Centralized or Competitive Securities Regulation: What Canada can learn from the US and the EU

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August 1, 2003

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Abstract

The promoters of the uniformity and centralization of securities regulation in Canada argue that a single authority and a perfectly homogeneous regulation would be preferable to the current situation. This paper summarizes the evidence and lessons from the U.S. and the E.U.'s experience in this field. We study the application of the concept of regulatory competition in the United States in the area of company law and securities law. We analyse the steps taken by the European Community to develop a mutual recognition system--the European passport. We conclude with the lessons learned from these initiatives and thoughts on the debate presently taking place in the Canadian securities industry.

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Arguments put forth by promoters of the uniformity and centralization of securities regulation in Canada rely essentially on the concept of the immediate effectiveness of such regulation: a single authority would be able to regulate the securities field in an optimal manner and at a lower cost, and perfectly homogeneous regulation would be preferable to the current situation. The imposition of this homogeneous regulation by a central authority was described by Breton (2000) as the strong harmonization method, a concept that contrasts with that of regulatory competition. Instead of monopolistic regulation, the defenders of this method propose a market approach to regulation, whether it concern taxation, the environment, companies or financial markets. Some promoters of this approach contend that competition should lead to less complete and stable harmonization than that of imposed harmonization, but one which is more in accordance with the real needs of participants. Breton calls this approach weak harmonization. Regulatory competition has been the subject of debate in the US for several years. The creation of a European arena, gaps noticed during recent financial scandals and market globalization have given new life to this important field of study, which encompasses both internal regulatory competition—which operates between the State and organizations—and external competition. Indeed, American and Canadian regulation is affected by that of other jurisdictions, particularly regarding securities, due to the emergence of integrated European markets[1].

Imposed harmonization and centralization are one means of optimizing the regulation of securities or companies in a country, federation or union such as that being built in Europe. This regulatory model is not, however, the only one presently in place; the United States presents a perfect example of an approach diametrically opposed to that of centralization for company law. Accordingly, the United States uses competitive regulation: there are as many company laws as there are states, and the laws of certain states are substantially more attractive for companies than others. This is especially true for Delaware, where almost half of American companies listed on the stock exchange are

incorporated. Between the two extremes lies a median position that engenders models of mutual recognition (or reciprocal delegation). Harris (2002) presents the advantages and disadvantages of each approach. Maykut (2001) believes that reciprocal delegation is reasonable and viable in Canada, while Anand (2001) and Scarlett (2001) criticize this idea. Anand observes that the mutual recognition approach requires *a real commitment to the harmonization of provincial securities statutes,* and believes that uniformity can be attained only by setting up a national regulatory body. The reciprocal delegation solution is, however, used by the European Community in the securities sector. It is also clearly found in the blueprint for uniform/harmonized securities laws proposed by the Canadian Securities Administrators (CSA) in January 2003.

In this context, Canada has important lessons to learn from the U.S. and the E.U.'s experience. The objective of this paper is therefore to summarize the evidence and lessons learned from the U.S. and the E.U., regarding securities and corporate regulation. We will begin by discussing the concept of regulatory competition, and we will then study its application in company law in the United States (Part 2), along with securities law (Part 3). We will then analyse the steps taken by the European Community to develop a mutual recognition system, known as the European passport (Part 4). The paper concludes with the lessons learned from these initiatives along with thoughts on the debate presently taking place in the Canadian securities industry.

1 REGULATORY COMPETITION: PRINCIPLES

Regulatory competition is part of a broader framework of interjurisdictional competition which we will describe here by the acronym IJC. IJC is defined as the rivalry among governments in which each government is trying to gain some scarce beneficial resources or to avoid a particular cost (Kenyon, 1997). This form of competition is multifaceted. Direct and indirect taxation, grants and tax expenditure programs intended to encourage or retain business are important elements therein. The quality of health care, education and infrastructure are also considered. Labour law, company law and environmental law are the main legislation used in securities regulation. The components mentioned above

determine the competitiveness of jurisdictions. This competitiveness depends, however, on the relevant economic agent. A paper company does not use the same criteria in its choice of location as a retiree. Moreover, globalization of stock exchanges has led to the internationalization of the concept of competitiveness. Perry (1994) defines international regulatory competition in the securities field as *a contest among regulatory jurisdictions to attract activity by offering the most efficient regulatory environment in which to operate. A regulatory environment is efficient if it offers participants precisely the regulation for which they are willing to pay.*

There are several theoretical models of IJC, from Tiebout (1956) to Breton (1996). Kenyon (1997) offers an overview of these models. They apply to different aspects of government intervention, yet unlike those of Breton, they are largely focussed on taxation. We will explore concepts, work and results that affect the underpinnings of IJC directly related to company law and securities law, while incorporating the dimension of associated accounting standards. Theoretical models of IJC stem from the work of economists who observe that regulatory authorities are not necessarily motivated to regulate for the better. For example, Breton wrote: *If we discard the assumption that politicians and public sector bureaucrats are somehow motivated to maximize a social welfare function, as the most superficial observation of the world entreats us to do, the most important reason for decentralizing the public sector is that decentralization makes possible and, in effect, stimulates intergovernmental competition*[1]*. Indeed, once it is accepted that public officials are like everyone else in society in that they are motivated, to a significant degree at least, to pursue their own interest, intergovernmental competition is required for two different, if related, reasons: a) as a check on political power much like market competition acts as a check on corporate power; and b) as an invisible hand mechanism capable of producing a maximum of social utility.*

Regulatory competition is therefore a necessary condition to counterbalance the excessive power of central authorities that do not necessarily act to maximise social well-being. It is also conducive to mechanisms that can maximise social utility.

Vietor (1994), following a comprehensive analysis of several cases of regulation and deregulation in the United States, makes the following observation. All regulation produces undesirable effects which are generally ignored. It tends to oppose market forces and technological progress rather than support them, and sooner or later the process takes the upper hand over permanency. These three strong tendencies ultimately create regulatory dysfunction and block the process of adjustment of regulations and organizations to the reality of accelerating market change. An ideal regulator must, on the contrary, anticipate the impact of its decisions, develop regulations which guide rather than constrain market forces, limit the procedural burden and regularly review its methods and regulations. Vietor posits that regulatory competition is a means of attaining, at least partially, these objectives. Levich (1993) suggests measuring the net regulatory burden (hereinafter NRB) on businesses. NRB represents the incremental regulatory cost less the marginal benefits of regulation[2]. When there are several jurisdictions, companies locate their business in the least costly regulatory environment. This regulatory arbitration causes companies to choose jurisdictions with a low NRB. This does not necessarily mean that these entities are less exacting, but that the advantages and costs of each regulatory element are offset. Authorities in high NRB jurisdictions must therefore reduce their requirements and eliminate all regulation whose marginal cost exceeds its marginal benefit. International regulatory competition thereby imposes discipline, which limits excessive regulation. As Tung (2002) notes, *in the areas of corporate, securities, and bankruptcy law it (regulatory competition) forces governments and their regulators to compete to offer regulation that firms and their investors prefer*. There are two divergent schools concerning the ultimate result of this competition: a race to the bottom or a race to the top. Proponents of these streams also disagree in terms of ability and rapidity of the systems to adapt, regardless of whether they are subject to competition.

For promoters of regulatory competition, it would also have the effect of causing a certain legislative uniformity. Provisions of which the net cost is to a large extent greater than the benefit should be abandoned, while overly flexible provisions should also be abandoned, as they cause an increase in the cost of capital in the fields of securities and

company law for example. This adjustment would be for the best, but may oppose the power of the various jurisdictions if competition is not perfect. Company law competition in the United States seems to have led to the emergence of relatively uniform laws in the various States (Romano, 1985; Black, 1990).

1.1 Race to the bottom versus Race or the top

Race to the bottom: This basic argument against regulatory competition states that jurisdictions will reduce their requirements to attract economic agents. For example, regarding laws governing takeovers, Bebchuk and Ferrell (1999) argue that American states take advantage of competition to introduce mechanisms to protect existing directors from takeovers. However, various mechanisms allow limits to be placed on the race to the bottom, notably the establishment of minimum common standards, described by Hertig (2001) in the European framework. The main argument against the race to the bottom, however, is economic, and allows for a race to the top, in particular concerning disclosure of financial information and securities regulation. In fields other than securities there are several examples of the race to the bottom, which Breton (2000) calls *decentralization failure.* Tariff wars between countries, grant programs to attract and keep business and tax wars betweens the States in the 1930s are some examples. However, Breton observes that at the international level these wars have lessened and mechanisms have been put in place to contain them.

Race to the top: This argument rests on the fundamental relationship of finance: the association between risk and reward. The lessening of regulation below the NRB limit increases the level of risk of investors who will require a risk premium. This results in a higher cost of capital for businesses subject to the reduced regulation. Evidence suggests that this situation occurs in particular in the field of securities, where traditionally the most restrictive jurisdictions have attracted a high number of issuers and investors. As Warren points out (1990, p. 189), *the New-York and London markets have emerged as the largest international securities markets despite having the two most comprehensive securities regulatory systems in the world.* The first beneficiaries of this action are

shareholders because an optimal regulatory system increases share value. The race to the top argument is defended by Romano (1993, 1998, 2001, 2002) and Winter (1977, 1989), among others. Jackson and Pan (2001) recapitulate the empirical works and professional studies which confirm that issuers tend to comply with the highest standards (those of the United Kingdom in Europe) in choosing their disclosure strategy. In addition, some of the works cited show that issuers exceed minimum disclosure standards in an attempt to positively influence the market. There is therefore a great deal of evidence in favour of the race towards the top regarding the disclosure of information. The reaction of issuing companies in the European Community after the adoption of the European passport directive is also consistent with this behaviour.

1.2 Stability and ability to change

Centralized and competitive regulatory systems also differ in terms of stability, ability to change and ability to implement new measures, as well as in terms of total or partial possibility of capture.

- Stability: for Harris (2002), a single centralized regulatory system is more stable than a competitive system. It is therefore more foreseeable, which represents a definite advantage for issuers and investors. However, a stable system is disadvantageous in a rapidly changing environment, as in the case of securities. A stable system is in fact synonymous with a diminished capacity for change.
- Capacity for change: this capacity has two dimensions. Legislation must be able to adapt to change (time adaptation) and geographical differences (place adaptation) when a jurisdiction is characterized by disparities, which is the case in Canada.
- Time adaptation: MacIntosh (1997, p. 232) notes that setting up a centralized regulatory system leads to decreased responsiveness. The securities field, as well as company law, are in rapid evolution. Decentralized regulatory bodies may be able to innovate more rapidly to respond to these changes. However, regulatory response must be followed by an implementation phase, which, in a decentralized system, is necessarily longer because it requires cooperation.

- Place adaptation: proponents of decentralization argue that this system allows better adjustment to local realities and more flexible adjustment to local changes in conditions.
- Implementation: even if regulatory bodies detect and adapt to changes, these changes must still be implemented at the global level. Proponents of a centralized system argue that fragmenting responsibility imposes a long and costly process, since cooperation is required. Within the framework of the capture theory, which specifies that regulatory bodies are inevitably captured by the regulated entities to their advantage, this process may have certain advantages. It limits the power of the largest pressure groups.

Regulatory centralization and decentralization thus both present advantages and disadvantages, which are easily described but not easily measured. We will therefore analyse existing situations to determine the extent that one model may be considered preferable. Accordingly we will analyse the existing situations in company and securities law, with special attention devoted to the European Community.

2 REGULATORY COMPETITION IN CORPORATE LAW

In the United States, regulatory competition is the standard for rules governing the relationship between directors and shareholders, falling under the jurisdiction of the states. However, the statute in force in the jurisdiction of incorporation governs the entire company, regardless of its operating location, and companies freely choose their state of incorporation. An identical situation has existed for a short time in Europe, where companies can choose their country of residence. This competition has created several important differences between the abilities of American states to retain the physical presence of companies in their territory. Bebchuk and Cohen (2002) observe that Illinois and California incorporate only 11% and 22% of "their" companies while Indiana and Minnesota keep 70% and 75% respectively. Delaware gets 85.23% of companies incorporated outside their state of location and this movement is increasing. From 1996 to 2000, Delaware incorporated 90.22% of new companies that chose a state other than their State of origin. These indicators caused Bebchuk and Cohen to conclude that the market domination of Delaware is even clearer and growing more than indicated by the figure

usually quoted. These authors found that 57.75% of all American public companies and 59.46% of Fortune 500 companies have their head office in that state, as opposed to less than 5% in the State of New York, which, however, comes second in terms of number of incorporations. Delaware also grants a very large proportion of IPOs. Daines (2001) shows that in 1996 this state attracted 64% of all U.S. IPOs, versus 36.5% in 1981.

Considering the similarities of the implications of company and securities laws, competition in company law is an important object of study and analysis that will contribute to a better understanding of the effects of regulatory competition for securities. Moreover, a great number of works have been devoted to competition in company law involving the special situation in Delaware.

2.1 The Delaware situation

Delaware has systematically adapted its laws to corporate needs. This State is the only one to offer a special court to settle disputes in company law and offer companies significant protection against hostile takeovers. Legal protection broadly authorizes defensive manoeuvres against takeovers. It has been reinforced by the development of a doctrine that notably permits recourse to poison pills by the Delaware courts. Jurisdiction shoppers recognize that Delaware's provisions are extreme, but other states have adopted provisions that go further still, without however attracting as many companies as Delaware (Bebchuk and Cohen, 2002)[3]. However, as these authors indicate, the ability to attract companies is directly associated with protection against takeovers.

The main legal characteristics of Delaware are the following: greater protection for directors against hostile takeovers; lower transaction costs on the sale of companies; fewer limits on defensive tactics of directors for takeovers; a body of law and vast experience in takeovers. From the outset, Carey (1974) states that the willingness of Delaware to attract businesses for tax revenue should result in the lowering of legal requirements, mainly in the area of shareholder protection. Carey argues that directors profit from a range of less restrictive legislation, at the shareholders' expense. Delaware

would therefore initiate a race to the bottom which would align its laws with the wishes of directors. We believe that the only way to counter this mechanism would be to enact a single statute at the federal level. Carey's argument has the advantage of allowing empirical verification of the effect of regulatory competition. Less investor protection represents increased risk, which should translate into a higher cost of capital. As company value is determined by the value of future changes actualized by this cost of capital, all things being equal, a company registered in Delaware should have a lower value than it would have in another jurisdiction. Changes of jurisdiction to or from this State must also translate into changes in company value. This theoretical statement is not confirmed empirically.

2.2 Empirical work

The many empirical studies of the effects of regulatory competition in company law in the US have been summarized by Bhagat and Romano (2002), Romano (2002) and Bebchuk *et al.* (2002). We will review the main methods and the principal results of tests related to the following hypotheses: if regulatory competition benefits shareholders, change of domicile to a more favourable jurisdiction should lead to an increased share price (and *vice versa*); all things being equal, a company registered in a state that has a favourable jurisdiction must be worth more than one located in a less favourable jurisdiction.

Using event analysis techniques[4], a few studies show an abnormally positive return on the announcement of reincorporation in Delaware (Romano, 1985; Wang, 1995; Hyman, 1979). However, Wang's results are more significant when he divides the sample by states where the companies locate, whereas Hyman's study is based on a summary methodology. Contrary to Romano (2002, p. 65), evidence of the effect of a transfer of head office to Delaware is not systematically positive or significant at the conventional 5% threshold. As Daines (2001) indicates, a change of head office is often associated with a change of strategy, and the effect of the two events is combined. For Bebchuk *et al.* (2002), it is difficult to infer from existing studies that a Delaware incorporation has a

significant positive effect on shareholder wealth. Moreover, Table 1 of Bhagat and Romano (2001) shows the rarity of significant statistical results in studies covering the period after 1983. Romano (2002, p. 65) retorts, however, that an abnormal return of 1% may be economically significant.

A second approach was used by Daines (2001), followed by Subramanian (2002) and a few other authors to determine the extent that company value is affected by the types of laws prevailng. Daines uses a measure of the company's value relative (Tobin's Q ratio)[5] and shows that, all things being equal, Delaware companies are worth more than those of other states. The study covered 4,481 companies listed on a stock exchange during the 1981-1990 period. The results are statistically significant for twelve of the sixteen years studied, and are economically significant as well. For example, in 1996 a 5% difference in value was observed. However, a similar study conducted during the following period shows that Delaware's advantage is decreasing. Subramanian (2002) estimates it at 2.8%. Although it is not perfectly clear that a transfer to Delaware has a significant effect on shareholder wealth, the fact remains that this state has been able to attract a very significant portion of American companies, which could not have occurred without the shareholders' consent. This movement does not seem to have caused major problems in terms of governance or executive behaviour. In the framework of regulatory competition, Delaware has therefore succeeded in developing a body of law that appears optimal for a majority of companies. Several provisions have been copied by other states and Delaware therefore seems to be contributing to an improvement in the company law system in the United States. This observation is the cornerstone of the argument developed by Romano (2002) in the field of securities law. Regulatory competition in corporate law, however, has raised criticism.

In Canada, the influence of regulatory competition in corporate law was analysed by Daniels (1992), and by Cumming and MacIntosh (2000, 2002). Daniels suggests that competition for corporate charters has played an important role in Canadian corporate law reforms. Cumming and MacIntosh report that *he suggests that the provinces were effectively forced to copy the reforms embodied in the (1975) federal enactment or lose*

chartering business to the federal government. However, in their first study of the incorporation market, Cumming and MacIntosh argued that the interjurisdictional competition has not played a significant role in shaping corporate law in Canada. They show that various legal and institutional factors limit the emergence of competitive federalism in corporate law. Accordingly, they attribute the affects to the provincial jurisdiction over securities law and the lack of dependence of Canadian jurisdiction on incorporation revenues. They concluded that *the theory and empirical evidence indicate that institutional barriers have limited the extent of competitive corporate law production.* In a second paper, Cumming and MacIntosh (2002) analyse the reincorporation of Canadian corporations. They use a survey to analyse the rationale underlying firms' decisions to reincorporate, and an event study to estimate the effects of these decisions on stock value. Overall, they find that law shopping did not serve as the primary motivator of inter-provincial reincorporations. Federal reincorporations have a more substantive law-shopping component. However, while some reincorporation transactions increase firm value, other reduce value.

2.3 Criticism of regulatory competition in company law.

Arguments and research results showing the advantages of regulatory competition in the field of company law are not unanimous. Bebchuk and Ferrell (1999), Bebchuk *et al.* (2002) and Bebchuk and Cohen (2002) present varying criticisms of this proposal. Certain criticisms are centered on a race to the bottom (from the shareholders' point of view) as states would be in competition to maximally protect executives from takeovers that may discipline executives. However, for Bebchuk and Cohen (2002) or Kamar (1998), the American situation is no longer one of competition but of a monopoly over new incorporations, where the body of law and knowledge of company law constitute an entry barrier. Despite these criticisms, Bebchuk recognizes that regulatory competition may produce beneficial effects. However, in the particular area of protection against takeovers, the effects would be negative.

3 REGULATORY COMPETITION AND THE SECURITIES INDUSTRY

3.1 General principles

In a sector subject to rapid changes, the ability of laws and regulations to adapt quickly and the rapid detection of problems and trends is essential. As the primary goal of a stock market is to provide issuing companies with capital at the lowest possible cost, regulation should be made to correspond to the needs of investors. The issue is therefore whether a competitive system will allow this double objective to be reached more efficiently than a regulatory monopoly. Also, because of international competition, it is important to define a regulatory system which is attractive to both local and foreign companies so as not to lose a share of the financial market. According to Choi and Guzman (1998) and Romano (1993, 1998, 2001, 2002), competition is preferable to reach this objective. The proposed forms of regulatory competition and, in practice, the existing forms of competition are two types, which, as Tung (2002) points out, are very often confused. The form proposed by Romano, and which prevails in company law in the United States, is direct regulatory competition. Choi and Guzman (1998) propose a type of model used in Europe, called portable reciprocity. The Canadian system, for the time being, resembles neither of these models, although certain forms of competition in terms of provisions may be observed. Tung analyses the differences between direct competition and the passport and shows the very important differences between them in terms of effects and policies.

Romano's main argument is the success of regulatory competition in the field of company law in the United States. To the extent that this system has allowed an optimal legal framework to be developed, it should be the same for securities. The model proposed by Romano is a transposition of the situation which prevails in company law. However, we have shown that, for several authors, the success of competition in that legal field is questionable. Issuers choose the jurisdiction, i.e. the place where they file their prospectus and ask for registration (federal regulation is becoming optional) and other jurisdictions recognize the laws and regulations of the state or province of registration[6]. The choice of place and therefore of regulatory system is clearly disclosed to investors, in particular by brokers when the securities are sold. The system chosen by a

company may subsequently be changed with shareholder approval[7]. Romano (2002, p. 115) recognizes that this system may lead to different treatment of the same situation for investors. However, application of the doctrine called *internal affairs,* already applied in company law, would solve this problem. This doctrine refers to the original jurisdiction all cases involving a corporation which is registered there. Romano recommends that the state of registration differ from that where the company carries on its principal business to allow competition to fully come into play.

The portable reciprocity approach of Choi and Guzman (1998) is an extension of the concept of bilateral recognition. In the classical system, two countries agree that an entity meeting the requirements of the original jurisdiction may operate in the host country. This is the principle used between Canada and the United States within the framework of the *Multijurisdictional Disclosure System* (MJDS). The portable reciprocity approach extends this approach to a situation involving several jurisdictions, where the issuer is entitled to choose the principal regulatory entity. Approval by this entity will be recognized by the other jurisdictions, but the principal jurisdiction must be indicated to investors (in the case of the issuance of securities). Although similar to the approach of Romano, reciprocity has very different implications and implementation requirements. In particular, and the case of the EC is a clear illustration of this, the regulatory competition approach can only function if the various jurisdictions agree on minimum standards. Otherwise, jurisdictions will use various techniques to block access to their market.

The advantages of this type of approach to regulation are quick reaction time and especially limits on over-regulation, which, in the opinion of certain participants in favour of deregulation, seems to be a tendency of authorities in the area[8]. Over-regulation is particularly penalising in the securities industry because of the mobility of capital. Laws and regulations developed in a context of competition take the real needs of participants into account to a greater extent. Regulatory competition leading to a bottom-up approach may be preferable to the classic top-down approach which seems to lead to over-regulation. In fact, regulatory competition allows the creation of a feedback effect which allows the preferences of agents to be revealed: these preferences translate into a

flow of issuers to the preferred systems. Romano (2001, 2002), but also Fox (2001), Choi (2001) and Jackson (2001), point out the advantages of regulatory competition for securities. The importance of the over-regulation argument warrants a special section all to itself.

3.2 Over-regulation, particularly with respect to disclosure

A single regulator may impose disclosure requirements without regard for investors. This argument is based on two observations. Firstly, in the absence of regulation, companies would still disclose information which would, in many cases, be certified by an independent body. Modeling this behaviour has given rise to a large body of work, of which Verrecchia (2001) gives a partial summary. Disclosure would have the effect of increasing liquidity and reducing information asymmetry, which allows the cost of capital to be reduced. In addition, imposition of disclosure regulation could produce positive external effects. The benefit of disclosure by companies would have overall positive effects greater than the effect on each company by allowing a more efficient, more liquid and less volatile stock market. However, regulating disclosure also has net costs and benefits of which the disclosure requirements have not been proven by the different analytical studies (Admati and Pfeiderer, 2000). The intervention of the regulator in this field comes from the proposition that the quantity and quality of the information which would be available in such a case would not be optimal. The regulator has therefore generally sought to increase the quantity and level of detail of information disclosed, which sometimes limits the disclosure of certain aspects of information considered potentially harmful such as management forecasts.

Empirical research in the field of accounting has effectively shown the lack of effect of several of the SEC's disclosure requirements. As Verrecchia (2001) mentions, it is almost impossible to show the positive or negative effects of additional disclosure requirements on the American market. Bushee and Leuz (2002) show that imposing disclosure requirements on companies whose shares are traded over the counter has had positive effects on the price and liquidity of these shares, from which companies not subject to

this requirement did not benefit[9]. The imposition of these rules would therefore seem to have had positive external benefits but the study shows that 74% of companies subject to this new obligation preferred to leave the OTCBB for the market known as the *Pink Sheet* of the *National Quotation Bureau*[10], which indicates that they believed the cost of compliance greater than the loss caused by their transfer to a less liquid and transparent market. This study evidences the positive and negative effects of a new regulatory requirement. In fact, although disclosure and liquidity increased for approximately one-third of companies involved, they decreased for two-thirds of the securities.

Lo (2000) studies the economic consequences of a change imposed by the SEC in 1992 requiring the disclosure of executive compensation. The objective of the SEC was to improve governance by requiring the disclosure of the methods and amounts of executive compensation. Lo distinguishes companies opposed to the change from those that did not conduct any lobbying. The first had abnormally high levels of compensation and saw their rate of return increase sharply after the adoption of the new standards. The performance of companies which did not oppose the regulatory change remained unchanged. This result is consistent with the hypothesis that increased disclosure causes a reduction in agency problems and improved governance among companies where it was relatively weak. The effects of fair disclosure (FD) regulation, which requires companies to disclose the same information to analysts as to all investors, was studied by Straser (2002), Bushee *et al.* (2002) and Eleswarapu *et al.* (2003) who obtained different results respecting this additional requirement on the quantity and quality of information issued by companies. Analytical and empirical studies therefore seem to point out the inherent difficulty in determining the optimal level of regulation in terms of disclosure.

3.3 Illustrations of regulatory competition in the securities field

There are fewer illustrations of regulatory competition than other fields because of the dominance of American and British models. Perry (1994) presents the development of the Euro-bond market as a successful example of competition as compared to the American market, due to lower regulatory costs. Several authors attribute lower

borrowing costs in this market to a NRB close to zero, which is not the case in the American market. As Niemeyer (2001) states, securities regulation may be influenced by pressure groups: *The regulator has to have the ability and the motive to impose adequate regulation. It is not obvious that a given regulatory body fulfills both of these requirements. Ability here refers to both the information available to the regulator and the enforceability of the regulation. For all rules and regulations, especially non-government regulation, it is important to scrutinize the motives of the regulator. Weak and diffuse groups, such as consumers and retail investors, often have difficulties in influencing regulatory solutions. Furthermore, strong interest groups are more likely to affect the regulatory solution for specific regulations, like securities regulation, than for more general forms of legislation and regulation. Conflicts of interest may therefore be important in securities regulation. In some cases, these conflicts may result in inappropriate regulation and therefore a non-regulated situation may be superior.*

There are factors other than regulation which guide the choices of issuers and investors. Liquidity is one of those factors. In Europe, several authors agree that we are witnessing a race to the top. Choi and Guzman (1998) say that *European firms often choose to comply with the disclosure requirements of British securities laws even though it would be permissible to comply with the weaker requirements of their home countries.* Also, according to Romano (1998), *in addition, European firms listing in London typically comply with the higher United Kingdom disclosure requirements rather than with the lower ones of their home countries, although they need not comply with U.K. rules under the European Community disclosure directives*.

Because of its regulatory structure, Canada has found itself for several years in an imperfect system of regulatory competition. The various jurisdictions can develop different regulations, but issuers and intermediaries remain subject to the jurisdiction of the provinces where they operate or offer securities. There are no mutual recognition agreements as in the case of the European Community (EC), or agreement for regulatory transfer from the state of incorporation as is the case under U.S. company law. However, despite its partial nature, regulatory competition for securities in Canada has attracted the

attention of several researchers. For Daniels (1992, p.94-96), *a dramatic shift in power to the federal government is not unequivocally desirable from a functional perspective, nor practically feasible from a political perspective.* Daniels describes the advantages of regulatory competition, which has allowed provincial regulations *extremely sensitive to the rapidly evolving needs of investors, issuers and registrants.* In particular, he notes that this structure has allowed the creation of distinct regional markets and an *enviable record of innovation and experimentation in regulatory products.*

Without drawing up an exhaustive list, the effects of competition in Canada may be illustrated through several examples. The creation of programs such as capital pool companies or Quebec stock saving plans are examples of innovation started in one province and copied in others. The fact that certain companies of these other provinces relocated to Alberta to benefit from the Junior Capital Pool program probably helped its adoption outside of Alberta. The case of negotiated brokerage fees, initiated in Quebec and subsequently accepted by the other provinces, is another example of the positive effect of competition. However, provincial securities initiatives are often ignored in later documents, which limits their visibility and underestimates the effect of regulatory competition in Canada. For example, the Fraser Institute[11] attributes the creation of labour funds to a federal government initiative in 1987, although the Quebec Labour Fund was created in June 1983 as a result of an initiative of the government of Quebec. Similarly, Todd (1983), in his analysis of the evolution of negotiated brokerage fees in Ontario, does not mention the fact that the movement was initiated in Quebec. As Roy points out (1985), regulatory competition has also played a role in the area of brokerage firm ownership.

3.4 Criticism of regulatory competition in securities

The main arguments opposed to regulatory competition are information externalities (Fox, 2001), the race to the bottom, instability and the absence of harmonization. For example, Cox (1999) predicts that if issuers have the possibility of choosing their jurisdiction of issue, they will choose the least demanding. Regulatory competition would then lead to relocation to the least stringent jurisdictions. However, the attraction of the

most strictly regulated markets for foreign issuers appears difficult to reconcile with this statement. Other arguments may also be put forward, such as the difficulty for investors to sue issuers and intermediaries internationally. We will now analyse these arguments which have not been discussed before.

Instability: Breton (2000) cites the case of securities in Canada as an example of non-convergence to an optimum. For Breton, this situation results from the dynamic instability caused by competition. Changes in one jurisdiction lead to more significant changes in competing jurisdictions, which leads to a new reaction. It seems to us that two other explanations should be considered in this specific case. Regulatory competition can only lead to harmonization at the top if the agents (issuers and investors) have similar concepts of utility. The need for information and propensity to risk of Alberta investors interested in junior gas exploration stocks are probably very different from those of an institutional investor which holds a large position in stocks of banks or insurance companies in Ontario. Furthermore, the Canadian system is not one of pure regulatory competition because regulation of the province of origin is only valid in that province. Provincial bodies therefore retain local monopoly power. Breton examines three ways to solve blockages. The first two destroy the competition mechanism and *whether they have worse effects than some types of instability is surely a possibility* (p. 12). The methods are centralization or the imposition of uniform standards. Breton prefers what he calls *weak harmonization* to *strong harmonization*. Control of instability can be achieved while preserving regulatory competition and instituting clear mechanisms for dispute resolution. This is the path the European Community seems to have chosen.

Absence of harmonization: Regulatory competition is often seen as being incompatible with harmonization. Tung (2002) argues that this is not the case, for several reasons. Firstly, minimal harmonization is required for certain forms of regulatory competition to exist such as the portable reciprocity which underlies the European passport. Secondly, in cases of direct regulatory competition, the law of the jurisdiction of origin applies in the host jurisdiction. There must therefore be minimal agreement between the regulatory bodies. In the EC, regulatory competition is seen as a means of harmonizing regulation

by meeting the needs of agents as opposed to imposed harmonization (top-down approach), considered unrealistic. In theory, competition should cause a tendency toward harmonization provided economic agents have similar concerns. However, there are several examples where the mechanism does not work. In U.S. company law, it seems that the system has led to a quasi-monopolistic situation of one state which has been able to build a significant comparative advantage. Moreover, Choi and Guzman (1998) recognize that the regulatory competition model does not necessarily lead to regulatory uniformity. They admit that regulatory needs differ depending on the investors and argue that the portable reciprocity model allows different regulatory systems to coexist, thereby eliminating costs caused by the imposition of uniform regulation on vastly different issuers and investors. The question then becomes the following: in a highly diversified community, should we consider one or more regulatory systems? On this point, and more broadly on the experience of regulation of a heterogeneous confederation, the European experience warrants careful analysis.

4 THE EUROPEAN SITUATION

The building of a common Europe is full of lessons because the Community was confronted with the necessity of analysing and reforming securities regulation in 15 countries. As Jackson and Pan (2001) write, *the European Union currently provides a regulatory structure analogous to what proponents of issuer choice advocate for the United States. Thus, Europe presents a natural laboratory for testing theoretical disputes arising out of the regulatory competition literature.* Numerous works and reports have been produced and may be used to put the Canadian situation in perspective and especially to analyse, in the real world, the idea of regulatory competition in the field of finance. Jackson and Pan also write: *The notion that the legal structure of the European Union might present a venue of regulatory competition has been recognized for some time now. In fact, the principle of mutual recognition has been associated with regulatory competition since its inception. Mutual recognition, as envisioned by the European Commission in its 1985 White Papers (...), was meant to generate a "competition among rules" and force regulatory harmonization among the member states. Several commentators predicted in the early 1990s that the passport concept could force all*

member states to lower regulatory protections to the minimum standards of the directives (a race to the bottom) while others speculated that member states might converge on some other standard (potentially a race to the top).

Steil (2002) expressed the wish that regulatory competition would allow a real European financial arena to be developed. However, the Lamfalussy Report[12] (2001, p. 13) makes an observation strangely similar to that observed in Canada by Mackay: *The Committee notes that an almost consensual view has emerged that the European Union's current regulatory framework is too slow, too rigid, complex and ill-adapted to the pace of global financial market change. Moreover, almost everyone agrees that existing rules and regulations are implemented differently and that therefore inconsistencies occur in the treatment of the same type of business, which threatens to violate the pre-requisite of the competitive neutrality of supervision*. The situations are, however, very different. Canada already has a very harmonized regulatory framework, which is not the case in Europe. The current steps following the Lamfalussy Report, the revision of ISD 93, new directives on prospectuses and the FSAP constitute different means used by the EC to ease dysfunctions in the mutual recognition system instituted in 1993. This system is one of the components of regulatory competition under the European model.

4.1 Different situations

The European situation differs greatly from that which prevails in Canada. A market structure based on bank financing in Europe is different from the much more disintermediated market structure in Canada, where the capital markets have a more important role in financing companies, probably due to the proximity of the United States[13]. The diversity of regulatory structures, legal systems, traditions and languages is very strong in Europe.

Gros and Lannoo (2000) describe very important differences which exist for tax, accounting standards and governance policies. They observe, in particular, (p. 113) that *the harmonization of accounting standards has not gone sufficiently far, and*

consequently mutual recognition does not work. Warren (1990) describes as follows the situation which prevailed at the beginning of the 1990's: *European securities regulation has been described as "virtually nonexistent outside the United Kingdom". Although corporate law is fairly well-developed in the various jurisdictions, European stock exchanges have been self regulating, with little or no direct oversight by national governments. Most European states have not mandated full disclosure systems for the distribution and trading of securities" nor have they prohibited insider trading" or other manipulative practices generally proscribed by United States securities laws for most of the 20th century. (..) Furthermore, most European states have lacked governmental "competent authorities" or regulatory bodies to administer those regulations that were in force or to supervise self-regulatory organizations in the securities industry.* Warren admits that efforts made in connection with establishing the common market in 1992 led to a rapid evolution toward the adoption of higher and more coherent standards but important differences remain ten years later. In his summary of answers made by member states to a series of questions respecting the treatment of prospectuses, the CESR (2002) illustrates very important differences between Community countries.

These differences affect the organizations in charge (exchanges, commissions, banks in certain cases), their powers to inspect, to delay takeovers or halt trades or simply their statutory authority to approve prospectuses. Laws sometimes do not define a public offering or the responsibilities of relevant authorities in several countries. Prospectuses are analyzed very differently depending on the country. The Lamfalussy Report also points out the absence of precise European regulation on a great number of issues (such as prospectuses, transborder guarantees, market abuse, investment services), as well as the differences between the legal and tax systems. Finally, the degree of cooperation at the European level was extremely limited and observation of this situation led to the creation in 1998 of Forum of European Securities Commissions (FESCO, Lannoo, 2001). In addition, there are no generally accepted guidelines which govern legislation on financial services (Lamfalussy Report). The challenges facing Europe are therefore of a different type than those facing Canada. However, analysis and the European experience may help our examination and will be discussed here under three headings. Firstly we

will study the investment service directive (ISD 93), then its update and finally the main recommendations of the Lamfalussy Report and the reactions it caused.

4.2 Competition and harmonization

For Ferrarini (2002, p. 5), *European Securities regulation is the result of an initial attempt at substantially comprehensive harmonization, which was soon converted into a plan of minimum harmonization and mutual recognition. As a result, some regulatory competition between the Member States is allowed, also in compliance with the subsidiarity principle*[14]. Regulatory competition for securities currently exists in Europe and this market therefore constitutes a preferred laboratory to analyse the effects of competition. However, this competition is mitigated by the adoption of minimal standards which constitute a basis which allows mutual recognition, in theory. However, this system has not functioned properly: few issuers have actually used mutual recognition (the passport) and additional requirements have regularly been imposed under the heading of "general good justification". Furthermore, slowness in the progress to a European financial arena has led to the development of an action plan, review of the investment service directive and the creation of a Committee of Wise Men (Lamfalussy Committee). We will quickly review these various elements, studying them from the point of view of regulatory competition.

4.3 The investment service directive (ISD 93)

The ISD, known as the European passport directive, has dominated the financial landscape since its adoption in 1993 (Moloney, 2002, p. 355). It is based on European directives respecting the carrying on of business and freedom of location which are the foundation of the European Treaty.

The overall strategy of this directive has been to totally free the investment service market by subjecting suppliers of services solely to the authority of their country of origin. ISD has thus allowed a true passport to be set up which allows a company

registered by the authority of its country of origin to offer services in all the countries of the Union without further authorization. A supplier of services remains governed by the rules of his country of origin. The ISD is an application of the principle of mutual recognition developed by the European Court of Justice. This principle has exceptions under the heading of general good justification. Tison (2000) analyses the conditions for exemptions under which a country may have additional requirements and thus contravene the principle of mutual recognition. At the level of all economic activity (outside ISD), the absence of harmonization is one of the causes put forward to derogate from this principle.

This situation also prevails for financial services despite the existence of minimum standards of harmonization which in theory limit recourse to the concept of general good justification. The ISD theoretically allows perfect mutual recognition. However, two areas remain problematic and can give rise to additional requirements: they are the rules of conduct, the oversight of which is up to the countries where the service is rendered (Article 11 (2) ISD) and the regulation of financial products in private law which is not covered by the principle of mutual recognition. To facilitate use of the passport, the second banking directive and the ISD provide for a notice procedure by which an authority of the host country notifies the supplier of services who requests market access of the specific rules required under the principle of general good justification. However, the commission is looking into the mandatory or discretionary nature of these additional roles and even into pursuing the notice system. The purpose of the ISD is not to harmonize laws but it uses a minimal harmonization approach. Analysis of issuer behaviour in the framework of the ISD has been conducted by Jackson and Pan (2001). They conclude that market forces determined the way in which companies conducted pan-European offers and not the provisions of the ISD.

Companies have not used the passport, but have conducted international-style offerings, i.e. private placements outside the country of origin where they were in compliance with existing provisions. Rules governing disclosure in this context are not so much affected by regulatory provisions, but by international practices based on American standards. Put

in a competitive system, issuers have therefore chosen not to use the lower standards prevailing in several countries of the Union and complied with higher standards and disclosure requirements not required by the regulation in place[15]. We cannot, however, rule out that the quasi-systematic use of general good justification by several countries has limited use of the mutual recognition provisions.

4.4 Revision of the ISD and FSAP

The effectiveness of the 1993 ISD[16] has been mitigated by extensive dilution of the ISD's principle of "home country control" whereby a firm can operate EU-wide on the basis of mutual recognition of supervision since numerous provisions of the ISD allow for host country intervention in the interests of the "general good". Article 11 of the Directive provides for host authorities to implement local conduct of business rules in addition to those enforced in the home country of the firm. Though this may be helpful in terms of protecting retail investors, it is currently applied indiscriminately to inter-professional business which is over-burdened with application of rules designed with the small, household investor in mind. In addition, there has often been wide variation in the interpretation and implementation of the ISD at the national level. Important obstacles to competition have been observed and, for example, use of the passport by issuers has been very limited. The EC has therefore developed a financial services action plan (FSAP, 1999), the main objective of which is maximum integration of European financial markets, with a 2005 horizon, to optimize the use of capital in the Community. The FSAP contains 43 measures, of which, according to Durance (2002, p. 12), the main ones are the following:

- The integration of "large" markets through universal recognition of prospectuses, the adoption of a common definition of professional investor, use of the same accounting standards, common minimum standards respecting takeover bids, institution of a single market for institutional investors based on the European passport and mutual recognition of retirement plans, life insurance and mutual funds.
- Opening up of retail markets to facilitate remote sale of financial services to customers through information and the application of the legislation of the vendor's country.

- Reinforcement of prudent surveillance by the definition of a common solvency ratio for banks.
- Authorization of optimal functioning of the European financial market by the reduction of the risk of tax distortion on savings income.

In February 2002, 25 measures had been achieved, including the adoption of uniform accounting standards (IAS, now IFRS) with a 2005 horizon for companies listed on an exchange and their subsidiaries. Several others are still being studied but two new measures have been adopted since then: the proposal on prospectuses (November 2002), and that on market abuse (insider trading and market manipulation, October 2002). The action plan thus involved the revision of the ISD as well as the setting up of a more efficient and, accordingly, more restrictive decision-making model for member states. This analysis of decision structures was the object of the Lamfalussy Report. As Ferrarini mentioned (2002, p. 22), the two steps are inseparable.

4.5 Revision of the ISD

The ISD 93 no longer allowed the use of an efficient framework governing transborder investment activity in the European Union. Its main deficiencies are the following[17]:

- The ISD does not provide for sufficient harmonization to allow effective mutual recognition of consents issued to investment firms. As a result, the efficiency of the passport it introduced has been largely diminished by the exercise of double, and sometimes multiple, oversight of transborder transactions;
- The restrictions it contains for investor protection are out of date: the rules of investor protection must be reviewed to require investment companies to actively use new trading opportunities in order to obtain the best possible results for their clients;
- The ISD does not cover the full range of services offered to investors (for example, investment advice or new distribution channels) or financial trading;
- The directive does not allow for a response to regulatory and competition issues raised by competition between stock exchanges and between them and the new trade execution infrastructure. Competition between the different methods of executing

trades constitutes the main regulatory challenge faced by the EC oversight authorities. The few provisions of the ISD respecting regulated markets, as they are excessively limited, do not provide a clear regulatory framework in which these regulated markets and other trading systems can compete to attract liquidity or in which investment firms can execute off-market orders when providing other services to their clients;

- The ISD has used an optional approach respecting regulation of market structures, thereby creating a major obstacle to the creation of a competitive and integrated trading infrastructure. From one member state to another, the methods of trade execution are therefore very diverse. Equally fundamental divergences in the regulation of market structures have indirectly caused disparities in national trading agreements, rules governing market operation, the competitive edge which exists between the infrastructure for trade execution and behaviour of market participants. These disparities greatly affect transborder trades and fragment liquidity;
- Provisions of the ISD respecting designation of authorities having jurisdiction and their cooperation are insufficient: a condition precedent to the existence of an orderly single market is total and immediate cooperation and the continuous flow of information between the national authorities.
- Provisions of the ISD are rigid and out of date: they do not allow for a response to the hot regulatory questions raised by the evolution of market structures, of business transacted in them and of prudent practice. This necessity testifies moreover to the futility of attempting to regulate financial markets by inserting very detailed provisions in unchangeable legislation.

Given that the ISD did not provide for any mechanism to harmonize national approaches to implementation, a new approach was needed to surmount the present difficulties, seize new possibilities offered and meet the legislative challenges caused by the transformation of European securities markets. An essential objective of this revision consisted of endowing the ISD with structural mechanisms of realization.

4.6 The Lamfalussy Report

The Lamfalussy Report deals essentially with setting up structures which would allow the ISD to be modernized, and more specifically with setting up minimum standards required for the mutual recognition system to function properly. It does not involve the creation of a European Securities Commission; the two committees set up are essentially joint decision-makers whose powers go further than those of the CSA because they can have their decisions approved by the European parliament. The Lamfalussy Report proposes a decision-making structure which uses four levels based on committees, within the framework of the principle of comitology[18].

Lamfalussy expresses the need for harmonization, which is not total but allows adequate operation of a mutual recognition system. Lannoo (2001) is also clearly in favour of harmonization but sets limits to it. He also criticizes the Lamfalussy Report for not paying sufficient attention to the process of stimulating proper market operation throughout the various institutions and financial intermediaries involved. He writes on page 1: Full harmonisation is not realistic, however, nor is it even desirable since some degree of competition between jurisdictions can do no harm. This reaction is rather common and several researchers have criticized the Committee for having very clearly defined how to reach a goal, but without defining it. However, the recommendation on structures was clearly the mandate of this committee. Contrary to what is sometimes argued neither the Lamfalussy Report nor the FSAP provides for the creation of a single securities commission in Europe, as the web site of the European Commission states[19]. This option is only mentioned and the approach of imposed harmonization is seen as an approach of last resort[20]. The sequential steps in the building of a financial Europe can be characterized as follows:

- Step 1: ISD 93 and regulatory competition, limited by the strong prerogatives of states.
- Step 2: updating of ISD 93 and new directives: regulatory competition made possible by the imposition of minimal standards for mutual recognition to become effective.
- Step 3: re-examination in 2004 which may lead, in the case of failure, to the institution of a single set of rules considered by numerous researchers as totally unrealistic. This

single commission would require that all countries give up their jurisdiction over securities, which seems highly unlikely.

The role and composition of the two committees set up following publication of the report are defined as follows on the EC website: *The European Securities Committee (ESC) is composed of representatives of Member States, chaired by the European Commission. It may invite experts and observers to participate in its meetings. (...) It will be consulted by the Commission when drafting legislative proposals on securities policy issues. (...) This Committee may also act as a regulatory committee in the context of work on future legislative proposals conferring implementing powers on the Commission. The Committee of European Securities Regulators (CESR) is composed of high-level representatives of the national public authorities competent in the field of securities. This Committee may invite experts or observers to participate in its meetings. (...) The CESR will advise the Commission on securities policy issues. After consulting the ESC, the Commission may mandate the CESR to prepare draft implementing measures.*

4.7 The directive on prospectuses

The directive on prospectuses is at level 2[21] with respect to the technical details of the various forms of prospectuses. The direction of the EC is clear. It is a system of complete mutual recognition. At this time, mutual recognition is only guaranteed when the prospectus includes the elements required by directive 80/390/ECE and the authorities of the host country may request additional information relating to their market specifics, including translation, which involves higher costs. Complete application (on level 4) of a European passport for an issue will imply automatic acceptance of the prospectus in all countries when it has been accepted in the country of origin. The language of drafting is independent of the authority of the country which is contemplated. It must be one recognized by the authority of the country which gives a final receipt in the case of an issue limited to the state of the head office. The prospectus may be drafted in the "usual language of international finance" in the other cases. For shares, the prospectus must be approved by the authority of the country of head office. For debt security, the authority

may be other than the country of head office for large issues if criteria of attachment exist. This is the case if the issue is registered in the host country.

The European visa system for prospectuses therefore goes further than the Canadian mutual reliance review system. There is effectively mutual recognition and reciprocal delegation of the power of review except, however, for small-scale issues. It remains to be seen, however, to what extent this system will in fact allow European offers and not international-style offerings. This depends on the wishes of countries to use provisions of general good justification. In theory, the quick application of the various directives should limit recourse to these provisions. In effect, a passport system can only function properly if the conditions of authorization are relatively similar in the different jurisdictions. Otherwise, a broker who is refused permission to do business in one jurisdiction could obtain a permit valid for the whole of the Community from a more compliant jurisdiction. FESCO, which became CESR, defined the minimum (not limitative) standards which are based on the principle that individuals who wish to offer financial services must meet high standards of integrity, ability and knowledge.

4.8 Control, legal proceedings and competition

The mutual recognition procedure poses significant problems with respect to law enforcement. The responsibility for supervision is divided between the state of origin which is primarily responsible under the ISD and the host state, which keeps important powers of enforcement for investor protection and integrity of the financial system. This problem is handled in two ways. Firstly, the directive sets out a hierarchy of responsibilities and interactions between the authorities of the country of origin and the host country. Secondly, a procedure of close cooperation and information exchange has been set up (Moloney, 2002, p. 409-416). Cooperation between countries and between various financial authorities in the same country is expressly provided for in the directive.

Competition between exchanges is a key element of upgrading the ISD[22]. The Community says: *With respect to global market efficiency, regulatory provisions directly*

limit competition between infrastructures which execute trades does not seem to produce, in terms of price, improvements which would justify such strong intervention in market structures to encourage execution on stock markets. A recent analysis of trading prices covering almost all shares traded in the main European stock exchanges has not in any way substantiated the hypothesis that concentration improves market efficiency (as measured by average ranges between actual buy and sell prices)[23]. There is thus a major difference in this respect between the Canadian and European situations.

5 CONCLUSION

Research studies and market observation allow us to argue that a regulatory monopoly is not necessarily preferable to regulatory competition, either in company law or securities. However, it is useful not to systematically oppose the two ideas and a certain form of competition is surely compatible with minimum harmonization. Besides avoiding the high cost of imposing uniform regulation on jurisdictions which do not wish to give up their prerogatives, this pragmatic approach allows for local adjustments and initiatives which may allow local or changing realities to be taken into account. This is the path taken by the European Community.

The European system of mutual recognition allows a certain form of competition but does not lead to the disappearance of local authorities, which several countries are currently strengthening. For example, in France, modernization of regulators has resulted in two new authorities: the *Autorité des marchés financiers* (AMF) and the *Commission de contrôle des assurances, des mutuelles et des institutions de prévoyance* (CCAMIP). For greater efficiency these authorities result from the merger of existing bodies. The AMF, in particular, is the result of the merger of the *Commission des opérations de bourse* (COB), created in 1967, the *Conseil des marchés financiers* (CMF), created in 1996, and the *Conseil de discipline de la gestion financière*, created in 1988. Its mission will be to protect savings invested in financial products, investor information and proper market operation. Europe seems to have adopted a position which reconciles a form of regulatory competition since certain jurisdictions may apply minimum standards and

others may require more. However, the minimal harmonization imposed prohibits the second group from refusing to allow intermediaries or companies located in the least stringent jurisdiction access to its market. Regulatory competition is therefore balanced by minimal standards, which limit the possibilities of a race to the bottom. This approach to harmonization for securities reflects a model of reciprocity and not convergence.

The reciprocity approach is based on the concept of respect for standards and regulations of other jurisdictions. To the extent that two or more jurisdictions have relatively similar principles in common, it is possible for them to accept, within the context of bilateral or multilateral agreements, that an entity which meets the requirements of the jurisdiction of origin also meets the requirements of the other jurisdictions. This mechanism can be set up based on minimum standards. For Warren (1990), the manner in which the EC has partially harmonized company and securities law to allow reciprocal recognition is an example of this pragmatic approach. This approach is applicable between jurisdictions which display, from the outset, similarities in terms of regulation. It has however been put in place in a European Community which is very diverse in terms of securities regulation and the role and responsibility of commissions[24].

Commonality requires the development of a body of equivalent or uniform rules which apply in all jurisdictions. In the securities field, these rules should include accounting and disclosure principles, insider trading, market manipulation, conflicts of interest and fraud (Warren, 1990, p. 191). The agreement in force between Canada and the United States (MJDS) is a reciprocal recognition system based on the establishment of substantially equivalent standards (Warren, 1990). This treaty operates almost unilaterally because shares of Canadian companies are traded on the American market whereas trades in Canada of American shares are extremely rare. Commonality does not necessarily require the disappearance of local jurisdictions. It seems however essential, in a non-homogenous body such as the EC, to maintain a degree of regulatory competition. According to Niemeyer (2001): *Thus, harmonization may very well improve the competition between different markets and agents. However, given the differences in legal system and regulatory tradition, harmonization is difficult. Furthermore, it may not even be*

desirable. First, individuals are likely to demand certain proximity in the regulation and supervision of securities markets. If this proximity is reduced, their confidence in the appropriateness and impartiality of the regulation and supervision may be hurt. Second, a far-reaching harmonization would reduce a healthy competition between different regulatory regimes. If the harmonized regulations are not open enough, they could easily curtail the development of new services and techniques. In the present non-harmonized regulatory situation, there are possibilities to compare how different regulatory structures handle different problems. There are therefore also possibilities to learn and over time improve the regulatory framework. In a fully harmonized world, this will be more difficult. As the pace of change in the markets increases, the need for regulatory change also increases. There is a clear risk that a fully harmonized regulatory system would be less flexible.

The issue of an adequate model of reciprocal delegation was debated at the 8th law symposium at Queen's University in 2001. Maykut (2001) presented this model as a reasonable and viable alternative to centralization proposals. For Maykut, this model recognizes *and makes the most of the political and constitutional realities of our country*. Maykut shows that the delegation of powers to securities commissions is in accordance with the Canadian constitution and points to the example of the MJDS, where a real delegation of power exists between the Canadian and American authorities. She presents inter-provincial delegation as a natural progression from the MRRS. She observes that this mutual recognition is at any rate becoming required between national jurisdictions because trades are becoming more and more frequently transborder. For the author, a condition precedent of setting up such a system is uniformity of legislation. The European experience shows, however, that uniformity is not an essential condition.

Minimal harmonization is certainly required, but perfect uniformity is neither an absolute condition nor probably a desirable situation. It would eliminate possibilities of innovation which are one of the advantages of regulatory competition. Anand (2001) opposes this proposal with the following arguments. Reciprocal delegation cannot be put in place without harmonization of provincial regulations. Anand then writes that "*uniformity can*

only be achieved with a national regulator in place". Two observations can be made. Firstly, a system of delegation can function without regulatory uniformity. Minimal harmonization is required, as the European example shows. Secondly, this harmonization may occur without a central authority even if it requires the creation of structures and mechanisms which bridge divergences between regulations of various jurisdictions. The Lamfalussy Report recommends onerous structures and a complex process which respond to the significant differences separating the regulations of European countries. The CSA already exists in Canada and its recent proposal for regulatory uniformity shows that harmonization may be attained without a national commission.

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Endnotes

[1] See Geiger (1997) or Perry (1994) for an analysis of these concepts with respect to securities.

[2] This is of course a simple illustration. A company will not benefit directly from regulation, for external reasons. For example, more stringent disclosure requirements may lead to greater confidence in the market, improve the situation of investors by reducing information imbalance and reduce the risk premium and thus the cost of capital for all companies.

[3] Pennsylvania, Ohio and Massachusetts

[4] These studies seek to measure the effect of an announcement on the market price of securities which are the subject of the announcement, taking into account other factors which may influence the price. In particular, the variation of the trading price is taken into account and the results of these studies are most often expressed in terms of excess return (as opposed to that of the reference index) still called residual.

[5] This common measure of the relative value is obtained by dividing the market value of the business by its adjusted book value, to take account of the replacement cost of its assets.

[6] Romano's analysis (2002) deals mainly with notions of disclosure, which ignores important aspects of securities regulation, notably those for intermediaries.

[7] The international extension of Romano's model will not be discussed here. See Tung (2003), or Ferrarini (2002).

[8] For an analysis of the heavy regulatory burden in the Canadian securities industry, See BCSC, 2002, "Making Securities Regulation Work for BC's New Economy", December.

[9] Before 1999, companies whose assets did not exceed $10 million and who had less than 500 shareholders, and whose shares were traded over the counter (OTC Bulletin Board) were not obliged to file the documents required by the SEC for other categories of issuers. The change made by the SEC in 1999-2000 has the same effect for these companies as the adoption of the *Security Exchange Act* of 1934 for large companies.

[10] This very illiquid and untransparent market in terms of price is available at the following address: http://www.nqb.com/.

[11] http://oldfraser.lexi.net/publications/forum/2000/07/section_04.html.

[12] European Commission, *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (Lamfalussy Report), 2001, http://www.europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf.

[13] According to Miville M. and A. Bernier (1999, p.4), "The Corporate Bond Market in Canada", Bank of Canada Review. In Europe, the bond market is used more to finance the wholesale business of large financial institutions.

[14] An analysis of the European situation cannot be made without defining the notions of subsidiarity and comitology. The EU is based on the principle of subsidiarity: it only applies where it is indisputable that common action will be more effective than action taken in isolation by one or two countries. Comitology is a community method of indirect administration. Under the treaty establishing the European Community, it is for the Commission to implement legislation at Community level. In practice, each legislative instrument specifies the scope of the implementing powers granted to the Commission and how the Commission is to use them. Frequently, the instrument will also make provision for the Commission to be assisted by a committee in accordance with a procedure known as "comitology". See: Glossary.-Brussels, European Commission, 1999, http://europa.eu.int/scadplus/leg/en/cig/g4000c.htm.

[15] This behaviour is consistent with the *race to the top* argument.

[16] http://europa.eu.int/comm/internal_market/fr/finances/mobil/2k-81.htm.

[17] http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0625en01.pdf

[18] Page 12 of the Lamfalussy Report (2001) shows a diagram of the current structure, which includes two committees: the Committee of European Securities Regulators, (CESR) and the European Securities Committee (ESC).

[19] http://europa.eu.int/comm/internal_market/en/finanCEs/mobil/01-213.htm#3.

[20] See on this topic page 52 of the Lamfalussy Report (2001).

[21] There are four levels of directives on securities regulation:

- Level 1: General directives which are limited to principles

- Level 2: Implementation steps developed by the Commission on the advice of an independent committee such as the CESR and approved by a committee of representatives of State members.
- Level 3: Recommendation, rules of conduct or standards issued by the CESR, in areas which are not specifically covered by the regulation.
- Level 4: Setting up of a Community law pursuant to decision of the European Commission.

[22] The new version of which is available at:
http://europa.eu.int/comm/internal_market/en/finances/mobil/isd/index.htm.

[23] Source: London Economics: 2002

[24] See Warren, 90, p. 195 on the absence of regulation and CESR, 2002.