Securities market regulation: international approaches

The organised interaction of buyers and sellers in securities markets serves three key purposes: price discovery, liquidity provision and the reduction of search and information costs. In a world of perfect markets and perfect competition, there is no welfare-theoretical justification for intervention in market mechanisms – but the story is altogether different if these conditions are violated. Reasons to justify such regulations include investor protection, enhancement of the markets' ability to function and the safeguarding of systemic stability.

Central banks have an interest in securities market regulation issues particularly because of their core task of safeguarding purchasing power and financial stability. In a "global village", regulation is at once in a (financial centre) competitive situation yet is increasingly being conducted in a framework of international cooperation. Rulemaking in the European Union is dedicated to the creation of a single market for financial services.

This article discusses reasons for regulation and describes the principles, forms and development trends of securities market regulation. It also provides an overview of key national and international players in securities regulation.

Reasons for regulation

Aims of regulation

If securities markets perform their intended functions (to reach an equilibrium, ie a market-clearing price; to provide selling and buying opportunities, ie liquidity; and to reduce transaction costs) efficiently, ie at the lowest possible costs, there is no (or at least no exclusively welfare-theoretical) justification for public intervention. The conventional justification for regulation is therefore that, because exchanges on securities markets lead to external effects (for non-participating and therefore non-considered third parties), there is a public interest in protecting potentially disadvantaged parties for reasons of market structure (the number and size of sellers, economies of scale and network effects) and owing to information asymmetry. In this light, the regulation and supervision of securities markets is important for investor protection, the safeguarding and maintenance of a functioning competitive framework and the prevention of potential systemic risks.

Markets that adequately fulfil their functions of price discovery and ensuring opportunities for competitive trading promote – in competition with financial institutions – the efficient allocation of capital. Consequently, economic resources are deployed appropriately and risk is assigned to those parties who are best able to bear it. This represents the optimum utilisation of an economy's growth and employment potential.

Role of markets

The markets' role in price discovery is particularly important for allocative efficiency: under optimum conditions, a price that establishes an equilibrium between the supply of and demand for financial assets reflects all the information relevant to its assessment. If all market players are price takers (ie do not have any market power) and markets exist for all goods or environmental conditions, decentralised management through relative prices is able to bring about the optimum coordination of all activities. No other allocation of resources that could improve the welfare of consumers or producers without being disadvantageous to one of the parties is conceivable.

Market imperfection

Real markets, however, are not quite so perfect: in these markets, the obtaining and processing of information is not free, transactions consume resources and goods are exchanged at non-equilibrium prices.[1] The first two aspects are particularly relevant to securities markets. Financial markets – like financial institutions – exist precisely because information is incomplete and because the execution of transactions in these places is not cost-free. The economics of information, which is widely applicable to the financial markets, therefore eases the rigorous assumptions about information requirements and market perfection.[2] It thus allows the consequences of imperfect or even non-existent markets

1 See T Gehrig (1993), Intermediation in Search Markets, in *Journal of Economics and Management Strategy*, pp 97-120. Gehrig explains the coexistence of very different price discovery mechanisms in real markets, in which there are costs associated with finding trading partners. He distinguishes between search markets where trading partners come into direct contact (housing markets and bazaars) and intermediated markets in which middlemen organise price discovery.
2 See eg B Nalebuff and J Stiglitz (1983), Information, Competition, and Markets, in *American Economic Review*, Vol 73, pp 278-284 or B Greenwald, J Stiglitz and A Weiss (1984), Informational Imperfections in the Capital Markets and Macroeconomic Fluctuations, in *American Economic Review*, Vol 74, pp 194-199.

and of asymmetric information to be addressed. Hence, it provides an appropriate perspective as a relevant and viable yardstick for setting rules for governing securities markets. Therefore, the main practical issue is to use regulation and supervision to create the conditions under which securities markets can effectively fulfil their intermediary role – with due consideration to the true characteristics of real markets.

Safeguarding liquidity

The price discovery process is facilitated by liquid markets. Liquidity represents the opportunity of finding – at a reasonable cost – a trading partner at any time, ie to trade in large amounts without biasing the price against oneself (called "market impact", ie a price markdown owing to large orders requiring rapid execution). Liquid secondary markets enable investors to divest themselves of their securities at low cost in the event of funds being needed unexpectedly. Liquid securities markets therefore, at the same time, increase willingness to invest in such paper in the first place. Thus, the main objective of regulation efforts is to lend support to the structural framework that can ensure deep, broad and robust – in short, liquid – markets.

Liquid markets, however, do not guarantee that the discovered price actually matches the fundamental value. A market may thus be able to balance supply and demand at very low costs – therefore being technically or operationally efficient – without simultaneously being able to ensure that the discovered price accurately reflects all of the economically relevant factors.[3] Such deviations between technical/operational and fundamental efficiency are, at the same time, a sign of potentially considerable mispricing which – in the event of an abrupt return to more fundamentally justified valuations – can also cause financial stability problems.

Effective information processing

Information asymmetry between investors and borrowers is a systemic feature of financial markets. However, this is associated with problems relating to their proper functioning. The disclosure requirements which issuers, especially those in primary markets (see, for instance, the Prospectus Directive adopted by the EU), must meet, are intended to allow investors to form an opinion that would be unfeasible in the absence of such information. However, total transparency is not possible. Under certain circumstances, it would even be fraught with difficulties. That much is obvious at the individual level. This is evidenced, for instance, by the objections of secondary market players to the disclosure of consolidated order books. Were the latent demand of investors to become known, this would undermine intermediaries' business models and could, in macroeconomic terms, lead to reduced liquidity, thus causing an increase in both transaction costs and price dispersion.[4]

Avoiding market power

Finally, the structure of a number of securities markets deviates from ideal competitive conditions.[5] For instance, although there are

3 See J Tobin (1984), On the Efficiency of the Financial System, in *Lloyds Bank Review*, pp 1-15.
4 See A Madhavan, D Porter and D Weaver (2005), Should Securities Markets Be Transparent?, in *Journal of Financial Markets*, Vol 8, pp 266-288.
5 These include not only the (public law) stock exchanges but also other securities markets such as alternative or electronic trading platforms or over-the-counter (OTC) markets, in which institutional investors, in particular, are active.

fewer and fewer vendors on the stock exchanges, they are becoming larger and larger. The barriers to entry are high (owing to high overhead costs and the resultant economies of scale). The same applies to the infrastructures on which the securities markets are based, such as the payment and settlement systems used for providing securities services. These systems, too, are characterised by considerably degressive overhead costs. In addition, their attractiveness generally increases commensurately with the number and volume of transactions conducted through them, ie network externalities exist. These, too, promote the concentration of securities trading on a few markets and platforms. In the world of stock exchanges, such a trend towards agglomeration has been evident for some time. In most countries, this trend has intensified to the detriment of regional financial centres – particularly due to improvements in information technology. This technology makes it possible to deal in information-sensitive financial assets more cost-efficiently, thereby leading to implicit standardisation.[6]

Consequently, the few remaining sellers could exploit their market power to the detriment of buyers and, possibly, have less incentive for innovation and technological progress.[7] The positive effects of concentrating market liquidity on a few platforms, however, include the more rapid execution of trades and the improved possibility of buying or selling major holdings of securities at largely stable prices. Focusing on one or only a very few networks, however, is not the only way to exploit economies of scale. Alliances and cooperation agreements among diverse marketplace operators could create the abovementioned positive externalities.[8] Competition between the trading systems of several marketplaces also holds out the promise of potential advantages in the form of lower costs, extended trading hours and greater product variety. To that extent, another regulatory aim could be to ensure robust variety, which ultimately serves to maintain competition and to keep monopolistic structures under control.

Limitation of systemic risks

An additional justification for securities regulation is the limitation of systemic risks. Such crises can cause considerable damage to the real economy. Regulatory intervention is therefore aimed at limiting the systemic risks on the markets. Effective securities market regulation therefore promotes market integrity and enhances the stability of the financial system.

Principles of regulation

Principle of effectiveness, ...

Regulation is obviously not an end in itself. The regulatory framework therefore has to be assessed in terms of its effectiveness. It must be operationally efficient, ie fulfil the desired

6 See T Gehrig (2000), Cities and the Geography of Financial Centers, in J-F Thisse and J-M Huriot (eds), *Economics of Cities*, Cambridge University Press, pp 415-445.
7 For information on current trends in the securities market network infrastructure in Europe, see Securities trading, clearing, central counterparties and settlement in EU 25 – an overview of current arrangements, Report by London Economics, commissioned by the Competition Directorate General of the European Commission, 30 June 2005.
8 See I Hasan and H Schmiedel, Do networks in the exchange industry pay off? European evidence, Bank of Finland Discussion Papers, 2/2003.

functions. The best reflection of the quality of effective securities regulation is the extent to which it ensures a functioning market mechanism.

... cost efficiency, ...

The benefits of regulation have to be compared with the costs, as regulation ties up resources on the part of both the financial industry and supervisors. It generates costs which are ultimately passed on to the market players. In addition, opportunity costs are created if market players' preferences are met either only partially or not at all, or if innovation is hampered. This is a danger that generally exists in an overregulated environment. Although, in practice, it is difficult to carry out a cost-benefit analysis, it is an indispensable element of a sound regulatory framework.

... competitive neutrality ...

In addition, regulation ought to be competitively neutral as a general rule. It should create equal competitive conditions for all market players without giving preferential treatment to or discriminating against any given player. Regulators should also avoid rules that set up barriers to entry or other competitive hurdles which hamper innovation or permit entrenched monopolistic revenue.

... and accountability

Finally, regulators have to carefully assess the implications of securities market regulation, starting with national markets but also looking at cross-border activities. In a world of internationally integrated markets, these two dimensions are inseparably linked. Regulators and supervisors should be required not only to conduct a cost-benefit analysis – both before and after a regulatory measure – but also to meet stringent transparency standards. Such an approach can help to reveal unnecessary regulation and thus to introduce deregulation measures.

Forms and development trends of regulation

Statutory regulation versus self-regulation

The regulatory framework for securities markets is, in principle, based on two different forms. Under statutory regulation, the state directly influences the market by prescribing rules for the market to follow and by conferring upon a supervisor, ie a government authority, the powers necessary to monitor and enforce compliance with these rules. This contrasts with self-regulation, in which market players independently monitor compliance with rules which they have agreed among themselves and undertaken to follow.[9] This is often complemented by framework conditions developed by a government supervisor. Self-regulation makes use of market players' expertise in financial market issues. It is thus also able to react more flexibly and quickly to market developments. A stated justification for self-regulation is also that the "securities industry" has a vested interest in functioning markets and protecting its reputation. Self-regulation can also pre-empt or even avoid statutory regulation. Moreover, self-developed standards can serve as a guideline for statutory regulations. One of the dangers of self-regulation, however, is that established market operators can seal off their markets,

9 See P Howells and K Bain (2004), Financial Markets and Institutions, Harlow, p 363.

thereby setting up barriers to new entrants. Even more, self-regulation (of service providers) has also, at times, been exploited at the customers' expense.[10] Securities regulation in most countries is therefore based on a combination of the two forms of regulation, though the specifics vary from one country to another.

Importance of self-regulation

The importance of self-regulatory bodies in setting down the framework conditions for the regulation of securities markets varies considerably in an international comparison. Whereas they are rather significant in the United States, they do not play any role in the United Kingdom and are hardly of any importance in Germany. In the EU, priority is given to the statutory approach to regulation. This is reflected especially in the implementation of the 1999 Financial Services Action Plan. In December 2005, the Commission, following a round of consultation, presented the basic elements of its financial services policy for the next five years.[11] The main feature of this strategy is that new statutory regulation initiatives are envisaged for only a few areas (such as the retail markets). Moreover, all new legislative projects must comply with the principles of "better regulation", which attach major importance to, *inter alia*, the accountability of regulators.

Total harmonisation versus minimum harmonisation

Until the mid-1980s, efforts were made in the European Community to achieve total harmonisation of national capital market legislation, but failed owing to the resistance of the member states. Total harmonisation was unable to do sufficient justice to the special characteristics of national markets and did not appear to be politically appropriate for protecting the markets.[12] As early as 1979, the European Court of Justice, in its "Cassis de Dijon" judgment, determined that the Treaty of Rome implicitly contains the mutual recognition of national laws; total harmonisation was therefore not a prerequisite for the establishment of the European Internal Market.[13] This heralded a change in outlook from the total harmonisation approach to the principles of minimum harmonisation and mutual recognition. The Commission can set minimum standards for areas in which harmonisation is regarded as being necessary. At the same time, competition for cross-border financial products has been facilitated by the introduction of the "European passport". With this more casuistic and pragmatic approach, the European Commission is seeking to create the conditions for

10 Collusion to the detriment of investors can often occur even in the absence of institutional conditions; one example is the 1995 NASDAQ price-fixing scandal which, in the end, led to a decimalisation of pricing (formerly pricing in ⅛ increments). See W Christie and P Schultz (1995), Did Nasdaq Market Makers Implicitly Collude?, in *Journal of Economic Perspectives*, Vol 9, pp 199-208.
11 White Paper – Financial Services Policy 2005-2010, 5 December 2005.
12 The European Community already made attempts to harmonise national capital market regulation in the EU/EC countries in the 1960s and 1970s. The 1957 Treaty of Rome enshrined the dismantling of non-tariff trade barriers and the promotion of the free trade of goods and services (including financial services) between the member states. The Treaty of Rome originally envisaged the principle of "host-country regulation". However, this principle tended rather to entrench the continued existence of fragmented and inefficient financial markets, as the individual EU countries often used the available legal and supervisory scope to shield their home markets from competition. See P Howells and K Bain (2004), *loc cit*, pp 378 ff.
13 In addition, a Commission White Paper on Completing the Internal Market (the "Cockfield Report") published in 1985 proposed introducing the principle of home-country regulation, which was enshrined a year later in the Single European Act. See P Howells and K Bain (2004), *loc cit*, pp 380-381.

the gradual realisation of a single internal market for financial services in Europe (see also page 46, "Financial Services Action Plan").

Regulatory competition: minimum standards ("race to the bottom") versus ...

Regulatory policy is a key locational factor. The globalisation of financial markets has made it possible for investors and capital-seeking companies to switch to lightly regulated or completely unregulated markets. This opt-out option has led to displacement competition between different regulatory systems (known as "regulatory arbitrage"). If regulatory requirements involve high financial and staff input for regulated parties, market players have a strong incentive to switch to countries with less regulation and thus lower costs. On the same vein, potential host countries have an incentive to reduce the relative intensity of their regulations in order to attract capital and business. Countries' efforts to outdo each other in reducing regulatory standards can trigger a downward spiral, also known as a "race to the bottom", at the end of which only minimum regulatory standards, at best, can be enforced, making market events increasingly opaque and risky. These problems are, for instance, at the heart of the current international debate on how to properly supervise the hedge fund industry.

... maximum standards ("race to the top")

In contrast, it is also possible to imagine a "race to the top", in which the regulatory system with the highest standards wins the day. If the benefits of participation in the more heavily regulated market at least make up for the costs involved, market players will accept the stricter regime, for example, the

Two angles to regulation

There are two different approaches to explaining government regulation. One explanation for regulation is as the government's aforementioned reaction to functional deficits. This normative view contrasts with the positive theory of regulation ("capture theory"), which ultimately sees the regulatory framework as being the result of a "market for regulation". [1] This theory indicates that it is difficult, in many cases, to pinpoint a public interest that can be protected by the regulatory framework. It also draws attention to the fact that the state is apparently also quite capable of failure. Capture theory imputes a direct interest on the part of particularly affected market players for regulation that is to their advantage (demand for regulation). The real architects of regulatory structures are therefore identified as being individual players, especially financial market players, who call for regulatory intervention – often as protection against market access and additional competition.

1 Stigler's work, in particular, has been seminal in this field. See, for instance, G J Stigler (1971), The theory of economic regulation, in *Bell Journal of Economics and Management Science*, Vol 2(1), pp 3-21.

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Sarbanes-Oxley rules.[14] When implementing comprehensive regulations, countries with especially large and attractive capital markets – in terms of both production and distribution – are at an advantage. They thus take the lead in setting standards. Financial market players from other countries wanting to tap into or keep their foothold in these markets accordingly have an incentive to subject themselves to these regulatory standards. A high standard of regulation can also be regarded by investors as an advantageous sign of quality. More weakly regulated markets could then feel pressure to tighten their own regulatory standards in order to maintain or regain their competitiveness.

National and international securities regulation agents

Regulation in the force field of internationalised securities markets

The regulation of a market for trading securities evolves as a result of the constant interaction of industrial and market structures and associated regulatory measures. To that extent, the status quo of a financial system's securities regulation framework also always mirrors this financial system's historical development and particular structural features.[15] The increasing integration of securities markets is not without consequences for the regulation of these markets and the organisation of such regulation. Internationally active financial service providers and issuers are confronted with numerous national rules and regulations. National securities regulations should therefore be implemented in the light of international developments and needs.

Creating a "level playing field"

The elimination of barriers to the cross-border exchange of financial services and the creation of a "level playing field" for the production and distribution of financial products is important for the efficiency of the financial markets and thus, above all, for their users, ie investors and capital seekers. For EU countries, securities regulation has been increasingly shifting to the European level. This has resulted in ex ante coordination, which is expedient owing to the ever-advancing integration of European markets. European rules, however, could lead to implicit locational effects for national markets. The safeguarding of the stability of the securities markets is thus no longer a task for national supervisors alone.

Regulation in Germany

The regulatory framework of the German financial system and thus also of the securities markets in Germany is increasingly being defined at the European level. One such way is through regulations that enter into force directly and another is through directives that must be transposed into national law (see below regarding the regulatory process in Europe). The framework for German exchanges, however, is still provided largely nationally. Owing to the historical fragmentation of the German stock exchange land-

14 The US Sarbanes-Oxley Act, passed in 2002, was developed as a response to a number of accounting scandals. Among other things, the Act tightened the disclosure requirements in corporate reporting and extended the obligations of external auditors. It applies not only to listed US companies and their foreign subsidiaries but also to foreign companies listed on a US stock exchange or the NASDAQ.
15 See T Theurl (2003), Internationale Finanzmarktregulierung: Begründung und Institutionalisierung, in T Eger (ed), *Institutionen und wirtschaftliche Entwicklung*, Berlin (*Schriften des Vereins für Socialpolitik, Neue Folge* Vol 298), pp 219-240.

scape, the stock exchange and securities supervision systems in Germany were highly decentralised for a long time. This also applies to the vast majority of other national stock exchange systems, however.[16] Only since 1995 has securities supervision been conducted at a Federal level. The regulatory and supervisory tasks are currently performed in a three-pronged system by the Federal Government, the states and each stock exchange's self-regulatory institutions.

At the Federal level, securities supervision is the domain of the German Federal Financial Supervisory Authority *(Bundesanstalt für Finanzdienstleistungsaufsicht,* or BaFin). BaFin was created through the amalgamation of the Federal Banking Supervisory Office *(Bundesaufsichtsamt für das Kreditwesen,* or BAKred), the Federal Supervisory Office for Insurance Enterprises *(Bundesaufsichtsamt für das Versicherungswesen,* or BAV) and the Federal Supervisory Office for Securities Trading *(Bundesaufsichtsamt für den Wertpapierhandel,* or BAWe) in May 2002, and reports to the Federal Ministry of Finance. As one of the predecessor agencies, BAWe was established by the Second Financial Market Promotion Act *(Zweites Finanzmarktförderungsgesetz)* of 1994 and given responsibility for supervising German securities markets with effect from 1 January 1995. This was the first time that the Federal Government had been given the power to supervise securities trading.[17] The legal and market supervision[18] of stock exchanges,[19] and thus of trading on stock exchanges, however, is still within the remit of the respective Federal states. Supervision of exchanges is the responsibility of each respective state's finance ministry or ministry of economic affairs.

The exchanges' self-regulatory bodies are an additional element of German exchange and securities supervision. Each exchange issues a set of stock exchange rules and regulations which it presents to the state supervisor for approval. Moreover, exchanges are required to set up "Trading Surveillance Offices" *(Handelsüberwachungsstellen)*, whose task is to independently monitor the trading and settlement of trades at the exchange. If problems occur, they inform the stock exchange supervisory authority and the exchange management, of which they are independent. The Trading Surveillance Offices are a hybrid of statutory regulation and self-regulation.

Regulation in the United Kingdom

Financial market regulation in the United Kingdom has changed profoundly in the past two decades.[20] By tradition, the system was based strongly on self-regulation by exchanges and organised market players (ie reputation-based supervision). Although the

16 See T Gehrig (2000), *loc cit*.
17 By contrast, BAKred, which was created in 1962, was solely responsible for supervising market entry and the solvency of credit institutions and financial services institutions, and thus for ensuring the functional viability of the German banking system.
18 Legal supervision means monitoring compliance with existing rules and regulations under stock exchange law. Market supervision means checking to ensure that stock exchange trading is being conducted properly in accordance with the terms and conditions of business, established trading practices and the stock exchange rules and regulations.
19 Cash exchanges include those in Berlin-Bremen, Düsseldorf, Frankfurt, Hamburg, Hanover, Munich and Stuttgart. In addition, the "Warenterminbörse Hannover" (Hanover Commodity Exchange), the European Energy Exchange in Leipzig and the German derivatives exchange EUREX are monitored.
20 For an overview of the evolution of financial market regulation in the United Kingdom see, for instance, P Howells and K Bain (2004), *loc cit*.

state provided a framework, it did not constantly intervene. Regulators, however, always reserved the right to intervene at their discretion. The increasing internationalisation of financial markets, the growing importance of new financial products, communication technology innovations, as well as several financial scandals in the United Kingdom in the mid-1980s all paved the way for the "big bang", which led to a much more rule-based securities regulation framework in the United Kingdom.[21] The Financial Services Act of 1986, which entered into force on 29 April 1988, was intended to create a modern, more competitively-oriented regulatory system. The main supervisory authority created by the Act, the Securities and Investments Board (SIB), entrusted several self-regulatory organisations (SROs) with the task of supervising the respective markets. However, some of the individual SROs' spheres of responsibility overlapped and SROs competed with each other for members. Owing to apparent and serious supervisory deficits, further profound changes in the United Kingdom's securities regulation were implemented in May 1997. The principle of self-regulation was jettisoned in favour of statutory regulation. To that end, the Financial Services Authority (FSA) was created to succeed the SIB with effect from 1 June 1998. Until the FSA completely assumed its regulatory powers at the end of 2001, the existing organisations continued to perform their previous tasks. In parallel, the Bank of England Act of 1998 transferred responsibility for supervising the banking system and the interbank money market from the Bank of England to the FSA. The FSA completely assumed its regulatory powers through the Financial Services and Markets Act (FSMA) in 2000. The FSMA gave the FSA four regulatory objectives: the creation and maintenance of market confidence, public awareness, consumer protection and combating financial crime. Since autumn 2004 the FSA has also been responsible for regulating the mortgage market and, since January 2005, for supervising general insurance business. The FSA is thus evolving more and more into a cross-sector supervisor. It maintains an intensive dialogue with market participants and involves them in the decision-making process through, for instance, consultation procedures.

Regulation in the USA

The regulation of the US securities markets by tradition stresses the principle of self-regulation. However, since the 1930s, ie following the banking and stock exchange crisis, the government has also issued distinct framework regulations. The leitmotif of securities regulation in the United States is to ensure that an investor has all the information about the issuing company and the markets that he needs to make an independent investment decision. Another feature that is distinctive of the USA is the large number of agencies involved in the regulation and supervision of the securities markets. Exchanges in the United States – against the background of the framework rules laid down by the Securities and Exchange Commission (SEC)[22] and the Commodity Futures Trading Commis-

21 See G Bishop (2001), Die Regulierung oder Selbstregulierung der Finanzmärkte, in C Randzio-Plath (ed), Zur Globalisierung der Finanzmärkte und Finanzmarktstabilität: Herausforderungen für Europa, Baden-Baden, pp 101-116.
22 The SEC was established by the Securities Exchange Act (SEA), which was adopted in 1934 in response to the Great Depression and numerous cases of securities fraud.

Overview of how regulation is organised

Item	Germany	United Kingdom	USA
Regulatory model	Central government regulation with involvement of Federal states; SRO elements	Government regulation	Central government regulation with private sector involvement (SROs)
Responsible authority	German Federal Financial Supervisory Authority (BaFin), each state's stock exchange supervisory authority	Financial Services Authority (FSA)	Securities and Exchange Commission (SEC), state authorities, Commodity Futures Trading Commission (CFTC)
Cross-sector supervision	Yes	Yes	No
Self-regulatory organisations	Yes (exchanges, especially Trading Surveillance Offices)	No	Yes, substantial involvement (exchanges, associations)
Regulatory philosophy	To ensure market transparency and integrity		
Accountability	Federal Ministry of Finance	Treasury	Congress

Source: Based on S Lütz (2002), Der Staat und die Globalisierung von Finanzmärkten: Regulative Politik in Deutschland, Großbritannien und den USA, Campus Verlag (Schriften des Max-Planck-Instituts für Gesellschaftsforschung Köln, Volume 43), p 250.

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sion (CFTC) – are SROs which are responsible for laying down the specific rules and regulations under which exchanges and market players operate. They are also responsible for the proper conduct of securities trading and for sanctioning violations of the stock exchange rules and regulations. Along with the registered exchanges as SROs, the National Association of Securities Dealers (NASD) also plays a key role. As a self-administrative body, the NASD supervises the NASDAQ[23] electronic exchange (to which it was closely linked until 2000) and the over-the-counter (OTC) markets as well as the persons active in the securities industry. It defines standard trading practices and monitors brokers and dealers.[24] The task of the SEC, which is a federal supervisory agency (with a mandate from the US Congress), is to constantly monitor the functioning of this self-supervision and, if necessary, to intervene in stock exchange activities for regulatory purposes.[25] The SROs are responsible for fleshing out the details of what constitutes permissible trading practices. Although the SEC has thereby delegated part of its control and steering functions, it still reserves the right to supplement or amend existing trading rules. If an SRO wants to amend any rules, these amendments have to be submitted to the SEC for approval. New securities have to be registered with the SEC

23 National Association of Securities Dealers Automated Quotation System.
24 Since the 1934 Securities Exchange Act did not contain any provisions governing the OTC market, in 1938 Congress passed the Maloney Act, which extended the scope of monitoring to the previously unsupervised OTC market. The NASD was established on the basis of this Act.
25 The securities clearance and settlement agencies are also SROs and are, therefore, registered with the SEC.

prior to issue and the SEC checks for compliance with the formal rules regarding the information to be disclosed. Securities traders (brokers and dealers) are also required to register with the SEC before they are permitted to conduct securities transactions. As a Congressional commission, the SEC is also required to report to Congress on a regular basis and to apply for a renewal of its mandate. Additionally, each US state has its own securities supervisory authority, which regulates intra-state securities trading and has its own regulatory and sanctioning powers. However, the provisions of an individual state apply only to securities trading within that state, not to trading between states. The financial and commodity futures markets and exchanges are regulated and supervised by the Commodity Futures Trading Commission (CFTC), which is a federal commission comparable to the SEC; the SRO approach is pursued here as well.

Regulation at an international level: the International Organization of Securities Commissions (IOSCO) ...

Given the increasingly global nature of securities markets, regulatory authorities are increasingly cooperating at the level of international organisations. The International Organization of Securities Commissions (IOSCO) is an international association of national securities regulators, SROs and exchanges from all over the world. In September 1998, IOSCO adopted and published the "Objectives and Principles of Securities Regulation".[26] These comprise 30 principles relating to three primary objectives of securities regulation and supervision: investor protection; market fairness, efficiency and transparency; and the limitation of systemic risk. These principles apply to rule-making supervisory authorities and – where nationally applicable – to self-regulatory bodies. They relate to the enforcement of rules (by supervisors), cooperation and the exchange of information between supervisory authorities, the obligations of securities issuers, fund business, the requirements for market participants and intermediaries, and the licensing and monitoring of exchanges and other trading systems. These objectives and principles stipulate, for instance, that rule-making supervisory authorities should be independent of external political and economic influences and should be individually accountable. They should also be given extensive powers of investigation and supervision.

... issues recommendations

As a voluntary association of national authorities, IOSCO can only issue recommendations; however, market discipline is quite capable of giving these recommendations the character of regulations. In 2003, IOSCO therefore adopted a comprehensive methodology for a criteria-based, graded assessment of the status of implementation of IOSCO principles in the individual jurisdictions, which can also serve as a basis for the development of practical action plans to remedy deficits. There are two main purposes behind the detailed specification of the individual principles and the setting of benchmarks: to make self-assessment easier for jurisdictions, and to serve as tools to be used by the World Bank and the IMF in their Financial Sector Assessment Programmes, with which they, for example, assess the quality of supervisory structures in individual countries.

26 These were modelled on the IOSCO "Principles for the Oversight of Screen-Based Trading Systems" of 1990.

At EU level: the Financial Services Action Plan

The comprehensive package of measures contained in the Financial Services Action Plan (FSAP) of 1999 is a reflection of the political will to press ahead with the creation of a single internal market for financial services within the European Union.[27] This action plan, created to harmonise the legal framework, is a milestone in the process of European integration and accordingly triggered high expectations. With an agreement on the transposition of the regulatory capital requirements for banks and financial services providers ("Basel II") into European law having been reached between the EU Council and the Parliament in autumn 2005, the action plan has now largely been completed.

Lamfalussy procedure

The Lamfalussy procedure was introduced as a procedural innovation for implementing selected legislative initiatives from the past few years. The intention was to remedy the shortcomings of the previous legislative process (the "co-decision procedure"[28]), which was regarded as too unwieldy, inflexible and imprecise for keeping up with current developments in the securities sector.[29] This procedure has been used to adopt securities regulation legislation since 2002.

MiFID: a case in point

A total of four legislative items of the action plan have been processed using the Lam-

27 See Deutsche Bundesbank, Regulation of the European securities markets, *Monthly Report*, July 2004, pp 33-48.
28 Pursuant to Article 251 of the EC Treaty: a Commission proposal to the Council of Ministers and the European Parliament, both of which decide independently and on equal terms.
29 See Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, p 21.

Lamfalussy procedure

The "Committee of Wise Men", chaired by Alexandre Lamfalussy, presented its final report on the regulation of European securities markets on 15 February 2001. Its recommendations included a reform of the legislative process through the introduction of a four-level procedure.

– At level 1, the member states (the Ecofin Council) and the European Parliament make fundamental political framework decisions and define the scope of implementing powers.
– These framework laws are fleshed out by implementing measures at level 2. The Commission works together with specially convened committees – in accordance with the comitology procedure developed by the Committee of Wise Men. For securities regulation, these are the Committee of European Securities Regulators (CESR) and the European Securities Committee (ESC), the latter comprising representatives of national governments. After consulting the CESR, the Commission proposes measures on which the ESC then votes. The Commission, in turn, adopts the measures.
– At level 3, the CESR develops common guidelines and recommendations on the national implementation of European legislation. This is to ensure consistent interpretation and application of the rules through coordination and cooperation among national regulatory authorities.
– At level 4, the Commission verifies the accurate and timely transposition of EU legislation into national law.

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falussy procedure since 2002.[30] Two of these projects – the Markets in Financial Instruments Directive (MiFID) and the Transparency Directive – are still pending implementing measures, which need to be adopted by the Commission upon a proposal by the European Securities Committee (ESC) and following consultations with the Committee of European Securities Regulators (CESR). In the case of the MiFID, CESR provided the Commission with numerous proposals for implementing measures in February and May 2005; it did the same for the Transparency Directive in June 2005. It is now up to the Commission to develop and adopt, in conjunction with the ESC, concrete legal acts (regulations or directives) in level 2 of the Lamfalussy procedure. The Commission is not bound by CESR's original proposals but will generally base its measures on these proposals. Although several comprehensive rounds of consultation – targeted primarily at market players, associations and the public sector – were already held by securities supervisors prior to the finalisation of the CESR proposals, the Commission has decided to conduct additional rounds of consultation before adopting measures to implement the MiFID.

Lamfalussy procedure in its test phase

It is still too early for a final assessment of the Lamfalussy procedure since only a very small number of legislative projects have been completed using this procedure. The checking of implementation at level 4, in particular, has only just begun. What is indisputable, however, is that the Lamfalussy procedure has strengthened cooperation among the national supervisory authorities and involves market players in the legislative procedure through intensive consultations. It is not possible to assess conclusively, however, the extent to which the Lamfalussy procedure has made the European securities legislation process faster and more flexible. Initial experience has shown, however, that the legislative process can still be time-consuming even using the Lamfalussy procedure. In November 2005, the Commission put forward a proposal for a directive[31] moving the deadline for the transposition of the MiFID into national law from April 2006 to October 2006; the new rules do not even have to be applied until 1 May 2007. This means that the MiFID will not come into effect until at least three years after the level 1 rules were passed – provided transposition into national law is actually accomplished within the (extended) deadline.[32] The complex nature of the material, as well as controversy about the content of the rules, especially the specific shape of the transparency requirements and the code of conduct, are factors behind the amended deadline. In addition, market players have indicated that the involvement of the regulatory committees

30 In 2003 and 2004, the following level 1 measures were adopted: the Market Abuse Directive (2003/6/EC) of 28 January 2003; the Prospectus Directive (2003/71/EC) of 4 November 2003; the Markets in Financial Instruments Directive (MiFID) (2004/39/EC) of 21 April 2004, and the Transparency Directive (2004/109/EC) of 15 December 2004. In March 2004, a directive extending the Lamfalussy procedure to the fields of banking, insurance and investment funds was adopted.
31 Proposal for a directive of the European Parliament and of the Council amending Directive 2004/39/EC on markets in financial instruments, as regards certain deadlines (COM(2005) 253 final).
32 Delays in the transposition into national law of EU directives by member states has provoked criticism time and again. For instance, the Prospectus Directive was transposed into national law in only 5 of the 25 member states by the 1 July 2005 deadline; Germany was one of these 5 countries.

(ESC, CESR) has led to a certain fragmentation of the legislative process. Although the – at times – comprehensive consultation papers give the institutions and associations concerned an opportunity to get involved, they also tie up considerable resources.

Conclusion

Securities markets make an important contribution to the integration process and the momentum of economic growth. There is a general consensus that securities markets need to be regulated as well as extensive agreement about the aims and principles of such regulation. The regulatory framework must be adapted to both the market structure and market developments, and must be continually refined. Flexible regulation enhances competitiveness and thus contributes to financial stability. In view of financial market globalisation, it has for a long time already been impossible to regulate from a purely national perspective. After all, the competition between financial centres runs parallel to the competition between regulatory systems. In order for locations to survive in this competitive environment, the level of regulation and its degree of restrictiveness in the various economic areas will tend to converge. In this process, one element that will need to be checked is whether regulatory goals can be achieved more efficiently through self-regulation or statutory regulation. Another major issue for discussion is the extent to which the international coordination of regulatory measures and bodies is better suited to meeting challenges which are similar the world over than if nations either act alone or restructure their supervisory regimes.