 78.

63. *Id.* at 80.

64. Wei, *supra* note 53, at 256.

65. Scott, *supra* note 54, at 16.

customary territorial jurisdictional activity."[66] This is unlikely, given the strong policy interests in maintaining at least some sovereign control over national securities regulation.

2. Competition. Regulatory competition is the idea that different regulatory standards should be encouraged as countries tailor laws to their specific circumstances.[67] At its most extreme, this view—also known as issuer-choice—advocates that securities issuers should be allowed to choose their regulatory regimes.[68] This is beneficial because, by giving participants in the financial markets the ability to choose among these standards, regulators would be subject to the discipline of the marketplace, resulting in a "race to the top." The "best" regime—in terms of balancing costs with risks—would succeed.[69] Contrary to initial impressions, advocates of this model argue that the competition would protect investors and provide a superior regulatory regime, just as competitive markets for products protect consumers from product exploitation.[70] Issuers of securities that choose regulatory regimes that are overly lax would, in theory, be at a disadvantage in the marketplace, as investors would require a higher return on their securities, increasing these issuers' cost of capital.[71] Moreover, by choosing a regulatory regime with a higher standard of disclosure, issuers signal to investors the quality of their financial information. Arguably, this is one reason why the United States has generally enjoyed a preeminent role as a place to raise capital, notwithstanding its complicated regulatory structure. On an intra-national level, the United States is an example of a competitive model, where different regulators exert separate, and to some extent competing, oversight of the commodities, securities, banking, and insurance industries.[72] While intra-national competition within the United States does not reflect the ability of an issuer to freely choose

66. Tung, *supra* note 44, at 1368.

67. Wei, *supra* note 53, at 256.

68. *See* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRY L. 387, 388-89 (2001) (discussing why issuers should be given a choice in disclosure levels).

69. *See* Shirinyan, *supra* note 1, at 535-36.

70. Romano, *supra* note 68, at 389, 393.

71. For a detailed study of the correlation between the quality of the regulatory regime and the cost of equity, see generally Venkat R. Eleswarapu & Kumar Venkataraman, *The Impact of Legal and Political Institutions on Equity Trading Costs: A Cross-Country Analysis*, 3 REV. FIN. STUD. 1081 (2006).

72. Markham, *supra* note 58, at 320-74.

their *national* regulatory environment, it does provide a theoretical contrast to certain European countries, such as the United Kingdom, that have a unified regulatory scheme.

A criticism of the competitive model is that, insofar as competitive regulation leads to competing or overlapping standards, it increases costs to investors and issuers.[73] In an age of financial conglomerates, this means a firm may be subject to oversight by several regulators, a number that only increases as the firm enters new national markets. The recent decision by the NYSE and the National Association of Securities Dealers (NASD) to combine their regulatory functions was, at least in part, a response to member firms' asserting that the overlapping jurisdiction of the two exchanges gave rise to inconsistencies and inefficiencies.[74] Moreover, there is the question of whether competition will indeed lead to a "race to the top" rather than a "race to the bottom."[75] Insofar as investors do not have perfect information, they may be unable to appropriately price differences among regulatory regimes.[76] Interestingly, the argument for full regulatory competition, like the argument for full harmonization, runs into practical difficulties with national sovereignty by requiring regulators to cede the decision of applicable law to the issuers of securities.[77] The concept of competition also runs into the paradox that if it works as expected—the most "successful" regime attracting the activity of issuers and investors—it will in any event lead to some degree of convergence because unsuccessful regimes will seek to imitate successful ones in order to promote

73. *See* Scott, *supra* note 56, at 88-90.

74. Tomoeh Murakami Tse, *NASD, NYSE Say They Will Merge Their Regulatory Bodies*, WASH. POST, Nov. 29, 2006, at D03, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/11/28/AR2006112801696.html. Mary L. Schapiro, former NASD chairman and chief executive, and current CEO of the merged body, known as the Financial Industry Regulatory Authority (FINRA), acknowledged as much by stating "duplicative and inconsistent regulation and overlapping jurisdiction will become a thing of the past." *Id.*

75. Shirinyan, *supra* note 1, at 537.

76. *See* James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1233-34 (1999); Scott, *supra* note 54, at 21. Moreover, there is the interesting notion of regulatory arbitrage and exploiting this model when information asymmetries exist. Do these disparities introduce possibility of regulatory arbitrage, or firms gaming the system in order to capture regulator cost savings? For discussion of this possibility in a domestic setting, among the competing regulators in the United States, see generally Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211 (1997).

77. For example, for an exposition of how issuer-choice will simply not work due to a lack of "supply" rather than "demand," because monopolistic regulators will not be willing to "supply" the market with competing regulatory choices, see Tung, *supra* note 44, at 1368.

capital formation.[78] Thus, an environment of truly competitive regulation in fact creates some conditions that would also induce at lease some degree of convergence of regulatory standards, although it is unclear precisely how similar these standards would be.

3. Convergence. Convergence lies between the two theoretical poles of harmonization and competition. Convergence does not imply securities laws should be identical, but neither does it mean there should be no coordination between various regulators in their lawmaking efforts.[79] Convergence is sometimes referred to as "equivalence,"[80] and is generally used in the sense that regulatory standards are roughly close enough to be functionally substitutable, such that the policy objectives of each nation are adequately fulfilled.[81] One commentator has noted there may be fine distinctions between the ideas of "convergence" and "equivalence."[82] However for the purposes of this article, "equivalence" and "convergence" are used interchangeably.[83]

Because of the lack of political feasibility associated with implementing a purely harmonized or competitive model, one benefit of convergence is its eminent practicability. It is highly unlikely that a regime of regulatory competition or harmonization would occur on an international scale. This is because it requires agencies to cede sovereignty and public policy decisions to issuers or an international

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78. A country's capital base and its ability to attract capital play critical roles in the macroeconomic definition of per-capita income. Thus, there is a strong incentive for countries to provide an environment conducive to capital formation.

79. *See* Wei, *supra* note 53, at 256 (using the term "equivalence" rather than "convergence").

80. Charles McCreevy, European Comm'r for Internal Market and Services, Remarks at the U.S. Securities and Exchange Comm'n Roundtable: On the Road Towards Convergence and Equivalence – State of Play in International Accounting (Mar. 6, 2007) (transcript available at http://www.eurunion.org/News/speeches/2007/070306cmcSECR.htm).

81. Wei, *supra* note 53, at 257-58.

82. *Id*. at 256-59. In addition, some regulators may have competing understandings of the terms "equivalence" and "convergence," however, these differences in understanding seem to be more the result of jurisdictional tensions between regulators in their attempts to define an appropriate measure of accommodation to foreign standards, and thus they do not want to appear to use a term that might only ambiguously convey the amount of accommodation they would agree to. *See id*. at 260-61 (explaining the different understandings E.U. and U.S. regulators may have of these terms).

83. For detailed treatment of the finer degrees of different approaches, see Scott, *supra* note 54, at 15; Wei, *supra* note 53, at 260-62; Shirinyan, *supra* note 1, at 526-38.

body.[84] To the extent that sovereignty still matters in a world where capital fluidly crosses national borders, convergence is powerful, as it recognizes that there are national policy interests in retaining an element of territorially-based securities law, while accommodating the needs of international capital markets. Arguably, capital markets and regulators are in fact working toward some form of convergence. The goals of securities regulators are universal, yet the proposed best methods of achieving these goals differ from nation to nation. For example, the twin aims of the SEC, protecting investors and promoting efficient capital formation,[85] are also the aims of securities regulators worldwide.[86] Yet, because of "differences in economic development, culture, legal and social environments, and the fact that different legal markets and their corresponding regimes develop at different rates of speed and over different periods of time . . . domestic rules will have to exist which will not be supplanted by the convergence process."[87] Thus, in contrast to harmonization and competition, convergence is better suited to balance the local with the global by considering the benefits of an international regulatory regime while accommodating important differences of economies, cultures, and legal environments.

B. Examples of Convergence

1. European Union Common Market. The European Union is a helpful case study because it has had to address many of the specific issues related to convergence in its attempt to create an integrated capital market, and thus is "a model, an experimental laboratory, as to how regulation might be formulated and implemented in the

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84. *See* Scott, *supra* note 54, at 16 (stating common rules require states subject to such rules to cede authority); Tung, *supra* note 44, at 1368 (claiming issuer choice is "politically implausible.").

85. *See generally* Consideration of Promotion of Efficiency, Competition, and Capital Formation, Securities Act of 1933, 15 U.S.C. § 77b (2006). *See also* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS SEC. REG. 210 (4th ed. 2004).

86. International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, at i (2003), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf ("[T]hree objectives of securities regulation . . . are: the protection of investors; [e]nsuring markets are fair, efficient, and transparent; [and t]he reduction of systematic risk."). The International Organization of Securities Commissions (IOSCO) is an international body comprised of securities regulators plus affiliate members that are stock exchanges, international organizations, and other similar entities. *See generally* IOSCO, http://www.iosco.org/about/.

87. Shirinyan, *supra* note 1, at 516-17, 539.

international system at large."[88] Steps toward convergence worldwide have succeeded largely due to the efforts of E.U. regulators promoting convergence as an approach to dismantling legal barriers to integrated financial markets.[89] European regulators have explicitly acknowledged the reduced cost of capital that is realized under converged standards, pointing to studies that indicate a benefit of approximately one percent of gross domestic product in the European Union alone.[90]

The Treaty of Rome was implemented to remove restrictions on the free movement of goods, services, persons, and capital within the European Union.[91] The E.U. initially attempted to fully harmonize its financial markets in the 1970s and 1980s, but noted it would require 300 pieces of legislation to be enacted on an E.U.-wide basis.[92] Thus, it shifted toward a policy that combined "home market regulation" with mutual-recognition; this meant member states agreed to certain minimum standards while tolerating non-essential differences, ultimately leaving the regulation of issuers to the "home market" (where the issuer was incorporated) rather than the "host market" (where the issuer was listed).[93] This policy was predicated on the host-country's recognition of the home-country's rules as controlling the operations of cross-border transactions, and was facilitated by the reciprocity of mutual-recognition granted between nations.[94] Such a policy required a degree of convergence, in that the home and host countries' standards had to be roughly equivalent in order for each to feel its policies were being served in the other's markets.

The European Union initially designed a timetable for the targeted adoption of these securities laws standards which was implemented through the Single European Act amendments to the

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88. Scott, *supra* note 54, at 8.

89. Wei, *supra* note 53, at 258.

90. *Hearing before H. Comm. on Financial Services*, 108th Cong. (2004) (testimony of Alexander Schaub, Director-General, DG Internal Market of the European Commission), http://ec.europa.eu/internal_market/finances/docs/general/2004-05-13-testimony_en.pdf.

91. Treaty Establishing the European Community (Treaty of Rome), Mar. 25, 1957, 2006 O.J. (C 321) 1.

92. Scott, *supra* note 54, at 15. *See generally Completing the Internal Market: White Paper from the Commission to the European Council*, COM (1985) 310 final (June 14, 1985), *available at* http://aei.pitt.edu/1113/01/internal_market_wp_COM_85_310.pdf (outlining the steps necessary for achieving an integrated internal market for a European Community).

93. Scott, *supra* note 54, at 27.

94. *Id.* at 27-28.

Treaty of Rome.[95] These amendments encourage the use of Directives to achieve a common market.[96] Directives originate with the European Commission (E.C.) and are not self-executing.[97] The Directives are binding on E.U. member states as each member state has a duty to implement the aims of the Directive; however, Directives allow member states to choose the appropriate method of achieving the Directive's final objectives.[98] In the European Union's attempt to establish a functioning common market, the E.C. has generally favored the use of Directives to achieve harmonization of laws.[99] The "implementation of these Directives is coordinated through E.U.-wide functional regulators" composed of individuals from member states, "such as the Committee of European Securities Regulators (CESR)."[100]

These Directives are largely responsible for the increased convergence of capital markets in Europe. Moreover, through the process of integrating fifteen different national securities regimes, E.U. regulators have developed a model of converged standards while leaving enforcement of territorially-based issues to national regulators. It is beneficial to look at three Directives promulgated to unify capital markets within Europe: the Transparency Directive, the Prospectus Directive and the Fifth Directive on Company Law.

a. Transparency Directive. The Transparency Directive[101] established requirements concerning the periodic disclosure of information, including the annual financial report.[102] A significant change made by the Directive, as it was amended in 2004, was the adoption of the requirement that issuers across the European Union complete reports, using the International Financial Reporting Standards (IFRS) by 2005.[103] This was significant because it

95. Karmel, *supra* note 32, at 12. For a detailed treatment of the background of the Single European Act and its basis in the, see also P.J.G. KAPTEYN & P. VERLOREN VAN THEMAAT, INTRODUCTION TO THE LAW OF THE EUROPEAN COMMUNITIES 33-35, 132-34 (3d. ed. 1998).

96. Karmel, *supra* note 32, at 13.

97. Roberta S. Karmel, *Reform of Public Company Disclosure in Europe*, 26 U. PA. J. INT'L ECON. L. 379, 383 (2005).

98. *See, e.g.*, K.P.E. LASOK AND D. LASOK, LAW & INSTITUTIONS OF THE EUROPEAN UNION 142 (7th ed. 2001).

99. KAPTEYN & VAN THEMAAT, *supra* note 95, at 779.

100. Scott, *supra* note 54, at 8.

101. Council Directive 2004/109, 2004 O.J. (L 390) 38 (EC); Council Regulation 1606/2002, The Application of International Accounting Standards, art. 4, 2002 O.J. (L 243) 1 (EC).

102. Karmel, *supra* note 94, at 394-95.

103. Council Regulation 1606/2002, *supra* note 101, at 2.

introduced the issue of whether non-E.U. issuers—particularly U.S. issuers that reported in U.S. Generally Accepted Accounting Principles (U.S. GAAP)—would also be required to report in IFRS.[104] Initially member states were given the option of allowing U.S. issuers to defer adoption of IFRS until 2007,[105] but this has been changed recently to 2009.[106] This amendment allows standard setters and regulators in each country to continue engaging in dialogue and working through the convergence process until that time.[107]

b. Prospectus Directive. Another important Directive that has facilitated capital market integration has been the Prospectus Directive.[108] The Prospectus Directive establishes a set of uniform requirements throughout the European Union concerning the comprehensive disclosure of information upon an issuer's securities offering.[109] It was intended to play a central role in integrating the market for financial services in the European Union.[110] Under the Directive, the regulators in the home state for each issuer process the issuer's disclosure documents, and, once approved, securities regulators in other E.U. member states cannot impose additional disclosure requirements.[111] Interestingly, the Prospectus Directive does not provide for civil liability, unlike the Securities Act of 1933; these matters are left to the host states.[112] This is an important issue from an enforcement and remedy standpoint, and is one this note will return to later.

c. Proposal for a Fifth Directive on Company Law. A Directive that was intended to facilitate convergence, but was highly

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104. Karmel, *supra* note 97, at 394-95.

105. Stuart H. Deming, *International Accounting Standards*, 40 INT'L LAW. 363, 364 (2006).

106. McCreevy, *supra* note 80.

107. Comm. of Eur. Sec. Reg., Technical Report, *CESR's advice to the EC on the Work Programmes of the Canadian, Japanese, and US Standard Setters, the Definition of Equivalence and a List of Third Country GAAPs Currently Used on the E.U. Capital Markets,* sec. II.8 (Mar. 8, 2007), *available at* http://www.cesr-eu.org/index.php?page=groups&mac=0&id=46 [hereinafter Technical Report].

108. Council Directive 2003/71, 2003 O.J. (L 354) 64 (EC).

109. Karmel, *supra* note 97, at 388.

110. *Id.*

111. *Id.* at 392. *See also* Council Directive 2003/71, *supra* note 108, at 65 (identifying the home member state as "the one best placed to regulate the issuer for the purposes of this Directive"); *id.* at 70 (defining "home member state" and "host member state"); *id.* at 78 (describing relationship between host and home member states in light of prospectus being approved by the home member state).

112. Karmel, *supra* note 97, at 392-93, 398; Scott, *supra* note 56, at 82.

controversial, was the Proposal for a Fifth Directive.[113] This Directive revealed sharp differences between E.U. member states, particularly the United Kingdom and Germany, over certain aspects of corporate law, and is thus instructive as to those areas of law where convergence may be difficult to achieve. The Fifth Directive, also known as the Company Structure Directive,[114] was amended and re-proposed three times yet was never adopted.[115] All of the Proposals for a Fifth Directive concerned corporate organizational structure, employee participation, rights and duties of the board, and shareholders' rights.[116] The Fifth Directive provoked disagreement in part because it touched upon fundamental differences concerning the significant role of shareholders' equity capital in the United Kingdom, in contrast "to the role of bank credit or government . . . funding on the Continent."[117] The Directive also highlighted significant differences between E.U. member states concerning the structure of the board, in particular the differences between one- and two-tier boards.[118] In fact the first proposed Directive mandated a two-tier board.[119] However, this revealed sharp differences between the U.K. model, which generally favors a one-tier board that can be amended through the articles, and the German model, which mandates a two-tier board separating the functions of supervision and management.[120] The German model gives stakeholders other than shareholders—the main group being employees—the possibility of influencing the company through the supervisory board.[121] Moreover, the Directive highlighted that the influence of shareholders wield through a shareholders' meeting is quite different from country to country. In the United Kingdom and France, the shareholders' meeting is seen as "the supreme organ" for shareholders, especially if it appoints managers directly; by contrast, in Germany the shareholders' meeting is seen "at most as being on an equal footing" with the exercise of the powers of other constituencies, such as employees and directors, and is

113. Amended Proposal for Fifth Directive, 1983 O.J. (C 240) 2 (EC).

114. *See* STEFAN GRUNDMANN, EUROPEAN COMPANY LAW: ORGANIZATION, FINANCE AND CAPITAL MARKETS 219 (2007).

115. *See id.* at 62, 65 fig.4a, 66, 219.

116. *Id.* at 62, 219.

117. Karmel, *supra* note 32, at 18.

118. *See* GRUNDMANN, *supra* note 114, at 219.

119. *Id.*

120. *Id.* at 225.

121. *See id.* at 225-31.

restrictive in regard to the actual powers that can be exercised at the meeting.[122]

The Transparency and Prospectus Directives have facilitated common standards within the European Union; however, they were supported by a common political infrastructure, which is lacking on an international scale between the E.U. and other countries. Regardless, the content of these Directives provides insight into what areas of law may see more convergence than others.[123] For instance, the Proposed Fifth Directive sparked significant controversy because it prescribed rules governing significant cultural and economic biases reflected in features such as the basic structure of corporate governance (one- versus two-tier boards), the administrative rights of shareholders (such as powers exercised at the shareholders' meeting), and the role of stakeholders such as employees; accordingly, it is unlikely that these areas—more broadly, areas affecting internal company structure and governance—will be subject to a globally converged set of standards.[124] Additionally, as the Prospectus Directive leaves civil liability determination to host states, it is likely that questions of liability and appropriate remedies may be left to each individual nation to determine. By contrast, questions of disclosure and accounting standards are more easily resolved via converged standards, because they do not touch upon culturally and politically sensitive corporate governance relationships between management, directors, shareholders, and auditors, and the relative rights and duties of each group.

It is also notable that E.U. member states do not apply securities laws to their own investors extra-territorially, as does the United States.[125] This fundamental difference between the European Union and United States may mean that convergence on an international

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122. *Id.* at 241.

123. *See* discussion *infra* Part III.

124. In some ways a European fear of America "exporting" SOX also reflects these core disagreements, because it was seen as an attempt to mandate an American style of corporate governance, in contrast to the very different relationships between auditors, shareholders, management, and directors that exist in Europe and elsewhere in the world. For example, prior to the passage of SOX, the E.U. sent Senator Sarbanes a letter urging for accommodations for foreign accounting firms. Congress Acts: *A Tough Corporate-Reform Bill Sails Through*, ECONOMIST, July 27, 2002, at 62. For an explanation of the differences between corporate governance law in Germany and the United States, see Jonathan Shirley, *International Law and the Ramifications of the Sarbanes-Oxley Act of 2002*, 27 B.C. INT'L & COMP. L. REV. 501, 511-13 (2004).

125. Scott, *supra* note 56, at 83.

scale would need to overcome the significant history of extra-territorial application of U.S. securities laws. The following section sketches out the relatively recent history of convergence as it has played out between the European Union and United States, focusing particularly on the possible convergence of accounting standards.

2. *Trans-Atlantic Convergence.* There has been a long history of cooperation between securities regulators in the United States and elsewhere. For example, the SEC has entered into a number of bilateral Memoranda of Understanding in the areas of insider trading and enforcement.[126] The SEC also has a long history of balancing the protection of investors with the facilitation of efficient capital markets.[127] Aiding the formation of efficient capital markets and allowing U.S. investors to access the securities of foreign companies encourages the accommodation of foreign issuers, so that they list on U.S. exchanges and are subject to the SEC disclosure system, while not being so accommodating that U.S. issuers (or investors) are at a disadvantage.[128] Historically, the SEC has walked this line by carving out specific exemptions for foreign issuers. For example, Regulation S was intended to provide a clear safe harbor from registration for foreign private issuers.[129] It operated "as a safety valve, relieving the SEC of pressure exerted by foreign issuers . . . U.S. investment banks [and others]."[130] Likewise, one of the goals of Rule 144A,[131] governing the private placement of securities, was to increase foreign investment in the U.S. economy.[132] Recently, the SEC has tried to accommodate foreign issuers with respect to SOX, as the Commission recognizes the importance of keeping the United States attractive to those wishing to raise capital, and the European Union was concerned with the foreign impact of SOX.[133] The SEC has also entered into regulatory dialogue with the European Union, including supporting meetings with the Commission of European Securities Regulators, a

126. Scott, *supra* note 54, at 11.

127. *See* Securities Act of 1933, 15 U.S.C. § 77b (2006).

128. Roberta S. Karmel, *The Securities and Exchange Commission Goes Abroad to Regulate Corporate Governance*, 33 STETSON L. REV. 849, 862-63 (2004).

129. *See* Regulation S, 17 C.F.R. §§ 230.902-230.904 (2006).

130. Karmel, *supra* note 32, at 512.

131. Rule 144A, 17 C.F.R. § 230.144 (2006).

132. Shirinyan, *supra* note 1, at 521.

133. Scott, *supra* note 54, at 12.

technical regulator, on several issues that may result in greater convergence of regulator standards between the two.[134]

One area of particular and recent interest has been the possibility of convergence in U.S. GAAP and IFRS accounting standards. National accounting standards are a cornerstone of a country's financial system, providing an essential means of disclosing critical information for the valuation and comparison of companies.[135] Thus, streamlining accounting standards is an essential first step before considering a more general convergence of securities laws. Some degree of convergence in accounting standards has taken on renewed importance now that the European Union operates under the single standard of the IFRS. For instance, IFRS is increasingly being used outside the European Union: Australia, New Zealand, Hong Kong, Singapore, and the Philippines have all adopted IFRS.[136] Canada and China have announced they will be moving their standards toward IFRS in coming years.[137] Meanwhile, U.S. issuers still use a separate standard, U.S. GAAP.

U.S. GAAP standards are set by a private body, the Financial Accounting Standards Board (FASB).[138] IFRS grew out of an effort by another private body, the International Accounting Standards Board (IASB).[139] These two private bodies have worked together since 2002, when they signed the Norwalk Agreement, in which they committed to the development of high-quality compatible accounting standards that could be used in cross-border financial reporting.[140] These were private efforts, given the IASB and FASB's status as

134. *Id.* For a list of SEC's dialogues and international efforts, see Securities and Exchange Commission, International Organizations, http://www.sec.gov/about/offices/oia/oia_intlorg.htm (last visited Jan. 22, 2008).

135. Shirinyan, *supra* note 1, at 550; *see also* Hal S. Scott, Nomura Professor and Dir. of Program on Int'l Fin. Sys., Harvard Law Sch., Remarks at International Financial Reporting Standards Roadmap Roundtable 3 (Mar. 6, 2007) (transcript available at http://www.sec.gov/spotlight/ifrsroadmap/ifrsroadmap-transcript.txt) ("Accounting standards may be arcane to some, but they are the bedrock of the financial system, and, ultimately, of the economy as a whole.").

136. Deming, *supra* note 105, at 365.

137. *Id.* at 366. *See also Cultural Revolution*, ECONOMIST, Jan. 13, 2007, at 63-64 (describing the significance of China's move to IFRS).

138. *See* FASB, Facts About FASB 1, *available at* http://www.fasb.org/facts/facts_about_fasb.pdf.

139. Deming, *supra* note 105, at 363.

140. Fin'l Accounting Standards Bd. & Int'l Accounting Standards Bd., Memorandum of Understanding (The Norwalk Agreement) (Sept. 18, 2002), *available at* http://www.fasb.org/news/memorandum.pdf.

private bodies. The U.S. government became involved after the passage of SOX, when Congress mandated that the SEC examine the possibility of changing the nature of the U.S. accounting system from a "rules-based" approach (which describes the U.S. GAAP approach) to a "principles-based" approach (which describes the IFRS approach).[141] Further, in 2005, the chief accountant of the SEC published an article that laid out a "roadmap to elimination of the SEC's requirement that foreign private issuers reconcile financial statements prepared under IFRSs to U.S. GAAP."[142] It acknowledged the increasing use of IFRS, stating the "[p]rimary driver behind the expanded use of IFRSs is a decision made by the European Parliament and the Council of the European Union that all listed European Union companies . . . must prepare their consolidated financial statements in accordance with IFRSs from 2005 onward."[143] The article and its roadmap were formally endorsed by the SEC just a few months after its publication.[144]

On the European side, the European Union, in both the Transparency and Prospectus Directives required that the European Commission establish whether non-E.U. accounting standards, including U.S. GAAP, were equivalent to IFRS.[145] As part of this process, the European Commission directed the Commission of European Securities Regulators (CESR) to determine whether these standards are equivalent and to advise whether non-E.U. issuers should continue to be allowed to use their respective accounting principles, instead of IFRS. The study recommended, first, that issuers be allowed to use U.S., Canadian, and Japanese GAAP until 2009. In 2009, the CESR's decision determining equivalence is set to be announced, after which use of non-E.U. accounting standards will be allowed only if they are determined to be equivalent to IFRS.[146]

These efforts are laudable. A determination that U.S. GAAP and IFRS were equivalent would be a significant step toward convergence. Additionally, there have been some steps toward

141. Christopher Cox, Chairman, Securities and Exchange Comm., Remarks at International Financial Reporting Standards Roadmap Roundtable (Mar. 6, 2007) (transcript available at http://www.sec.gov/news/speech/2007/spch030607cc.htm).

142. Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, 25 NW. J. INT'L L. & BUS. 661, 662 (2005).

143. *Id.* at 661-62.

144. *See* Cox, *supra* note 141.

145. *See* Technical Report, *supra* note 107, sec. II.8.

146. *Id*. sec. II.9.

international convergence with respect to disclosure standards where there are few national differences and rules are generally consistent with U.S. law.[147] The European Prospectus Directive, for example, adopts disclosure requirements that are generally the same as those in the United States.[148] However, full harmonization on all aspects of securities law is both unlikely and undesirable. For instance, the trans-Atlantic dialogue over accounting standards, as well as the European Union's experience creating an integrated regulatory scheme, highlights particular areas where convergence is relatively easier to achieve, as opposed to areas such as enforcement. "Standardized enforcement would require countries to have similar enforcement remedies, both administrative and private. . . . [A] significant number of foreign issuers have reportedly avoided U.S. public markets because of the stiff enforcement remedies employed by the SEC—including potential criminal liability—and the prospect of costly private class action suits. . . ."[149] For example, the Prospectus Directive does not provide for civil liability, and illustrates how enforcement and remedies available to investors will likely remain territorially-based. Indeed, even in the highly unified European Union, responsibility for enforcement is left up to host country regulators.[150]

Moreover, there are significant differences in the type of investors in the European Union versus in the United States.

> In the U.S., 50% of investors are retail, whereas in Europe, the number of retail investors is quite small. Further, securities in Europe are overwhelmingly debt instruments, in contrast to the equity instruments being the dominant security in the U.S. Consequently, investor protection means different things to Americans and Europeans.[151]

Likewise, as seen from SOX and the Fifth Company Directive, any attempt to harmonize laws related to corporate governance will face stiff resistance because it implicates culturally and socially informed norms about the corporate power relationships between shareholders, managers, owners, and auditors. These differences reveal that for

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147. Scott, *supra* note 56, at 78-79.

148. Scott, *supra* note 54, at 17.

149. Scott, *supra* note 56, at 78-79.

150. Karmel, *supra* note 97, at 392; Scott, *supra* note 56, at 82; *see* discussion *supra* Part II.B.1.b.

151. Roel C. Campos, Comm'r, Sec. and Exc. Comm., Speech at the U.S.-Europe Symposium Program on International Financial Systems: Convergence and Beyond (Nov. 13, 2003).

particular public policy interests, regulators have an incentive to remain territorially-focused in their approach, so as to protect those distinctive financial market characteristics or political aims that are not shared by other nations. There are limits to convergence, and by acknowledging these limits regulators are able to focus their efforts more productively on those areas where coordinated, roughly equivalent, and high-quality standard-setting is more likely.

III. RESPONSES TO CONVERGENCE AND THE ROLE OF EXCHANGES

A. Regulatory Responses to Convergence

Regulators on both sides of the Atlantic have been engaged in a dialogue for some years concerning the possibility of convergence, and accommodations on both sides have been made. Yet, these efforts have taken on renewed significance with the increased consolidation among demutualized exchanges such as the recent merger between the NYSE and Euronext. This merger brings together one of the world's oldest, largest, and most respected exchanges, the NYSE, with the most transnational exchange, Euronext, which operates exchanges in five different European countries.[152]

Despite a trend toward convergence, the idea of shared standards is not always viewed positively; it can be characterized as overly accommodating to foreign regulatory standards. For example, Annette Nazareth, SEC Director of Division of Market Regulation, testified before Congress concerning a proposed directive in the European Union:

> [The SEC] is concerned about the possible imposition of standards on U.S. firms by the European Community in the form of 'equivalence' determinations. . . . To the extent that 'equivalence' is really a means of having a 'coordinator' in the E.U. evaluate the quality of our regulatory regime, we do not think that approach will be productive or add to investor protection.[153]

152. *See* Euronext, http://www.euronext.com/editorial/wide/editorial-1994-EN.html (last visited Jan. 22, 2008); Euronext, http://www.euronext.com/editorial/wide/editorial-1612-EN.html (last visited Jan. 22, 2008).

153. Annette L. Nazareth, Dir., Div. of Market Regulation, Sec. and Exch. Comm., Testimony Concerning Pending Proposals by the European Commission (May 22, 2002), *available at* www.sec.gov/news/testimony/052202tsaln.htm.

Her comment highlights the interest regulators have in maintaining sovereign control and preventing domestic standards from being subjected to the evaluative authority of a foreign agency.[154] Given this interest, it is in some measure inevitable that E.U. and U.S. regulators base their decision-making on domestic rather than international factors.[155] Regulators quite naturally appear unwilling to cede their delegated authority without strong policy reasons, which is a reason neither full harmonization nor complete competition are likely. Disagreements in regulatory approaches can arise for a number of reasons, since "nations are no different than commentators in disagreeing widely as to just what policy consideration is to be served . . . [and] how best to fulfill a policy objective."[156] Further, when considering multi-jurisdictional securities transactions that implicate conflicting regulatory demands, there arises the fundamental issue of whether such transactions should be governed by public or private law.[157] When evaluating the prospect of convergence, this issue is likely to remain a principal consideration that can introduce a basic, and perhaps even irreconcilable, tension between different regulatory approaches. This tension comes sharply into focus as the capital markets continue to pull international securities law in the direction of convergence.

B. Exchange Activity Pushes Regulators Toward Convergence

The merger between NYSE and Euronext will not dramatically change the current, territorially-focused regulatory environment. As noted in the SEC's approval of NYSE rule changes associated with the merger, "[a] core aspect of the structure of the Combination is local regulation of the marketplace, members, and issuers. Therefore, securities exchanges, members, and issuers of NYSE Group and Euronext will continue to be regulated in the same manner as they are currently regulated."[158] The SEC and the College of Euronext Regulators (regulators from each of the five countries in which Euronext operates an exchange) signed a Memorandum of

154. *See* discussion *supra* Part II.A.

155. *See* Karmel, *supra* note 97, at 379.

156. Cox, *supra* note 51, at 1180-81.

157. *Id.* at 1181.

158. Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Regarding the Proposed Combination Between NYSE Group, Inc. and Euronext N.V., Exchange Act Release No. 34-55293, 72 Fed. Reg. 35,8033, 35,8035 (Feb. 22, 2007).

Understanding on January 25, 2007, in which they affirmed the importance of keeping the markets locally regulated.[159] Yet the increased cooperation via this regulatory Memorandum is directly connected to the NYSE's and Euronext's merger. Significantly, a large part of the Memorandum was committed to ongoing cooperation and dialogue.[160] Each regulator stated that, to the extent practicable, it would keep the other informed of regulatory changes or material events that would have an impact on NYSE-Euronext, including enforcement actions that could adversely impact the exchange or any other market in another regulator's jurisdiction.[161] While Memoranda of Understanding between regulators concerning enforcement are not new,[162] exchanges, in their new roles as demutualized organizations, are necessitating even closer regulatory dialogue beyond solely enforcement. The NYSE-Euronext Memorandum extends to keeping each other informed of regulatory changes or material events. Such increased communication will facilitate incremental movements toward convergence in other areas such as accounting and disclosure requirements.

Presently, the activity in capital markets and among regulators seems to be a validation of Professor John Coffee's argument that exchanges play a role in creating convergence because they create a "bonding mechanism" when an issuer lists on an exchange.[163] For example, foreign issuers enter into listing agreements with the NYSE before listing their stock. By entering into this agreement, a foreign issuer agrees to be bound by those regulatory standards that it may not be subject to under its home jurisdiction.[164] Listing on an exchange represents a voluntary agreement by foreign issuers to be subjected to a host country's corporate and securities laws, and these "bonding" agreements between exchanges and issuers are a significant factor in creating converged standards.[165] One argument

159. Memorandum of Understanding, Sec. Exch. Comm. and College of Euronext Regulators, arts. 2, 13 (Jan. 25, 2007).

160. *Id.* arts. 2, 6.

161. *Id.* arts. 3, 16.

162. LOUIS LOSS AND JOEL SELIGMAN, SECURITIES REGULATION 5241 (3d. ed. 2005).

163. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 674, 691-92 (1999).

164. *Id.* at 691.

165. *See id.* at 652-53. Professor Coffee also distinguishes between "functional convergence" and "formal convergence," and appears to categorize the "bonding mechanism" of exchange listings as a type of functional convergence. *See id.* at 650, 679-82. For analyses of

against this possibility is that self-regulatory organizations (SROs), while standard-setters, are not able to pre-empt the laws of the overseeing government regulatory body, such as the SEC.[166] However, the SEC and the International Organization of Securities Commissions have a history of respecting the self-regulatory role that exchanges play in the capital markets.[167] The SEC has previously stated that "[e]nhancing an SRO's ability to implement and to respond quickly to changes in the marketplace should encourage innovation and better services. . . . Investors should also benefit from a competitive environment in which SROs may easily adapt their trading rules to respond to market opportunities."[168] There has been a long history favoring self-regulation in the U.S. markets. The SEC has acknowledged that, in creating the self-regulatory structure of American securities markets, "Congress determined that the securities industry self-regulatory system would provide a workable balance between federal and industry regulation."[169] Moreover, exchanges themselves are an interest group. Now that they are operating as demutualized entities with shareholders, they will be facing pressure from new constituencies to sustain and increase their profitability.[170] Thus, exchanges have an arguably greater interest now that they are demutualized in pushing for the convergence of regulatory standards. As both interest groups and standard-setters, exchanges are increasingly influencing the regulatory landscape going forward, albeit on an incremental and indirect level.

CONCLUSION

The international landscape of securities law has been undergoing significant changes for several years, as capital markets

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specific corporate governance dynamics that might incentivize a company to list on a foreign exchange, see *id.* at 680-83.

166. Shirinyan, *supra* note 1, at 529.

167. *See* SRO Consultative Comm., Int'l Org. of Sec. Comm'ns, *Model for Effective Regulation* 1, 4 (May 2000), *available at* http://www.iosco.org/download/pdf/2000-effective_self-regulation.pdf ("In an environment characterized by a variety of different markets and different types of participants, a specialized and thorough knowledge is very beneficial.").

168. Rule Changes of Self-Regulatory Organizations, Exchange Act Release No. 34-43860, 66 Fed. Reg. 8,912 (proposed Feb. 5, 2001).

169. Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-507000, 69 Fed. Reg. 71,256 (proposed Dec. 8, 2004) (citing S. Rep. No. 1455, 73d Cong., 2d Sess. (1934); H.R. Doc. No. 1383, 73d Cong., 2d Sess. (1934)).

170. For a view of the NYSE as acting as an "interest group pressuring the SEC to relax its disclosure standards," see Karmel, *supra* note 32, at 487.

become increasingly interconnected and global. This movement appears to have accelerated recently with the development of demutualized exchanges, leading to international consolidations and alliances among exchanges. Going forward, the possibility of international convergence of securities regulations, will largely evolve based on how exchanges, as businesses, navigate the regulatory waters surrounding cross-border combinations, and how, as self-regulatory organizations, they promulgate standards for issuers and investors. Regulatory dialogue and approval is necessary and helpful, yet the current activities of the exchanges themselves are strong catalysts in the convergence of particular standards, such as those governing accounting and disclosure.