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MARKETS AS REGULATORS: A SURVEY

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# Markets as Regulators: A Survey

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ABSTRACT: In this paper we explore the allocation of regulatory responsibilities to market infrastructure institutions, administrative agencies and central government entities in the eight most influential jurisdictions for securities regulation in the world. After reviewing the academic literature on the role of self-regulatory organizations in the oversight of modern stock exchanges, we report the results of a survey of the allocation of regulatory powers in a sample of eight key jurisdictions. In that survey, we examine the allocation of such powers in three levels: rulemaking, monitoring of compliance with these rules, and enforcement of rules violations. Based on our findings, we categorize these jurisdictions in three distinct models of allocation of regulatory powers: a Government-led Model, that preserves significant authority for central government control over securities markets regulation albeit with a relatively limited enforcement apparatus (France, Germany, Japan); a Flexibility Model, that grants significant leeway to market participants in performing their regulatory obligations but relies on government agencies to set general policies and maintain some enforcement capacity (UK, Hong Kong, Australia); and a Cooperation Model that assigns a broad range of power to market participants in almost all aspects of securities regulation but also maintains strong and overlapping oversight of market activity through well-endowed governmental agencies with more robust enforcement traditions (US, Canada).

*JEL Code: G28, K22, K23*

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# Markets as Regulators: A Survey

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## Introduction

In this paper, we present a survey of the allocation of regulatory responsibilities over stock exchanges in a number of leading jurisdictions.  Our interest is in understanding how countries divide regulatory authority over these market institutions among government ministries, independent agencies, and stock exchanges themselves. As explained below, we find that while there is considerable similarity in the scope of market oversight in the eight jurisdictions we surveyed, the allocation of regulatory responsibilities within the various jurisdictions differs a good deal.  Indeed, our research suggests that there are three distinctive approaches to the divisions of regulatory responsibility: a Government-Led model found in France, Germany, and Japan; a Flexibility model, found in the United Kingdom, Hong Kong and Australia; and a Cooperation Model found in the United States and Canada.

We begin our analysis with a literature review on the role of exchanges as self-regulatory organizations, touching on both the history of regulation by exchanges and the traditional arguments for and against self-regulation in capital markets.  We then turn our attention to recent developments in the organization of stock exchanges around the world, focusing on the wave of demutualizations that have occurred in the past decade.  We next summarize the academic debate that these demutualizations have stimulated so as to provide a perspective on the current thinking of scholars and public policy analysts on the appropriate regulatory function of exchanges and other self-regulatory organizations in the context of a modern and competitive global capital market, populated with numerous for-profit exchanges and a variety of alternative trading mechanisms.

We then turn from the academic to the real world, and present a survey of the kinds of regulatory accommodations that have evolved around the world to deal with the allocation of regulatory authority over exchanges and their activities.  While these practices do not map easily onto academic prescriptions, they do provide a range of approaches to regulatory responsibilities in which government bodies exert different degrees of control over exchanges and their activities.  As yet, no single model has emerged as dominant and, indeed, the three largest stock exchanges in the world – the U.S., the U.K., and Japanese all follow different approaches.

## 1. Literature Review and Recent Developments

### *I. The Regulatory Role of Stock Exchanges*

a. Organizing a Market and Setting its Rules

Stock exchanges predate government agencies as regulators of equity trading markets;[1] in fact, regulating the trading process was the primary goal behind the establishment of organized stock markets. Exchanges constituted an attempt by a group of brokers to take control of trading in certain equities so as to offer more streamlined trading conditions through increased liquidity in exchange for a fee.[2] As a result, setting out rules that define the operation of the market was inherent in the notion of an exchange. Similarly, the nature of exchanges dictated the ultimate sanction available to them for disciplining purposes: expulsion from the exchange hub. To set up the market, exchanges sought to control the trading members, the stocks to be traded among them, and the rules under which trading would take place. Below we look at each one in turn.

The aim of member regulation was to ensure that all market participants would be reliable trading partners. Thus, exchanges sought first to establish certain eligibility criteria.[3] However, continuous oversight post the admission stage was necessary to maintain high quality standards for trading participants. Exchanges set qualification standards for brokers' personnel, capital adequacy requirements, and best practice principles.[4] As trading participants are interested in safeguarding the quality of order execution, they have an interest in removing from the exchange potentially deceitful counterparties.[5] Moreover, exchanges required brokers and other market professionals to maintain the infrastructure necessary for conducting exchange transactions, as well as, more recently, to obtain certain technological capabilities.[6]

To maintain a high-quality marketplace, exchanges focused also on establishing criteria to determine which stocks they are going to admit and ensuring that investors receive appropriate information as to the characteristics of each stock. Thus, exchanges put in place a signaling function: admission to listing indicates to investors that the stock is worth investing in.[7] To enhance this perception beyond the initial listing stage, exchanges gradually required listed companies to offer ongoing disclosures on their business activities, their investments, their obligations and their future plans. Moreover, seeking to ensure investors that they are protected against abuses of corporate power, stock exchanges even adopted corporate governance standards for their listed firms.[8] To complement the mandatory disclosure and corporate governance regimes, as well as

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[1] *See* Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1349 (2004).

[2] *See* Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: the Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 317 (1985). Liquidity, of course, did not come for free: brokers charged increased commissions for the privilege of offering access to the exchange to their clients.

[3] *See* INT'L ORGANIZATION OF SECURITIES COMMISSIONS (TECHNICAL COMMITTEE), CONSULTATION REPORT: REGULATORY ISSUES ARISING FROM EXCHANGE EVOLUTION 6 (2006).

[4] *See id.* at 7.

[5] *See* Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System* (Aug. 2004) available at http://ssrn.com/abstract=579261.

[6] *See* INT'L ORGANIZATION OF SECURITIES COMMISSIONS, *supra* note 3, at 7.

[7] *See* Jonathan Macey and Hideki Kanda, *The Stock Exchange As a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1006, 1009 (1990). In a separate article, Macey argues that by denying listing to firms that their members did not trust, exchanges "effectively pooled the information of all [their] members." *See* Macey and Haddock, *supra* note 3, at 318.

[8] *See* Roberta Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SO. METH. U. L. REV. 325 (2001).

further strengthen their integrity credentials, exchanges developed an enforcement mechanism.[9]

Finally, exchanges set their own rules determining how the trading process is going to be conducted, offering standardized-format trading contracts to brokers and investors.[10] As different trading systems confer different advantages to trading participants and investors, designing an efficient trading process has been a key concern for exchanges throughout their existence. Often, exchanges promulgated rules relating to clearing and settlement of transactions executed through their facilities. In addition, exchanges often undertook a policing role over their markets, monitoring compliance with trading rules, supervising day-to-day trading to identify instances of potential fraudulent or abusive behavior and often undertaking enforcement actions against their members.[11]

As stock exchange regulatory power was based, at least initially, on contract, their sanctioning abilities were structured in a contract-like manner; discontinuation of the contract often constituted the harshest measure over the regulated entity, either a trading member or a listed firm. Consequently, the exchange had the power to devise less strict measures that addressed the particular concerns associated with the behavior in question.

These rule-making, monitoring and enforcement efforts allowed stock exchanges to develop a "brand": listing on the NYSE, for example, confirmed that an issuer was able to meet some of the highest corporate standards at a global scale.[12] The exchange offered to listed companies a "panoply of rules" to govern their activities.[13] The importance of a brand for an exchange lies in the brand's ability to attract revenue: for example, the NYSE and Nasdaq have traditionally been in intense competition with one another for listing fees, which has recently been expanded to competition for trading fees and fees from the sale of market trading information.[14]

b. A Public Interest Role for Exchanges

While rulemaking for members, listed companies and trading processes has been a key feature of an organized marketplace, the central role exchanges play in the economy has lent an important public interest perspective to their regulatory function.[15]

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[9] *See* Adam Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 967 (1999). Pritchard argues that exchanges will be more efficient enforcers of securities anti-fraud rules because the value of their members' seats will vary depending on the trading volume the exchange attracts, which in turn depends on the level of fraud in the their market.

[10] *See* Macey and Kanda, *supra* note 7, at 1009.

[11] *See* INT'L ORGANIZATION OF SECURITIES COMMISSIONS, *supra* note 3, at 7.

[12] Some commentators have argued that the high mandatory disclosure requirements of U.S. laws have attracted foreign issuers to list on a U.S. exchange to offer concrete evidence of their overall performance. *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 (1999).

[13] *See* Jonathan R. Macey and Maureen O'Hara, Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective, 28 J. LEGAL STUD. 17, 22 (1999).

[14] *See* James D. Cox, *Brands v. Generics: Self-Regulation by Competitors*, 2000 COLUM. BUS. L. REV. 15, 16 (2000).

[15] Jennifer Elliott, *Demutualization of Securities Exchanges: A Regulatory Perspective* 17 (IMF Working Paper WP/02/119, 2002) *available at* http://ssrn.com/abstract=879869.

Exchanges are the main gateway through which corporate issuers access public financing, and thus their interest in maintaining a high quality marketplace coincides with the public goal of more efficient allocation of resources.[16] Exchanges provide liquid secondary markets, which are a precondition for effective primary markets.[17] Other functions exchanges offer are also beneficial to the wider investing public: for example, by requiring ongoing disclosure about a firm's activities, exchanges reduce information costs for the wider public and contribute to the efficiency of the markets in assessing the true value of the stock.[18] In addition, by maintaining orderly markets, exchanges decreased the likelihood of serious market disruptions, which could impose negative externalities on the larger economy.

The combination of a public interest objective with concretely self-beneficial motivations to ensure market quality formed the basis for the extensive use of self-regulation as a regulatory technique in the securities markets. In other words, policymakers noted the significant interests of exchanges in effectively organizing their market and opted to take advantage of this dynamic to achieve the overarching goal of maintaining fair and orderly markets for investors and promoting market integrity. This combination also reveals its inherent limitations: exchanges will pursue the overarching public interest goals in so far as it is in their interest to do so. Some commentators, especially in the U.S., often portray the adoption of a self-regulatory scheme for the securities exchanges as a "historical anachronism"[19] or, at best, a "historical accident."[20] According to this account, it was convenient for Congress to assign regulatory powers to exchanges, as they already had significant regulatory infrastructure in place. However, it is hard to reconcile this argument with the almost universal appeal of the self-regulatory model around the world.

## *II. Self-Regulation: Advantages and Concerns*

Stock exchanges had strong incentives to provide a regulatory framework for the operation of an organized market, and government authorities similarly had strong interests in sound regulation for the securities industry. While these parallel motivations show a potentially shared regulatory goal, at least in part, they fall short of explaining why governments around the world chose to regulate securities markets by assigning a wide array of regulatory powers to primarily private organizations. Although the self-regulatory models adopted over time in various jurisdictions vary significantly, they

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[16] For a discussion of the policy repercussions of efficiency as a goal for regulatory policy in securities law, *see* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997).

[17] *See* John W. Carson, *Conflicts of Interest in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them?* 2, (World Bank Policy Research Working Paper 3183, 2003) *available at*: http://ssrn.com/abstract=636602.

[18] *See* Macey and Haddock, *supra* note 2, at 319.

[19] *See* Morris Mendelson and Junius W. Peake, *Intermediaries' or Investors': Whose Market is it Anyway?* 19 J. CORP. L. 443, 444 (1994).

[20] *See* Dombalagian, *supra* note 5, at 8.

largely involve the grant of regulatory powers to a market infrastructure institution (such as a stock exchange or a clearing system), to be exercised under the supervision of a government agency. An allocation of roles among a regulator and a regulated entity seems hardly a straightforward solution, and has understandably generated a major debate in the academic community. Why is such a system preferable to consolidating all regulatory powers to a government agency, or to eliminating any government oversight, leaving stock exchanges as the sole regulators of their markets?

a. Why grant regulatory powers to stock exchanges?

The technical expertise that SROs possess as to the operation of the market is, arguably, unrivaled: the market flows through their facilities, the traders follow their rules, their regulatory staff is exclusively engaged with overseeing their systems. Indeed, in a market where trading volumes are ever increasing, the day-to-day task of supervising transaction activity seems so intensive and complicated that it is better left to the same entity to conduct.[21] The strength of this argument is prevalent as to aspects of stock exchange regulated activities that are highly technical in nature; however, as stock exchange regulatory powers expand to issues of wider interest, such as review of the accuracy of financial statements or corporate governance requirements, the advantages of stock exchanges over other regulatory bodies become unclear.

To legislators reluctant to spend taxpayers' money to finance ambitious regulatory plans, self-regulation presents an attractive solution, as self-regulatory organizations are financed directly by the industry they regulate.[22] The resources of these organizations are independent of the government budget and the political considerations that surround it, effectively ensuring that significant resources will be utilized for supervising the securities industry. Having enlisted financial support from the industry, the government can then focus on its own priorities and direct resources to issues where its intervention is most needed.[23]

Self-regulation is also often praised for its ability to establish regulatory standards in an industry through a largely consensual process. Trading members in particular are more willing to conform their behavior to rules promulgated by their representative bodies.[24] Moreover, exchanges and other SROs constitute a useful counterpart for negotiations for a government seeking to introduce regulatory initiatives, as they concentrate the industry's interest and simultaneously have the ability to enforce negotiation outcomes.[25] For that reason, exchanges are thought able to induce industry compliance with standards higher than or beyond those technically required under the law.[26] Thus, self-regulation may also constitute an efficient way to strike the right balance between overregulation and underregulation of the stock exchange industry, as it

[21] *See* David Lipton, *The SEC and the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets* 16 U.C. DAVIS L. REV. 527, 545 (1983).
[22] *See* JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION: CASES AND MATERIALS 673 (9th Ed., 2003)
[23] *See* Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination* 42 WASH. & LEE L. REV. 853, 855 (1985).
[24] *See* Dombalagian, *supra* note 5, at 45.
[25] *Id.* at 48.
[26] *See* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1458 (1997).

is more flexible than government-imposed rules and is driven by the needs of the industry. For Mahoney, the stock exchanges' responsiveness to the pulse of the market and to the requirements of investors is the key justification for the self-regulatory model.[27]

Exchanges are also free of the limitations that constrain government action in many respects. First, from a substantive point of view, stock exchanges' powers are not limited by any specific mandate, as regulators' powers often are.[28] Thus, exchange-originating rules may reach areas and utilize regulatory tools that may not be available to government regulators. The scope of self-regulation is wider than government regulation with regard to the character of the rules promulgated: self-regulation extends beyond enforcing legal standards to establishing ethical standards and best practice principles.[29] Second, from a procedural point of view, exchanges are not subject to the same due process requirements and other procedural restrictions that render government enforcement actions inflexible and often unsuitable for the fast-changing and highly competitive environment of the financial markets.

Finally, the quality of an exchange's regulatory environment contributes to its reputation as a listing location. Exchanges developed a regulatory apparatus to safeguard their business and to ensure that they attract high-quality issuers. Therefore, the integrity of their regulatory environment is a significant component of their value as a "brand name."[30] Exchange members, whose business depends upon the trading interest listed issuers generate, would not jeopardize the reputation of the exchange by abusing its regulatory powers to achieve limited short-term benefits. Similarly, an issuer that decides to list on a high-quality exchange subscribes into a set of regulatory standards that increases investors' confidence in its stock and thereby reduces its own transaction costs.[31] As Mahoney points out, exchanges have often imposed upon the entities they regulate stricter standards than those required by the federal securities laws.[32] Moreover, competition will lead different exchanges to develop different regulatory standards and trading models, thus catering for varying needs of the investing public. For a market economy to flourish, exchanges should be able to shape the services they offer to their customers, while investors should be free to choose the bundle of services that matches their preferences.[33]

b. What are the concerns traditionally associated with self-regulation?

Arguments against self-regulation have sought to outline the limitations of the self-regulatory mechanism as proposed by its advocates, and to disclose the complications caused by what is seen as the major weakness of the self-regulatory model, its potential for conflicts of interest. We will discuss these arguments in turn.

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[27] *Id.*
[28] *See* Business Roundtable v. Securities and Exchange Commission, 905 F.2d 406 (D.C. Cir. 1990).
[29] *See Self-Regulatory Organizations: Hearing Before the S. Committee on Banking, Housing and Urban Affairs*, 109th Cong. (2006) (Testimony of Robert Glauber, N.A.S.D. Chairman and C.E.O.).
[30] *See* Carson, *supra* note 17, at 7-11.
[31] *See* Macey & O'Hara, *supra* note 13, at 20.
[32] *See* Mahoney, *supra* note 28, at 1458.
[33] *See* Macey & O'Hara, *supra* note 13, at 22.

Traditional justifications for self-regulation remain strong with respect to core areas of stock exchange activity, but grow weaker as the scope of regulatory powers granted to exchanges expands beyond the core aspects of their activity. There are strong arguments in favor of permitting exchanges to set their own trading rules, as they possess higher expertise and are better placed to understand the demands of the market. Still, aspects of trading regulation, such as the intervention of specialists to stabilize trading activity or the widening of bid-ask spreads in the Nasdaq markets of the 1990s, have triggered accusations for regulatory capture. Moreover, while technical expertise is arguably helpful in trading model design, it is less apparent why corporate governance rules should be set by stock exchanges.[34] Seeking to increase the number of listed companies, stock exchanges may adopt corporate governance rules that promote managements' interests, as the decision for the listing location is a responsibility of the management. However, management interests may not necessarily align with the goal of profit maximization.[35]

The limitations inherent in the stock exchanges enforcement mechanism also present challenges for self-regulation in this area. While exchanges arguably have a clear picture of the trading activity in their markets, they often lack the investigation powers that government entities usually possess.[36] Moreover, the sanctions available to them are limited, as they are often exhausted with expulsion from the exchange.[37] Thus, the enforcement apparatus of the self-regulatory model has many imperfections.

The greater risk associated with self-regulation, repeatedly underlined by some of its most vocal opponents, relates to the potential for conflicts of interest inherent in a grant of regulatory powers to an organization representing, essentially, the regulated entities themselves.[38] The concept of self-regulation is premised upon the exchange's ability to use its market power for regulatory purposes, mainly by threatening individual members and listed issuers with termination of their contractual arrangements in case of non-compliance with the rules of the "club."[39] Using the same power to achieve less public-minded goals is simply the other side of the same coin; while the potential for abuse is disquieting, self-regulation would not be successful without the stick of dominant stock exchange power.

Commentators have often interpreted rule-making or enforcement initiatives by stock exchanges as indications of anti-competitive behavior seeking to exclude or limit the influence of potential competitors in their market. As entities controlled by their members, stock exchanges were bound to use their regulatory powers to promote their members' interests.[40] In the United States, there has been a long history of controversies

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[34] *See* Dombalagian, *supra* note 5, at 40. This analysis echoes the predictions of the modern economic theory of regulation, which suggests that the industry will request the intervention of their regulators when they face intense competition by newcomers. *See* Macey and Haddock, *supra* note 2, at 319.

[35] *See* Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation* 83 VA. L. REV. 1509, 1511 (1997). Kahan mentions especially the ability of stock exchange rules on corporate governance to alter the balances in the market for corporate control in favor of managers.

[36] For example, SROs in the US do not possess power to subpoena entities or individuals. *See* Ernest E. Badway and Jonathan M. Busch, *Ending Securities Industry Self-Regulation As We Know It*, 57 RUTGERS L. REV. 1351, 1355 (2005).

[37] *See* Dombalagian, *supra* note 5, at 80; *see also* Kahan, *supra* note 37, at 1517.

[38] *See* Coffee & Seligman, *supra* note 22, at 675.

[39] Others have preferred the term "cartels." *See* Mendelson and Peake, *supra* note 19, at 452.

[40] *See* Dombalagian, *supra* note 5, at 8.

over perceived anti-competitive practices whereby major exchanges, particularly the NYSE, exploited their market power to extra monopoly rents.[41] More recently, academics have attributed the lack of modernization in US exchanges to the SEC's decision to enlist the NYSE and Amex to design the national market system.[42] According to this view, the two major self-regulatory market operators in the US at the time opted for a design that continued fragmentation of the markets and stalled innovation so as to suppress competition. As Seligman has argued, the NMS forced orders to the NYSE floor by allowing the possibility for price improvement.[43] Moreover, Gkantinis has argued that, by limiting competition among marketplace to price, the NMS rules (including SEC's 2005 Regulation NMS) have consistently favored the NYSE over its competitors for trades in NYSE-listed stocks.[44] In addition, the ability of the stock exchange to design its trading rules may allow certain interest groups within the exchange to push regulation favorable to them but detrimental to investors.[45] According to some academics, the central part specialists have maintained in the floor of the NYSE illustrates this scenario: they see the specialists as an outdated institution surpassed by modern trading designs, which has managed to survive by virtue of the NYSE mutual ownership structure, which allows specialists to control NYSE management.[46] To sum up, self-regulation acts as a shield "insulating" the industry it purports to regulate from government intervention that enhances investor protection but at a cost to industry members.

The severe repercussions of conflicts of interest for prospective regulators are even more evident in the case of enforcement. How vigorously will such an organization undertake enforcement actions against its own members? Enforcement actions by exchanges against their trading members often result in punishing no more than "a few bad apples," while failing to reveal weaknesses in the underlying system, to prosecute wide-spread practices that, although harmful to investors, are financially beneficial to members, or to trigger regulatory reforms.[47] On the other hand. exchanges may be willing to use the full panoply of their regulatory powers to silence criticism against their rules or practices by individual firms they regulate.[48] If exchanges show leniency towards their members, they must be even less vigilent with respect to their customers, the listed firms.[49] As the numbers of listing venues multiply, exchanges will be less willing to

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[41] *See, e.g., Gordon v. NYSE*, 422 U.S. 659 (1975), *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963).
[42] *See* Mendelson & Peake, *supra* note 19, at 447.
[43] *See* Seligman, *supra* note 1, at 1347.
[44] *See* Stavros Gkantinis, *Regulation and Innovation: Comparing U.S. and European Equity Trading Markets* (2006) *available at* http://ssrn.com/abstract=887645.
[45] *See* Scott Miller, *supra* note 23, at 864.
[46] *See* Dale Arthur Oesterle, Donald Arthur Winslow, and Seth C. Anderson, *The New York Stock Exchange and Its Out Moded Specialist System: Can the Exchange Innovate to Survive?*, 17 J. CORP. L. 223 (1992).
[47] *See* Kahan, *supra* note 35, at 1517. The failure of self-regulatory organizations to tackle industry-wide abusive practices is evident in the examples listed below, drawing from the US and the UK experience.
[48] *See* Mendelson & Peake, *supra* note 19, at 463.
[49] In some cases, such as the US, national laws require trading firms to be part of an SRO, thus increasing the leverage SROs have towards their members. For issuers, however, the decision to list on an exchange is strictly voluntary.

displease the issuers they fought hard to attract. Thus, exchanges maintain a poor record of enforcing their corporate governance requirements.[50]

Although self-regulation has the advantage of opening additional financial resources to regulatory purposes, industry financing may also entail diversion of regulatory efforts from their intended goal. At least, allowing the industry to hold the "power of the purse" may provide it with a saying over crucial issues, either dictating the content of regulatory measures or leading to compromises. For example, in order to avoid losing trading participants or listed firms, a stock exchange may be willing to lower its regulatory standards.[51] Moreover, while self-regulation may serve the government's budgetary interests, it is arguably more expensive for investors as a whole, as it often entails duplication of regulatory efforts and is plagued by lack of coordination among different self-regulatory bodies with overlapping spheres of competence.[52]

According to the theory of the self-regulation model, the role of the administrative agency overseeing the SROs is to alleviate some of the concerns outlined above. In practice, however, the ability of the agencies to stir the SROs to the direction public interest dictates is limited. As market infrastructure institutions, SROs are crucial to the undisrupted operation of the market. While agencies can threaten fines and require regulatory reforms, they are ultimately constrained from imposing measures that would jeopardize the continuous operation of the market.

Over the years, opponents of the current self-regulatory model have been able to point to a number of instances where SROs failed to respond efficiently to their supervisory mission. Especially in the US markets, where the self-regulatory system has a long history, such examples are plentiful. Perhaps the most impressive cases are the most recent ones – involving Nasdaq bid-ask spreads and NYSE specialists -- which helped to reinforce voices requesting to curtail the self-regulatory model.[53] But earlier examples exist too: the October 1987 crash was attributed by some to trading by NYSE specialists in a manner inconsistent with public interest.[54] Similarly, in the UK, industry-wide practices regarding the selling of personal pensions, which was in violation of the rules of the self-regulatory organizations overseeing the market, led to a massive "clean-up exercise" by the authorities and an enormous compensation to misled investors.[55] In the late 1990s, the UK government felt that the SRO system generated such complexity and inefficiency that it decided to transfer their regulatory powers to the FSA.

## *III. Demutualization and Its Impact on Academic Debates over the Regulation of Exchanges and Other Self-Regulatory Organizations*

The 1990s witnessed a transformation in the organizational structure of stock exchanges. One after the other, stock exchanges abandoned the typical mutual membership format they had adopted since their inception to become private corporations

[50] *See* Dombalagian, *supra* note 5, at 71.
[51] *See id.* at 39, 42.
[52] *See* Scott Miller, *supra* note 23, at 860.
[53] *See* Badway & Busch, *supra* note 36, at 1357.
[54] *See* Macey & O'Hara, *supra* note 13, at 39.
[55] Howard Davies, What's Left for Self-Regulation, Address in Hong Kong (Mar. 26, 2004), *available at* http://www.lse.ac.uk/collections/meetthedirector/articlesReviewsAndLectures.htm.

under general corporate law. The first exchange to adopt the private corporation format, or "demutualize," was the Stockholm Stock Exchange in 1993. Others followed suit and, after the grant of exchange status to Nasdaq and the completion of the NYSE-ArcaEx merger in 2006, all major stock exchanges of the world have now demutualized. The table below provides some additional information on the major milestones in the demutualization process for the most important stock exchanges in the jurisdictions included in our study.

*Table 1. Demutualization of Major Stock Exchanges*

| Stock Exchange | For-profit structure | Listing |
|---|---|---|
| Euronext | 1997 | 2001 |
| Australian Stock Exchange | 1998 | 1998 |
| London Stock Exchange | 1999 | 2001 |
| Deutsche Börse | 2000 | 2001 |
| Hong Kong Exchanges | 2000 | 2000 |
| Tokyo Stock Exchange | 2001 | - |
| TSX Group | 2002 | 2002 |
| Nasdaq[56] | 2000 | 2000 (2006) |
| NYSE | 2006 | 2006 |

Most exchanges justified their move to a for-profit structure on the basis of their need to raise capital so as to finance their infrastructure expenses. The introduction of electronic trading heightened competition among exchanges, both within their national borders and internationally, and allowed the emergence of alternative low-cost trade execution venues. Thus, most exchanges invested heavily in technical infrastructure so as to offer cheaper and more efficient trading services. However, introduction of electronic trading systems was not always popular with stock exchange members, who saw a threat to their privileges over trading activity.[57] The transition from a mutually-held organization to a corporation liberated stock exchange managers from their subservience to members' demands. Stock exchanges now were able to implement trading structures relying less on the involvement of intermediaries and to enter into alliances or mergers with other exchanges.[58]

[56] Nasdaq was founded in 1971 as a wholly owned subsidiary of the National Association of Securities Dealers, Inc. (NASD). In 2000, NASD initiated a restructuring in Nasdaq through a two-phase private placement of its securities which were offered to all NASD members, some issuers listed on the Nasdaq Stock Market and investment companies. On January 13, 2006, the SEC granted Nasdaq's application to operate as a national securities exchange. See Nasdaq 2005 Annual Report, available at http://files.shareholder.com/downloads/NDAQ/52812485x0x36919/4926252F-A3F3-446A-85D0-AEA84A42CB82/NASDAQ_2005AnnualReport.pdf (last visited Sep 10, 2006). Nasdaq became operational as a national securities exchange on August 1, 2006. See Nasdaq Press Release, available at http://ir.nasdaq.com/releasedetail.cfm?ReleaseID=205921 (last visited Sep 10, 2006).

[57] *See* Gkantinis, *supra* note 44, at 15.

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

a. How Does Demutualtization Affect the Traditional Model of Self-regulation?

As a result of demutualization, the orientation of the exchange operation changes from catering for the interests of its members to catering for the interests of its shareholders. While exchanges were traditionally accused for their "clubby" perspective in terms of protecting the interests of their members, they are now oriented towards maximizing profits for their shareholders. The traditional model of self-regulation found its justification in the alignment of interests between the investing public and member firms. In the post-demutualization world, self-regulators must establish that they share the interests of their shareholders and their corporate managers. The potential for conflict between the exchange's business goals and regulatory mission is apparent.[59]

Competition among exchanges, as well as between exchanges and alternative venues of trade execution, has increased dramatically in recent years. First, technological developments have allowed alternative trading platforms and large brokerage houses to slash trading costs and threaten traditional exchanges. These venues are mostly attractive to institutional investors, whose participation in the market has increased over the years. Finally, the emergence of large international financial centers, such as London and, most recently, Hong Kong, has also diverted liquidity away from more traditional exchanges.[60] Many commentators have urged regulators to "maintain a watchful eye" for anti-competitive behavior by the incumbent exchanges through their self-regulatory powers.[61] Demutualization further intensifies competition between marketplaces by enshrining profit maximization as the top priority of modern exchanges. The concern is that, following demutualization, exchanges would be institutionally either more inclined to misuse their regulatory powers so as to achieve their goals, or less efficient in enforcing securities laws and their own rules.[62] The possibility for abuse of regulatory powers is greater in cases where the exchange is responsible for regulating some of its competitors, such as large brokerage houses or firms operating alternative trading systems.[63] As many jurisdictions require alternative trading system operators to obtain a broker-dealer/investment firm license, many firms run the risk of falling prey to their main competitors.

Demutualization has also resulted in strengthening the ability of two particular groups to affect stock exchange decision-making. First, for-profit exchanges place higher emphasis on the revenue that regulated entities bring to the exchange in the form of listing fees, trading fees or other charges. The loss of a source of revenue has much more immediate and tangible consequences for the exchange and its profit-maximizing management, in comparison to a threatened diminution of the exchange's reputation, which is much harder to quantify and may not eventually materialize. Thus, for-profit exchanges are more sensitive to the needs of these customers, which membership organizations could afford to ignore because their priorities lay elsewhere. Expecting

[59] *See* Carson, *supra* note 17, at 11.
[60] *See* Gkantinis, *supra* note 44, at 22-25.
[61] *See* Cox, *supra* note 14, at 16.
[62] *See* GENERAL ACCOUNTING OFFICE, REPORT: COMPETITION AND MULTIPLE REGULATORS HEIGHTEN CONCERNS ABOUT SELF-REGULATION 2 (2002).
[63] *See* Roberta Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L. J. 367, 401 (2002).

stock exchanges to rigorously enforce their rules against their much sought-out customers may prove misguided.[64] Moreover, stock exchange shareholders have more leverage over an exchange they own than exchange members have traditionally had. Active secondary markets in the stock allow shareholders to exit the exchange immediately if they disagree with the firm's business strategy. In the pre-demutualization world the powers of members, who owned the exchange, were limited, as their future was tied with the future of the exchange. As a result, exchanges were less prepared to succumb to requests by listed or member firms than a private firm whose primary goal is profit maximization.

For these reasons, increasing competition may gradually erode the dominant power of exchanges, which was a critical assumption underlying the old self-regulatory model. The new alternative venues for listing, while performing functions identical or very similar to those of the exchanges, often lack the financial resources and the market power to build an adequate regulatory apparatus.[65] At the same time, continuing to demand existing exchanges to invest in their regulatory efforts puts them in a grave disadvantage against the newcomers.[66] Some commentators have seen the emergence of these low-cost competitors as signaling a move away from an exchange-centered marketplace,[67] which would jeopardize the future of the self-regulatory model. As large brokerage houses and alternative trading systems have made their presence felt in the market for trading services, the functional borders that the self-regulatory model envisioned are becoming blurred and the rationale for granting regulatory powers to some marketplaces rather than others is not consistent with the underlying realities.[68]

While enlisting exchanges as front-line regulators relieves the government budget from regulatory costs, exchanges themselves need to devote significant resources in performing their respective obligations. For a private corporation, regulatory expenses of this type are a competitive burden that disadvantages it towards more flexible businesses that are not subject to similar requirements, such as alternative trading systems.[69] Arguably, high-quality regulation contributes to an exchange's "brand name" and thus justifies, at least partly, the costs of the exchange's regulatory apparatus. Still, in periods of financial hardship, a private corporation seeking to minimize its expenses may look into cutting its regulatory budget, possibly right at the moment that market conditions would justify a high-level intervention more than ever.

For-profit exchanges, especially following a public offering or listing of their shares, are also open to foreign investors. Many exchanges have attempted or completed cross-border mergers or entered into international alliances of market infrastructure institutions. These exchange formations are less tied to the interests of a single national market, jurisdiction or government than membership exchanges operating in a monopolistic or oligopolistic national market. The central place exchanges enjoy in a country's financial infrastructure may lead national governments to oppose such mergers or alliances or to diminish the self-regulatory powers of exchanges so that they maintain

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[64] *See* Carson, *supra* note 17, at 13.
[65] *See* Dombalagian, *supra* note 5, at 92.
[66] NYSE comment letter to the SEC Market 2000 study, *quoted in* Mendelson & Peake, *supra* note 19, at 462.
[67] *See* Dombalagian, *supra* note 5, at 117.
[68] *See* Maureen O'Hara, *Searching for a New Center: U.S. Securities Markets in Transition*, 89(4) FED. RES. BANK ATL. ECONOMIC REVIEW 37 (2004).
[69] *See* Cox, *supra* note 14, at 18.

ways to affect the policy decisions exchanges may take.[70] Another concern associated with exchanges as public companies relates to the conflicts of interest that arise when responsibility for reviewing the application for listing and, more generally, overseeing the listed exchange falls upon the exchange itself.[71] Andreas Fleckner, for example, has questioned whether an exchange can perform its role as guarantor of the quality of listed firms and as a link for the transmission of accurate information to investors, when the financial interests of the exchange's shareholders may be in conflict.

b. Academic Perspectives on the Regulatory Implications of Demutualization

Stock exchange demutualization has rekindled a long-standing debate among academics, policymakers, and industry representatives regarding the regulatory role of self-regulatory organizations. One segment of this debate focuses on whether efficient market oversight post-demutualization requires greater regulatory intervention or whether the highly competitive modern environment calls for reduced government regulation. Another line of inquiry examines the appropriate regulatory structure to deal with the conflicts of interest inherent in the post-demutualization world.

Academics have long been concerned that regulators tend to neglect issues of market structure. Back in the mid-1980's, Walter Werner argued that the SEC's scrutiny of proposed SRO rules was inadequate and proposed to assign SRO oversight to a specialized administrative agency that would not grow indifferent of its major task.[72] Seligman has criticized SEC regulation of market structure as a product of crisis reaction that lacks a vision for the market.[73] More recently, David Ahdieh identifies a "cueing" function for law in relation to market structure, suggesting that law and its primary enforcers, the regulators, should seek to coordinate regulatory efforts of separate bodies, push market participants to cooperate in industry-wide technical schemes, and shape market developments towards the direction most beneficial to the investing public as a whole.[74] For some commentators and industry observers, new regulation will be necessary to resolve the conflicts of interest resulting from demutualization, at least in some respects. Even the Securities Industry Association suggested more regulatory attention to SRO funding as a potential channel of influence to SRO rulemaking.[75] The GAO, in its 2002 Report on self-regulation, noted that market participants were not in favor of fundamental changes in the regulatory framework and recommended that the SEC puts in place a formal mechanism to identify material regulatory inefficiencies caused by the differences in interpretation of the rules among various self-regulatory organizations.[76] Seligman argues that a restructuring of the SRO oversight framework

[70] *See* Elliott, *supra* note 15, at 17.
[71] *See* Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541 (2006). *See also* Karmel, *supra* note 63, at 422.
[72] *See* Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 783 (1984).
[73] *See* Seligman, *supra* note 1, at 1348.
[74] *See* Robert B. Ahdieh, *Law's Signal: A Cueing Theory of Law in Market Transition*, 77 S. CAL. L. REV. 215, 246-248 (2004).
[75] *See* Letter from Marc E. Lackritz, President, Sec. Indus. Ass'n, to Jonathan Katz, Secretary, S.E.C. (Mar. 9, 2005) [hereinafter *SIA Letter*] (on file with authors).
[76] *See* G.A.O. REPORT, *supra* note 62, at 3.

should provide more safeguards of SRO independence from industry interests by increasing SEC powers as to SRO board member selection and budgeting.[77]

The emergence of numerous competitors for exchanges has led advocates of less regulation to argue that the new conditions in the market can alleviate many of the concerns associated with demutualization. O'Hara argues that we need to reorient the direction of capital markets regulation to take account of today's more competitive environment. Greater competition reduces the need for regulation in some respects, such as pricing and access.[78] However, the power of the stock exchange to oversee individual member firms has collapsed, and thus regulators need to explore other solutions in this regard. Karmel also notes that the invasion of modern technology and new competitors in the market for trading services is likely to lead to less regulation.[79] On the other hand, she points out that the expansion of the marketplace beyond national borders may justify the survival of the self-regulation model.[80]

In general, while commentators may disagree on whether the overall level of regulatory intervention in the market should increase or decrease, there is agreement that there are areas where regulators should step up their efforts, and areas where new highly competitive conditions remove the need for strict regulatory oversight. Identifying these areas and assigning respective regulatory powers to the most appropriate entity, either a government agency or a self-regulatory organization offering higher safeguards of independence, has led to a new debate on restructuring securities markets' regulatory framework, to which we now turn.

The conflicts of interest inherent in self-regulation have led many academic commentators and policymakers to propose a restructuring of the securities markets regulatory framework, i.e. to strengthen the powers assigned to some regulatory bodies or create new ones, or to change regulatory processes so as to achieve greater transparency and accountability. From the late 1990s onwards, stock exchange demutualization has reinforced voices calling for restructuring. Below, we will discuss some characteristic proposals before turning to the regulatory framework currently in place in the eight jurisdictions we study. While the solutions each proposal favors are very different, they all share a common underlying rationale: to alleviate conflicts of interest by segregating market operation from market regulation.[81]

A straightforward method to achieve greater independence of market regulation from market operation would be to vest regulatory powers to a separate subsidiary of the exchange operator. This approach predates the demutualization era as it resulted directly from an SRO regulatory failure in the mid-1990s. A series of academic papers suggested that Nasdaq market-makers engaged in market-wide collusion by avoiding quotes in odd-eighths so as to artificially inflate spreads.[82] As a result of the SEC enforcement action, NASD, who operated the Nasdaq market, undertook to separate its regulatory operations from any interest in an exchange through the establishment of an independent regulatory

[77] *See* Seligman, *supra* note 1, at 1347.
[78] *See* O'Hara, *supra* note 68, at 51.
[79] *See* Karmel, *supra* note 63, at 369.
[80] *Id.* at 370.
[81] Mendelson & Peake capture the essence of this aim long before demutualization became a concern for regulators. *See* Mendelson & Peake, *supra* note 19, at 462.
[82] *See* William Christie & Paul Schultz, *Why do Nasdaq market makers avoid odd-eighth quotes?*, 49 J. FINANCE 1813 (1994).

corporate subsidiary, NASD Regulation Inc.[83] Arguably, the twin corporate structure of the model will help bring some separation between the two functions, as the two entities will have separate personnel, separate culture, and a clearer division of missions between the two arms. However, both entities will still be under common management and will be receiving funding by common sources. In addition, this approach maintains the complexities associated with the existence of multiple SROs in a single jurisdiction.[84]

To minimize any conflicts of interest still persisting despite the allocation of the regulatory function to a separate entity, SROs could establish governance measures that provide additional guarantees of independence. Joel Seligman examines the governance framework of the PCAOB, the newly formed regulator of the audit profession,[85] and argues that it presents clear advantages to the current governance structure of SROs in the US. The PCAOB board includes a majority of independent directors that the SEC appoints, and has the power to set its own budget, which remains subject to SEC approval but stands aloof from industry pressure. In Seligman's view, the PCAOB governance framework addresses successfully these two major sources of interest group influence over an SRO's regulatory output.[86]

In its 2004 SRO Concept Release, the SEC suggested that it would consider the establishment of a separate SRO that would be responsible for broker-dealer regulation both from a financial stability and from an investor protection perspective.[87] Market operators would still maintain their regulatory powers, but only with respect to matters related to the operation of their markets. This structure would achieve the parallel goals of ensuring greater independence for member regulation and avoiding duplicative and expensive regulatory measures. It would also remove any concerns associated with potentially anti-competitive behavior from current SROs to some of their members who offer alternative trading services. However, it would not eliminate all channels of member influence, as this SRO would still be funded by broker-dealers, and it would still require exchanges to finance regulatory services without imposing similar burdens on its competitors. The broker-dealer community supported the idea of separating SROs by function. In its response to the SEC's Concept Release,[88] the Securities Industry Association endorsed this proposal, noting however that it would require increased SEC involvement in coordinating the various SROs. Moreover, SIA suggested that direct membership participation in the single SRO board, even in a minority position, would be necessary to channel market expertise in the single SRO's management.

A more radical approach would be to consolidate all SROs in a single organization, so as to avoid coordination inefficiencies between multiple regulatory bodies and impose proportionate financial obligations on the trading venues regulated, regardless of their history or trading system. Some jurisdictions, such as Canada, have

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[83] Following the grant of the Nasdaq application to be recognized as an exchange, the NASD has entered a process of selling its financial interest on Nasdaq, which it hopes to complete by the end of 2006. *See* Robert Glauber, *supra* note 29.

[84] Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71,255, 71277 (Dec. 8, 2004) [hereinafter *SRO Release*].

[85] PCAOB was established in 2002 in the context of the Sarbanes-Oxley Act. *See* Seligman, *supra* note 1, at 1348.

[86] *See id.* at 1380.

[87] *See* SRO Release, *supra* note 84, at 71,278.

[88] *See* SIA Letter, *supra* note 75.

followed a variant of this approach: they have allowed the establishment of a separate entity to which SROs may outsource their regulatory operations.[89] Arguably, this system offers a more effective shield from the influence of special interest groups, as it is a collective venture that promulgates rules of general applicability. However, the risk is, as the SEC pointed out in its 2004 SRO Concept Release, that the SRO would be detached from the markets and thus lacking in trading expertise.[90] Canada has attempted a compromise to this dilemma through SRO governance measures: half the directors in the SRO board are independent, while the remaining directors represent the market operators and the broker-dealer industry association.[91] The Canadian independent SRO performs day-to-day surveillance of trade activity in the markets it oversees, both from a market manipulation perspective and from a customer care perspective, and has the power to bring enforcement proceedings against violators.[92]

As this brief account of the major solutions to the concerns associated with self-regulation demonstrates, eliminating or limiting the effects of the conflicts of interest inherent in the self-regulatory model is a grueling task with uncertain outcomes. It is perhaps no surprise that policymakers around the world are questioning its continuing benefits.[93] The most impressive sweep of self-regulatory powers in favor of a government agency was arguably the establishment of the FSA in the UK, which replaced a number of self-regulatory organizations and undertook many powers that the London Stock Exchange previously monopolized, including the power to decide on listing applications for the stock exchange's markets. Still, the advantages of self-regulation, especially the additional resources it brings to market surveillance, its ability to establish new rules through a consensual process with the regulated entities, and its high expertise, are not easily done away with. As our analysis demonstrates, the FSA's approach to regulation is different from that of other regulators, seeking to induce best practices to industry members while also allowing them significant leeway in framing their behavior. The correlation between FSA's broad authority over the financial services industry and its gentler regulatory approach may reveal some of the limitations of a government-agency dominated system.

## 2. Survey and Analysis: Three Models for Allocating Regulatory Power

Our account of the academic literature on self-regulation and of representative policymakers' studies has illustrated the emergence of a consensus regarding the

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[89] The most characteristic example is Canada, where the Toronto Stock Exchange and the Investment Dealers Association have formed a joint venture in the form of a not-for-profit self regulatory organization funded through a user pay fee structure.

[90] *See* SRO Release, *supra* note 84, at 71,280.

[91] SRO ownership is shared between the market operator and the broker-dealer industry association. *See* MARKET REGULATION SERVICES, INC., ANNUAL REPORT 2003, 2, *available at* http://docs.rs.ca/ArticleFile.asp?Instance=100&ID=6C7BBE67ED6043298B14BB1EC4870D2F .

[92] *See id.*

[93] In its SRO Release, the SEC considers the alternative of resorting to SEC-only regulation. *See* SRO Release, *supra* note 84, at 71,281.

regulatory response to demutualization. In particular, there is agreement on two points: first, there remains some merit to self-regulation, at least in particular areas of regulatory oversight, and thus the complete abandonment of the self-regulatory model would have substantial costs. Second, demutualization of stock market ownership does introduce new and potentially significant conflicts of interest, which may warrant a greater degree of separation of regulatory oversight from market operation. However, each of these two propositions leaves ample space for variation among different jurisdictions. Do states agree as to the areas in which the contribution of the self-regulatory model is most beneficial? What methods can states use to achieve greater separation of regulatory oversight from market operation? Is there a universal approach to the challenges demutualization poses for self-regulation?

The purpose of our survey is to examine how the regulatory framework of various influential jurisdictions has addressed these questions in the post-demutualization era. In particular, we seek to explore whether the legal treatment of self-regulatory organizations around the world reflects the emerging consensus of academic thinkers and policymakers described in the preceding section. We then consider how these jurisdictions have allocated regulatory responsibilities among market infrastructure institutions as self-regulatory bodies, administrative agencies, and government ministries. As self-regulatory organizations represent just one tier of the regulatory hierarchy in securities markets, a study of SRO powers would be incomplete without considering how the SROs interact with the government agencies that supervise them. Moreover, we seek to identify the mechanisms states have used to segregate market operation from market regulation. The tools available to policymakers range from enhancing procedural safeguards imposed on market institutions to transferring regulatory functions from exchanges to government bodies to recasting the balance of powers among government agencies and self-regulatory organizations in various other ways. Furthermore, enhanced corporate governance mechanisms may provide an additional internal layer of insulation of the regulatory function from market operation. While our study explores the powers of regulators over stock exchange governance, it does not cover measures that stock exchanges have voluntarily adopted to deal with these concerns, which are the subject of another study in this volume.

We begin this section with an overview of our research methodology. We then summarize our findings, outlining three general approaches to the allocation of regulatory responsibility that emerged from our surveys. We then discuss each of these models in detail. Summaries of individual country case studies appear in Appendix A. In Appendix B we reproduce a copy of the survey form used to collect the data upon which our analysis is based.

## *I. Overview of Survey Design*

We examine the regulatory framework of eight influential jurisdictions for capital markets regulation: US, Japan, UK, France, Canada, Germany, Hong Kong, Australia. These jurisdictions include the three largest stock exchanges by market capitalization in three large regions: North America, Europe, and Asia-Pacific,[94] covering 74% of the

[94] *See* WORLD FEDERATION OF EXCHANGES, ANNUAL REPORT AND STATISTICS 2005, 66, *available at* http://www.world-exchanges.org.

world's aggregate stock exchange capitalization. We have asked stock exchanges and local lawyers to respond to a common questionnaire seeking to outline the allocation of regulatory powers to administrative agencies and market infrastructure institutions in their local jurisdiction.[95] (A copy of that survey appears in Appendix B.) Where necessary, we have complemented their work with research in related legal and regulatory provisions.

To identify the areas in which different jurisdictions have opted for the self-regulatory model, we have adopted a *functional* perspective. Our questionnaire has analyzed securities markets regulatory oversight in 45 distinct regulatory functions, divided in six greater areas: Authorizing and Supervising the Public Offer Process; Issuer Regulation Following Public Offer / Listing; Regulation of the Trading Process; Regulation of Marketplaces; Supervision of the Financial Intermediation Process; and Supervision of Clearing and Settlement. In each of the 45 functions, we have asked our respondents to indicate separately the regulatory body responsible for rule-making, monitoring and enforcing local laws. Thus, responses to our questionnaire yield a detailed breakdown of 135 different regulatory powers for each jurisdiction.

The functional approach of our survey and the detail in the responses allow us to understand the extent of real powers each institution has over the markets it runs or oversees. In this way, we attempt to avoid confusions caused by open-ended jurisdictional assignments as well as ambiguities resulting from legal provisions that have not been fully implemented. Through our surveys, we obtain a full map of the allocation of regulatory powers in each jurisdiction by outlining each institution's powers against another's, and by identifying areas of activity that remain unregulated or that fall within the sphere of competence of more regulatory bodies. From an analytical standpoint, a functional methodology facilitates comparisons across jurisdictions and among regulatory entities. Overall, our functional methodology explores the first prong of our research question by setting out the areas where states have permitted market infrastructure institutions to retain regulatory powers in a post-demutualization world.

Our questionnaire also explores mechanisms to separate market operation from market regulation by enquiring into the capacity of governmental authorities to oversee market infrastructure institutions or capital markets in general. The role of an institution in a regulatory framework is defined not only by its own powers, but also by the powers of other institutions to set out, limit the scope, or overturn the institution's actions. Thus, looking simply at powers the SROs have would not depict accurately their overall role in the regulatory framework of each jurisdiction.

Increased regulation of market infrastructure institutions could range from greater government intervention in SRO governance to limiting the decision-making flexibility of SROs. Our survey reflects the interplay between market infrastructure institutions and state authorities in three main ways. First, we distinguish between the different types of state authorities that may become involved in the regulatory process, such as central government bodies (e.g., ministries), regulators (agencies or specialized authorities), and courts. Second, we seek to identify varying degrees of interaction among these authorities by separating cases where an institution acts alone and cases where approval by another institution is required. Third, we report the role of different levels of government authorities (federal or state) where relevant.

[95] All responses to the questionnaires are on file with the authors.

### *II. Summary of Survey Results*

As our individual country case studies illustrate,[96] our results confirm the consensus we identified among academic thinkers and policymakers regarding the role of market institutions in the regulatory structure of modern capital markets. While some jurisdictions reacted immediately and with great force to stock exchange demutualization, none has considered necessary to remove all regulatory powers from stock exchanges and other market institutions. Although trends to concentrate supervisory powers to a single regulatory body have emerged across borders, all jurisdictions in our study have designed a multi-faceted regulatory apparatus for their markets. Their regulatory structures seek to utilize, within a single nation, a wide variety of regulatory bodies, public and private, and an equally wide variety of regulatory approaches, more or less interventionist, to address different concerns. The purpose of our study is to illuminate these differences and reveal diverging policy rationales; however, we find the overarching fractionalization of regulatory authority noteworthy. Modern regulatory regimes have also reached a remarkable degree of sophistication and completeness. Despite an extensive questionnaire of separate regulatory functions, we rarely encountered blank responses, indicating that most jurisdictions denied leaving these functions unregulated. Indeed, the jurisdictions participating in our survey sought to provide an affirmative response to demutualization by adopting measures that separate market regulation from market operation.

Still, differences among the jurisdictions we examined are plentiful. As we predicted, there is no common position as to the areas in which regulation by market institutions or government bodies can be more beneficial. Jurisdictions have followed different approaches to separating market operation from market regulation, ranging from divesting market institutions of regulatory powers to simply imposing additional governance measures. How vast are these differences? Are there any preferred responses to demutualization that proved popular across borders? Has demutualization resulted in scaling down the regulatory powers of market institutions?

Our results indicate that there are three distinct patterns of allocation of regulatory powers to market institutions and government agencies among jurisdictions. In France, Germany and Japan, central governments have shaped the regulatory framework so as to ensure that, regardless of a specialized administrative agency, they maintain a tight grip over securities markets regulation. We characterize this pattern of regulatory powers' allocation as the "Government-led Model." In contrast, the UK, Australia, and Hong Kong have sought to grant as much leeway as possible to market participants in structuring their activities while also fulfilling their regulatory obligations (the "Flexibility Model"). Finally, the US and Canada regulatory frameworks grant a much wider regulatory role to market infrastructure institutions, while also strengthening the oversight government agencies exercise over market institutions in respect of their regulatory tasks (the "Cooperation Model"). The lines between jurisdictional responsibilities in countries following the Cooperation Model tend to be blurred and both administrative agencies and self-regulatory organizations tend to have strong and independent enforcement traditions. The regulatory reforms introduced in these

[96] *See infra* Appendix A.

jurisdictions in the wake of stock exchange demutualizations vary depending on the model each jurisdiction follows. Government-led Model jurisdictions sought to create more efficient government oversight mechanisms for their financial markets, primarily by reorganizing administrative agencies and secondarily by increasing their already strong regulatory powers. Flexibility Model jurisdictions sought to curtail the role of market infrastructure institutions in the post-demutualization world, and enhance the powers of administrative agencies respectively; however, the regulatory approach they employ still seeks to maintain flexibility for issuers, investors and other market players. Finally, Cooperation Model jurisdictions could hardly afford to abolish the regulatory functions of market infrastructure institutions given the important role that these organizations have historically played in these jurisdictions; thus, they turned to segregation of these functions to an independent subsidiary of the market operator as a viable alternative. Below, we set out in further detail the characteristics of each model.

## *III. Government-led Model*

a. Overview

The allocation of regulatory powers in Government-led jurisdictions favors administrative agencies and central government officials over market infrastructure institutions. Laws in these jurisdictions tend to require greater involvement of central governments in certain key actions and regulatory measures than exists under other models. The regulatory powers of market institutions are specific, carefully defined and relating to areas where the involvement of market institutions is strictly necessary, such as the regulation of the trading process. Even in these limited areas, the exercise of regulatory powers by market institutions is often subject to approval by an administrative agency. At the enforcement stage, however, these jurisdictions devote substantially less efforts than Flexibility or Cooperation jurisdictions.

b. How do agencies and market institutions divide areas of regulatory responsibility?

In the Government-led Model, the allocation of areas of regulatory responsibility between administrative agencies and market infrastructure institutions is *issue-specific*: statutes direct market institutions' regulatory efforts to precisely delineated areas of activity and regulatory responsibility, assigning specific tasks and granting to them specialized powers. Thus, market institutions derive their regulatory powers from a complex set of different provisions, each one aiming to provide regulatory solutions to a particular concern; their regulatory role comes together in a piecemeal fashion, rather than through a general authorization to uphold securities laws and formulate rules for their implementation.[97] A further consequence of the issue-specific approach to allocation of regulatory powers is that, in these jurisdictions, the government agency is

[97] Compare this structure with the approach followed in the Cooperation Model. *See infra* Part 2.V.b.

the default regulator for the securities markets, in the sense that when a power has not been expressly assigned to a market institution, it rests with the government.

In addition to the method of allocating regulatory responsibilities, jurisdictions in the Government-led model are also distinctive with regard to the specific areas in which they have preserved market institutions' regulatory powers. Thus, market institutions in these jurisdictions appear on the regulatory map in the following areas: setting out prospectus disclosure requirements, establishing listing requirements and ongoing disclosure obligations, setting the trading rules according to which transactions are effected in the stock exchange, and setting out clearing and settlement procedures.[98] In other words, stock exchanges have a role in controlling whether issuers can obtain access to their markets and how trading will take place, while clearing and settlement institutions are responsible for designing the clearing and settlement process.

This allocation of powers in jurisdictions following the government-led model is consistent with the view that stock exchanges may be more effective in regulating certain aspects of the securities markets, as well as an effort to restrain market institutions' regulatory role at the bare minimum, i.e. at the areas where their involvement is either strictly necessary, or hugely beneficial for the smooth operation of the market.[99] The limited rulemaking and review authority granted to exchanges with regard to initial and ongoing issuer disclosure constitutes a channel through which the exchange familiarizes itself with the new issuer. Especially as ongoing disclosure takes place through bulletins and other methods of dissemination of information that exchanges operate, the case for exchanges retaining some regulatory powers over issuer disclosure is particularly strong. Similarly, the exchange trading system is one of the core aspects of an exchange's activity in which market institutions' daily involvement guarantees a high level of expertise. Thus, it is not surprising that regulation of the exchange trading process is one of the few areas where all the jurisdictions in our survey, including those of the Government-led Model, coincide in granting significant regulatory powers to exchanges. Given the complicated technical questions associated with market microstructure, most jurisdictions leave wide discretion to exchanges and limit themselves in setting high-level principles that a trading system must abide with.[100] An analogous argument holds for clearing and settlement regulation, where government agencies focus on financial stability and infrastructure adequacy aspects, leaving the design of the highly technical clearing and settlement systems to the institutions operating them.

The degree of discretion market institutions have in these areas varies. For example, government intervention in rules that determine which issuers will have access to public financing is stronger, as statutes and agency rulemaking usually prescribe the conditions that trigger the prospectus requirement and outline a prospectus's required

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[98] *See* tables 1, 2, and 3, summarizing the allocation of regulatory powers for France, Germany and Japan respectively.

[99] Of all the market infrastructure institutions included in our survey, the only one whose regulatory powers cover less areas than the four areas covered in the Government-led model is the LSE. However, the philosophy that underpins the UK regulatory framework is fundamentally different. *See infra* Appendix A.V.

[100] Perhaps the most prescriptive rules in the jurisdictions we study here with regard to exchanges' trading models can be found in France. The AMF General Regulation enshrines the principles of price priority and time priority that in effect point to a central-limit-order-book model very close to that employed by Euronext.

contents; on the other hand, central governments are usually less interested in specifying rules that determine market microstructure issues, leaving trading technicalities for exchanges to determine.[101] In the areas where market infrastructure institutions enjoy regulatory responsibilities, their powers are not exclusive in most cases; regulators will also bear some authority in these same areas. Often, the law will subject the market institution's discretion in the exercise of its powers to government agency oversight. Section c. below examines in further detail the interaction between market institutions and regulators in the Government-led Model; the point in this section, however, refers to the all-encompassing scope of agency authority. These jurisdictions have avoided entrusting to a market institution the sole authority to regulate a group of functions identified in our questionnaire. The presence of parallel government powers was deemed necessary to achieve the related regulatory goals.

The tables that follow demonstrate the similarities in the pattern of allocation of regulatory responsibilities among the countries in the Government-led Model. For the purposes of facilitating graphic representation in a concise manner, we have reduced the 40 functions included in our survey in 10 major categories. The areas marked in light grey illustrate government or administrative agency authority, while the areas left white indicate market institution authority. Similarities in the color pattern among the three jurisdictions are apparent.

Table 1. Overview of the Regulatory Framework in France

| | RULEMAKING | | MONITORING | | ENFORCEMENT | |
|---|---|---|---|---|---|---|
| Prospectus Disclosure | AMF | E | AMF | E | AMF/C | E |
| Securities Distribution | AMF | | AMF | | AMF | |
| Listing – Ongoing Disclosure | AMF | E | AMF | E | AMF | E |
| Issuer Corporate Governance | AMF | | AMF | | AMF | |
| Market Abuse | Ministry / AMF | | Ministry / AMF | | AMF/C | |
| Trading Rules | AMF | E | AMF | E | AMF | E |
| Marketplace Oversight | Ministry / AMF | | Ministry / AMF | | AMF | |
| Brokers – Investment Firms | CECEI/CB | E | CECEI/CB | E | CECEI/CB | E |
| Clearing & Settlement | AMF | LCH | AMF | LCH | AMF | LCH |

KEY

AMF: Authorité des Marchés Financieres
CB: Commission Bancaire
E: Euronext Paris
CECEI: Comité des établissements de crédit et des entreprises d'investissement
LCH: LCH.Clearnet
C: Courts

[101] It is interesting to note that, in the public debate in the US surrounding SEC's adoption of Regulation NMS, NYSE Chairman John Thain warned the SEC that it should avoid turning the US market into an immense central limit-order book. *See* John Thain, *The Quest for the Right Balance*, Wall St. J., Dec. 21, 2004, at A14. A year later, the NYSE entered into a merger agreement with Euronext which, although it does not provide for trading platform at the moment, it is generally expected to lead to a unified trading platform in the future.

Table 2. Overview of the Regulatory Framework in Japan

| | RULEMAKING | | MONITORING | | ENFORCEMENT | |
|---|---|---|---|---|---|---|
| Prospectus Disclosure | JFSA | TSE | JFSA | TSE | JFSA/C | TSE |
| Securities Distribution | JFSA | | JFSA | | JFSA | |
| Listing – Ongoing Disclosure | JFSA | TSE | JFSA | TSE | JFSA | TSE |
| Issuer Corporate Governance | JFSA | | JFSA | | JFSA | |
| Market Abuse | JFSA | | JFSA | | JFSA | |
| Trading Rules | JFSA | TSE | JFSA | TSE | JFSA | TSE |
| Marketplace Oversight | JFSA | | JFSA | | JFSA | |
| Brokers – Investment Firms | JFSA/JSDA | | JFSA/JSDA | | JFSA/JSDA | |
| Clearing & Settlement | Ministry | JSCC | Ministry | JSCC | JSCC | |

KEY

JFSA: Japanese Financial Services Agency | TSE: Tokyo Stock Exchange | JSCC: Japan Securities Clearing Corp.
JSDA: Japan Securities Dealers Association | Ministry: Ministry of Finance | C: Courts

Table 3. Overview of the Regulatory Framework in Germany

| | RULEMAKING | | MONITORING | | ENFORCEMENT | |
|---|---|---|---|---|---|---|
| Prospectus Disclosure | BaFin | | BaFin | | BaFin | C |
| Securities Distribution | BaFin | | BaFin | | BaFin | |
| Listing – Ongoing Disclosure | BaFin | DB | BaFin | DB | BaFin | DB |
| Issuer Corporate Governance | BaFin | | BaFin | | BaFin | |
| Market Abuse | BaFin | | BaFin | | BaFin/C | |
| Trading Rules | DB | | HÜSt | DB | Länder | DB |
| Marketplace Oversight | Länder/ BaFin | | Länder/ BaFin | | Länder/ BaFin | |
| Brokers – Investment Firms | BaFin | | BaFin | | BaFin | |
| Clearing & Settlement | BaFin | DB | BaFin | DB | BaFin | DB |

KEY

BaFin: Bundesanstalt für Finanzdienstleistungsaufsicht | DB: Deutsche Börse | C: Courts
Ministry: Ministry of Finance | HÜSt: Market Surveillance Office

The administrative agencies currently dominating the regulatory scene in the Government-led model jurisdictions sprung out of a series of regulatory reforms in these countries at the turn of the decade. In France, AMF succeeded a number of smaller agencies specializing in securities markets oversight. In Japan, the JFSA came into being as a high-level supervisory body for agencies regulating the banking and securities markets. BaFin is an amalgamation of the administrative agencies previously responsible for the German insurance, banking and securities industries. Reformers justified this extensive reorganization as necessary to respond to increasing complications and constant innovations in modern financial markets. Stock exchange demutualizations, occurring in the same period with these reforms, contributed to the sense that the outlook of financial markets is rapidly changing. Although the introduction of these new agencies sought to avoid disturbing the allocation of authority in the regulatory structure, subsequent measures have increased their powers at the expense of stock exchange autonomy. Thus, the response of Government-led Model jurisdictions to the changing environment of modern finance consists in creating a more efficient mechanism for stronger government supervision of the securities markets.

c. What rules define the interaction between market infrastructure institutions and administrative agencies?

As already demonstrated above, the regulatory powers of market infrastructure institutions generally coexist with powers afforded to the administrative agencies active in securities markets regulation. Given this overlap, the risk of clash between these bodies' actions is almost inevitable. The Government-led Model jurisdictions have employed a number of solutions to counter this problem, most of which result in giving precedence to agency powers over stock exchange or clearing house powers. First, stock exchange rules often require agency approval to enter into force; although a similar requirement also exists in other models,[102] the dynamics in the Government-led Model are different, because the market institution's power is more narrowly prescribed in the first place given its issue-specific character. As a result, the space left to market institutions for rulemaking is much narrower in comparison to the discretion these institutions have under the Cooperation Model, for example. Moreover, the law often grants agencies the ability to direct market institutions to adopt certain measures in areas where they also enjoy the power of prior approval of market institution rulemaking. Second, agencies are often granted the power to reverse decisions by market infrastructure institutions; for example, the AMF in France has the power to object to Euronext's decision to admit a security for listing or to delist an issuer. Finally, the character of SROs' rulemaking and enforcement actions in the Government-led Model is secondary to agency initiatives. On the rulemaking side, SRO rules often seek to implement agency directives in a concrete way, rather than define new regulatory objectives. On the enforcement side, their powers come often in support of agency initiatives, such as by expelling from the exchange issuers whose fraudulent activities have already been the target of agency investigations.[103] To sum up, the regulatory mission of market institutions in the Government-led model consists largely in supplementing agency regulatory actions, rather than bring concrete regulatory initiatives to the fore.

d. What is the role of central government in the securities markets regulatory framework?

In all the Government-led Model jurisdictions, the central government has shaped the securities regulatory framework so as to maintain important channels of influence in the operation of market institutions. Sometimes, these channels of influence are direct, as powers to approve the establishment of a stock exchange or a clearing house rest with a central government official, such as a Minister.[104] Often, these channels are indirect, expressed through a tight relationship between the central government and the administrative agency responsible for the regulatory oversight of the securities markets. For example, JFSA is positioned under the Prime Minister's Cabinet in the Japanese regulatory hierarchy, and some of its rules require the Prime Minister's approval before

[102] *See infra* Part 2.V.c., concerning the Cooperation Model.
[103] Japan is a good example. *See infra* Appendix A.II.
[104] This is the case in France. *See infra* Appendix A.I.

entering into force.[105] In France, all AMF rules require the approval of the Ministry of Finance before entering into force. Moreover, the Ministry can influence the AMF deliberation process through its directly appointed representative in the AMF board.[106] In this way, central governments in these jurisdictions maintain a strong grip over the regulation of securities markets.

e. How vigorously are securities laws enforced in these jurisdictions?

We focus primarily on data on securities law enforcement by public authorities, as they present a central aspect of the relationship between government agencies and market institutions.[107] We base our conclusions on the responses we have received from market institutions to our questionnaires, as well as data Howell E. Jackson has collected and presented in the past.

The Government-led jurisdictions present the lowest levels of enforcement intensity among the jurisdictions in our survey. The response we have collected in our questionnaire from Japan indicates that, while local regulators and market institutions are aware of this weakness and are taking measures to step up regulatory efforts, actual enforcement levels remain low.[108] Past research by Howell E. Jackson suggests that, similar to Japan, enforcement intensity in Germany remains also at low levels. Examining data on the number of actions brought by BaFin between 2000 and 2002 (which, however, do not reflect the level of monetary sanctions BaFin has imposed),[109] he concludes that they amount only to about one fifth of the actions brought in the US, even after controlling for market size. Similarly, Government-led jurisdictions devote significantly less budgetary resources to securities markets regulation than Flexibility and Cooperation jurisdictions, as Howell E. Jackson has pointed out.[110]

## *IV. Flexibility Model*

a. Overview

Whereas the Government-led Model seeks to preserve inroads for central government influence in securities markets regulation, the philosophy of the Flexibility Model is to grant as much leeway as possible to market participants in structuring their activities while also fulfilling their regulatory obligations. This does not necessarily entail lack of clarity or rigorousness in setting out firm objectives for securities markets

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[105] *See infra* Appendix A.II.

[106] *See infra* Appendix A.I.

[107] Although we refer to the availability of private enforcement routes where relevant, we have not included data on private enforcement in this paper, as we have referred to this data extensively in past work. *See* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* (Harvard John M. Olin Discussion Papers Series No. 521, Aug. 2005) *available at* http://www.law.harvard.edu/programs/olin_center/.

[108] It is interesting that enforcement efforts with regard to the management of the stock exchange, such as conduct of its officials and staff and internal organization and control, enforcement levels are extremely low. *See* Tokyo Stock Exchange Responses to the Questionnaire (on file with authors).

[109] *See* Jackson, *supra* note 107, at 28.

[110] *Id.* at 19-20.

regulation, nor does it signal laxity in enforcement; on the contrary, regulatory objectives remain clear and enforcement efforts in these jurisdictions are often stronger than in the Government-led Model. However, in considering how to implement these objectives, regulated entities often have the ability to shape their own solutions, either through reaching an understanding with the regulators directly, or through channeling their preferences as the clientele of a market infrastructure institution which enjoys regulatory powers. *Overall, these jurisdictions achieve flexibility by channeling agency rulemaking through the issue of guidance rather than or in addition to prescriptive rules, and by limiting central government involvement in the monitoring and enforcement stages.*

Among the Flexibility jurisdictions, the UK stands apart not only for its particular role as a global financial center but also for its decision to create a single regulator for the banking, securities and insurance industries, the FSA. On the surface, the FSA seems like a particularly strong regulator with extremely wide scope of powers; indeed, at the time the FSA was being created many industry participants were lobbying the UK government in an effort to tone down its sweeping powers.[111] However, a closer look at the FSA and its relationship with UK Treasury reveals that its true character is different from the government-dominated agencies of the Government led-model. As detailed in the UK Country Study, the FSA is a hybrid regulator, operating in the form of a corporation whose Board is appointed by the government. Historically, the FSA resulted from a merger of a series of self-regulatory institutions. Its regulatory approach is non-intrusive, resonating largely the regulatory approaches followed in the other Flexibility jurisdictions.

b. How do agencies and market institutions divide areas of regulatory responsibility?

Similarly to the Government-led Model, the allocation of regulatory powers in the Flexibility Model is *issue-specific*; government entities, regulators and market infrastructure institutions have distinct responsibilities for regulatory oversight. This does not necessarily mean that there are no risks of overlap or clash in the fringes, but rather that the core powers each entity has are designed as distinct (although, in some cases, they are complementary). In contrast to the Government-led Model, where the central government maintains powers to intervene directly in the day-to-day oversight of capital markets, the Flexibility Model tilts towards allowing market- or industry-led initiatives to shape regulatory policy and enforcement. In the Australian and Hong-Kong regimes, market infrastructure institutions enjoy greater responsibilities; the UK reaches the same result through the regulatory approach employed by the FSA. The paragraphs that follow outline the similarities and differences in the pattern of allocation of regulatory responsibilities in the jurisdictions of the Flexibility Model, and the following section discusses the regulatory approaches these jurisdictions have adopted.

A brief look at Tables 4 and 5 below confirms that market infrastructure institutions in Flexibility jurisdictions enjoy a wide scope of regulatory powers, covering areas in the regulatory spectrum as diverse as primary markets' disclosure rules and regulation of stock exchange member firms, and even extending to the regulatory

[111] *See* Eilís Ferran, *Examining the United Kingdom's Experience in Adopting the Single Financial Regulator*, 28 BROOK. J. INT'L L. 257, 296 (2003).

oversight of the marketplaces themselves. A comparison between Tables 4 and 5 in the Flexibility Model and Tables 1, 2 and 3 in the Government-led Model reveals telling differences between the two models. First, Flexibility jurisdictions have entrusted market infrastructure institutions with substantially more powers than Government-led jurisdictions. Second, in the areas where the market institutions of the Government-led Model have regulatory powers, market institutions of the Flexibility Model also have regulatory powers. In other words, there is a core set of areas, namely Prospectus Disclosure Rules, Listing – Ongoing Disclosure Rules, Trading Rules and Clearing and Settlement Rules where both Flexibility Model jurisdictions and Government-led jurisdiction have trusted market institutions with regulatory powers. The UK example notwithstanding, these powers constitute "the bare minimum" regulatory role assigned to market institutions. Jurisdictions in the Flexibility Model have then expanded the powers of their market institutions by adding incrementally to this set of minimum powers. Finally, there are many areas in the Flexibility Model where market infrastructure institutions are the exclusive regulators, without significant powers residing with government entities or administrative agencies. This is a stark characteristic of the Flexibility Model that sets it apart both from the Government-led Model and the Cooperation Model, none of which allow such leeway to market institutions. These three attributes of the regulatory role of market institutions in Flexibility Model regimes, i.e. the volume of regulatory powers, the allocation of powers beyond the "bare minimum," and the exclusivity market institutions enjoy in some areas, illustrate the greater flexibility these regimes allow to market participants.

As the traditional role of market institutions in the regulatory structure of Flexibility Model jurisdictions was more important, developments such as demutualization had a profound impact in their regime. The decision of the UK government to strip the London Stock Exchange of its Listing Authority powers and to assign this role to the FSA is perhaps the most celebrated government response to a stock exchange demutualization, but policymakers in the other Flexibility Model jurisdictions also reacted to similar developments in their markets. The Hong Kong government, although fully supportive of the stock exchange's demutualization, resolved to strengthen the powers of the regulator in the post-demutualization regime.[112] Australia maintained an important regulatory role for ASX but established an enhanced governance regime over the stock exchange: ASX Supervisory Review ("ASXSR"), a wholly owned subsidiary of ASX, was created to function as an independent internal auditor to ASX in respect of the performance of its supervisory functions.[113] In addition, ASX entered into a special memorandum of understanding with ASIC regarding its supervision as a listed entity[114] that enhanced ASIC's supervisory role. Overall, Flexibility Model jurisdictions responded to stock exchange demutualization by strengthening the position of regulators towards stock exchanges and implementing additional governance measures where necessary. To avoid sacrificing flexibility for investors in the name of combating conflicts of interest through stronger government agencies, these jurisdictions employed a

[112] *See* Laura Cha, *Securities Markets Reform: the Hong Kong Experience*, Address at The Commonwealth Club of California (Jun. 6, 2000) *available at* http://www.sfc.hk/sfc/html/EN/speeches.
[113] *See* Press Release, Australian Stock Exchange (Dec. 15, 2005) (on file with authors). *See* also *infra* Appendix A.V.
[114] *See* http://www.asx.com.au/research/market_info/history/history_ASX.htm.

more investor-friendly regulatory approach, illustrated in their preference for guidance over rules and the preservation of significant powers in the hands of market institutions.

Table 4. Overview of the Regulatory Framework in Australia

| | RULEMAKING | | MONITORING | | ENFORCEMENT | |
|---|---|---|---|---|---|---|
| Prospectus Disclosure | Treasury | ASX | ASIC | ASX | ASIC/C | ASX |
| Securities Distribution | Treasury | | ASIC | | ASIC | |
| Listing – Ongoing Disclosure | ASX | | ASX | | ASX | |
| Issuer Corporate Governance | Government | | ASIC | | ASIC | |
| Market Abuse | Government | | ASIC | | ASIC | |
| Trading Rules | ASX | | ASX | | ASX | |
| Marketplace Oversight | Treasury | ASX | ASIC | ASX | ASIC | ASX |
| Brokers – Investment Firms | Treasury | ASX | ASIC | ASX | ASIC | ASX |
| Clearing & Settlement | Treasury | ASX | RBA | ASX | ASIC | ASX |

KEY

ASX: Australian Stock Exchange
ASIC: Australian Securities and Investment Commission
RBA: Reserve Bank of Australia
C: Courts

Table 5. Overview of the Regulatory Framework in Hong Kong

| | RULEMAKING | | MONITORING | | ENFORCEMENT | |
|---|---|---|---|---|---|---|
| Prospectus Disclosure | SFC | HKEx | SFC | HKEx | SFC | HKEx |
| Securities Distribution | HKEx | | HKEx | | HKEx | |
| Listing – Ongoing Disclosure | HKEx | | HKEx | | HKEx | |
| Issuer Corporate Governance | HKEx | | HKEx | | HKEx | |
| Market Abuse | SFC | HKEx | SFC | HKEx | SFC | HKEx |
| Trading Rules | HKEx | | HKEx | | HKEx | |
| Marketplace Oversight | SFC | HKEx | SFC | HKEx | SFC | HKEx |
| Brokers – Investment Firms | SFC | HKEx | SFC | HKEx | SFC | HKEx |
| Clearing & Settlement | SFC | HKEx | SFC | HKEx | SFC | HKEx |

KEY

BaFin: Bundesanstalt für Finanzdienstleistungsaufsicht
DB: Deutsche Börse
Ministry: Ministry of Finance
C: Courts
HÜSt: Market Surveillance Office

Table 6. Overview of the Regulatory Framework in the UK

| | RULEMAKING | MONITORING | ENFORCEMENT |
|---|---|---|---|
| Prospectus Disclosure | Treasury | FSA | FSA/C |
| Securities Distribution | Treasury | FSA | FSA |
| Listing – Ongoing Disclosure | Treasury | FSA | FSA |
| Issuer Corporate Governance | FSA/Panel | FSA | FSA |
| Market Abuse | Treasury/FSA | FSA | FSA |
| Trading Rules | LSE | LSE | LSE |
| Marketplace Oversight | Treasury/FSA | FSA | FSA |
| Brokers – Investment Firms | Treasury/FSA | FSA | FSA |
| Clearing & Settlement | Treasury/FSA | FSA | FSA |

KEY

FSA: Financial Services Authority LSE: London Stock Exchange C: Courts
Panel: Panel for Takeovers and Mergers

c. What rules define the interaction between market infrastructure institutions and administrative agencies?

In the Flexibility Model, the administrative process constraints agencies pose over market infrastructure institutions are limited. In Australia and the UK, the approval of the local agency is generally not required for a stock exchange rule to enter into force.[115] Given that the allocation of regulatory responsibilities is issue-specific, as outlined above, the absence of a prior approval requirement effectively grants market infrastructure institutions wide flexibility in the exercise of their rule-making authority over the areas they regulate. In Hong Kong, HKEx must still obtain SFC's prior approval before its rules can enter into force. However, the areas over which HKEx enjoys exclusive regulatory powers are many, while in all remaining areas HKEx shares regulatory powers with the SFC. This structure strengthens considerably the presence of HKEx as a market regulator in Hong Kong.

A central characteristic of the regulatory process in the Flexibility Model lies in the non-intrusive approach these jurisdictions employ as to capital markets regulation in general, and rulemaking in particular. As in all jurisdictions in this study, the laws passed by the legislature require implementation by second-tier legislative measures that deal with the practical details of enforcement. Unlike other jurisdictions, however, the task of implementation often falls in the hands of a central government entity, such as the Treasury, which must issue the necessary legislative instruments for the government agencies and market infrastructure institutes to comply and ensure compliance with. Often, these second-tier measures may contain general principles that do not lend themselves to direct implementation in practice in the same way rules of a day-to-day regulator do. Thus, these measures may require further elaboration by the agency or market institutions under whose sphere of competence their subject-matter falls and which is asked to add "teeth" to the law. Moreover, the issuing government entities are

[115] In Australia, the Department of Treasury maintains the right to disallow certain ASX rules changes that refer to the regulation of the marketplace itself. *See* Australian Stock Exchange, Responses to Questionnaire (on file with authors).

often reluctant to revisit their rules, but view them as a "one-off" obligation the law imposes on them. In many cases, administrative agencies are further authorized to issue implementing regulations; however, administrative agencies in the Flexibility Model jurisdictions have also developed the practice of issuing to regulated entities "guidance" illustrating their approach in the implementation of a specific legal requirement. Guidance resembles rulemaking in that it is phrased in terms of general applicability and is not addressed to a specific entity;[116] however, language in guidance is not prescriptive, often phrased in "best practice" terms rather than firm regulatory obligations. In many cases of non-compliance with guidance, agencies do not threaten sanctions against regulated entities, but instead ask them to disclose non-compliance to the public and explain the reasons that led to it, leaving to the market to appreciate their validity.[117] Overall, these jurisdictions take less of a hard-line approach in determining compliance with their rules while they are ready to recognize that adherence to general principles may require different actions from different entities.

d. What is the role of central government in the securities markets regulatory framework?

The non-intrusive character of capital markets regulation in Flexibility jurisdictions stems also from the relationship between the central government on one hand, and the administrative agencies and market institutions that form the backbone of the regulatory framework, on the other hand. Agencies in the Flexibility Model enjoy greater independence from central government and greater flexibility in monitoring and enforcing securities laws. Below, we illustrate the Flexibility Model institutional arrangements by drawing a comparison with similar arrangements under the Government-led Model.

In the Government-led Model, central governments seek to influence securities markets regulation through their sway over administrative agencies, which dominate the full spectrum of regulatory responsibilities (rulemaking, monitoring or enforcement).[118] In the Flexibility Model, central governments have provided more independence to administrative agencies and market infrastructure institutions, maintaining only limited ways to affect their day-to-day operation and decision-making process. In most jurisdictions, the main direct power central governments maintain over securities markets operation consists in their power to approve the agency decision for the establishment of a new stock exchange or clearing house.[119] Although central government may influence the operation of the agencies indirectly, through the appointment of agency officials, governments do not have other means of influencing a particular agency decision.[120]

In return, central governments in the Flexibility Model have retained significant rulemaking powers, often having a central government entity issuing implementing

[116] In this respect, guidance is different than No-Action letters issued by other agencies, such as the SEC. Moreover, guidance represents the official view of the agency, as opposed to No-Action letters.
[117] FSA follows this approach when reviewing compliance with takeover rules; ASX follows the same approach when reviewing compliance with Corporate Governance Council rules.
[118] *See supra* Part 2.III.c.
[119] *See* Australian Stock Exchange, Responses to Questionnaire, and UK, Responses to Questionnaire (on file with authors).
[120] As is the case in France, for example. *See infra* Appendix A.I.

legislation that in Government-led jurisdictions would have been issued by an administrative agency.[121] As the tables 4, 5, and 6 above illustrate, the presence of central government entities in the rulemaking column is strong; however, as already discussed above, the legal instruments these entities produce often require further elaboration by agencies before they can be implemented. As agencies are exclusively responsible for monitoring and enforcing implementing legislation, their interpretations of these rules in the form of guidance dominates the oversight process. Given the non-prescriptive character of guidance, there is room for negotiation with the agency and for arguing in favor of a regulatory approach the agency dislikes before a court. Often, agencies themselves follow a "comply or disclose" approach with regard to substance of their guidance. As a result, although central governments are the promulgators of the initial rule, agencies still possess significant tools to frame its implementation in practice.

e. How vigorously are securities laws enforced in these jurisdictions?

In general, Flexibility jurisdictions seek to extend their non-intrusive approach to securities markets regulation in their enforcement strategy, while also ensuring that market participants do not abuse the freedom allowed by law. Their enforcement efforts often consist in selected investigations of securities laws violations, yet the budgetary and staff resources they devote to enforcement are significant in comparison to Government-led jurisdictions. This picture may suggest that, in their view, more intensive enforcement efforts are a necessary corollary of the greater flexibility they allow to market participants and a guarantee for fulfilling their regulatory role.

John Tiner, the current FSA Chief Executive, has successfully summarized the regulatory philosophy of the Flexibility jurisdictions by stating that the FSA is not primarily an enforcement agency.[122] Thus, FSA's enforcement philosophy is largely preventive: the agency conducts investigations on a sample basis whose primary purpose is to deter potential violators rather than to unveil any instance of potential misbehavior in the industry.[123] Still, the UK devotes significant resources in enforcement, especially in comparison with Government-led jurisdictions such as Germany, as past research has shown. Comparing data on number of actions and brought in these two jurisdictions between 2000 and 2002, Howell Jackson shows that the cases considered in the UK are substantially more than those in Germany. The responses we have received in our questionnaire indicate a similar pattern in Hong Kong and Australia,[124] as representatives of these jurisdictions consider the levels of enforcement in their jurisdictions as medium or higher. Howell Jackson's analysis of data on budgetary resources devoted to securities markets regulation suggests that the UK and Hong Kong are towards the medium range,

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[121] In the Government-led jurisdictions, however, agencies will also have to obtain the approval of a central government entity before their rules enter into force. *See supra* Part 2.III.c.

[122] *See* John Tiner, C.E.O., FSA, Keynote Address at the Enforcement Law Conference (Jun. 16, 2006) available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0616_jt.shtml. Tiner states: "...we are emphatically not an enforcement-led regulator."

[123] *Id.*

[124] *See* Hong Kong Stock Exchange, Responses to Questionnaire, and Australian Stock Exchange, Responses to Questionnaire (on file with authors).

while Australia occupies one of the top spots in that scale.[125] The responses we have received in our questionnaires as to Australia and Hong Kong confirm that picture.

## *V. Cooperation Model*

a. Overview

The main characteristic that distinguishes the Cooperation Model from the Flexibility Model is the pervasiveness of the self-regulatory structure, which provides market institutions with wide powers as well as extensive responsibilities for the fair and efficient operation of securities markets. In the Cooperation Model, market institutions have a role in almost all aspects of securities markets regulation, devote significant resources to assist and support agencies' efforts and undertake their own independent regulatory initiatives. Thus, their role in the securities markets regulatory framework is pervasive. The involvement of market institutions is also strong at the stage of enforcement, to which self-regualtory bodies in these jurisdictions devote significant effort and resources. While central governments in jurisdictions following the Cooperation Model have a very limited role in regulatory oversight, specialized agencies are actively involved in market oversight responsibilities, often sharing jursidctions with self-regulatory agencies and pursuing independent enforcement actions. But rather than delegating specific and limited powers to market institutions (as is the case under the Government-led Model) or granting broad latitude to these entities (as is true in the Flexibility Model), administrative agencies operating under the Cooperation Model tend to engage in continuous dialog with market structure institutions, under which the the boundaries of regulatory responsibility and even the content of regulatory requirements remain in a constant state of flux.

b. How do agencies and market institutions divide areas of regulatory responsibility?

The Cooperation Model tends to avoid the issue-specificity of the Government-led and Flexibility Models in favor of a structure were the regulatory powers of market institutions are *pervasive*, extending in almost all areas of the regulatory spectrum. Statutes in the Cooperation Model jurisdictions do not attempt to draw clear lines between the authority of the government agencies and the authority of market institutions neither they seek to avoid jurisdictional overlaps and create separate spheres of competence. Instead, they call on administrative agencies and market institutions to cooperate in almost all aspects of securities markets activities so as to better achieve the high-level objectives the law sets, such as investor protection and fair and efficient operation of the markets. While the law sets out certain obligations for administrative agencies and market institutions and sketches out the basic framework of securities markets operation, agencies and market institutions maintain significant leeway as to the functions they choose to regulate, the manner they choose to regulate and the sanctions they may threaten to violators.

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[125] *See* Jackson, *supra* note 107, at 19-20.

This regulatory philosophy constitutes a stark departure from the approach of other jurisdictions; although Flexibility and Government-led model jurisdictions have reached a similar allocation of regulatory powers to agencies and market institutions in certain isolated areas, only in the Cooperation jurisdictions has this approach become the dominant regulatory technique. Inspired by the self-regulatory tradition of common law jurisdictions,[126] this regulatory approach was a political choice that sprung out of a New Deal compromise in the US and sought to maintain market institutions as the front line regulators under the vigilant eye of a public interest-minded agency. The benefits self-regulation brings,[127] which include the enhanced expertise and the de facto supervision of market operation by market institutions, justified the attempt to channel input from market participants to regulation through the market institutions that encompassed them. The pervasive character of the Cooperation Model, although clear in the exercise of rulemaking authority, extends also to monitoring and enforcement authority. Under the Cooperation Model, market institutions are not responsible for monitoring and enforcing compliance with their own rules only, but their responsibilities include also ensuring compliance with securities laws in general.

Although it is clear how this approach differs from the Government-led model, where agencies dominate the pattern of allocation of regulatory powers, it is perhaps less clear how it differs from the Flexibility Model, which, after all, also seeks to combine market initiatives with government power to achieve regulatory efficiency. From the perspective of regulatory powers' allocation, the main difference lies in the type of powers agencies and market institutions in both jurisdictions exercise. Flexibility Model agencies hardly ever exercise direct rulemaking powers, often opting for issuing guidance to regulated entities to assist them in implementing central government rules; agencies in Cooperation Model jurisdictions are active rulemakers, often dominating the securities markets regulatory universe. Moreover, agencies and market institutions often share enforcement responsibilities, with parallel enforcement proceedings taking place in both to investigate the same alleged violations.

For market professionals in Cooperation Model jurisdictions, participation in self-regulatory organizations is mandatory. Most self-regulatory organizations are associated with a market institution, or have historically originated under the auspices of such institutions. Mandatory membership in SROs illustrates both the central role these organizations play in the regulatory structure as well as the pervasive sharing of responsibilities between SROs and government agencies.

[126] *See* Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1 (2001).
[127] *See supra* Part 1.II.a.

Table 7. Overview of the Regulatory Framework in the US

| | RULEMAKING | | MONITORING | | ENFORCEMENT | |
|---|---|---|---|---|---|---|
| Prospectus Disclosure | SEC | | SEC | | SEC/C | |
| Securities Distribution | SEC | SROs | SEC | SROs | SEC | SROs |
| Listing – Ongoing Disclosure | SEC | SROs | SEC | SROs | SEC | SROs |
| Issuer Corporate Governance | SEC | SROs | SEC | SROs | SEC | SROs |
| Market Abuse | SEC | SROs | SEC | SROs | SEC | SROs |
| Trading Rules | SEC | SROs | SEC | SROs | SEC | SROs |
| Marketplace Oversight | SEC | SROs | SEC | SROs | SEC | SROs |
| Brokers – Investment Firms | SEC | SROs | SEC | SROs | SEC | SROs |
| Clearing & Settlement | SEC | SROs | SEC | SROs | SEC | SROs |

KEY

SEC: Securities and Exchange Commission SROs: Self-Regulatory Organizations C: Courts

Table 8. Overview of the Regulatory Framework in Canada

| | RULEMAKING | | MONITORING | | ENFORCEMENT | |
|---|---|---|---|---|---|---|
| Prospectus Disclosure | OSC | TSX | OSC | TSX | OSC/C | TSX |
| Securities Distribution | OSC | | OSC | | OSC | |
| Listing – Ongoing Disclosure | OSC | TSX | OSC | TSX | OSC | TSX |
| Issuer Corporate Governance | OSC | TSX | OSC | TSX | OSC | TSX |
| Market Abuse | OSC | TSX | OSC | TSX | OSC | TSX |
| Trading Rules | OSC | TSX | OSC | TSX | OSC | TSX |
| Marketplace Oversight | OSC | TSX | OSC | TSX | OSC | TSX |
| Brokers – Investment Firms | OSC | TSX | OSC | TSX | OSC | TSX |
| Clearing & Settlement | OSC | TSX | OSC | TSX | OSC | TSX |

KEY

OSC: Ontario Securities Commission TSX: Toronto Stock Exchange C: Courts

One interesting feature of the regulatory structure in jurisdictions following the Cooperation Model is the prevalence of efforts to segregate the regulatory functions of exchanges and other SROs from other activities. In the United States, the incorporation of a separate NASD Regulation, Inc., subsidiary of the NASD in 1996 is a good illustraton of this phenomenon. The development of a separate NYSE Regulation division is to similar effect. In Canada, one sees similarly spirited efforts of work, with the creation of RS as a separate oversight body to which the major Canadian exchanges and even the IDA have delegated supervisory responsibilities. Arguably, it is no coincidence that Cooperation Model jurisdictions have been the countries most apt to experiement with segregated regulatory units within larger SRO organizations. A defining characteristics of the Cooperation Model is the delegation of robust regulatory functions and enforcement powers to self-regulatory organizations. When scandals (such as the NASDAQ price fixing investigation of the 1990's in the United States) reveal weakness in SRO oversight of market practices, dramatic changes in SRO oversight responsibilities -- conceivable in those operating under a Government-Led Model – are difficult to accomplish in Cooperation Model jurisdictions. Hence, segregation of regulatory function emerges as a viable alternative. With Cooperation Model jurisditions, similar responses are likely to occur in the face of the regulatory challenges posed by stock market demutualizations. Hence, the proposal within the United States to spin off the NYSE's regulatory activities to another SRO but not to an administrative agency in the wake of its recent public stock offering.

c. What rules define the interaction between market infrastructure institutions and administrative agencies?

The essence of the Cooperation Model lies in the methods government agencies and SROs work together to regulate securities markets effectively. The Cooperation approach is a result of certain key features of the regulatory regime, as well as several distinctive characteristics of the national securities markets in these jurisdictions. The Cooperation Model's regulatory regime subjects SRO rules to the requirement to obtain the approval of the government agency prior to entry into force. Although the requirement for agency approval in SRO rulemaking seems to gear the Cooperation model in the direction of the Government-led model, a number of countervailing features differentiate the two models. First, Cooperation Model jurisdictions are home to multiple and diverse SROs that are often in competition with each other. For them, rulemaking is another method of attracting members and gaining business from their competitors. Second, the law grants government agencies the power to intervene by rulemaking when it deems necessary; as a result, SROs are constantly seeking to convince agencies that their rules successfully achieve the objectives set out in the law so as to avoid loss of powers and more intrusive regulation for their members. In other words, SROs compete not only amongst themselves, but also against the agency. As a result, SRO rulemaking under the Cooperation Models is different than rulemaking by the same organizations under the Government-led model, where the requirement for prior approval of SRO rules by agencies also prevails. In the Cooperation Model, SROs are not limited to the role of a second-tier regulator whose mission consists in implementing agency rulemaking. On the contrary, they take their own initiatives and develop their own regulatory program.

d. What is the role of central government in the securities markets regulatory framework?

Central governments in the Cooperation Model maintain a high-level oversight of the securities markets, expressed mainly through their lawmaking powers and their influence over government agencies. As the Cooperation Model assigns SROs with the power to undertake regulatory initiatives, lawmakers must consider the successes and failures of the SRO- and agency-promulgated regulatory framework before they decide to act. Moreover, while SRO rules require prior agency approval, agency rules do not require prior government approval in the Cooperation Model. Thus, the entities that constitute the main actors in the Cooperation Model – market institutions and agencies – perform their day-to-day rulemaking tasks without direct interference from the central government. However, once lawmakers establish the need to intervene in securities markets regulation, often in response to a crisis, they may establish rules that hold agencies and SRO's to higher standards than in the past. Thus, governments constitute in effect the final institutional layer that guarantees protection to investors, intervening when there is a perceived agency failure, often in addition to an SRO failure.

While the Cooperation Model does not provide for direct channels of government intervention in securities markets regulation, some indirect channels of intervention still persist. Most importantly, governments maintain the power to appoint the agency officials. However, local law often limits the level of influence central governments are able to exercise through indirect channels in comparison with other jurisdictions, allowing agency officials to set their own political goals independent of the central government.[128] In the two jurisdictions that we study here, the US and Canada, the federal structure of the government also introduces limitations in the combined influence central government entities exercise over securities markets. Finally, the presence of SROs with strong regulatory powers and agencies that possess highly regarded market expertise ensure that any high-level changes in securities markets regulation will be the subject of much debate and criticism, thus increasing the political cost a central government must pay in case it decides to intervene. Consequently, central governments may exercise only limited influence over securities markets regulation indirectly.

e. How vigorously are securities laws enforced in these jurisdictions?

Enforcement intensity in Cooperation jurisdictions is higher than in any other model discussed here. Howell Jackson has pointed that the number of public securities law enforcement actions brought in the US on an annual basis is almost double that of the UK, and almost five times that of Germany, while the level of enforcement sanctions imposed in the US is dramatically higher to the UK.[129] Academic commentators have repeatedly portrayed the SEC as primarily an enforcement agency and have often complained about its policymaking efforts.[130] In addition to public enforcement actions, market infrastructure institutions often undertake parallel enforcement initiatives, while the wide use of private actions by individuals complements the regulatory framework for enforcement in these jurisdictions.

The data discussed above in relation to enforcement intensity in these three models suggest that, as market institutions' participation in the regulatory structure increases, enforcement efforts intensify. Indeed, enforcement intensity was low in the Government-led model jurisdictions, higher in Flexibility jurisdictions which assigned a greater role to market institutions, and yet higher in the Cooperation jurisdictions where market institutions have a wide presence in the regulatory system. At this stage, we do not possess any data that would suggest a causal relationship between the two trends or point to the direction of the causality.

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[128] For example, US administrative law restricts the President from dismissing an independent agency chairman merely on the grounds of disagreement with the agency chairman's policies.
[129] *See* Jackson, supra note 107, at 28-29.
[130] *See* Macey & Haddock, *supra* note 2, at 317; *see also* Werner, *supra* note 72, at 783.

# Appendix A:  Individual Country Case Studies

## *I. France*

<u>*Overview:*</u> One of the most characteristic elements of the French regulatory structure is the existence of multiple regulatory bodies and the range of powers directly maintained by the central government over the securities industry. In an effort to bring some consolidation to the exercise of regulatory oversight of the French financial services sector, three prominent regulators merged in 2003 to create the Autorité des Marchés Financiers ("AMF"). Although the AMF has the status of an "independent public authority," which allows it to levy fees and receive revenue directly, a government representative attends and can intervene in all deliberations. In addition to the influencing the AMF, the Ministry of Finance maintains significant direct powers, especially in rule-making: AMF rules require the prior approval of the Minister of Finance to enter into force. Furthermore, a number of separate Commissions, whose operating infrastructure is provided by the Banque de France and whose members are appointed by the Minister of Finance, have been entrusted with significant regulatory powers in this area.

The most important stock exchange in France is operated by a private company, ***Euronext Paris SA***, a wholly owned subsidiary of Euronext N.V., a holding company incorporated in the Netherlands and formed following a merger of the Amsterdam, Brussels and Paris bourses in 2000. The Euronext group now includes the Lisbon stock exchange and London's International Financial Futures and Options Exchange (LIFFE). Despite the clear tendency in the French regulatory structure to maintain powers at the central government level, the stock exchange has retained responsibility for promulgating rules, monitoring compliance and enforcement in a number of significant areas. While some of there rules require prior approval by the AMF before entry into force, others may enter into force immediately upon adoption by the exchange.

<u>*Authorizing and Supervising the Public Offer Process:*</u> The AMF and the stock exchange share parallel competences with regard to conduct of a public offer of securities and admission to listing, with the AMF powers prevailing over the exchange's in case of disagreement. In particular, the AMF is responsible for reviewing and approving the issuer's prospectus, drafted according to AMF rules approved by the Minister of Finance. In addition to obtaining AMF's authorization, the issuer must also have his listing application approved by the stock exchange, which has the power to set its own prospectus disclosure and listing requirements independent of the AMF and of any government approval. However, the AMF has the power to object to the decision of the Board of Directors of Euronext Paris as to listing or delisting of a certain security. Apart from prospectus disclosure, AMF regulations govern the remaining aspects of the public offer process. AMF is also principally responsible for monitoring and enforcing the law in this area, while the stock exchange also maintains some monitoring obligations coupled with the ability to impose certain enforcement measures, such as expulsion of an issuer from the exchange.

<u>*Issuer Regulation following Public Offer/Listing:*</u> Regulating issuers' obligations post admission to listing falls mainly under AMF's powers, with the Exchange

maintaining a secondary, complementary role to AMF. Thus, the AMF sets out obligations for periodic filings and reports, ad hoc disclosure of important developments, the process for tender offers and merger activity approvals. The exchange's rulemaking, monitoring and enforcement powers as to periodic and ad hoc disclosure requirements are supplementary to AMF requirements. However, the exchange is exclusively responsible for setting out obligations for listed companies as to investor relations.

*Regulation of the Trading Process:* Rulemaking powers in this area are split between the central government, who sets out rules on market manipulation and insider trading, and the AMF, which regulates issues such as order and execution priority and best execution requirements. Surprisingly, the exchange retains limited room for flexibility; although the exchange takes the final decision for the format of the trading mechanism, its options are limited by AMF rules. In particular, the AMF General Regulation sets limits on the trading structure a stock exchange can adopt, requiring that, in general, order matching must be continuous or through call auctions, and that any order matching departing from that trading structure is limited and subject to specific rules, especially as to price deviation. In addition, the General Regulation enshrines the principles of price-priority and time-priority, to which stock exchanges must adhere, and requires that post-trade disclosure of prices and quantities is immediate. Stock exchange rules govern issues such as halting of trades, deviation from the trading structure for a limited number of trades, cancellation of trades, continuous disclosure of trade prices and quantities. In any cases, stock exchange rules require AMF's prior approval. AMF is also principally responsible for overseeing compliance with the trading process; the exchange is required to immediately furnish information on trading activity to the AMF. Similarly, on the enforcement level, the exchange has limited sanctioning powers, as contemplated in the contractual arrangements with its member firms, while the AMF carries on the bulk of enforcement responsibilities.

*Regulation of Marketplaces:* The tendency to concentrate significant powers at the central government level is particularly evident in the oversight of the exchanges themselves. The power to authorize the establishment of a stock exchange and to withdraw this authorization rests with the Minister of Finance, operating upon a proposal by the AMF. The AMF is principally responsible for regulating the remaining aspects of exchange activity, such as appointment and conduct of stock exchange management and staff, internal organization and control rules, and ownership restrictions. Monitoring and enforcement powers also rest generally with the AMF. Moreover, AMF is also responsible for regulating firms that operate alternative trading systems.

*Supervision of the Financial Intermediation Process:* France is unique among the jurisdictions in this study in assigning oversight of the financial intermediation process to more regulators, as well as maintaining a part for the stock exchange. Yet, the central government has delegated only limited rulemaking powers to agencies, retaining the authority to set the framework for the provision of investment services. As far as licensing, authorizing and monitoring powers are concerned, the AMF is responsible for authorizing investment firms that intend to offer portfolio management services. All investment firms wishing to offer other types of investment services[131] and all firms

[131] Investment services in France are categorized into core and ancillary activities. The core activities consist in receiving, transmitting and/or executing orders on the account of third parties, dealing on own account, managing client portfolios, underwriting on a firm commitment basis and placing securities on a

wishing to operate as credit institutions must obtain their authorization from the Comité des établissements de crédit et des entreprises d'investissement ("CECEI")[132], although AMF's consultation as to the operation plan of the firm must still be sought. The capital adequacy and position risk supervision of investment firms falls within the competence of the Commission Bancaire ("CB"), which also supervises the financial position of credit institutions. In order to be able to conduct trading on a stock exchange, an authorized investment firm must then become a member of that stock exchange and comply with the rules of that market. The application for membership is a separate process, and access to membership is granted by the market operator itself (i.e. Euronext Paris). Issues considered by Euronext Paris in connection with the membership application refer to professional qualifications, informational technology resources, and staff organization. Similarly, enforcement powers are divided among these regulators along the lines of their monitoring responsibilities.

*Supervision of Clearing and Settlement Functions:* In the past, the law required clearing houses to have the status of credit institutions, i.e. to become authorized as banks, who obtain their authorization from the Ministry of Finance. Although no such requirement is in effect anymore, LCH.Clearnet, the designated clearing house for Euronext Paris, has been established under this regime and operates still as a credit institution. Clearing houses operate under the supervision of the AMF, who is responsible for setting general operation requirements, approving their rules, monitoring compliance with these rules and bringing enforcement actions in case of violation. Thus, although clearing houses maintain significant self-regulatory powers, their exercise is subject to important constraints. Thus, the AMF General Regulation requires a clearing house to establish internal regulations and conduct of business rules for its staff, which is subject to professional secrecy and honesty obligations. Clearing houses are required to appoint officials responsible for supervising clearing, for supervising clearing house members and for ensuring compliance, providing them with independent decision-making power and resources necessary to perform their tasks. These officials, whose appointment is subject to approval by the AMF, are then required to file annual reports regarding their activity to the AMF. The conditions for membership in the clearing house are set out in the rules of the clearing house (which are subject to AMF approval).

## II. Japan

*Overview:* On the surface, Japan's two-tiered institutional structure for securities markets regulation bears a remarkable resemblance to the U.S. regime. Thus, self-regulatory organizations in Japan include not only stock exchanges, such as the Tokyo Stock Exchange, but also a broker-dealers association largely responsible for regulation of these intermediaries, the Japanese Securities Dealers Association ("JSDA"). Moreover, the Japan Securities Clearing Corporation, a self-regulatory organization that operates the Japanese clearing and settlement systems, has extensive regulatory capabilities in the area of its activity. These SROs operate under the supervision of a government agency, the Japan Financial Services Agency ("JFSA").

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"best efforts" basis. In order to supply any of these services (or more than one) a firm must be authorized as an investment firm or a credit institution (i.e. a bank).

[132] CECEI is chaired by the Governor of the Banque de France.

Despite these similarities, a closer look at the Japanese system reveals that its institutional dynamics, ties to central government, and low intensity of enforcement make for a regulatory philosophy fundamentally different to the U.S. one. For example, the JFSA supervises also the banking industry, the insurance market as well as public auditors and accountants. In addition, as the JFSA's position in the Japanese government structure is under the Prime Minister's Cabinet,[133] some of its rules take the form of an Ordinance of the Cabinet Office which requires the Prime Minister's approval.[134] By and large, the regulatory powers of the SROs run parallel to JFSA authority to regulate markets. In some areas, usually the most crucial ones, SRO rules require the approval of the JFSA in order to enter into force,[135] while in other areas SROs are unrestricted to pass their own rules. For the cases where JFSA does have approval powers, it also has the authority to direct the SROs to amend their rules, should it decide that market developments demand a new regulatory solution.

On the regulatory authorities' side, enforcement of securities laws is a responsibility of the Securities and Exchange Surveillance Committee ("SESC"),[136] a separate government agency which is subject to the JFSA and chaired by an JFSA Commissioner. SESC carries out most of the day-to-day market surveillance and enforcement tasks,[137] and may suggest rulemaking or enforcement actions to the JFSA.[138] However, enforcement efforts in Japan have been less than rigorous. In some areas, such as broker-dealer supervision, government powers are relatively limited, leaving supervisory efforts largely at private hands[139] and thus voiding any threats of agency intervention in case of material wrongdoing by market participants or substantial SRO failure. However, even in areas where the law provides administrative authorities with all necessary powers, the volume of enforcement actions brought is not impressive.[140] SRO enforcement efforts are often secondary and supplementary to government enforcement efforts, and often consist in reporting to the SESC facts indicating potential violations.[141]

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[133] As FSA's place in the regulatory pyramid is under the Prime Minister's cabinet, the Prime Minister may be responsible, in some cases, for imposing sanctions for securities laws violations.

[134] In practice, the Prime Minister has very rarely, if ever, exercised any powers to intervene in the regulation of the securities markets (telephone conversation with Mr. Masahiro Takada, Deputy General Manager, Tokyo Stock Exchange New York Representative Office). However, the availability of a direct channel for government intervention at the highest level may prove influential in its own right under certain circumstances.

[135] Some SROs, and in particular the Tokyo Stock Exchange, have established a working relationship with the FSA over the years, which allows them to gauge FSA's intentions with regard to a proposed rule before it becomes approved by their board of directors. Due to this informal consultation process, rulemaking at the SRO level takes place with FSA's cooperation.

[136] In addition to securities markets, the SESC also supervises financial futures markets.

[137] Since April 2005, the SESC administers also a civil money penalty system. *See* SESC ANNUAL REPORT 2004/2005, 4 (2005), *available at* http://www.fsa.go.jp/sesc/english/reports/re2004pamph/all.pdf.

[138] *See* JFSA PAMPHLET 13 (2006), *available at* http://www.fsa.go.jp/en/about/pamphlet.pdf.

[139] Traditionally, SESC's supervision of broker-dealers was limited to a fair-trading perspective. Since July 2005, the JFSA has delegated to the SESC further power to supervise broker-dealers from a financial solvency perspective. *See* SESC ANNUAL REPORT, *supra* note 138, at 21. However, this shift of powers from the JFSA to the SESC does not significantly impact our assessment of the overall involvement of governmental agencies in broker-dealer regulation.

[140] *See* TSE, Responses to Questionnaire (on file with authors).

[141] TSE cooperates closely with the SESC in broker-dealer supervision. *See* TSE COMPLIANCE REPORT 2006, *available at* http://www.tse.or.jp/english/guide/compliance/comp_report/report.pdf. TSE submits to

Thus, most SRO enforcement powers co-exist with agencies' authority to impose sanctions on securities law violators. However, Japanese law has provided significant enforcement powers and policy independence to stock exchanges by granting them the exclusive power to enforce their listing and membership requirements.

*Authorizing and Supervising the Public Offer Process:* Perhaps due to strong public policy considerations arising when granting access to public financing, rulemaking in this area is dominated by the central government and the administrative agencies. SROs' rulemaking powers are limited to issues relating to misstatement liability in the issuer's disclosures, for which the stock exchanges also maintain the power to impose enforcement sanctions. As far as monitoring is concerned, both administrative agencies and SROs are responsible for reviewing prospectuses and ensuring adherence to rules regarding promoting securities to the public. Thus, TSE's Listing Department reviews issuers' prospectuses and may require additional disclosures.[142] However, SRO review process in this sphere is secondary to SESC reviewers who take the lead in assessing issuers' disclosures.[143]

*Issuer Regulation following Public Offer / Listing:* Contrary to the regulatory pattern at the pre-listing stage, regulatory oversight at the listing and post-listing stages relies heavily upon the stock exchanges. First, stock exchanges are primarily responsible for setting their own listing requirements, provided they obtain the JFSA's approval. Moreover, stock exchange decisions to list or de-list a company, as well as any other related sanctions, are not subject to agency approval or appeal, and thus a firm has very limited leeway against the exchange. On all other aspects of issuer regulation post-listing (such as periodic filings or reports, ad hoc disclosure of important developments, etc), both government agencies and stock exchanges share significant powers with regard to rulemaking, monitoring and enforcement, although stock exchange rulemaking initiatives generally require FSA's approval.

*Regulation of the Trading Process:* Stock exchanges are granted the power, subject to agency approval, to set, monitor and enforce their own trading rules. On issues central to the smooth operation of the market, such as market manipulation, insider trading and order priority rules, primary enforcement obligations belong to the SESC. However, stock exchanges retain significant rulemaking, monitoring and enforcement authority in all these areas that run parallel to JFSA and SESC powers. Often, SROs duties consist in identifying a potential violation and forwarding the case to the SESC for further investigation.[144] In addition, the SESC supervises self-regulatory organizations to ensure their effectiveness in carrying out their market surveillance and member compliance duties. On the other hand, the JSDA sets, monitors and enforces best execution requirements, also operating in parallel with the central government/regulatory agency framework.

*Regulation of Marketplaces:* Central government and regulatory agencies in Japan intervene in the regulation of marketplaces both in a direct and an indirect way. First,

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the SESC it semi-annual inspection plan, along with analysis of its achievements in the past 6 months and its priorities for the future. For each inspection it conducts, TSE sends a separate report to the SESC.

[142] *See* TSE COMPLIANCE REPORT, *supra* note 142, at 2(ii).

[143] Telephone Interview with Mr. Takada, Tokyo Stock Exchange New York Representative Office (Jul. 23, 2006).

[144] *Id.*

rulemaking and monitoring powers with regard to stock exchange establishment and ownership restrictions rest with the JFSA, who thus maintains a tight grip over the exchange. Second, while stock exchanges are almost unconstrained on setting their own internal organization and control rules, most of these rules are part of the facts considered by the JFSA in the context of its approval for the establishment of the exchange, and the continuous assessment of its operations, thus involving the JFSA indirectly as the stock exchanges amend their rules in these areas.[145] Although the central government and regulatory agencies retain some limited monitoring powers in this respect, enforcement tends to be lax, if not non-existent. As far as alternative trading systems and OTC markets are concerned, the JSDA plays a prominent in regulating alternative marketplaces, presumably operated by broker-dealers that are JSDA members, along with the central government and regulatory agencies.

*Supervision of the Financial Intermediation Process:* In the Japanese regulatory system stock exchanges retain significant powers to regulate their members, especially with regard to fiduciary duties, conduct of business rules and capital adequacy, where they share rulemaking, monitoring and enforcement powers with agencies and industry associations. Stock exchanges have significant leverage vis-à-vis their members due to their exclusive power (i.e. without the approval of regulatory authorities being required) to set the requirements for stock exchange membership, monitor ongoing compliance with these requirements and decide to disqualify a broker-dealer from membership. However, central government and regulatory agencies have the exclusive power to grant, suspend or revoke the license of a broker-dealer. On the other hand, significant rulemaking, monitoring and enforcement powers with regard to security analysts, investment advisers and collective investment schemes are shared between the JSDA and the central government / regulatory agency.[146] Enforcement in these areas is remarkably lax.

*Supervision of Clearing and Settlement Functions:* While the central government and regulatory agencies retain the power to license, impose and monitor restrictions as to a clearing house's ownership interests and membership and access policies, the core aspects of the clearing and settlement function, such as operating rules and procedures, fall to be regulated by the Japan Securities Clearing Corporation ("JSCC").

## *III. Germany*

*Overview:* The German regulatory structure is characteristic among the jurisdictions in our study for the parallel existence of federal and state powers in the oversight of securities markets. State powers are especially preeminent in the regulation of the stock exchanges, and marketplaces more generally. Although Germany is home to eight stock exchanges, the largest and most important one is the Frankfurt Stock Exchange, located in the state of Hesse. Deutsche Börse, the operator of the Frankfurt Stock Exchange, is a private company licensed as an investment firm. The federal government undertook a serious initiative over financial services supervision with the

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[145] *Id.*

[146] TSE and JSDA cooperate closely to select broker-dealers they will target in their inspections. *See* TSE COMPLIANCE REPORT, *supra* note 142, at 5.

establishment of BaFin,[147] an administrative agency responsible for regulating the banking, insurance and securities industries. BaFin is independent of the federal budget as its revenues consist in fees and charges to the industries it supervises.[148] However, BaFin's Administrative Council, its highest internal collective organ also responsible for setting its budget, comprises a majority of government appointees[149] and a minority of industry representatives.[150] In addition, the Administrative Council appoints BaFin's president. The states ("Länder") may advise BaFin with regard to securities markets issues through the Securities Council, one of BaFin's advisory committees that consists solely of states' representatives.[151] Although federal supervision of the securities markets dates only from 1994, and BaFin was created as recently as 2002, the federal arm has gradually come to dominate the regulatory structure to the expense of both state powers and stock exchange powers.

*Authorizing and Supervising the Public Offer Process:* Since its inception, BaFin was responsible for overseeing the public offer process, promulgating rules regarding the requirement to issue a prospectus and ensuring issuer compliance with the rules regarding the procedural steps to offer securities to the public.[152] As a result of the implementation of the recent EU Prospectus Directive in Germany, BaFin obtained the sole authority for reviewing the contents of prospectuses for accuracy and completeness, a power which previously relied with the stock exchange. BaFin powers have been expanded in similar fashion on the rule-making, monitoring-authorizing and enforcement side. Recent laws have also facilitated enforcement against fraudulent statements in disclosure documents in the case of actions brought by a wide number of investors (similar to class actions under US law). Court judgments resulting from such actions are binding for future courts faced with an action brought by other defendants against the same issuer.

*Issuer Regulation following Public Offering / Listing:* The stock exchanges, under the supervision of state authorities, are responsible for setting the listing requirements in the markets they operate. The federal government has promulgated rules regarding the obligations of the issuer post-listing, setting mandatory disclosure and periodic filling requirements as well as external auditors requirements. These rules do not prohibit stock exchange to impose additional obligations to issuers so as to ensure higher transparency for their markets, although stock exchange rules may not contravene federal government rules. The stock exchange has made use of this power to enhance issuer disclosure to the market. However, the federal government dominates regulation of the issuer's corporate behavior following listing, and in particular takeovers, tender offers and mandatory bids.

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[147] BaFin is an abbreviation for "Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)."

[148] *See* BaFin, http://www.bafin.de/cgi-bin/bafin.pl?verz=0101010000&sprache=1&filter=&ntick=0 (last visited Sep. 20, 2006).

[149] The similarities with the organizational structure of the AMF are apparent. *See supra* Appendix A.I.

[150] The Administrative Council's 21 members include four representatives of the Federal Ministry of Finance (including the Chairman), one representative of the Ministry of Economics and Labor, one representative of the Ministry of Justice, five Members of the German Bundestag (Lower House of Parliament), and ten representatives of the banks, investment companies and insurance companies. *See* BAFIN, ANNUAL REPORT 2002, 177.

[151] *See* BAFIN, ANNUAL REPORT 2002, 178.

[152] *See* BAFIN, ANNUAL REPORT 2002, 166-168.

*Regulation of the Trading Process:* The stock exchange has the power to set its own trading rules, design its trading model and set the principles for order interaction in its markets. BaFin, on the other hand, is responsible for promulgating rules that maintain the integrity of the markets, such as rules regarding market manipulation and insider trading. While authority on the rulemaking side is divided between the stock exchange and BaFin, their cooperation is necessary in order to monitor compliance with these rules, as the stock exchange has immediate oversight of trading activity in its markets. The German regulatory framework is unique in establishing a special authority, HüSt, with the exclusive mission to supervise the trading process. Although HüSt is technically the Market Surveillance division of the Frankfurt Stock Exchange, the law protects it with unusual safeguards of independence (such as special rules regarding the hiring and dismissal of its staff).

*Regulation of Marketplaces:* State authorities in Germany are primarily responsible for the regulatory regime governing stock exchanges. However, the federal government has recently adopted laws that directly affect the regulation of the stock exchanges, such as related European directives. The federal government has a greater role in the regulation of alternative trading venues, requiring them to register with BaFin as providers of investment services, in addition to their registration as operators of marketplaces with state authorities.

*Supervision of the Financial Intermediation Process:* the main regulator responsible for the oversight of investment firms is BaFin. Its rulemaking, monitoring and enforcement powers cover the whole spectrum of investment firm activity, such as licensing requirements, fiduciary duties and conduct of business, and capital adequacy. However, the stock exchange continues to play an important role with respect to member regulation. First, it sets, monitors and enforces membership requirements. Moreover, it often complements BaFin rules with additional requirements its members must fulfill, focusing largely on issues relating to adequate performance of members' professional obligations, such as members' behavior towards other members in the context of trading or their ability to meet the financial obligations they incur towards their counterparties.

## IV. United Kingdom

*Overview:* For many commentators, the existence of a single regulator for the financial services industry, whose powers expand into banking and insurance, sets the UK regulatory approach apart from other jurisdictions. To delineate the allocation of powers among business, this study focuses on a different question: how do the powers allocated to the FSA in the area of capital markets regulation compare with the powers of regulators in other jurisdictions possess in the same area? We find that, in terms of sheer scope, FSA powers are sweeping: indeed, the regulatory role of the London Stock Exchange is practically limited to setting its own trading rules and providing the FSA with information on trading activity; other powers retained by the exchange are only secondary and complementary to FSA's rules. We observe, however, that exercise of rulemaking power by the FSA is substantially different than what other legal systems prescribe: first, a series of secondary legislative instruments implementing the Financial Services and Markets Act of 2000 ("FSMA") are issued by H.M. Treasury; and, second, in respect of some crucial aspects of securities regulation, such as regulation of exchanges and clearing houses, the FSA has often opted, instead of promulgating specific rules binding investors as well as itself, for issuing in a number of areas non-binding guidance on the implementation of the provisions it is charged with overseeing.

Given the preeminence of London as an international financial center and the competition it provides to US markets, comparisons between the US and the UK regulatory frameworks are plentiful in the academic literature. In considering differences and similarities between the SEC and the FSA in particular, commentators often point to the wide range of powers afforded to the FSA and the variety of objectives of the FSA mandate, in contrast with SEC's focus on investor protection. While these differences in scope are important, the difference in regulatory technique between the two agencies is, in our view, more profound. The SEC is primarily an enforcement agency, pursuing a large number of individual cases each year;[153] by contrast, the FSA only initiates a limited amount of enforcement actions against the entities it oversees, resting instead on other tools to ensure compliance with its rules.[154] Further, SEC rulemaking is more detailed and more prescriptive, while FSA operates largely through issuing non-binding guidance, allowing significant flexibility to the application of its rules. FSA's non-interventionist approach is perhaps less surprising, if one considers is organizational format and structure: contrary to most regulatory authorities we examine in this study, which are government agencies, the FSA is itself an independent non-governmental body, organized in the form of a company limited by guarantee. The financial industry finances the operation of the FSA, but the Treasury appoints the FSA Board.

*Authorizing and Supervising the Public Offer Process:* Traditionally, UK law designated the London Stock Exchange as the UK Listing Authority, vesting it with the power to approve disclosure documents necessary prior to obtaining a UK listing, and thus allowing it to shape UK disclosure requirements. Following the London Stock Exchange's decision to demutualize in 1999, H.M. Treasury assigned the role of UK Listing Authority to the FSA, stripping the LSE of any regulatory powers in this area. As a result, rulemaking authority with regard to the public offer process is now divided between the central government and the FSA. In particular, H.M. Treasury has issued key legislative instruments in this area, such as the Prospectus Regulations 2005.[155] The monitoring and enforcement powers, on the other hand, have passed exclusively to the FSA, while the law threatens criminal sanctions in certain cases.

*Issuer Regulation following Public Offer/Listing:* H.M. Treasury has set the regulatory framework in this area, delegating however detailed rulemaking powers to the FSA. For example, the Treasury has issued the regulations necessary to implement the Market Abuse Directive in the UK, but the FSA provides the detailed provisions issuers must eventually follow in the FSA Handbook (Disclosure Rules). The Treasury has followed a similar pattern with the implementation of the Transparency Directive (currently ongoing). The Handbook also contains significant guidance for the implementation of these rules. The Department of Trade and Industry, responsible for companies regulation in the UK, has designated the Panel on Takeovers and Mergers, an independent industry body, as the supervisory authority to carry out certain regulatory

[153] *See* Jackson, *supra* note 107, at 27-28.
[154] *See* Tiner, *supra* note 123.
[155] SI 2005/1433.

functions in relation to takeovers pursuant to the Takeover Directive.[156] The primary responsibility of the panel is to issue and administer the City Code on Takeovers and Mergers.

*Regulation of the Trading Process:* This is the single area in UK securities regulation where the London Stock Exchange still maintains significant regulatory powers. In particular, the exchange sets out its own trading and order priority rules and monitors and enforces compliance with these rules. While the central government sets out the framework of market manipulation and insider trading law, the FSA promulgates implementing regulations that provide detailed rules in these areas. Best execution aspects, on the other hand, are set out exclusively by the FSA. As supervision of compliance with the market abuse and best execution regimes requires keeping a close eye to activity in the trading market, the London Stock Exchange has the obligation to cooperate closely with the FSA to this end.

*Regulation of Marketplaces:* The regulatory framework for marketplaces constitutes perhaps the clearest example of the non-interventionist approach to regulation that FSMA seeks to establish and the FSA embodies. Exchanges that seek to operate as regulated markets[157] must obtain an authorization from the FSA, provided that it meets the standards set out in the Recognition Requirements for Investment Exchanges and Clearing Houses Regulations, promulgated by the Treasury. While these Regulations require the FSA, when granting its authorization, to consider specific aspects of an exchange operation, such as the suitability of its management, the adequacy of its financial resources, or the sufficiency of its internal control and governance system, it does not prescribe specific thresholds that an exchange must meet, leaving the task of specifying the standard itself to the FSA. The FSA has addressed these questions through guidance included in its Handbook, again providing wide flexibility to regulated entities, both through careful shaping of individual standards and by virtue of the non-binding nature of this guidance. To sum up, while the FSA possesses the power to mandate certain measures from the exchanges and the alternative trading systems it regulates, should it wish to do so, it also has the flexibility to strike an individual deal with each marketplace. Despite the uncertainty this framework introduces, FSA's independence guarantees to market participants a "level playing field," at least in theory.

*Supervision of the Financial Intermediation Process:* Similar to the areas already discussed above, the UK regime has ensured that the involvement of the stock exchanges in the supervision of the financial intermediation process is limited to the bare minimum. In essence, the only leeway the stock exchange is allowed refers to its ability to set its own membership requirements; however, the FSA still has the power to ensure the objectivity of these requirements. In all other material respects, regulatory oversight of the financial intermediation process is at the hands of the FSA. In the context of the statutory instruments it has issued to implement FSMA, the Treasury has promulgated the Regulated Activities Order, which specifies the activities for which registration an investment firm is required. While the law sets out general rules on investment firm

[156] In addition, the FSA requires issuers to comply with the Panel, or otherwise disclose non-compliance with its rules.
[157] The EU Investment Services Directive introduced the term "regulated market" to identify markets that fulfilled certain criteria that allowed them to operate cross-border. *See* Council Directive 93/22, art. 1, 1993 O.J. (L 14) 27.

activities, such as fiduciary duties and conduct of business, FSA guidance allows regulated entities to understand its perspective on what constitutes compliance with the law.

Supervision of Clearing and Settlement Functions: The regulatory framework for clearing houses bears many similarities to the regime governing the operation of exchanges. Thus, the Treasury has promulgated the rules prescribing specific requirements for clearing house establishment and setting out ownership restrictions while the task of supervising these entities belongs to the FSA. However, establishment of a clearing house requires, in addition to FSA authorization, the prior approval of the Treasury. Otherwise, the FSA provides some rules and also guidance to assist regulated entities comply with their obligations, oversees the operation of the clearing houses and is mainly responsible for bringing enforcement actions in case of violations.

### *V. Australia*

Overview: The most important market infrastructure institutions in Australia are the Australian Stock Exchange ("ASX") and its subsidiaries, the Australian Clearing House and the Australian Settlement and Transfer Corporation. Significant aspects of securities markets regulation remain at the hands of these institutions. The main government body responsible for the regulatory oversight of these institutions and the markets they operate is the Australian Securities and Investment Commission ("ASIC"); however, other government entities, such as the Reserve Bank of Australia ("RBA") and the Department of Treasury, also enjoy some powers over specialized aspects of the Australian securities markets. Thus, securities regulation in Australia takes place at the federal level.

The extensive regulatory powers that market infrastructure institutions, and in particular ASX, enjoy constitute the defining feature of the Australian regime. The bulk of regulatory powers, especially as to rule-making, but also as to monitoring and enforcement, belong to stock exchanges, and especially ASX. To ensure fair operation of its markets, ASX has established a wholly owned subsidiary, ASX Supervisory Review Pty Limited ("ASXSR"), which operates under safeguards of independence and whose role is to assess whether ASX "*…adequately complies with its obligations as a market operator and a clearing house operator*."[158] In contrast to exchange subsidiaries in the US and Canada, ASXSR does not exercise itself the regulatory powers granted by law to ASX, but rather acts as an independent auditor that reviews ASX's own performance of its regulatory functions. ASX is under an obligation to notify ASIC of its rules. Despite the emphasis Australia places on self-regulation, no industry association participates in its regulatory structure.

ASIC operates more as a market watchdog rather than as rule-setter. As far as rulemaking is concerned, ASIC's role is, at a first glance, extremely limited: the agency possesses few direct rulemaking powers, and its involvement consists in overseeing rules promulgated by market infrastructure institutions. Often, it exercises policymaking through issuing guidance in the form of policy papers, or by issuing class orders, an enforcement tool that whose scope extends simultaneously to a wider number of

[158] *See* ASX, http://www.asxsr.com.au/role.htm (last visited June 26, 2006)

regulated entities.[159] However, ASIC's monitoring and enforcement powers provide it with undoubted leverage in the policymaking arena. For example, in the context of its duty to assess how well a licensed market operator is complying with its obligations as a holder of a markets license, ASIC considers ASX's broader approach to regulation and supervision, and suggests methods to improve its performance as a market supervisor.[160] Many changes in ASX's regulatory and supervisory functions result from related ASIC recommendations.[161] In addition, ASIC considers part of its mission to advise the central government on rule changes and report to it on market supervisory arrangements.

*Authorizing and Supervising the Public Offer Process:* Rule-making powers in this area belong almost exclusively to the central government. ASX maintains some powers to set the requirements to submit a prospectus. However, ASIC is responsible for authorizing the issue of the prospectus and reviewing its contents, as well as monitoring issuer compliance with rules regarding the process of promoting securities to the public. In addition to exclusive monitoring powers, ASIC also has exclusive sanctioning powers for violations in this area.

*Issuer Regulation following Public Offer/Listing:* Rulemaking powers in this area are split between the ASX and the central government. Thus, the stock exchange sets out listing requirements, rules on periodic filings and reports and disclosure of important developments, while the central government focuses on external audit requirements and the tender offer and M&A process. Corporate governance rule-making takes place under a special institutional structure: the ASX has established an informal Corporate Governance Council which put together the "Principles of Good Corporate Governance and Best Practice Recommendations." These principles are not mandatory, but ASX requires issuers to explain any deviations from the Corporate Governance Council's recommendations.[162] The stock exchange is also responsible for monitoring and enforcing the rules it has competence to promulgate. On the other hand, the ASIC is entrusted with monitoring and enforcing central government laws on tender offers and M&A.

*Regulation of the Trading Process:* While the central government maintains the law-making initiative in this area, stock exchanges are granted wide powers to set rules in many core aspects of market activity, such as market manipulation, order priority and trading rules. Stock exchanges also bear the main burden of monitoring compliance with these rules; their authority runs parallel to ASIC's supervision of market manipulation rules. Interestingly, stock exchanges have no participation in the insider trading regime: the central government set out insider trading laws and has assigned their supervision on administrative agencies exclusively. Similarly, ASIC is also exclusively responsible for enforcing the insider trading regime, while it shares enforcement powers with stock exchanges as to market manipulation; criminal sanctions are in place for violations of

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[159] *See* ASIC, BETTER REGULATION - ASIC INITIATIVES, FLYER, 8, *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Better_regulation.pdf/$file/Better_regulation.pdf.

[160] *See* ASIC, ANNUAL ASSESSMENT (S794C) REPORT, 3 (2005).

[161] *See id.* at 5.

[162] These institutional arrangements are similar to the position in the UK, where the FSA has incorporated in the listing rules a requirement for issuers to state whether they comply with the Combined Code on corporate governance issued by the Financial Reporting Council (FRC), or otherwise explain any deviations from that code.

both regimes. In contrast, stock exchanges have the exclusive power to enforce their trading and order priority rules.

*Regulation of Marketplaces:* This sphere of regulatory activity illustrates vividly the extent of powers still resting with market infrastructure institutions in Australia. The central government has limited itself to setting out the requirements for the establishment of stock exchanges, and has left almost all other remaining issues to be determined under the self-regulatory model. Thus, stock exchanges are responsible for promulgating rules regarding appointment and conduct of stock exchange management and staff or internal organization and control, unrestrained by any requirement to have their rules approved by ASIC. ASIC's decision to license a new stock exchange requires approval by the central government. ASIC's remaining tasks consist in supervising compliance with the marketplace regime and in enforcing these rules (assisted, in some respects, by the market infrastructure institutions themselves).[163]

*Supervision of the Financial Intermediation Process:* Australia follows distinct approaches with regard to broker-dealer firms' regulation and regulation of other market professionals, such as security analysts and investment advisers. Rule-making powers for broker-dealers are divided between the central government and the stock exchange, which sets out rules on fiduciary duties, conduct of business, capital adequacy and stock exchange membership. In contrast, rule-making authority over security analysts, investment advisers and collective investment schemes is shared by the central government and ASIC. In accordance with the allocation of tasks in rule-making, stock exchanges maintain monitoring and enforcement functions with regard to broker-dealer firms, operating however under ASIC's supervision; ASIC is further responsible for monitoring and enforcing rules on security analysts, investment advisers and collective investment schemes.

*Supervision of Clearing and Settlement Functions:* The involvement of Australian central government in clearing and settlement of equity trades is limited to legislation on central securities depository establishment and ownership requirements. The core issues associated with the clearing and settlement function, such as membership and access to the CSD, CSD operation rules, and exclusivity arrangements, fall to be determined by the stock exchange. Similarly, the stock exchange is responsible for monitoring and enforcing compliance with these rules. In line with the systemic risk considerations associated with the clearing and settlement function, RBA oversees compliance with CSD establishment requirements, cooperating with ASIC in this regard.

## *VI. Hong Kong*

*Overview:* Hong Kong Exchanges & Clearing Ltd. (HKEx) manages the main market infrastructure institutions in Hong Kong: it operates the only stock and derivatives exchanges as well as their related clearing houses, Hong Kong Securities Clearing Company Limited (HKSCC), HK Clearing Corporation Limited (HKCC) and the SEHK Options Clearing House Limited (SEOCH). HKEx is itself a recognized exchange controller under the Securities and Futures Ordinance (SFO). The principal government agency responsible for the oversight of Hong Kong's securities and futures markets is the

[163] For more information, *see* ASIC, ANNUAL ASSESSMENT (S794C) REPORT, ASX AND ASXF (2004-2005).

Securities and Futures Commission (SFC), an independent statutory body established in 1989.[164]

The main characteristic of the Hong Kong securities regulatory model is the extensive powers vested with HKEx, which constitutes the front line regulator of Hong Kong market. These powers are evident in two respects: first, the rule-making process offers a number of important advantages to HKEx over the SFC, and second, the areas that HKEx is principally responsible for regulating, namely the public offer process, the ongoing requirements for listed companies and the trading process, constitute the main points of contact between the financial system and investors. In the rule-making sphere in particular, HKEx enjoys a general rule-making authority over issues subject to its competence, constrained only by the requirement to obtain SFC approval for its rules. SFC may use public enforcement powers to require listed companies to comply with HKEx rules. The SFC itself may promulgate its own rules with respect to certain aspects of securities activities, such as admission to listing or requirements for stock exchange membership for financial intermediaries; however, our research indicates that SFC has not exercised its powers in this regard, and HKEx rules issued under the exchange's parallel powers continue to govern activity in these areas. Although SFC rules prevail over HKEx rules in case of conflict, the SFC must consult with the Financial Secretary and HKEx before finalizing its rule. In addition, the SFC will need to consult with the Financial Secretary before requesting the HKEx itself to promulgate a rule on a certain issue.

However, this wide grant of regulatory powers to the exchange is coupled with a strictly interventionist approach as to its governance structure, fee scheme, and ability to address systemic risk concerns. Although the government does not strictly control the HKEx board, since it appoints only 6 of its 12 directors, it follows developments within HKEx closely and will probably be able to intervene in a decisive manner, if necessary from its perspective.

*Authorizing and Supervising the Public Offer Process:* HKEx regulation dominates access to public financing in Hong Kong, as the exchange possesses significant rule-making, monitoring and enforcement powers and is the primary point of contact for prospective issues. However, the SFC has recently increased its role in this area through monitoring and enforcement functions. In particular, the 2003 SFO has established a "dual filing" regime, whereby a prospectus filed with HKEx is deemed to have been also filed with the SFC and is subject to its enforcement powers.[165]

*Issuer Regulation Following Public Offering/Listing:* HKEx plays the most important role as to listed companies regulation. Through its power to set listing requirements, it has recently taken a number of high-profile initiatives as to listed companies' corporate governance arrangements. Following the dual filing arrangements

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[164] The statutory instrument that established the SFC in 1989 is the Securities and Futures Commission Ordinance (SFCO). The SFCO and nine other securities and futures related ordinances were consolidated into the Securities and Futures Ordinance (SFO), which came into operation on 1 April 2003. It is worth noting that the Hong Kong Chief Executive may, if satisfied that it is in the public interest to do so, give the Commission written directions as to the furtherance of any of its regulatory objectives or the performance of any of its functions. SFC is required to comply with Chief Executive written directions.

[165] Interestingly, there are currently discussions in Hong Kong about enhancing SFC's position by transferring some elements of HKEx present role to the SFC by incorporating into statute provisions that are currently in the listing rules. *See* HKEx Responses to Questionnaire (on file with authors).

referred to above, SFC's presence in this area has also increased. In addition, SFC administers the Takeovers and Mergers Code and the Share Repurchases Code.

*Regulation of the Trading Process:* HKEx's powers as to regulating the trading process are extensive. HKEx's sets the rules under which trading takes place and conducts day-to-day surveillance of the market. Thus, brokers who wish to trade in the exchange must obtain, in addition to their SFC license, a special trading right by the exchange and comply with its rules and regulations.[166] As far as enforcement is concerned, HKEx maintains the power to impose sanctions for violation of its rules, but will also refer any wrongdoing to the SFC. Following the transfer of the power to supervise trading participants from HKEx to the SFC,[167] HKEx tends to prefer referring enforcement matters to the SFC rather than imposing sanctions on a unilateral basis.

*Regulation of Marketplaces:* While the HKEx maintains significant regulatory powers in many fields, supervision of the exchange itself by SFC has intensified. The stock exchange still has the power to set its own rules as to internal organization and control and appointment and conduct of stock exchange management. However, government presence, especially in the HKEx management structure, is strong. 6 out of 12 HKEx board members are appointed directly by the government, and acquiring a shareholding of 5% or higher requires SFC approval. In addition, law has required HKEx to set up a risk management committee to address systemic risk concerns. To avoid conflicts of interest, supervision of HKEx as a publicly listed company has passed to the SFC. Thus, the government has framed the exchange governance structure and set out its systemic stability obligations so as to countenance the wide grant of regulatory powers to the stock exchange.

*Supervision of the Financial Intermediation Process:* As a result of HKEx's demutualization in 2004, the bulk of regulatory powers over the broker-dealer profession passed from HKEx to the SFC. The exchange continues to require that broker-dealers, in addition to their SFC license, obtain a right to trading in its facilities and comply with its rules and regulations. HKEx powers in the broker-dealer sphere include capital adequacy supervision and broker-dealer fiduciary duties and conduct of business rules.

*Supervision of clearing and settlement functions:* The SFC has obtained the power to regulate establishment of clearing and settlement infrastructure institutions, approve their ownership structure and oversee its linkage and exclusivity arrangements with stock exchanges. On the other hand, stock exchanges set out, monitor and enforce rules relating to the operation of the clearing houses, such as membership requirements or clearing and settlement process rules.

## VII. United States

*Overview:* The current system of allocation of regulatory powers among administrative agencies and market infrastructure institutions in the U.S. has survived longer than any other regulatory framework discussed in this study; although the merits of self-regulation, which underpins the U.S. system, have long been debated in both the

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166 See HONG KONG STOCK EXCHANGE, PARTICIPANTSHIP AND TRADING RIGHTS GUIDE, 4 (2005), *available at* http://www.hkex.com.hk/expartadm/guide/guide.pdf.
167 *See* discussion on supervision of the financial intermediation process *infra* p.56.

academic and the business community, reforms introduced over the years were aimed at mending specific deficiencies of the system rather than effecting a complete overhaul.

The Securities Exchange Act of 1934,[168] building upon the surveillance infrastructure stock exchanges had already put in place to supplement their business activities, officially assigned a regulatory role to stock exchanges, granting them powers to regulate both their member firms and the companies they listed. The 1938 Maloney Act completed the self-regulatory scheme of the U.S. markets by granting self-regulatory status to a broker-dealers industry association, renamed as the National Association of Securities Dealers ("NASD"). Today, all broker-dealers in the U.S. are required to be members of a self-regulatory organization.[169] The government agency responsible for the supervision of these SROs is the U.S. Securities and Exchange Commission ("SEC"), which stands at the peak of the pyramid in the U.S. regulatory hierarchy. The SEC supervises SROs seeking to ensure that they adequately perform their regulatory function and that they dedicate the effort and resources necessary to achieve their regulatory objectives. All SRO rules must be approved by the SEC before entering into force, and the SEC has the power to require SROs to amend their rules according to its discretion.[170] However, in some respects SRO rulemaking powers are wider than the SEC's own.[171]

In contrast with most other jurisdictions,[172] where distinct areas of regulatory oversight fall under SROs' sphere of competence, while other such areas are exclusively regulated by government agencies, the U.S. system is characteristic for the co-existence of SRO and SEC powers throughout, with the exception of public offer regulation. As a result, the SEC appears to have wider powers than almost any other government agency among these discussed here. However, it often opts to exercise these powers through the SRO surveillance channel, rather than through direct rulemaking or enforcement. In this sense, the precise frontier in the allocation of powers between the agency and market infrastructure institutions is constantly changing, so as to adjust to market developments, SEC policies, and often SRO failures.

One of the most important changes in the U.S. self-regulatory structure over the past decade as been attempts to separate the regulatory aspect of the SROs from the organizations other functions. The creation of a separate regulatory units is best exemplified by the creation of NASD Regulation, Inc., as a separate regulatory division of NASD. This separation was largely the result of regulatory lapses regarding the maintenance of excessively large bid-ask spreads by NASDAQ market-makers. The NYSE subsequently made analogous efforts to insulate its regulatory arm from inappropriate interference by member firms. At the time of the NYSE's demutualization, there were suggestions that the exchange's regulatory activities should be spun off entirely and possibly merged with NASD's regulatory functions. To date, however, no such divestiture has occurred.

<u>*Authorizing and Supervising the Public Offer Process:*</u> Regulating the distribution of securities to the public so as to ensure adequate disclosure of information to investors was the hallmark of the 1933 Securities Act. Thus, the presence of the SEC

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[168] Securities Exchange Act of 1934, 15 U.S.C.A. § 78a.
[169] Securities Exchange Act of 1934 § 15(b)(8), 15 U.S.C.A. § 78o.
[170] Securities Exchange Act of 1934 § 19(b), 15 U.S.C.A. § 78s.
[171] *See* Business Roundtable v. SEC, *supra* note 28.
[172] With the exception of Canada, *see infra* Appendix A.VII.

in regulating the primary portion of the securities market is strong. SEC rules determine requirements for and exemptions from registration under the securities act and SEC No-action letters often provide guidance to issuers about the implementation of the 1933 Act provisions. Apart from the SEC, the NASD has also promulgated rules that govern the behavior of its members in securities distributions.[173] SEC is primarily performing monitoring functions in this area, while the NASD is responsible for securing compliance with its rules. On the enforcement side, SEC efforts are complemented by the availability of private enforcement measures, primarily through bringing class actions against issuers in courts.

*Issuer Regulation following Public Offer / Listing:* Traditionally, stock exchanges determined post-offer disclosure obligations for companies included in their list. However, it was gradually becoming clear that the investor protection rationale that demanded high quality of disclosures at the public offer stage persisted, perhaps further reinforced, at the post offering stage. In establishing the integrated disclosure system,[174] the SEC sought to align requirements at both stages. Moreover, the advent of Sarbanes-Oxley Act, which raised the regulatory obligations of listed firms in response to Enron and other corporate scandals, especially as to internal audit, officer certifications and audit committee independence, entailed new rule-making responsibilities for the SEC. Despite increased SEC responsibilities in this area, SROs have continued to impose additional, and sometimes stricter, disclosure obligations for listed firms. In some respects, SRO powers are wider than SEC powers, especially in relation to corporate governance.[175] Moreover, SROs are also involved, together with the SEC, in monitoring and enforcing listed firm obligations under these rules. Given that, Sarbanes-Oxley notwithstanding, corporate law is primarily determined at the state level, states are responsible for regulating aspects of corporate activity relating to mergers and acquisitions, tender offers and mandatory bid requirements. However, SEC rulemaking addresses concerns these actions may raise for the wider investing public, either because they trigger a public offer process or otherwise.

*Regulation of the Trading Process:* SROs and the SEC share rulemaking powers in this area, with each of them taking the lead in different aspects of the trading process. In particular, responsibility for rulemaking on market abuse-related issues falls largely under SEC powers,[176] and SRO-imposed rules in this regard largely reinforce members' obligations to comply with federal laws. On the other hand, responsibility for designing trading models and setting order priority rules rests primarily with the exchanges that are in principle free to choose their trading model. However, by mandating the establishment of a national market system that connects all U.S. marketplaces,[177] Congress gave the

[173] NASD Manual Rules 2710 - 2790.
[174] The SEC adopted the integrated disclosure system in 1982. On the history of and the rationale behind the adoption of the integrated disclosure system, *see* generally Edward F. Greene, Daniel A. Braverman and Sebastian R. Sperber, *Hegemony or Deference: U.S. Disclosure Requirements in International Capital Markets*, 50 BUS. LAW. 413 (1994). *See also* Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS 45 (2000) (arguing however that SEC enforcement of the integrated disclosure system is less than it should be).
[175] *See* Business Roundtable v. SEC, *supra* note 28.
[176] One should not underestimate the role played by courts in this area; protection against insider trading has largely sprung out of the courts' interpretation of SEC's Rule 10b-5.
[177] Securities Exchange Act of 1934 § 11A, 15 U.S.C.A. § 78k-1.

SEC significant powers to intervene in trading microstructure and to set specific requirements which all markets need to adhere to. The extent to which SEC powers in this field may intervene in the operation of the market was evident in the adoption of Regulation NMS, which some criticized as over-intrusive.[178] As a result, direct SEC rule-making authority in this area goes deeper than in any other jurisdiction in our study.[179] With regard to enforcement of laws on trading processes, SROs, and exchanges in particular, are the front-line regulators in the U.S., due to their daily involvement in trading. Similarly, SEC and the SROs share enforcement responsibilities in this area.

*Regulation of Marketplaces:* SEC powers to regulate the marketplaces constitute one of the foundations of the U.S. system of self-regulation, as these powers provide the SEC with the ability to ensure that self-regulatory organizations perform their tasks adequately and with the necessary leverage over powerful market institutions. Thus, SEC rulemaking powers cover most aspects of the regulation of marketplaces. In addition, the SEC took the initiative to address the concerns raised in connection with the regulatory treatment of alternative trading systems by introducing Regulation ATS in 1998. Still, stock exchanges are responsible for setting rules on and monitoring the appointment and conduct of their management and staff.

*Supervision of the Financial Intermediation Process:* The regulatory framework for the oversight of broker-dealers in the U.S. illustrates how closely tied are SRO and SEC powers. All broker-dealers must be registered with the SEC and be members of an SRO, in most cases the NASD. In addition, broker-dealers are also subject to licensing requirements at the state level. Broker-dealers may also apply for membership to exchanges, who thus also have rulemaking and disciplinary powers over their member firms. The powers each regulatory body has are often overlapping, and concerns about the costs of duplicative regulation have been repeatedly raised.[180] Despite this overlap, it is natural to expect each regulatory body to focus on different aspects of broker-dealer operation. Thus, the exchanges are more likely to focus on compliance with market-specific trading rules and on technical infrastructure that allows them to communicate with their markets and conduct their trading activities seamlessly. NASD, especially following Nasdaq's spin-off, is more likely to focus on broker-dealer conduct of business and customer treatment rules. Similar patterns follow with regard to monitoring and enforcement powers. It is worth pointing that recent years have been marked by large-scale SRO failure to adequately supervise their members' activity. In particular, academic research in the mid'90s revealed market-wide collusion at Nasdaq, where members were avoiding quotes in odd-eights, thus artificially inflating market-maker spreads.[181]

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[178] These critical voices included SEC Commissioners Glassman and Atkins, who dissented to the decision of the majority to adopt the rule. *See* Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS (Jun. 2005), *available at* http://www.sec.gov/rules/final/34-51808-dissent.pdf.

[179] It is true that agencies in other jurisdictions also have to approve the trading rules of the exchanges through their power to grant licenses to stock exchanges. However, their review is limited to the adequacy of the trading model, and does not extend to mandating specific requirements for trading processes.

[180] *See supra* text accompanying notes 51-52.

[181] *See* Christie & Schultz, *supra* note 82.

Moreover, the SEC successfully pursued charges against NYSE specialist firms for trading ahead of their clients.[182]

## *VIII. Canada*

Overview: Contrary to the U.S., where securities laws operate at the federal level, Canadian securities regulation remains at the hands of its thirteen provinces and territories. As a result, these separate jurisdictions often differ in their approaches with regard to allocation of powers among market infrastructure institutions and government agencies. All provinces have established government agencies responsible for regulating local securities markets; in most provinces, the structure of the government agency is two-tiered, including an appointed commission, and a lower-ranking director supported by the agency staff. To promote cooperation among provinces, local regulators have formed a collective representative body, the Canadian Securities Administrators ("CSA"). To avoid an overly complicated presentation of the position in Canada, we have chosen to focus our research on the regulatory framework in force at the province of Ontario, where Toronto Stock Exchange ("TSX"), Canada's largest stock exchange, is located. Where regulatory structures apply across Canada, we will indicate this accordingly.

Provincial governments in Canada orecognize a number of self-regulatory organizations to which they assign regulatory functions alongside provincial government regulators. The SROs are recognized and overseen in virtually all cases by the provincial or territorial regulators, not by the provincial government itself. In Ontario, self-regulatory organizations that operate marketplaces include TSX and TSX Venture Exchange, a marketplace specializing on smaller and upstart companies. A publicly traded entity, TSX Group Inc., operates both these marketplaces. In addition to marketplaces, the self-regulatory model extends to the broker-dealer industry, where the Investment Dealers Association of Canada is a major national SRO, divided further along provincial districts. Another SRO, the Mutual Fund Dealers Association, also provides supervisory oversight. The provincial securities administrator for Ontario is the Ontario Securities Commission ("OSC").

Similar to the U.S. regulatory model, the participation of SROs in the Canadian regulatory structure is pervasive, with SROs and government agencies retaining powers to regulate the same areas and possessing monitoring and enforcement capacities to ensure adherence to the same rules. There are, however, two major differences between the Canadian and the U.S. regulatory framework. First, the rulemaking powers of the OSC, although wide in scope, are subject to approval of its rules by the Ontario Minister of Finance, thus allowing a direct channel for the provincial government to influence the regulation of securities markets. Second, TSX Group and IDA have formed a joint venture to create an independent non-profit self-regulatory organization, Market Regulation Services Inc. (widely abbreviated as "RS"), which can undertake the performance of regulatory duties relating to market supervision on behalf of other self-regulatory organizations, and also regulates trading on marketplaces that are not self-regulatory organizations (i.e., alternative trading systems) in return for a fee. From 2002

[182] Eventually, specialist firms concluded a settlement with the SEC that reached the unprecedented amount of $250 billion.

onwards,[183] RS has regulated trading on all Canadian marketplaces for publicly-traded equity securities, including the TSX and TSX Venture Exchange, and CNQ exchange (another small-cap exchange). The IDA regulates fixed income trading, and the Montreal Exchange regulates derivatives trading on its own market. In April of 2006, IDA and RS announced plans to merge their operations in the future.

*Authorizing and Supervising the Public Offer Process:* Regulation of the primary securities markets falls generally in the hands of the OSC, which has wide authority to promulgate rules in respect of the distribution process and the disclosures by the issuer, subject to the framework set out in provincial government laws. OSC is also primarily responsible for reviewing disclosure in the prospectus and ensuring compliance with other rules on the distribution process. In addition to OSC regulation, the TSX also sets rules as to prospectus contents and performs a review of the prospectus if the issuer also seeks a listing there. As a result, enforcement of disclosure obligations takes place through penalties imposed by the OSC and sanctions by the TSX, as well as through private parties' initiatives, such as class actions in courts and individual complaints to the OSC.

*Issuer Regulation following Public Offer / Listing:* Stock exchanges may set their own listing requirements, some of which are subject to agency approval, and may decide unconstrained on admission of an issuer for listing. In all other respects of issuer regulation post-listing, agency and stock exchange rulemaking, monitoring and enforcement powers run parallel. Issuer regulation at the post-listing stage was traditionally dominated by stock exchange rules, while government regulators and state corporate laws maintained a less pronounced role. Following the Enron collapse and the other high-profile corporate scandals of the early '00s, government agencies undertook a number of initiatives with regard to listed firms' corporate governance, as a result of which the scope of their direct powers in this area is now wider. Stock exchanges, however, continue to maintain an important role in regulating the takeover and M&A process, in conjunction with state corporate law requirements. Monitoring and enforcement authorities are divided among exchanges and the OSC along the lines suggested above, while the availability of private enforcement channels in this area is another characteristic of the Canadian regulatory framework.

*Regulation of the Trading Process:* The main focus of government rulemaking, supervision and enforcement powers in this area is market abuse. Thus, OSC rules and the rules administered and enforced by RS in relation to public equity marketplaces govern issues such as insider trading or market manipulation. On the other hand, stock exchanges are primarily responsible for designing their own trading model and setting rules on order priority, while their own rules on market abuse are supplementary to the agency's ones. The task of monitoring the market, both to protect investors against abusive practices and to ensure compliance with stock exchange trading rules, belongs to the stock exchanges as market operators, and is delegated to RS. RS also monitors trading on alternative trading systems. RS has the power to impose sanctions and to refer violations of provincial securities laws to the OSC, although OSC may also undertake investigations on its own initiative. Following the adoption of laws turning insider trading to a criminal offence enforcement powers for such violations rest solely with the OSC and with federal authorities. Criminal jurisdiction is now shared with the Royal Canadian

[183] *See* RS, http://www.rs.ca/en/about/index.asp?printVersion=no&loc1=about.

Mounted Police as a result of recent amendments to the federal Criminal Code adding insider trading and tipping as criminal offences.

# Appendix B: Sample Questionnaire

## THE REGULATION AND GOVERNANCE OF MARKET INFRASTRUCTURE INSTITUTIONS

## QUESTIONNAIRE

**Introduction**

This questionnaire is part of a large research project being undertaken on the governance of market infrastructure institutions (exchanges, central-counterparties and central securities depositories). It explores how are regulatory powers allocated between governmental and non-governmental bodies in securities and other financial markets.

The questionnaire and its analysis is being undertaken by Professor Howell E. Jackson, Andreas Fleckner, and Stavros Gkantinis, of Harvard Law School. Please address any questions you may have to Professor Howell E. Jackson at hjackson@law.harvard.edu.

## ALLOCATION OF POWERS AMONG MARKET INFRASTRUCTURE INSTITUTIONS

This section of the questionnaire seeks to examine how regulatory powers are allocated between governmental and non-governmental bodies for seven broad areas in the securities markets:

1. Overview of Regulatory Structure;
2. Authorizing and Supervising the Public Offer Process;
3. Issuer Regulation Following Public Offer / Listing;
4. Regulation of the Trading Process;
5. Regulation of Marketplaces;
6. Supervision of the Financial Intermediation Process; and
7. Supervision of Clearing and Settlement.

For each of these areas, the questionnaire seeks to explore:

a) the allocation of rule-making powers;
b) the allocation of licensing-authorizing and monitoring powers;
c) the sources and intensity of enforcement activity within the last 3 years; and
d) some general questions.

Specific instructions as to how to fill in the tables that follow are included in the respective sections. However, if anything is unclear, please contact us.

Please identify yourself, your institution, and the type of your institution.

| **Name:** | **Institution:** |
|---|---|

| **Type of Institution:** | |
|---|---|
| Stock Exchange | |
| Derivatives Exchange | |
| Central Counter Party | |
| Central Securities Depository | |
| Other: | |

## 1) Overview of Institutional Framework in Your Jurisdiction

Please fill in the table below by indicating, in the boxes provided, the name and legal type of institutions that are allocated any regulatory powers (either rule-making, licensing, monitoring-authorizing or enforcement) in the respective fields in your jurisdiction (e.g. for the US SEC, you would indicate: "Securities and Exchange Commission – Independent Administrative Agency" in the "Administrative Agency" box). Please list all institutions that have any degree of regulatory power over the respective fields. If you are not clear as to which institutional pattern in the horizontal axis of the questionnaire corresponds to your jurisdiction, please feel free to check "Other" and specify further in the General Comments section. Questions about the precise scope of regulatory power and enforcement activities of these institutions appear below.

| | Authorizing and Supervising the Public Offer Process | Issuer Regulation Following Public Offer / Listing | Regulation of the Trading Process | Regulation of Marketplaces | Supervision of the Financial Intermediation Process | Supervision of Clearing and Settlement |
|---|---|---|---|---|---|---|
| Administrative Agency (State or Federal) | | | | | | |
| Central Government (e.g. Ministry) | | | | | | |
| Provincial Government (e.g. State Ministry) | | | | | | |
| Stock Exchange (including stock exchange operating bodies or companies) | | | | | | |
| Industry Association (only if accorded formal powers) | | | | | | |
| Other | | | | | | |

## 2) Authorizing and Supervising the Public Offer Process

In the tables below, the institutions to which powers may be allocated are on the horizontal axis, and the functions regulated are on the vertical axis. Please put an "X" in the box that corresponds to the institution entrusted with each of the powers specified in the vertical axis.

### a) Rule-making Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Requirement to Submit a Prospectus / Registration Statement | | | | | | | | |
| Prospectus / Registration Statement Contents | | | | | | | | |
| Process of Promoting Securities to the Public | | | | | | | | |
| Misstatement Liability | | | | | | | | |

### b) Authorizing and Monitoring Authority

| | Central Government | Provincial Government | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Issue of Prospectus / Registration Statement | | | | | | | | |
| Prospectus / Registration Statement Contents | | | | | | | | |
| Process of Promoting Securities to the Public | | | | | | | | |

### c) Enforcement

Please assess the intensity of enforcement efforts actually occurring in your jurisdiction in the area of authorizing and supervising the public offer process in the last three years, taking into account considerations such as frequency of enforcement actions, severity of penalties actually imposed, and effectiveness of the overall enforcement scheme. Under the "Intensity" column, please put a grade from "0" to "5" ("0" corresponding to a situation where, to the best of your knowledge, no enforcement action has been taken in the last three years, and "5" corresponding to very intense enforcement). Please fill in the remaining columns regarding allocation of enforcement jurisdiction among market infrastructure institutions by putting an "X" in the appropriate box for any form of public or private enforcement which could be used to impose monetary or non-monetary sanctions for violations of law in your jurisdiction. Please indicate the existence of enforcement jurisdiction even if no enforcement actions brought in the past three years.

| | Intensity (0 to 5) | PUBLIC ENFORCEMENT | | | | PRIVATE ENFORCEMENT | | | | Other |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Administrative Agency Sanctions | Stock Exchange Sanctions | Industry Association Sanctions | Criminal Sanctions | Arbitration | Individual Complaints to Agencies | Individual Complaints to Courts | Class Actions in Courts | |
| Prospectus / Registration Statement Contents | | | | | | | | | | |
| Process of Promoting Securities to the Public | | | | | | | | | | |
| Misstatement Liability | | | | | | | | | | |

### d) General Comments on Authorizing and Supervising the Public Offer Process

| |
|---|
| In your view, what are the main difficulties associated with the pattern of allocation of powers with regard to authorizing and supervising the public offer process? Are there areas where overlapping powers among regulatory institutions have led to confusion or have otherwise affected regulatory outcomes? |
| Please comment briefly on any recent changes and/or historical trends associated with the pattern of allocation of powers set out above. |

## 3) Issuer Regulation following Public Offer/Listing

In the tables below, the institutions to which powers may be allocated are on the horizontal axis, and the functions regulated are on the vertical axis. Please put an "X" in the box that corresponds to the institution entrusted with each of the powers specified in the vertical axis.

### a) Rule-making Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Listing Requirements | | | | | | | | |
| Periodic Filings and Reports | | | | | | | | |
| Ad hoc Disclosure of Important Developments | | | | | | | | |
| External Auditors Requirements | | | | | | | | |
| Corporate Governance Requirements for Listed Issuers | | | | | | | | |
| Tender Offer Prospectus | | | | | | | | |
| Tender Offer Process | | | | | | | | |
| Mandatory Bid Requirements | | | | | | | | |
| M&A Prospectus or other Circular to Shareholders (apart from Tender Offer) | | | | | | | | |
| M&A Process | | | | | | | | |

### b) Authorizing and Monitoring Authority

| | Central Government | Provincial Government | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Admission to Listing | | | | | | | | |
| Periodic Filings and Reports | | | | | | | | |
| Ad hoc Disclosure of Important Developments | | | | | | | | |
| External Auditors Requirements | | | | | | | | |
| Corporate Governance Requirements for Listed Issuers | | | | | | | | |
| Tender Offer Prospectus | | | | | | | | |
| Tender Offer Process | | | | | | | | |
| Mandatory Bid Requirements | | | | | | | | |
| Prospectus or other Circular to Shareholders for other M&A (apart from Tender Offer) | | | | | | | | |
| M&A Process | | | | | | | | |

### c) Enforcement

Please assess the intensity of enforcement efforts actually occurring in your jurisdiction in the area of issuer regulation following public offer/listing in the last three years, taking into account considerations such as frequency of enforcement actions, severity of penalties actually imposed, and effectiveness of the overall enforcement scheme. Under the "Intensity" column, please put a grade from "0" to "5" ("0" corresponding to a situation where, to the best of your knowledge, no enforcement action has been taken in the last three years, and "5" corresponding to very intense enforcement). Please fill in the remaining columns regarding allocation of enforcement jurisdiction among market infrastructure institutions by putting an "X" in the appropriate box for any form of public or private enforcement which could be used to impose monetary or non-monetary sanctions for violations of law in your jurisdiction. Please indicate the existence of enforcement jurisdiction even if no enforcement actions brought in the past three years.

| | Intensity (0 to 5) | PUBLIC ENFORCEMENT | | | | PRIVATE ENFORCEMENT | | | | Other |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Administrative Agency Sanctions | Stock Exchange Sanctions | Industry Association Sanctions | Criminal Sanctions | Arbitration | Individual Complaints to Agencies | Individual Complaints to Courts | Class Actions in Courts | |
| Compliance with Listing Requirements | | | | | | | | | | |
| Periodic Filings and Reports | | | | | | | | | | |
| Ad hoc Disclosure of Important Developments | | | | | | | | | | |
| External Auditors Requirements | | | | | | | | | | |
| Corporate Governance Requirements for Listed Issuers | | | | | | | | | | |
| Tender Offer Prospectus | | | | | | | | | | |
| Tender Offer Process | | | | | | | | | | |
| Mandatory Bid Requirements | | | | | | | | | | |
| Prospectus or other Circular to Shareholders for other M&A (apart from Tender Offer) | | | | | | | | | | |
| M&A Process | | | | | | | | | | |
| Misstatement Liability | | | | | | | | | | |

### d) General Comments on Issuer Regulation following Public Offer/Listing

| |
|---|
| In your view, what are the main difficulties associated with the pattern of allocation of powers with regard to issuer regulation following public offer/listing? Are there areas where overlapping powers among regulatory institutions have led to confusion or have otherwise affected regulatory outcomes? |
| Please comment briefly on any recent changes and/or historical trends associated with the pattern of allocation of powers set out above. |

## 4) Regulation of the Trading Process

### a) Rule-making Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Market Manipulation Rules | | | | | | | | |
| Insider Trading Rules | | | | | | | | |
| Stock Exchange Trading Model Rules | | | | | | | | |
| Order Priority Rules | | | | | | | | |
| Best Execution Requirements | | | | | | | | |

### b) Monitoring Authority

| | Central Government | Provincial Government | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Market Manipulation Rules | | | | | | | | |
| Insider Trading Rules | | | | | | | | |
| Stock Exchange Trading Model Rules | | | | | | | | |
| Order Priority Rules | | | | | | | | |
| Best Execution Requirements | | | | | | | | |

### c) Enforcement

Please assess the intensity of enforcement efforts actually occurring in your jurisdiction in the area of trading process regulation in the last three years, taking into account considerations such as frequency of enforcement actions, severity of penalties actually imposed, and effectiveness of the overall enforcement scheme. Under the "Intensity" column, please put a grade from "0" to "5" ("0" corresponding to a situation where, to the best of your knowledge, no enforcement action has been taken in the last three years, and "5" corresponding to very intense enforcement). Please fill in the remaining columns regarding allocation of enforcement jurisdiction among market infrastructure institutions by putting an "X" in the appropriate box for any form of public or private enforcement which could be used to impose monetary or non-monetary sanctions for violations of law in your jurisdiction. Please indicate the existence of enforcement jurisdiction even if no enforcement actions brought in the past three years.

| | Intensity (0 to 5) | PUBLIC ENFORCEMENT | | | | PRIVATE ENFORCEMENT | | | | Other |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Administrative Agency Sanctions | Stock Exchange Sanctions | Industry Association Sanctions | Criminal Sanctions | Arbitration | Individual Complaints to Agencies | Individual Complaints to Courts | Class Actions in Courts | |
| Market Manipulation Rules | | | | | | | | | | |
| Insider Trading Rules | | | | | | | | | | |
| Stock Exchange Trading Model Rules | | | | | | | | | | |
| Order Priority Rules | | | | | | | | | | |
| Best Execution Requirements | | | | | | | | | | |

### d) General Comments on Regulation of the Trading Process

| |
|---|
| In your view, what are the main difficulties associated with the pattern of allocation of powers with regard to regulation of the trading process? Are there areas where overlapping powers among regulatory institutions have led to confusion or have otherwise affected regulatory outcomes? |
| Please comment briefly on any recent changes and/or historical trends associated with the pattern of allocation of powers set out above. |

## 5) Regulation of Marketplaces

### a) Rule-making Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Stock Exchange Establishment Requirements | | | | | | | | |
| Stock Exchange Trading Rules | | | | | | | | |
| Appointment and Conduct of Stock Exchange Management | | | | | | | | |
| Appointment and Conduct of Stock Exchange Staff | | | | | | | | |
| Stock Exchange Internal Organization and Control Rules | | | | | | | | |
| Stock Exchange Ownership Restrictions | | | | | | | | |
| Alternative Trading System Establishment Requirements | | | | | | | | |
| Alternative Trading System Trading Rules | | | | | | | | |
| Alternative Trading System Access Rules | | | | | | | | |
| Alternative Trading System Internal Organization and Control Rules | | | | | | | | |
| OTC Market Rules | | | | | | | | |

## b) Authorizing and Monitoring Authority

| | Central Government | Provincial Government | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Stock Exchange Establishment | | | | | | | | |
| Stock Exchange Trading | | | | | | | | |
| Conduct of Stock Exchange Management | | | | | | | | |
| Conduct of Stock Exchange Staff | | | | | | | | |
| Stock Exchange Internal Organization and Control Rules | | | | | | | | |
| Stock Exchange Ownership Restrictions | | | | | | | | |
| Alternative Trading System Establishment (if different from Stock Exchange or Broker/Dealer) | | | | | | | | |
| Alternative Trading System Trading Rules | | | | | | | | |
| Alternative Trading System Access Rules | | | | | | | | |
| Alternative Trading System Organization and Control Rules | | | | | | | | |
| OTC Markets | | | | | | | | |

### c) Enforcement

Please assess the intensity of enforcement efforts actually occurring in your jurisdiction in the area of marketplace regulation in the last three years, taking into account considerations such as frequency of enforcement actions, severity of penalties actually imposed, and effectiveness of the overall enforcement scheme. Under the "Intensity" column, please put a grade from "0" to "5" ("0" corresponding to a situation where, to the best of your knowledge, no enforcement action has been taken in the last three years, and "5" corresponding to very intense enforcement). Please fill in the remaining columns regarding allocation of enforcement jurisdiction among market infrastructure institutions by putting an "X" in the appropriate box for any form of public or private enforcement which could be used to impose monetary or non-monetary sanctions for violations of law in your jurisdiction. Please indicate the existence of enforcement jurisdiction even if no enforcement actions brought in the past three years.

| | Intensity (0 to 5) | PUBLIC ENFORCEMENT | | | | PRIVATE ENFORCEMENT | | | | Other |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Administrative Agency Sanctions | Stock Exchange Sanctions | Industry Association Sanctions | Criminal Sanctions | Arbitration | Individual Complaints to Agencies | Individual Complaints to Courts | Class Actions in Courts | |
| Stock Exchange License Suspension / Revocation | | | | | | | | | | |
| Stock Exchange Trading | | | | | | | | | | |
| Conduct of Stock Exchange Management | | | | | | | | | | |
| Conduct of Stock Exchange Staff | | | | | | | | | | |
| Stock Exchange Internal Organization and Control Rules | | | | | | | | | | |
| Stock Exchange Ownership Restrictions | | | | | | | | | | |
| Alternative Trading System License (if not a Broker/Dealer or Stock Exchange) | | | | | | | | | | |
| Alternative Trading System Trading Rules | | | | | | | | | | |
| Alternative Trading System Access Rules | | | | | | | | | | |
| Alternative Trading System Internal Organization | | | | | | | | | | |

### d) General Comments on Regulation of Marketplaces

| |
|---|
| In your view, what are the main difficulties associated with the pattern of allocation of powers with regard to regulation of marketplaces? Are there areas where overlapping powers among regulatory institutions have led to confusion or have otherwise affected regulatory outcomes? |
| Please comment briefly on any recent changes and/or historical trends associated with the pattern of allocation of powers set out above. |

## 6) Supervision of the Financial Intermediation Process

### a) Rule-making Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Broker/Dealers Establishment | | | | | | | | |
| Credit Institutions' Provision of Equity Trading Services | | | | | | | | |
| Broker/Dealers Fiduciary Duties and Conduct of Business | | | | | | | | |
| Broker/Dealers Capital Adequacy | | | | | | | | |
| Stock Exchange Membership | | | | | | | | |
| Securities Analysts | | | | | | | | |
| Investment Advisers Establishment and Licensing/Registration | | | | | | | | |
| Investment Advisers Fiduciary Duties and Conduct of Business | | | | | | | | |
| Collective Investment Schemes Establishment | | | | | | | | |
| Collective Investment Schemes Conduct of Business | | | | | | | | |

### b) Licensing, Authorizing and Monitoring Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Broker/Dealer Licensing | | | | | | | | |
| Credit Institutions' Provision of Equity Trading Services | | | | | | | | |
| Broker/Dealers Fiduciary Duties and Conduct of Business | | | | | | | | |
| Broker/Dealers Capital Adequacy | | | | | | | | |
| Stock Exchange Membership | | | | | | | | |
| Securities Analysts | | | | | | | | |
| Investment Advisers Establishment and Licensing/Registration | | | | | | | | |
| Investment Advisers Fiduciary Duties and Conduct of Business | | | | | | | | |
| Collective Investment Schemes Licensing and Establishment | | | | | | | | |
| Collective Investment Schemes Conduct of Business | | | | | | | | |

### c) Enforcement

Please assess the intensity of enforcement efforts in your jurisdiction in the area of supervizing the financial intermediation process in the last three years, taking into account considerations such as frequency of enforcement actions, severity of penalties actually imposed, and effectiveness of the overall enforcement scheme. In the "Intensity" column, please put a grade from "0" to "5" in the same manner as above. Please fill in the other columns regarding allocation of enforcement jurisdiction among market infrastructure institutions by putting an "X" in the appropriate box for any form of public or private enforcement which could be used to impose monetary or non-monetary sanctions for violations of law in your jurisdiction. Please indicate the existence of enforcement jurisdiction even if no enforcement actions have been brought.

| | Intensity (0 to 5) | PUBLIC ENFORCEMENT | | | | PRIVATE ENFORCEMENT | | | | Other |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Administrative Agency Sanctions | Stock Exchange Sanctions | Industry Association Sanctions | Criminal Sanctions | Arbitration | Individual Complaints to Agencies | Individual Complaints to Courts | Class Actions in Courts | |
| Broker/Dealer License Suspension or Revocation | | | | | | | | | | |
| Credit Institutions' Provision of Equity Trading Services | | | | | | | | | | |
| Broker/Dealers Fiduciary Duties and Conduct of Business | | | | | | | | | | |
| Broker/Dealers Capital Adequacy | | | | | | | | | | |
| Stock Exchange Membership | | | | | | | | | | |
| Securities Analysts | | | | | | | | | | |
| Investment Advisers Establishment Licensing/ Registration | | | | | | | | | | |
| Investment Advisers Fiduciary Duties and Conduct of Business | | | | | | | | | | |
| Collective Investment Schemes License Suspension / Revocation | | | | | | | | | | |
| Collective Investment Schemes Conduct of Business | | | | | | | | | | |
| Broker/Dealer License Suspension or Revocation | | | | | | | | | | |

### d) General Comments on Supervision of the Financial Intermediation Process

| |
|---|
| In your view, what are the main difficulties associated with the pattern of allocation of powers with regard to supervision of the financial intermediation process? Are there areas where overlapping powers among regulatory institutions have led to confusion or have otherwise affected regulatory outcomes? |
| Please comment briefly on any recent changes and/or historical trends associated with the pattern of allocation of powers set out above. |

## 7) Supervision of Clearing and Settlement Functions

### a) Rule-making Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Clearing House – Central Securities Depository (CSD) Establishment | | | | | | | | |
| Clearing House – CSD Ownership Restrictions | | | | | | | | |
| Clearing House – CSD Membership and Access | | | | | | | | |
| Clearing House – CSD Operation Rules | | | | | | | | |
| Exclusivity Arrangements for Clearing House – CSD Services to Local Stock Exchanges | | | | | | | | |

### b) Licensing, Authorizing and Monitoring Authority

| | Central Government-Legislator | Provincial Government-Legislator | Administrative Agency (no Government Approval) | Administrative Agency with Government Approval | Stock Exchange (no Agency Approval) | Stock Exchange with Agency Approval | Industry Association | Other (please specify) |
|---|---|---|---|---|---|---|---|---|
| Clearing House – Central Securities Depository (CSD) Licensing | | | | | | | | |
| Clearing House – CSD Ownership Restrictions | | | | | | | | |
| Clearing House – CSD Membership and Access | | | | | | | | |
| Clearing House – CSD Operation Rules | | | | | | | | |
| Exclusivity Arrangements for Clearing House – CSD Services to Local Stock Exchanges | | | | | | | | |

### c) Enforcement

Please assess the intensity of enforcement efforts occurring in your jurisdiction in the area of supervision of clearing and settlement functions in the last three years, taking into account considerations such as frequency of enforcement actions, severity of penalties actually imposed, and effectiveness of the overall enforcement scheme. Under the "Intensity" column, please put a grade from "0" to "5" ("0" corresponding to a situation where, to the best of your knowledge, no enforcement action has been taken in the last three years, and "5" corresponding to very intense enforcement). Please fill in the remaining columns regarding allocation of enforcement jurisdiction among market infrastructure institutions by putting an "X" in the appropriate box for any form of public or private enforcement which could be used to impose monetary or non-monetary sanctions for violations of law in your jurisdiction. Please indicate the existence of enforcement jurisdiction even if no enforcement actions were brought.

| | Intensity (0 to 5) | PUBLIC ENFORCEMENT | | | | PRIVATE ENFORCEMENT | | | | Other |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Administrative Agency Sanctions | Stock Exchange Sanctions | Industry Association Sanctions | Criminal Sanctions | Arbitration | Individual Complaints to Agencies | Individual Complaints to Courts | Class Actions in Courts | |
| Clearing House – CSD Licensing | | | | | | | | | | |
| Clearing House – CSD Ownership Restrictions | | | | | | | | | | |
| Clearing House – CSD Membership and Access | | | | | | | | | | |
| Clearing House – CSD Operation Failures | | | | | | | | | | |
| Exclusivity Arrangements for Clearing House – CSD Services to Local Stock Exchanges | | | | | | | | | | |

## d) General Comments on Supervision of Clearing and Settlement Functions

| In your view, what are the main difficulties associated with the pattern of allocation of powers with regard to supervision of clearing and settlement functions? Are there areas where overlapping powers among regulatory institutions have led to confusion or have otherwise affected regulatory outcomes? |
|---|
| Please comment briefly on any recent changes and/or historical trends associated with the pattern of allocation of powers set out above. |