DIAMONDS AND PEARLS AMONG FINANCIAL MARKETS: 
THE KEYS TO SUCCEED IN REGULATORY COMPETITION

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Abstract

Recent turmoil has indicated that it is time to re-think the regulation of financial markets and all entities directly involved therein. Moreover, we also believe it is time to re-consider the regulatory determinants of financial markets’ success, evaluating them in light of increased global competition among capital markets. In this paper we give evidence of some regulatory initiatives taken in recent years, as well as some of those currently developing. Furthermore, we evaluate three regulatory issues that affect competition between financial arenas: i) the process of reciprocal pursuit between regulators and regulated entities; ii) the differing regulatory approaches; iii) competition between regulators. Finally, we show that re-considering the regulatory determinants of financial markets’ success in light of competition between individual markets confirms certain policy objectives.

Keywords: Financial markets, Stock exchanges, Competition.

Index: 1. Introduction; 2. Recalling why financial market success ‘matters’; 3. Competition between legal and financial systems; 4. Recent changes in financial structures: operations and operators; 5. Recent changes in financial structures: Stock Exchange Integration; 6. Recent regulatory initiatives; 6.1 Recent North American regulatory initiatives; 6.2 Recent European regulatory initiatives; 6.3 Recent

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1. Introduction

Traditionally, listing in New York had a strong signalling effect with regard to good corporate governance, sound financials and strong or at least stable growth projections. The bonding effect sought by foreign issuers who chose to cross list in the United States has indeed been identified by numerous authors.\(^1\)

The events of 9/11/2001 accelerated a shift in the ‘balance of powers’ within the global financial arena.\(^2\) In recent years, the perceived lack of competitiveness of U.S. capital markets\(^3\) has revitalized the debate on the regulatory determinants of financial markets’ success, as capital markets have moved from a (quasi-U.S.) monopoly, to a terrain of fierce competition.

The general academic discussion has moved away from the convergence of financial systems and corporate governance models: market-oriented versus bank-oriented systems.\(^4\) If nothing else, recent financial turmoil has shown that path dependency in the generalized financial context of public corporations has a role, if any, in mitigating the repercussions on marginalized portions of a global financial market.\(^5\)

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\(^3\) Numerous reports and articles have been published on the subject. See further in Section 6.1.


\(^5\) Most Italian banks have, for example, not been ‘intimately’ involved because of path dependent regulatory stances.
It is certainly time to re-think the regulation of financial markets and all entities directly involved therein. Moreover, we also believe it is time to re-consider the regulatory determinants of financial markets’ success, evaluating them in the light of increased global competition among individual capital markets.

In this paper we give evidence of some regulatory initiatives taken in recent years, as well as some of those currently developing. Furthermore, we evaluate three regulatory issues that affect competition between financial arenas: i) the process of reciprocal pursuit between regulators and regulated entities, ii) the differing regulatory approach enacted and iii) the competition developing between regulators.

Re-considering the regulatory determinants of financial markets’ success in the light of competition between individual markets confirms certain policy objectives. Firstly, the need of a supranational supervisory and regulatory authority. Secondly, the need not to discourage stricter regulatory standards resulting from specific choice or path dependencies. Thirdly, encouraging strict minimum harmonization regulatory standards.

This paper proceeds as follows. In section 2 we briefly examine the doctrinal and empirical debate linking financial market growth to economic growth. Section 3 outlines the debate on competition between legal and financial systems. In section 4 we examine fundamental regulatory changes in financial market structures regarding financial operators and operations. In section 4 the major changes in financial structures regarding stock exchanges are outlined, with specific reference to recent integrations and consolidations. In section 6 the major regulatory initiatives in the United States, in Europe and in the U.K are briefly set out. Section 7, in light of our discussion, evaluates the optimal regulatory balance for financial market success in the light of recent competition. In section 8 we conclude that re-considering the regulatory determinants of financial markets’ success in the light of increased competition confirms the policy objectives of a supranational regulatory authority; the need not to discourage stricter regulatory standards resulting from specific choice or path dependencies; the need to encourage strict minimum harmonization regulatory standards.
2. Recalling why financial market success ‘matters’

Academic research and debate has focused on development of financial systems because of the central role they play in connecting households (providers of capital) with enterprises (in search of capital). The discussion has referred mostly to the choice between bank-oriented and market-oriented regimes, where the United States was viewed as the most efficient market-oriented model.

The importance of an efficient model of financial capital markets has also been examined by numerous important academic contributions in the light of the relationship between financial markets and economic growth and development.

At the beginning of the twentieth century, Joseph Schumpeter suggested that a well-functioning banking (and financial) system stimulates technological innovation by identifying and promoting enterprises which use innovative products and production processes.

As early as 1969, analyzing 35 countries, Goldsmith found that stock market liquidity and banking development are both positively correlated with economic growth and increase of productivity. Nonetheless, the author was unable to establish the direction of the causal mechanism, i.e., whether financial factors were responsible for the acceleration of economic development or whether...

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financial development reflected economic growth whose mainsprings were to be sought elsewhere.\footnote{R.W. Goldsmith, \textit{Financial Structure and Development}, New Haven, Yale University Press, (1969), p. 400.}

Most of the empirical literature now agrees on the existence of a positive correlation between degree of financial market development and economic growth; that is, essentially, between capitalization and market depth/liquidity and gross domestic product or other similar indicators of growth.\footnote{An interesting and complete reference to these contributions can be found in S. Paris, \textit{La borsa nel sistema finanziario italiano}, Il Mercato finanziario italiano: borsa, competitività delle imprese e tutela del risparmio, Luiss University Press, (2005).}

In 2001 Demirgüç-Kunt and Levine analyzed 150 countries and concluded that financial development ‘matters’ for economic success, but financial structure \textit{per se} does not seem to matter much. According to these authors, policy makers should concentrate less on the extent to which their country is bank or market oriented, and more on the regulatory reform necessary to promote an efficient capital market.\footnote{Financial structure and economic growth, MIT (2001).}

3. \textit{Competition between legal and financial systems}

The law and finance view has had an important role in theorizing the role of regulation in the development of financial markets.\footnote{The seminal work of La Porta, Lopez de Silanes, Schleifer, Vischny (LLSV), \textit{Law and finance}, was first published in 1996. Since then, numerous other papers and academic contributions have followed.} In their analysis, La Porta, Lopez de Silanes, Schleifer, Vischny (LLSV) customarily divide the countries examined in four different legal families according to their legal origins: French civil law; German civil law; English common law; Scandinavian law.

LLSV conclude that retail investor and creditor protection are highest in countries with common law origins. Differently, in French civil law countries, retail investor and creditor protection are low.
Consequently, in common law countries they find a greater tendency to have public companies, as minority investments are encouraged and protected – capital markets are developed. In French civil law countries, block-holders are more common as their participants have a greater possibility of protecting their own interests – the banking system is more developed.

Globalization has brought to the fore-front the theme of competition between legal and financial systems. In a globalized world, national frontiers no longer constitute a separation or a hindrance to trade and investment. Correspondingly, national authorities often have a limited role – capital markets are international.

In this framework, private agents are allowed to decide the law and financial arena they prefer (forum shopping). As in the case of a market for goods, competition should establish an efficient regulation. Nonetheless, the possibility of choosing the lieu where to offer or purchase securities carries also the risk of a race-to-the-bottom.

This kind of discussion, with reference to the competition between states for incorporation, has recently been carried out both in the United States and in the European Community.

In the United States the discussion was rekindled as the Sarbanes Oxley Act (2002) seemed to interfere with the internal affairs of corporations – usually left to state law; the matter of debate was whether inter-state competition had been superseded by federal-state competition. In the European Community, the possibility of forum shopping was recently envisaged after the Uberseering and Inspire art cases and there progeny.

Academia has studied the advantages of competition between different legal and financial systems\(^{12}\). Competition between financial platforms poses the central problem of regulatory determinants of financial success and development. LLSV have shown countries with lower investor protection run the risk of losing out in global competition between financial platforms.

Recent national regulatory initiatives have indeed been focused towards attracting investment, both foreign and national, by

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\(^{12}\) See, for example, S. Casse, Mercatizzazione del Mercato o Arena Pubblica?, in A. Zoppini (edited by) La concorrenza tra ordinamenti giuridici, Bari, Laterza, (2004).
adopting regulations aimed at creating an ‘investor friendly’ environment. Markets have been forced to efficiency and there is now a process of adjustment which involves the financial platforms, market operators and market operations.

This process of adjustment has to be inserted in the general context of a globalized economy and, more specifically, of a common market for investment securities in Europe. Among other things, regulators are faced with the choice regarding which regulatory approach to adopt.

The strict interdependency and interconnection - physical, technological, ideal - of different financial arenas, which remain subject to different national legislations, also introduces problems of systemic risk. This confirms the need not only to harmonize regulations – not only capital requirements - but also to adopt a regulatory approach which is common to the different countries, or directed by a supra-national authority.

4. Recent changes in financial structures: operations and operators

The current situation has been characterized by simultaneous innovations in interdependent fields. Technological innovations, on the one hand, have led to new innovative financial instruments and, on the other hand, have changed financial operators’ transaction costs structure. These changes have in turn led to new organizational models, which have become more efficient in the developing configuration of competing financial markets.

The consolidation of financial markets has modified each market’s structure and each new structure needs regulations regarding the increased market power of operators and the process of platform integration.

Ultimately, regulators must decide whether to allow the market to select an efficient structure or whether to impose one directly, achieving immediate stability. The first solution generates an innovative effect through competition between operators – where competition is intended as a dynamic process tending towards efficiency. Differently, if the market is left to decide an efficient
structure - in an ex-post perspective – competition will develop mostly between regulators. For example, the MiFID directive\textsuperscript{13} seems to create an incentive for competition between financial arenas\textsuperscript{14}.

The interdependencies present in the financial market may cause problems in the process pursuing an efficient outcome. Consequences related to systemic risk can for instance emerge as a consequence of operators’ wrong choices. The failure of an inefficient structure could affect efficient operators and the system as a whole. Overall, this might lead regulators to reconsider an approach that guides markets toward an efficient structure - in an ex-ante perspective -, even though this solution could dampen the process of innovative competition between operators.

Regulators should examine whether these two approaches are consistent with each other, with a view to achieving immediate stability without losing excessively the benefits of the process of innovation. Regulators should also pay attention to avoid the risk of a ‘regulatory pendulum’: swigging from the first to the second approach.

In recent years a new business model of banking has also developed, as a result of the proliferation of complex and esoteric financial products. Innovative financial instruments were created for two different goals: \textit{i)} to allocate as many resources as possible to those entities able of performing efficient exchanges; \textit{ii)} to reduce concentration of banks’ risk regarding loan portfolios and to create additional funds for new loans.

In such a framework, pervasive informational asymmetries in the financial market have led to market failures: agents maintain an incentive to act in an opportunistic manner. Asymmetries are strengthened by the complexity of the new business models’ structure – such as the ‘originate to distribute model’\textsuperscript{15}.

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\textsuperscript{14} See, for example, S. Micossi, La direttiva MiFID e la nuova struttura dei mercati regolamentati, (2008). Conferenza Dieci Anni dal Testo Unico della Finanza, Rome, Tor Vergata University, October 29, 2008.

\textsuperscript{15} The ‘Originate to distribute model’ is a financial intermediation through which lenders have dispersed the credit risks of underlying assets over investors, via markets. This model provides a source of finance for new loans, but also makes financial
In the traditional lend-and-hold banking model, the bank would enter into a relationship with the borrower and make its own assessment of the client’s financial stability. This meant that the bank would have a reasonably clear appreciation of the likelihood that a loan would indeed be paid back.

Under the new business model, the bank that offers credit does not care as much about the risk of default because it can package a number of loans into new financial instruments\(^\text{16}\). These highly complex structured finance products are then sold on to investors, such as other banks, hedge funds, and other financial institutions across the globe, including special investment vehicles created to invest in such products.

Overall, a trade-off between incentives for transactions and confidence is created. The market alone cannot solve the problem and new regulatory interventions are thus necessary.

Ultimately, whenever a crisis affects the financial system, a new regulation intervenes to counteract the imbalance between the actual and perceived financial condition. In fact, crises are often due to a misperception of the actual financial condition\(^\text{17}\). This misperception is the consequence, among the other things, of the firm’s efforts to get around regulation. In other words, on the one hand regulators try to solve possible misperceptions on the firms’ financial condition due to technical and technological changes. On the other hand, the firms’ management is often led to using technical and technological changes, the current economic environment and culture, to get around regulation and signal its healthy condition. This is indeed a dynamic process for institutions’ funding more dependent on sustained demand for credit instruments in capital markets. The model involves a long chain of participants from the original lender to the end-investor. Those at the end of this chain, who bear the final risk, have less information about the underlying quality of loans.

\(^{16}\) Such as Mortgage-Backed Securities or, more generally, Asset-Backed Securities (ABSs), which can then also be repackaged and bundled together into Collateralised Debt Obligations (CDOs), or Collateralised Loan Obligations (CLOs). See for example A.B. Ashcraft, T. Shuermann, Understanding the Securitization of Subprime Mortgage Credit, Federal Reserve of New York, Staff report N. 318, (2008).

search of an equilibrium. Like in an economic pray-predatory model, regulators pursue the regulated, thereafter the regulated hunt the regulators.

5. Recent changes in financial structures: Stock Exchange Integration

In the modern, globalized economy, financial markets are common enterprises, managed by entities similar to any other profit-seeking corporation. Competitive forces have thus created incentives to integration, in search of more efficient structures and outcomes.

In the last few years, the stock exchange industry has been characterized by bids and mergers concerning different financial platforms spread throughout the world, a trend that has resulted in a process of integration. Nonetheless, it is probable that this process of integration will not lead to a future centralization of financial markets.

The present state of consolidation in the stock exchange industry could be briefly described as follows.

Deutsche Börse presented in June 2006 a proposal, based on a federal model of governance, for a merger with Euronext NV. The proposal was rejected. In October 2006, Deutsche Börse signed a letter of intent with Borsa Italiana aimed “at creating a federal European exchange that includes Euronext”. In the same month, Euronext NV and the New York Stock Exchange offered to open talks with Deutsche Börse and Borsa Italiana regarding the purchase of their share trading businesses. Deutsche Börse rejected this offer and, in November 2006, also abandoned its offer to buy Euronext NV. Recently, an influential financial newspaper has reported that Deutsche Börse is talking to the

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18 Duncan Niederauer (the NYSE’s chief executive officer) expects this process to lead towards four or five global players along with smaller players; similarly, J. ATTALI, cited above. The Nasdaq’s chief Bob Greifeld expects that the sector will continue to fragment. See the article “Nasdaq chief says the sector will fragment”, by Anuj Gangaharan, appeared on The Financial Times of January 8, 2008.

19 See the article “Business European exchanges eye merger”, appeared on http://news.bbc.co.uk/1/hi/business/6046696.stm
Kuwait Stock Exchange about a technical relationship and it would be planning a number of initiatives aimed at increasing its competitiveness.

NYSE - Euronext is the first transatlantic stock exchange. It is a holding company created in 2007 by the merger of NYSE Group Inc and Euronext NV. Euronext NV itself resulted from the merger of four different stock exchanges (Amsterdam, Brussels, Lisbon and Paris) and the London International Financial Futures and Options Exchange (Liffe). NYSE Group Inc also signed an agreement to purchase a 5% stake in the Mumbai-based National Stock Exchange of India Limited and a co-operation agreement with Tokyo Stock Exchange (TSE). Recently, a leading financial newspaper has reported that NYSE - Euronext has taken a 25% equity stake in the Stock Exchange of Qatar - fending off the competition from Deutsche Börse and the London Stock Exchange.

The London Stock Exchange (LSE) received, in November 2006, a hostile bid from Nasdaq, which also increased its stake in the LSE from more than 3% to 28.75%. LSE shareholders overwhelmingly rejected the bid. In February 2007 LSE and TSE signed a co-operation agreement to exploit their synergies. In August 2007 LSE and Borsa Italiana were integrated, diluting Nasdaq’s stake in the London market to about 22%.

The Nasdaq acquired the Boston Stock Exchange in October 2007 and the Philadelphia Stock Exchange in November 2007. It has also been engaged in a complex deal with Borse Dubai to gain the control of OMX. OMX is the Nordic financial platform which resulted from the combination of all the Scandinavian and Baltic stock exchanges (Stockholm Stock Exchange, Helsinki Stock Exchange, Riga Stock Exchange, Tallinn Stock Exchange, Vilnius Stock Exchange, Copenhagen Stock Exchange and Iceland Stock Exchange) with the

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20 See the article “Qatar’s ambition revealed in plans for exchange” by Simon Kerr and Jeremy Grant, appeared on The Financial Times of June 24, 2008.
21 See the article “Deutsche Börse reaping benefits of diversity” by James Wilson and Jeremy Grant, appeared on The Financial Times of August 10, 2008.
22 See the article “NYSE Euronext pays $250m for 25% stake in Qatar’s exchange” by Simon Kerr and Jeremy Grant, appeared on The Financial Times of June 25, 2008.
only exception of the Oslo Børs (in October 2006 OMX acquired a 10% strategic stake in the Norwegian stock exchange).

The Toronto Stock Exchange acquired the Montreal Exchange in December 2007, creating the TMX Group based in Toronto.

A process of consolidation is also taking place among the US derivatives markets. The Intercontinental Exchange launched in March 2007 an unsuccessful bid for the Chicago Board of Trade (CBOT). In July 2007, the Chicago Mercantile Exchange Holdings Inc (CME) acquired the CBOT and created the CME Group. Recently, a renowned financial newspaper has reported that the CME Group has entered into talks with the Osaka Securities Exchange for a cooperation on 24-hours futures trading services\(^\text{23}\).

Finally, almost a year ago - according to an important financial newspaper\(^\text{24}\) - while western countries were experiencing a consolidation in the stock exchange industry, an opposite process of fragmentation was occurring in Asian countries. Many cities, from Mumbai in the west, to Sydney in the east, apparently had plans of becoming financial hubs. Rivalries and national pride seem to intensify, as financial centres across the region seek to attract investments.

Beside Hong Kong and Singapore, usually regarded as the two Asian leading cities for finance, China encouraged companies to list in Shanghai and not overseas. Even on the mainland, Chinese authorities were perceived to build up Tianjin, a city near Beijing, as an alternative financial centre. Beijing itself is expected to emerge as an important centre of commerce and finance.

Two years ago Seoul took several steps aimed at becoming a leading financial centre and Tokyo tried to shed its image as a primarily domestic market. Sydney studied how to best reach a prominent position, especially in the area of asset management\(^\text{25}\).

\(^{23}\) See the article “CME joins Osaka in 24-hour trading deal”, by Hal Weitzman and Lindsay Whipp, appeared on The Financial Times of September 3, 2008.

\(^{24}\) See the article “Nationalism bites the dust”, by John Authers, appeared on The Financial Times of November 19, 2007.

\(^{25}\) See the article “Asian financial centres: Rivals to HK and Singapore emerge”, by Sundeep Tucker, appeared on The Financial Times of November 16, 2007.
In this scenario, in 2007 the Singapore Stock Exchange acquired a 5% stake in the Mumbai Stock Exchange and the Tokyo Stock Exchange acquired a 4.99% stake in the Singapore Stock Exchange. However, some financial commentators still considered barriers to the consolidation of Asian stock exchanges as formidable.

The Asian scenario is now completely changed. While some markets (such as the Tokyo Stock Exchange) are still independently pursuing plans for expansion, China is considering to be unifying its indexes and a number of stock exchanges of various Asian countries (Thailand, Malaysia, Singapore, Vietnam, Indonesia and the Philippines) are planning to create a single platform.

Moreover, even within other regions of the world, there are plans of consolidation. The two main Russian stock exchanges are planning to merge and, according to an important financial newspaper “the Johannesburg Stock Exchange is in talks with bourses in at least five African countries about forming a pan-African board that would list stocks in some of the continent’s biggest companies”.

In conclusion, notice must be given of the fact that the information reported above refers only to a very limited part of what really happened during the last years around the world concerning financial markets. For instance, the emergence and the recent apparent success of the so-called “alternative trading platforms” (e.g. BATS Trading, Turquoise, Chi-X) has been neglected within the survey.

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26 See the article “Consolidation runs up against expensive buffers”, by Sundeep Tucker, appeared on The Financial Times of November 19, 2007 and the article “Asian financial centres: Rivals to HK and Singapore emerge”, by Sundeep Tucker, cit.
27 See the article “Exchange has big plans for its expansion”, by Lindsay Whipp, appeared on The Financial Times of September 12, 2008.
28 See the article “Single index for Hong Kong and China”, by Andrew Wood, appeared on The Financial Times of June 12, 2008.
29 See the article “Asian regional platform planned”, by Raphael minder, appeared on The Financial Times of July 9, 2008.
30 See the article “Stock markets: it may be time to consolidate the rival houses”, by Jeremy Grant, appeared on The Financial Times of September 30, 2008.
31 See the article “JSE intends to list pan-African stocks”, by Jeremy Grant, appeared on The Financial Times of June 1, 2008.
32 The “alternative trading platforms” (or “multi-lateral trading facilities”) are new financial markets emerged in the last few years (since 2000 in the U.S. and after the passing of MiFID in Europe) and aimed at challenging the historic and well-established...
provided above, as well as many other important data. Such omissions are not due to our laxity. Conversely, they have been decided in consideration of the global structure of this paper, since an excessively prolonged review would be pointless with reference to the final aim of the present work. Notwithstanding this, there is full awareness of many other events that have been not explicitly reported here.

6. Recent regulatory initiatives

In recent years, regulatory initiatives have followed major scandals such as Enron et al. in the United States, or the Argentinian bonds and Parmalat in Europe. The turmoil currently being experienced by financial markets has also evidenced conditions which call for a new set of regulatory initiatives.

We briefly consider some of the most recent regulatory initiatives, with a view to characterizing the extent and type pursued in different countries, in light of competition between financial platforms.

6.1 Recent North American regulatory initiatives

In recent years, following the signing into law of the Sarbanes Oxley Act in 2002, numerous academic and institutional contributions have sought to investigate whether capital markets in the United States have lost their competitive edge33. The evidence often cited relates to IPO activity in the United States. Measured by value, the market share of IPOs declined stock exchanges (Nasdaq, NYSE Euronext, London Stock Exchange, Deutsche Börse, etc.) by adopting faster technologies of trading and lower fees.

33 The Committee on Capital Markets Regulation published an Interim Report focused on the U.S. financial markets competitiveness. At the beginning of January 2007, New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer released a report (prepared by an independent consulting firm) outlining regulatory, legal and accounting changes they deem necessary to maintain New York’s status as world financial capital. Later, in March 2007, the Commission on the Regulation of U.S. Capital Markets in the 21st Century (an independent and bipartisan commission established by the U.S. Chamber of Commerce) issued its report and recommendations.
from 50% in the year 2000 to 5% in 2005. The number of IPOs dropped from 37% in the year 2000 to 10% in 2005. Measured by size, 24 of the 25 largest IPOs in 2005 and 9 of the 10 largest IPOs in 2006 occurred in markets outside the United States.

Academic papers have also concentrated on other issues such as the declining need for foreign issuers to cross-list in the United States to tap financial liquidity or create a bonding effect. In this perspective, an author has even found that, controlling for a number of characteristics which differ between the London Stock Exchange and the New York Stock Exchange, in reality cross listings have not declined in recent years.

The reports propose a number of different regulations and regulatory approaches to react to competition from other stock exchanges, particularly in London. The starting point is, of course, realizing that things have changed: “(...) since the end of World War II, firms raising capital did not so much choose to come to the United States, they came naturally. Today, the forces at work are increasingly different. Firms must choose to come to the United States to raise capital: they do not have to come.”

Aside from other characteristics influencing these recent trends in competition between financial markets, differences in legal
rules and regulatory environment have been noted by most reports as an incentive to stay away from U.S. capital markets; other foreign markets have indeed been made a viable possibility. A number of different regulatory determinants of a perceived decline of competitiveness have been enumerated.

The structure of the regulatory framework is excessively fragmented and complex. It is the result of political compromise between state and federal authorities. In the past, the fear of centralization of power led to the duplication or articulation of supervisory bodies\(^{38}\). Moreover, the common law system, because of its very nature, often has developed bottom-up, rather than the opposite. This framework creates shady areas where no regulation or regulator has jurisdiction and leads to inefficient results tied to the overlapping of functions and responsibilities, with a general decrease in accountability.

At present day U.S. financial regulation is articulated in federal, state, and private-sector regulatory bodies; both federal and state law enforcement officials (the Department of Justice, state attorney-generals); and a myriad of federal financial regulators (the S.E.C., the C.F.T.C., and four banking regulators)\(^{39}\).

Financial derivatives, very much in the news lately, have for example proven notoriously difficult to regulate because they are often considered neither a ‘security’ under the “Securities Acts” (the 1993 Securities Act and the 1934 Securities Exchange Act), nor a ‘future’ or other commodity under the Commodity Exchange Act. Indeed hybrid instruments are often hard to categorize and may escape regulation\(^{40}\).

More generally, rules need to be simplified in order to enhance U.S. financial institutions’ competitiveness. A single charter would give U.S. companies a uniform regulatory platform from which


\(^{40}\) Other federal regulatory agencies, other than those cited in the text, also may be involved in the regulatory framework concerning derivatives. For example, the Federal Reserve Board.
to operate. This would remove constraints that still exist between the regimes of the 50 states, lower ‘duplicated’ costs, ensure faster speed to market for new products.\(^{41}\)

In this perspective, a New York State Commission to Modernize the Regulation of Financial Services was established in 2007\(^{42}\) with a view to harmonising diverse regulatory powers and thus enhance capital promotion and investor protection\(^{43}\).

Capital markets and market operators are also forced to apply a regulation which is excessively rules-based. Indeed it has been suggested that the S.E.C. and S.R.O.s should adopt a more principle-based approach regulation\(^{44}\). A principle-based approach is adopted by the British Financial Services Authority and is often cited as one of the

\(^{41}\) “Much of the U.S. regulatory system has developed in response to financial crises and other historical and political events. No central architect was assigned to design the overall system or lay out a single set of principles (…) The U.S. banking system, as well as its regulation and regulatory objectives, has undergone many changes during the nation’s history. The present regulatory system developed as the result of a series of experiments. When regulations were found inadequate, they were changed or discarded for a new regulatory structure. Regulations that were judged successful became the more permanent elements in the system” (SPONG K., *Banking Regulation*, Kansas City, Federal Reserve of Kansas City, 2000, p. 5 and 15).

\(^{42}\) “2. The Commission shall consist of at least 15 members appointed by the Governor, including: (a) the Superintendent of Insurance, the Superintendent of Banks, the Secretary of State, the Chairperson of the Consumer Protection Board, and the Attorney General; (b) the Chairs of the Senate and Assembly Insurance and Banking Committees; and (c) at least six additional members appointed by the Governor, including representatives of the insurance, banking and securities industries, other business leaders and consumer groups. The Superintendent of Insurance shall serve as the Chair of the Commission” (see the article 2 of the executive order establishing the commission on [http://www.ny.gov/governor/executive_orders/exeorders/15.html](http://www.ny.gov/governor/executive_orders/exeorders/15.html)).

\(^{43}\) “4. The Commission shall conduct a comprehensive review of New York’s financial services statutes, regulations, rules and policies. The Commission is charged with: (a) identifying ways in which regulatory powers may be integrated, rationalized, and changed in order to promote economic innovation and protect consumers; (b) recommending specific changes in statutes and regulations that promote competition and the growth of business, while effectively protecting both consumers and businesses from unfair or unethical practices; and (c) ensuring that all statutes and regulations serve a beneficial purpose and do not impose costs higher than any benefits they provide” (see the article 4 of the executive order establishing the commission on [http://www.ny.gov/governor/executive_orders/exeorders/15.html](http://www.ny.gov/governor/executive_orders/exeorders/15.html)).

\(^{44}\) See p. 8 of the Interim Report of the Committee on Capital Markets Regulation.
main determinants of the London Stock Exchange’s increasing success. Differently, both the United States and countries of continental Europe have rules-based regulations. Of course, one size does not necessarily fit all, so greater consideration should be given to such possible shift in the regulatory approach.

U.S. convergence towards E.U. and London models is also characterized with regard to other initiatives such as the International Financial Reporting Standards (IFRS) and Basel II. Implementation of the Basel II Capital Accord would bring the U.S. system to be more harmonized with the rest of the world, reducing the ‘step’ created by a differing regulatory stance. The same is of course true for convergence towards IFRS, significantly regarding the elimination of U.S. GAAP reconciliation requirements for foreign IFRS issuers.

While all the other major countries have implemented (or are planning to implement) the Basel II Capital Accord, the United States have proposed several substantial modifications in the Notice of Proposed Rulemaking (N.P.R.). This would defeat the benefits of harmonization and could affect the competitiveness of U.S. banks.

Excessive litigation has also been a matter of concern in relation to the competitiveness of U.S. capital markets. It has been shown that the mere filing of a securities class action lawsuit results, on average, in a 3.5% drop in the defendant company’s equity value. Aside from issues regarding the way damages are calculated, observers have referred to an abusive use of class action lawsuits.

Until 1995, claims of securities fraud were governed by common law rules as well as the Securities Act of 1933 and the Securities Exchange Act of 1934. To combat frivolous ‘strike’ suits which customarily alleged violations of the Federal securities laws in absence of proof but in the hope that defendants would settle to avoid the expense of litigation, Congress enacted the Private Securities

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45 Even if, according to the Oxera study of November 2005, practitioners seem to prefer the more flexible, principles-based regulatory philosophy adopted by the FSA to the prescriptive, rules-based approach of the SEC.


47 It is indeed common wisdom, taught in any securities laws class, that as soon as the share price of a company drops, suits are often filed immediately.
Litigation Reform Act of 1995 ("PSLRA"). This was aimed at lowering the cost for raising capital while maintaining the incentive for non-frivolous actions.

After 1995, plaintiff lawyers began to file securities claims in state court, to avoid the federal law provisions. In 1998 Congress was thus forced to pass the Securities Litigation Uniform Standards Act ("SLUSA"), which barred securities class actions in state courts. Nonetheless, recent economic analysis of the securities litigation system has raised questions on the effectiveness of this legal construct.

The Sarbanes Oxley Act (SOX) has been generally recognized to have had major effects on the competitiveness of U.S. capital markets. It must be noted however, that most countries with a market-oriented system enacted similar legislations, borrowing many ideas from the United States. SOX introduced a number of obligations and changes directly concerning the corporate governance - that is, the internal affairs of public corporations - a matter usually left to the flexibility and professional inclination of state courts, such as those in Delaware.

These new imperative rules were thus imposed also on foreign issuers. In particular, under Section 404 management must produce an “internal control report” as part of each annual Exchange Act report. The report affirms “the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting” and must contain an assessment of the Company and of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Section 404 was very much criticized as it was seen as imposing excessive obligations and potential liabilities. In 2007, the S.E.C. approved the Public Company Accounting Oversight Board’s Accounting Standard No. 5, a new audit standard for the internal

48 A report on “Securities Class Action Litigation: How is the System Working Ten Years After Enactment of the Private Securities Litigation Reform Act?”, released by the U.S. Chamber Institute for Legal Reform, in February 2006.
49 Australia adopted “CLERP 9” in 2003; Italy adopted the Savings Law in 2005, etc.
control over financial reporting aimed to improve the implementation of the Sarbanes-Oxley Act’s Section 404. This has been considered as an important step towards facilitating a more effective and efficient approach to the implementation of Section 404.

The imperative and far-reaching nature of SOX has led observers to suggest greater flexibility in favour of foreign issuers. Specifically, eliminating barriers to exit from U.S. capital markets could increase its competitiveness\(^{50}\). As with any other issuer, at the moment the Exchange Act applies, and listed foreign companies already listed in the United States cannot exit the U.S. marketplace unless certain requirements regarding minimum assets and number of shareholders are satisfied.

In order to make U.S. markets more appealing for foreign companies some observers have even proposed the exemption for foreign issuers and foreign broker-dealers from U.S. securities regulation, if the S.E.C. determines that they are subject to comparable home-country regulation. This proposal is certainly interesting, although it might be excessively far-reaching and all-encompassing.

6.2 Recent European regulatory initiatives

The European Commission published a ‘Financial Services Action Plan’ in 1999, with a view to achieving a single common market in the financial services and securities industries.

Before examining individual regulatory initiatives, it is interesting to note that among the main regulatory tasks of the European financial markets supervisory authorities of the 25 member states, only Ireland and the U.K. expressly refer to promoting the competitiveness of markets and/or industries. The Italian government has submitted a bill to the Italian Parliament containing similar provisions.

For what concerns the European Union, some points seems especially interesting to be (albeit quickly) considered.

\(^{50}\) The Committee recommends that the S.E.C. loosen capital requirements at least for foreign companies.
First of all, it’s possible to claim that any problem about the implementation of the Basel II Capital Accord is faced by the European banks. Indeed, every Member State implemented (or is implementing) that agreement. Therefore, the only European interest from this point of view is that also the U.S. banking groups operating within the Member States would comply with the Basel II Capital Accord. In this perspective, the recommendation 6 of the Bloomberg-Schumer Report\textsuperscript{51} is going towards the European interest.

Secondly, recent regulatory initiatives at the European Community level include the directives on the market abuse, transparency and (most of all) markets in financial instruments\textsuperscript{52}

The market abuse directive\textsuperscript{53} is conceived to ensure the integrity of European financial markets and to enhance investor confidence in those markets. In doing so, it is not confined to “regulated markets” but also takes in other types of market (such as the “alternative trading platforms”), as these can be used for insider dealing or market manipulation in connection with financial instruments negotiated on regulated markets.

The transparency directive\textsuperscript{54} is intended to harmonise ongoing and periodic minimum disclosure requirements for issuers whose securities are admitted to trading on a regulated market situated or operating within a Member State, and for holders of such securities, in order to improve investor protection throughout the European Union.

Above all, the markets in financial instruments directive (MiFID) is the regulation of greatest consequence which has been

\textsuperscript{51} Within the initiatives to level the playing field group, the recommendation 6 claims the need to protect the U.S. global competitiveness in implementing the Basel II Capital Accord. See the so-called Bloomberg-Schumer Report, available on www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REP ORT%.

\textsuperscript{52} Another point of interest is the modernization of financial companies’ charters. The intent to provide a uniform regulatory platform would imply the improvement of some provisions contained in the Directive 2000/12/EC (in particular: articles 7, 8 and 17) in order to design a more common regulatory framework.


recently adopted in the field of securities’ markets. An in-depth description of this directive is beyond the scope of this paper. However, the main objectives and features must be recalled in order to assess the impact it is having on competition within the stock exchange industry.

The Directive was conceived with two fundamental objectives. First, it was to provide a strengthened ‘single passport’ for investment firms in the European Community, on the basis of a single authorisation and a high level of home member state control. Second, it was intended to abolish the rule regarding the concentration of trades, thus providing for free competition between exchanges, MTFs and systematic internalisers for the trading of shares.

From a regulatory perspective, MiFID is expected to produce a number of effects: (i) serve as a catalyst for innovation and market structure changes; (ii) increase competition both between trading venues and cross-border; (iii) increase trading volumes and financial information flows; (iv) make electronic trading more attractive; (v) create deeper, more liquid integrated capital markets; (vi) lower costs for issuers and investors.

After almost a year from its entry into force, this Directive has incredibly achieved most of its objectives. Specifically, it is possible to state that, through the provisions synthetically outlined above, MiFID has impressed a strong impulse to competition within the European stock exchange industry. More precisely, MiFID has been viewed as the principal factor both in the emergence and in the recent success of “alternative trading platforms”.

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57 “The emergence of Turquoise is the latest sign that a grand project set in motion by the European Commission in November, known as Mifid – the Markets in Financial Instruments Directive – is working” (see the article “Will exchanges feel blue over Turquoise?” by Jeremy Grant, appeared on The Financial Times of June 15, 2008).
Competition between financial platforms and, in particular, the increased degree of competition resulting from the emergence of the above mentioned alternative platforms, stimulates the development of technological improvements. Specifically, competition is increasingly based on cost reduction and increase of transaction speed. New kinds of trading venues such as the so called “dark pools” - a mechanism of anonymous trading of large blocks of shares – have also arisen.

Several established exchanges are planning to develop their own “multi-lateral trading facilities” in order to compete directly with the technological improvements of the emerging trading platforms.

6.3 Recent British regulatory initiatives

The City of London’s regulatory framework is considered a model of best practices. During the last ten years, two initiatives have noticeably changed British regulation of financial markets: the creation of Turquoise and Chi-X are competing with Europe’s established bourses for market share in European equities trading. Their emergence as rivals to the incumbents – such as the London Stock Exchange and Deutsche Börse – has been made possible by the Markets in Financial Instruments Directive, a Brussels initiative designed to break the monopolies of established exchanges” (see the article “Turquoise grabs 2% share of trading” by Jeremy Grant, appeared on The Financial Times of September 23, 2008). Ultimately, see the article “Alternative platforms: US electronic networks step on exchanges’ toes” by Anuj Gangahar, appeared on The Financial Times of October 17, 2008.

“Europe’s established exchanges face an assault by share trading platforms, such as Turquoise and Chi-X, which are challenging them with fast trading and low fees” (see the article “Nasdaq OMX calls for client benefits” by Anuj Gangahar, Jeremy Grant and Tracy-Marie Ishmael, appeared on The Financial Times of September 22, 2008).

See the the article “Alternative platforms: US electronic networks step on exchanges’ toes” by Anuj Gangahar, cit; and the article “NYSE Euronext draws battle lines over MTFs” by Jeremy Grant, appeared on The Financial Times of September 7, 2008.

For instance, “Turquoise has developed, with its Swedish technology provider Cinnober, a system that allows dark orders to be matched – or ‘crossed’ – with orders in the main order book, where orders are posted in smaller batches” (see the article “Will exchanges feel blue over Turquoise?” by Jeremy Grant, cit.).

Before then, the regulatory framework was characterized by numerous self-regulatory organizations (S.R.O.s), widely regarded as bureaucratic, interventionist, insufficiently independent and rules-based. The creation of the F.S.A. unified the S.R.O.s in a single regulator for banking, securities and insurance, with extensive powers of investigation and enforcement. The F.S.M.A. outlines four statutory objectives: 1) maintaining market confidence; 2) promoting public understanding of the financial system; 3) securing an appropriate degree of protection for consumers; 4) fighting financial crime.

To pursue these objectives, lawmakers recognized that any attempt to write a rules-based regulation would result in a problem of contractual incompleteness. The F.S.A. thus adopted a set of eleven principles and the F.S.M.A. provided a second tier of six principles.

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61 "Gordon Brown announced his decision to merge banking, securities, insurance, and investment services supervision in May 1997 under what would become the Financial Services Authority (FSA). The Bank of England transferred banking supervision authority to the FSA in June 1998, and in May 2000, the FSA assumed the role of UK Listing Authority from the London Stock Exchange. The roles of several other organizations were later incorporated into the FSA’s mandate under the Financial Services Markets Act (FSMA), which took effect at the end of 2001. In October 2004, the FSA assumed responsibility for the mortgage industry and, in January 2005, for the general insurance industry." See “Sustaining New York’s and the US’ Global Financial Service Leadership” (the so-called Bloomberg-Schumer Report) page 90 (available on www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPO RT%).

62 Every firm should: “1) conduct its business with integrity; 2) conduct its business with due skill, care, and diligence; 3) take reasonable care to organize and control its affairs responsibly with adequate risk management systems; 4) maintain adequate financial resources; 5) observe proper standards of market conduct; 6) treat customers fairly; 7) communicate appropriate information to clients in a clear and fair manner; 8) manage conflicts of interest fairly; 9) take reasonable care to ensure the suitability of its advice to customer entitled to rely on its judgment; 10) adequately protect clients’ assets when responsible for them; and 11) deal with regulators in an open and cooperative way”. See the already quoted “Sustaining New York’s and the US’ Global Financial Service Leadership” (the so-called Bloomberg-Schumer Report) page 90.

63 The F.S.A. must consider these principles while pursuing its statutory duties: 1) Efficiency and economy; the F.S.A. must report to the Treasury every year; the Treasury may also commission reviews of the F.S.A.’s value for the money. 2) Role of
to ensure that the regulator systematically acts to further the market’s best interest. This two-tiered and principles-based regulatory framework has been viewed as one of London’s keys to success.

Equally important is also F.S.A.’s enforcement strategy. Indeed the F.S.A. adopted a collaborative model of enforcement that encourages regulated entities to be forthcoming about potential problems.

A report released by the City of London which analyzed the reduction in the number of authorities and centralization under a single body, also highlighted some risks resulting from this regulatory approach. One of these risks was related to the creation of monopolies; the report prescribes that incumbent bodies should be exposed to real competition to ensure that they will remain efficient.

The impact of some E.U. directives such as MiFID is quite discussed in the U.K. due to its traditional ‘isolationist’ stance. It is interesting to note that because of the U.K.’s non-participation in the Eurozone, it is not involved in decisions on matters regarding financial structure taking place both at the Ecofin and at the Central Bank.

management: senior management is responsible for taking reasonable steps to ensure that a firm’s business complies with regulatory requirements and that adequate risk management controls are in place. 3) Proportionality: the F.S.A. must take a cost/benefits approach to any restrictions imposed on industry. 4) Innovation: the F.S.M.A. allowed for different methods of compliance so as to not unduly discourage the launch of new financial products and services. 5) International character: the F.S.A. must consider the impact on U.K. markets and consumers of developments occurring abroad, consider the international mobility of financial businesses, and avoid damaging the U.K.’s competitiveness. 6) Competition: the F.S.A. must avoid unnecessarily distorting or impeding competition, including via regulatory barriers to entry or business expansion. (See the already quoted “Sustaining New York’s and the US’ Global Financial Service Leadership” (the so-called Bloomberg-Schumer Report) page 91).

65 Among initiatives taken by the European Central Bank, one of the most recent, is the proposal to set up a clearing and settlement system of securities and derivatives transactions for the Eurozone (the so-called Target2Securities).
The recent report released by the City of London\textsuperscript{66} highlights the non-antagonistic roles between the New York and London stock exchanges\textsuperscript{67}. The report mentions that the financial centres are interdependent: both cities compete to attract investors, but the success of one over the other is just temporary and cyclical.

In 2005 the F.S.A. implemented a Better Regulation Action Plan, taking into account more than 30 proposed changes to the way in which the Authority regulates the market.

7. An optimal regulatory approach

Financial market success derives from a combination of factors: regulatory determinants are certainly only one of the keys to success, albeit a very important one. Firms and investor activities are influenced by technical and technological developments, structural changes, the economic cycle, the social attitude and culture, as well as the perception of the current economic condition.

The globalized economy and technological improvements have led to a noticeable decrease in transaction costs of operators. Financial instruments have become increasingly complex and capable of suiting the needs of different markets and operators.

In such a situation, the entrepreneurial character of stock exchanges has revealed itself at its highest peak. Competition between financial markets has triggered a series of regulatory processes which

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\textsuperscript{66} See the already quoted “The Competitive Impact of London’s Financial Market Infrastructure”, written by Bourse Consult and published by the City of London, April 2007 (available www.cityoflondon.gov.uk/economicresearch).

\textsuperscript{67} “Considerable coverage has been given in recent months to the suggestion that London has overtaken New York as the world’s most important international financial centre. It is important to view this in context. London and New York are not engaged in a football match – this is not Manchester United versus Chelsea. If it were, we would have to ask why the world’s best players (like Goldman Sachs, Morgan Stanley, Merrill Lynch, Credit Suisse, Deutsche Bank, BNP Paribas and many others) were playing for both teams. Thus terms frequently used by the media (such as the “fight” between London and New York) are quite inappropriate” (see the already quoted “The Competitive Impact of London’s Financial Market Infrastructure”, written by Bourse Consult and published by the City of London, April 2007, page 67).
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should ultimately achieve an efficient outcome. As discussed above, regulatory agencies have the possibility of choosing the regulatory approach they wish to pursue: whether to intervene *ex ante*, or allow the market to self-adjust.

Recent legislation at EC level (above all MiFID) has opened financial markets and platforms to increased competition. On the other side of the Atlantic, the ‘perceived’ decline in the competitiveness of U.S. capital markets has probably become irreversible, as other financial centres develop throughout the world. In a certain sense, the U.S. capital markets no longer have a monopoly; they too are involved in competition between financial markets. In this respect, the regulatory responses the U.S. have proposed tend, with a path dependent approach, to mirror some of the growing financial centres such as London, Dubai, Hong Kong and Tokyo.

At a more generic level of regulatory environment, infrastructures’ location and ownership have also proven important in determining a financial centre’s competitiveness. Financial institutions also need support services such as other intermediaries or lawyers. The same is true for some regulators. After 9/11,

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69 “If, therefore, London were to lose several of its major infrastructure providers (say the LSE and LCH.Clearnet), this would undoubtedly have a damaging effect not only upon the credibility of London as Europe’s main financial centre, but also on its overall capacity to support that position” (see the already quoted “The Competitive Impact of London’s Financial Market Infrastructure”, written by Bourse Consult and published by the City of London, April 2007, page 46).

70 “Some of those we interviewed felt that, as an example, it was more important to locate the clearing and settlement mechanisms in the City than elsewhere. The logic underlying this reasoning was that if there were a crisis involving the failure of a large player in London then that would need to be solved rapidly by the clearing house, the settlement agency and above all by the Bank of England. If either the clearing house or the settlement agency were located remotely this could make the task of resolving such a crisis rapidly significantly more complicated and time consuming. If the location became sufficiently obscure, the issue of lender of last resort would arise: which central bank would be expected to come up with liquidity or to rally around the other banks in a crisis?” (see the already quoted “The Competitive Impact of London’s Financial
corporations realized that risk regarding these structures had to be diversified. This explains, in part, the decline in competitiveness of U.S. capital markets.

Interestingly, financial services professionals have identified skilled workers, legal environment and regulatory balance – that is, the overall regulatory environment - as the second most important determinant of a financial centre’s competitiveness. Availability of skilled personnel is the first.

8. Conclusions

The Emergency Economic Stabilization Act, passed by U.S. Congress on October 3rd 2008, is aimed at restoring liquidity and stability to the U.S. financial system. It outlines a number of measures: (i) the Secretary of the Treasury’s authority to purchase troubled assets, as well as institutions eligible to participate and assets that can be purchased; (ii) the Treasury’s possible debt or equity stakes in participating institutions; (iii) the regulation of compensation schemes of participating institutions; (iv) the establishment of principles for asset management and servicing; (v) the authorization of the SEC to suspend mark-to-market accounting for certain derivative products; (vi) the temporary increase of the limit on federal deposit insurance from $100.000 to $250.000; (vii) the troubled assets relief program, which allows the Secretary to purchase certain troubled assets from eligible financial institutions.

Significantly, it also requires the Secretary of the Treasury to make recommendations for regulatory modernization.

Market Infrastructure”, written by Bourse Consult and published by the City of London, April 2007, pp. 45-46).

Other countries - EC member states with some degree of coordination - have adopted similar measures. A discussion of these measures is of course beyond the current scope of this paper. Nonetheless, these temporary measures have confirmed that it is time to re-think the regulation of financial markets and all entities directly involved therein.

Moreover, we also believe it is time to re-consider the regulatory determinants of financial markets’ success, evaluating them in light of increased global competition among capital markets.

We have indeed discussed the necessity to enucleate the dynamic processes of competition, which are developing and evaluate the regulatory strategies to be adopted. We have also given evidence of some regulatory initiatives taken in recent years.

Re-considering the regulatory determinants of financial markets’ success in the light of competition between individual markets – even under current financial market turmoil - confirms the need for certain policy objectives.

Firstly, the need of a supra-national supervisory and regulatory authority, in light of the supra-national expansion of dynamic processes regarding competition between financial markets. This would indeed provide uniform enforcement. Secondly, the need not to discourage stricter regulatory standards resulting from specific choice or path dependencies. Thirdly, encouraging strict minimum harmonization regulatory standards.