Harmonization of International Securities Markets Regulation: A Trade Perspective

by

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A thesis submitted in conformity with the requirements for the degree of Master of Laws

Faculty of Law
University of Toronto

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2012

Abstract

Widespread cross-border securities trading have led to the internationalization of securities markets. No one seriously disputes that such securities dealings require regulation, but there is no academic consensus on the best normative approach to such regulation. The academic debate initially focused on whether regulatory competition or cooperation constitutes the better model. However, the debate seems to have evolved to adopt a hybrid model combining the virtues of these two approaches. ‘Harmonization’ constitutes the dominant hybrid model. Nevertheless, the implementation of the harmonization model has barely received any attention in the literature.

The aim of this thesis is hence two-fold: first, justify why harmonization should be the preferred model for the regulation of international securities markets; and second, develop, applying an international trade regulation perspective, a regulatory framework to implement the harmonization model using the World Trade Organization and General Agreement on Trade in Services (WTO/GATS) framework.
To my mother, my wife Nisha, my daughter Jeeya and the impending member of my family
Acknowledgments

This thesis marks the end of my current passage at the University of Toronto. My experience at the Faculty of Law has exceeded all expectations. I have been impressed by the level of education and the diversity of the Master of Laws class.

I wish to express my gratitude to Professor Anita Anand, my Faculty Supervisor, for her continuous support during the writing process. I also wish to place on record my recognition to Professor Michael Trebilcock for his insightful comments on chapter 5 of this thesis. Likewise, Hambyrajen Narsinghen (Trade Representative at the Permanent Mission of Mauritius in Geneva, Switzerland and Consultant for the WTO) has been of considerable assistance on chapter 5.

It has also been a great pleasure to receive comments, reviews and advice from Rommel Salvador (my SJD Advisor), Lorenzo Bonera (fellow LLM candidate), Ezra Spilke (fellow LLM candidate), Vishnu Dhunputh (Barrister), Ashvin Jorai (BSc Accounting with Finance candidate), Max Samuel (MSc Finance candidate) and Meenakshi Bappoo (LLM – International and Commercial Law). Rachael Cayley, Peter Grav and Daniel Newman of the English Language and Writing Support, as well as Gail Henderson, Hugo Leal-Neri and Daniele Bertolini, SJD candidates at the Faculty of Law, have equally been helpful in my writing endeavours, although they were not particularly associated with this thesis.

My sincere thanks are equally directed towards the Associate Dean of Law (Graduate) and all the wonderful Faculty Members who have been amazing sources of inspiration during my stay at the University.

Finally and most importantly, I would like to express my admiration to my family for their unwavering support, sacrifice and understanding.
TABLE OF CONTENTS

Abstract ii
Dedication iii
Acknowledgements iv
Table of contents v

Chapter 1: INTRODUCTION 1

1.1 Internationalization of securities markets
1.2 Response to internationalization of securities markets
  1.2.1 Regulatory competition
  1.2.2 Centralization of international securities regulation
  1.2.3 Hybrid models: Harmonization, mutual recognition and convergence
1.3 Harmonization model
1.4 Implementation of harmonization model
1.5 Thesis outline

Chapter 2: ALTERNATIVE APPROACHES TO INTERNATIONAL SECURITIES REGULATION 14

2.1 Role and function of securities regulation
2.2 Models of securities regulation for international markets
  2.2.1 Privatization
  2.2.2 Regulatory Competition
  2.2.3 Centralization
  2.2.4 Convergence
  2.2.5 Mutual Recognition
Chapter 3: THE REGULATORY COMPETITION MODEL

3.1 Historical perspective and scope of application of regulatory competition theory

3.2 Application of regulatory competition theory to securities law
   3.2.1 Issuer-choice model
   3.2.2 Portable reciprocity model

3.3 Transposition of Tiebout model and US corporate charter competition model to international securities regulation

3.4 Claimed benefits of regulatory competition
   3.4.1 Disciplining of national regulators and governments
   3.4.2 Potential for experimentation and innovation in regulation to improve regulatory product quality
   3.4.3 Restraining regulatory capture and customizing consumer choice

3.5 Limitations of regulatory competition model
   3.5.1 Threat to investor protection
      3.5.1.1 Disclosure of regime and approval of midstream change in chosen jurisdiction
      3.5.1.2 Role of the state judiciary
   3.5.2 Systemic risk arising from negative externalities and collective action problems
      3.5.2.1 Definition of terms
      3.5.2.2 Application of concepts to the regulatory competition model
3.6 Conclusion

Chapter 4: THE REGULATORY HARMONIZATION MODEL

4.1 Views of regulatory-competition proponents on harmonization

4.1.1 Three observations on the dilemma of regulatory-competition proponents

4.2 Evidence supporting superiority of harmonization model

4.2.1 Canadian passport system

4.2.2 The Multi-Jurisdictional Disclosure System (MJDS)

4.2.3 The European Union (EU) model

4.3 Why is regulatory harmonization preferable to regulatory competition?

4.3.1 Mechanism to address systemic risk through reduction in negative externalities and prevention of collective action problems

4.3.2 Investor protection

4.3.3 Economies of scale on cost of compliance

4.3.4 Enhancement of allocational efficiency

4.3.5 Reduction of risk of regulatory gaps

4.3.6 Reduction of information costs

4.3.7 Greater ease of comparability and analysis

4.4 Conclusion

Chapter 5: USING THE WTO/GATS FRAMEWORK TO HARMONIZE REGULATION OF INTERNATIONAL SECURITIES MARKETS

5.1 Introductory comments on the WTO, GATS and the Financial Services Agreement

5.2 Trade Liberalization
5.3 Barriers to trade

5.4 GATS and the harmonization model

5.5 GATS and the sovereign right to regulate

5.6 Specific commitments under GATS

5.7 Relationship between the right to regulate & specific commitments on national treatment and market access

5.8 Mechanisms for GATS to promote harmonization and advantages of using the GATS framework

5.8.1 Recognition

5.8.2 Harmonization versus convergence

5.8.3 Institutional framework

5.8.3.1 Progressive liberalization

5.8.3.2 Dispute settlement mechanism

5.8.4 Disciplining effects on provincial or local governments and SROs

5.8.5 High governmental level representation

5.8.5.1 WTO/GATS and IOSCO

5.8.5.2 GATS v Stand alone multilateral agreement on securities

5.9 Conclusion

Chapter 6: CONCLUSION

BIBLIOGRAPHY
Chapter 1: INTRODUCTION

Widespread cross-border securities trading have led to the internationalization of the securities market. There is general consensus that such securities dealings, just as securities transactions intra-jurisdiction, require regulation.¹ The academic debate has mainly been focused on whether regulatory competition or cooperation constitutes the better normative approach to such regulation.² More recently, the literature seems to have evolved to adopt a hybrid model combining the virtues of these two approaches.³

¹ See e.g. Mary Condon, “Canadian Securities Regulation and the Global Financial Crisis” (Walter S Owen Lecture, delivered at the Faculty of Law, University of British Columbia, 26 March 2009), (2010) 42:2 UBC L Rev 473 at para 33(Available at SSRN) [Condon 2010]: “[F]ar from regulation being a drag on markets as the neoclassical law and economists would have it, regulation is actually intrinsic to the survival of markets. If we can accept that basic premise, the “only” matter left for debate about is how to effectively accomplish that regulation.”

² See also the recent empirical research by Hans B Christensen, Luzi Hail & Christian Leuz, “Capital-Market Effects of Securities Regulation: Hysteresis, Implementation, and Enforcement” (2011) Chicago Booth Research Paper No. 12-04 (Available at SSRN) at 6: “[T]he imposition of stronger securities regulation on firms can indeed have significant economic benefits in terms of market liquidity (and cost of capital) for a broad cross-section of firms.” Paul G Mahoney, “The Development of Securities Law in the United States” (2009) 47:2 J Accounting Res 325 at 325: “Given the existence of contract, property, fraud, and company law, what is the purpose of securities laws? Broadly speaking, they can serve either of two functions, or some mix of both. The first is to facilitate contracting among entrepreneurs, managers, shareholders, and financial intermediaries by providing a standardized set of rights and obligations. Such laws are motivated by the desire to reduce transaction costs where contracting parties are widely dispersed and both writing complete contracts ex ante and renegotiating ex post are difficult. A second possible function is to restrict contracting by limiting the set of legally available terms. Such laws reflect the view that securities markets are beset by market failures stemming from externalities or investor irrationality.” (footnotes omitted)

³ Another term which can be used for ‘cooperation’ is ‘harmonization’ in its generic sense. However, I also use ‘harmonization’ in a technical sense in this thesis. In its latter case, ‘harmonization’ consists of agreement between various jurisdictions on minimum or essential requirements, or basic norms with the possibility for any jurisdiction to regulate beyond this minimum threshold. Hence, to avoid confusion between the generic and technical use of the term ‘harmonization’, I will use cooperation for the generic sense and harmonization only for the technical sense.

However, the implementation of such a hybrid system has barely received any attention in the literature. While the normative debate is a necessary step, the final outcome is more constructive when the debate is complemented with an analysis of a framework which can put the preferred normative option into practice.

The aim of this thesis is hence two-fold: first, justify why the hybrid model should be the preferred model for the regulation of international securities markets; and second, develop, applying an international trade regulation perspective, a regulatory framework for cross-border securities trading using the World Trade Organization and General Agreement on Trade in Services (WTO/GATS) framework to implement the hybrid model.

1.1. Internationalization of securities markets

In recent years, cross-border activities between financial markets have continuously increased. As a result, economies are increasingly interdependent. The current financial crisis has provided striking evidence of the ‘interconnectedness’ of the global economy. A prime sector of the economy which has been impacted by this internationalization is the securities market. Trading in securities from around the world has been facilitated by the accelerated pace and broadened scope of globalization in capital markets.


5 Financial Services Authority (of Great Britain), International Agenda (October 2010), online: <http://www.fsa.gov.uk> at para 1.2; See also Condon (2010), supra at note 1 at para 24: “One phenomenon that has been in evidence over the last number of years, but has been accelerated by the Global Financial Crisis, is the internationalization of securities regulation and, in particular, the enlarged role played by IOSCO.”

Various features illustrate the internationalization of securities markets. For instance, the number of foreign listed companies at major stock exchanges has drastically increased.\textsuperscript{7} Alliances between exchanges of different countries have also become more common.\textsuperscript{8} The following figures provide a further indication of the global nature of the securities market. There have been foreign purchases and sales of US stocks for USD 6.75 and 6.63 trillion respectively in 2010.\textsuperscript{9} USD 3.67 and 3.73 trillion of foreign securities were purchased and sold respectively in the US.\textsuperscript{10} According to Statistics Canada figures, there have been foreign purchases and sales of Canadian stocks of CAD 1.01 and 1.00 trillion respectively in 2010.\textsuperscript{11} CAD 504.9 and 491.5 billion of foreign stocks were purchased and sold respectively in Canada.\textsuperscript{12} For a tiny island-State like Mauritius having a land area of 1860 m\textsuperscript{2} and a population of 1.2 million only, foreign investors purchased Mauritian stocks on the Official Market of the Stock Exchange for MUR\textsuperscript{13} 3.61 billion and sold for MUR 2.07 billion in 2010.\textsuperscript{14}

\textsuperscript{7} Thilo Marauhn, “The Regulatory Dilemma in International Financial Relations” in Rainer Grote & Thilo Marauhn, eds, The Regulation of International Financial Markets: Perspectives for Reform (United Kingdom: Cambridge, 2006) 1 at 3. See also ibid. at 13: “[T]here can be no doubt that there is a globalised capital market as of today…. Financial transactions are performed within truly international markets.”

Note that I do not consider the specific case of foreign listings on US exchanges, which have decreased over the years, much before the onset of the 2008 financial crisis. For a discussion of this specific aspect and the reasons for this trend, see Bradley J Bondi, “Facilitating Economic Recovery and Sustainable Growth through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation” (2010) 33 Harv JL & Pub Pol’y 607 especially at 612-613 and 619-620 (Available at SSRN)

\textsuperscript{8} Canada’s largest stock exchange, the TSX, was itself the subject of advanced negotiations for a merger with the parent company of the London Stock Exchange in 2011. The deal however did not get through because of lack of shareholder support: see News Release of TMX dated June 29, 2011 entitled “TMX Group and LSEG Terminate Merger Agreement”, online: TMX Group <http://www.tmx.com>

\textsuperscript{9} Figures provided by the US Board of Governors of the Federal Reserve System in its release of December 23, 2011, online: <http://www.federalreserve.gov/er/releases/secholdtrans/current.htm>

\textsuperscript{10} Ibid.

\textsuperscript{11} Statistics Canada, Table 376-0018 - International transactions in securities, portfolio transactions, net and gross sales and purchases, by type and sector, annual (dollars), CANSIM (database), Using E-STAT (distributor), online: <http://estat.statcan.gc.ca/cgi-win/cnsmcgi.exe?Lang=E&EST-Fi=EStat/English/CII_1-eng.htm>

\textsuperscript{12} Ibid.

\textsuperscript{13} 1 USD is approximately MUR 30

\textsuperscript{14} Annual Statistical Bulletin of the Mauritius Financial Services Commission (2011), online: <http://www.fscmauritius.org/media/63343/fsc%20stats%20bulletin.pdf>. I cite Mauritius since it is a jurisdiction familiar to me and is my country of origin.
Several factors have contributed to the internationalization of securities markets. The four main ones are:

(i) advances in computer and communications technology (which have improved the ability to gather and process information from foreign sources, lowered the transaction costs of dealing in foreign markets and increased the potential of exploiting market inefficiencies in pursuit of arbitrage profits); (ii) developments in finance theory and derivative securities (which have promoted the portfolio theory suggesting that internationally diversified portfolios are more efficient portfolios and the development of derivatives leading to accrued institutional interest in international securities markets); (iii) the rise of the institutional investor; and (iv) deregulation and the removal of barriers and restrictions like foreign exchange controls, restrictions on foreign ownership, restrictions on institutions like government pension funds to purchase foreign securities and prohibition against listing of foreign firms.

The interconnected capital markets give rise to new opportunities but also to risks. The bright side of the internationalization of the securities market is the relative ease to develop and manage a diversified investment portfolio through purchasing comparable securities from foreign and national issuers of securities. Portfolio theory suggests that internationally diversified portfolios are more efficient. Issuers of securities will also have a wider range of potential buyers and have more windows of opportunities to exploit. On the other hand, the main dangers which result from intertwined markets are the threat to investor protection, systemic risks arising from negative externalities and collective action problems and incoherence in the regulatory activity of different jurisdictions which can either take the form of duplication and overlap or a regulatory gap.


16 MacIntosh (1995), supra note 15 at 2
1.2 Response to internationalization of securities markets

In order to maximize the opportunities and counter these risks, national regulators must provide for impacts beyond their own jurisdictions even when seeking to achieve domestic regulatory objectives. Otherwise the standards they set will be “systematically sub-optimal”: under-regulated if cross-border regulatory benefits are ignored and over-regulated if cross-border regulatory costs are ignored.

Nonetheless, there is no consensus among academics about the capacity of existing regulatory frameworks to counteract these risks and maximize the opportunities. The academic literature can be divided into those who favour regulatory competition and those who favour regulatory cooperation. However, a third strand is emerging in the literature: those who argue in favour of a hybrid model combining features of both regulatory competition and cooperation.

This thesis will consider six models of regulation: privatization, competition, centralization, convergence, mutual recognition and harmonization. Privatization and regulatory competition espouse a competition rationale. On the other hand, centralization constitutes a pure cooperation model. Convergence, mutual recognition and harmonization are hybrid regimes. I will describe the operation of each of these models, when applied to the field of international securities regulation.

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17 Daniel C Esty & Damien Geradin, “Regulatory Co-Opetition” in Esty & Geradin 30, supra note 3 at 33. Chapters 3 and 4 of the thesis will elaborate on the causes of such ‘sub-optimality’ like externalities, information asymmetry, collective-action problems like prisoners’ dilemma and tragedy of the commons, failure to maximize economies of scale and multiplication of costs of compliance.

18 The appellation of these six models derive from Eric C Chaffee, “Finishing the Race to the Bottom: An Argument for the Harmonization and Centralization of International Securities Law” (2010) 40 Seton Hall L Rev 1581 at 1595 [Chaffee]. However, the description and content of the models in this thesis differ from this source. I will elaborate on the differences in chapter 2.
1.2.1 Regulatory competition

Proponents of regulatory competition not only support the current regime characterized by an absence of harmonization at the international level, but propose to broaden the fragmentation among jurisdictions to create more competition. Such competition will enable both issuers and investors to choose the law that governs their transactions without any restriction.

Regulatory competition, according to proponents of these models, is a benefit for investors in securities. It also allows policy makers to correct mistakes more promptly. A regulator will thus readjust its policies if faced with a “decline in its jurisdictional sphere.” The self-correcting mechanism also fosters experimentation and innovation as each regulator will strive to improve its system.

In this respect, the “issuer choice” and “portable reciprocity” models have been suggested. In these models, the choice of the competent jurisdiction is independent of the place of incorporation of the issuer, the investor residence or the location of the transaction. Issuers and investors have the ability to choose the law that governs their transactions.

20 Romano (2001), supra note 19 at 393
21 Romano (2001), supra note 19 has proposed the issuer choice model; Choi & Guzman, supra note 19 has proposed the portable reciprocity model.
1.2.2 Centralization of international securities regulation

There is a strong current in the academic literature against regulatory competition.\textsuperscript{22} Opponents of regulatory competition rely on the premise that divergent regulatory strategies and approaches across jurisdictions is a hindrance to economic integration. They favour a model (which I term ‘centralization’ in this thesis) where all states formally agree to devolve their authority for regulating those parts of the securities market which is transnational to a singular body.\textsuperscript{23} It hence envisages a ‘one size fits all’ regulatory framework for all States.

1.2.3 Hybrid models: Harmonization, mutual recognition and convergence

Whereas the initial debate seemed bipolar, with advocates of regulatory competition denying any form of cooperation and critics of regulatory competition arguing in favour of complete centralization, the consensus now seems to acknowledge the virtues of

\textsuperscript{22} Even adherents of the regulatory competition model concede the movement towards convergence and cooperation. They however offer a different explanation for this trend. See for example Jonathan R Macey, “The ‘Demand’ for International Regulatory Cooperation: A Public-Choice Perspective” in Bermann & al 147, supra note 3 at 147: “[D]evotion to sovereignty appears to be inconsistent with the increasing trend towards the establishment of international agreements and institutions, since they involve a surrender of some degree of sovereignty.” Using a public-choice perspective, Macey (ibid. at 152) contends that: “[W]hen technological change, market processes, or other exogenous variables threaten either to remove power from a nation’s regulatory structure or cause it to become irrelevant, then the regulators in that nation will have strong incentives to engage in activities such as international coordination in order to protect their autonomy.” I strongly disagree with such an analysis because it seems to consider regulators as zombies which have an independent existence, unrelated to and unchecked by other state agencies. See also Michael J Trebilcock, “Trade Liberalisation, Regulatory Diversity and Political Sovereignty” in John J Kirton & Peter I Hajnal, eds, Sustainability, Civil Society and International Governance : Local, North American and Global Contributions (Hampshire: Ashgate Publishing, 2006) at 216: “While political markets are unlikely to function perfectly competitively, rendering governments vulnerable on occasion to rent-seeking behavior (political market failure), one should not assume (as many public choice theorists tend to) that all government policies are explicable in these terms. Thus from this perspective, it would be a major and unfortunate irony if the price of adopting rules that are designed to remove constraints on and enhance competition in international goods and services markets is the adoption of rules or institutions that have the effect of monopolising or cartelising government policy making…”

\textsuperscript{23} Chaffee, supra note 18 at 1600
both forms and hence propose a hybrid model. Proponents of the hybrid model have proposed alternatives which take variant forms based on the degree to which they negate the potential for regulatory competition. The models they propose can be grouped into three categories: convergence, mutual recognition and harmonization. I will consider each of them briefly here.

Convergence occurs where regulators “naturally” adopt similar or comparable standards through inspiration from the regulatory model of a dominant jurisdiction or otherwise. This model has no element of compulsion or certitude. It neither has an institutional structure nor an implementation mechanism. Convergence is also “less transparent, less democratic and – in the long run – perhaps even less sustainable approach.”

In a mutual recognition scheme, regulators agree on principles of deference or delegation to one another. The baseline of this deference or delegation is that, despite the variations in regulations between the two jurisdictions, their systems and overall policies are comparable. Compliance with the regime of the home country (the jurisdiction where the issuer is based) is deemed to be compliance with the host country regulations (the jurisdiction where the issuer will distribute securities).

The harmonization model consists of an agreement between various jurisdictions on minimum or essential requirements, or basic norms with the possibility for any

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24 See supra note 3
25 Chaffee, supra note 18 at 1597
26 Thilo Marauhn, “The Regulatory Dilemma in International Financial Relations” in Rainer Grote & Thilo Marauhn, eds, The Regulation of International Financial Markets: Perspectives for Reform (United Kingdom: Cambridge, 2006)1 at 10: “[In international financial relations, the approach at regulation has not been] “an international agreement dealing with conflict of laws or aiming at some approximation or harmonization of normative standards... Private actors, regulatory bodies, and governments have chosen a much less transparent, less democratic and – in the long run – perhaps even less sustainable approach: they opted for regulatory co-operation below the level of formal juridification. In other words: they preferred loose cooperation within the framework of international regulatory organizations to international treaty-based regimes.”
jurisdiction to “upwardly depart”\textsuperscript{27}, i.e. to regulate beyond the minimum threshold. Unlike the centralization model, harmonization does not entail the adoption of “identical and equivalent” requirements by all participating jurisdictions. Given that comparability of the regimes mutually recognizing each other has also become a permanent feature of the mutual recognition model, there is no substantial contrast between harmonization and mutual recognition. When ‘mutual recognition’ becomes pervasive and binds several countries as opposed to two or a few, it is better qualified as harmonization.

From this brief description of three alternative forms of the hybrid model, it may be noted that convergence has neither an institutional structure nor an implementation mechanism. In the absence of any certitude as to what which norms can be considered as being ‘generally accepted’ and when they may be said to be comparable across all jurisdictions, I argue that convergence cannot form the basis of a formal regulatory structure. This leaves mutual recognition and harmonization as the only serious alternatives.

1.3 Harmonization model

As seen earlier, the mutual recognition and harmonization models are distinct only in terms of the extent of their application: when applied on a lower scale between two countries, it is known as mutual recognition and when applied multilaterally, it is termed harmonization.

The harmonization model is of hybrid nature combining elements of regulatory competition and cooperation. Based on a cooperation rationale, it relies on multilateral agreement regarding minimal or essential requirements of regulation between various

\textsuperscript{27} Chaffee, supra note 18 at 1600
jurisdictions whereas the possibility for any jurisdiction to regulate beyond the minimal level provides sufficient room for competition among the jurisdictions. Compliance with the minimum requirements, in principle, allows an issuer market access in any jurisdiction as long as that issuer is subject to regulation by the home regulator, which is normally the regulator of the place of incorporation or registration. A significant portion of the literature has evolved to favour these models.\textsuperscript{28} The reasons for choosing harmonization as the preferred model are many.\textsuperscript{29} This preference is underpinned by the possibility for this model to rely on cooperation without negating the beneficial effects of regulatory competition.

Harmonization minimizes the risk of negative jurisdicational externalities and other market failures.\textsuperscript{30} The cooperative mechanism through which the model operates also provides the tools to address systemic risk and reduces regulatory gaps. Issuers derive economies of scale on cost of compliance given that distribution of securities can be made in any jurisdiction based on compliance with home State regulation. Harmonization also reduces information costs, which is the cost of learning and evaluating the regulatory system and laws of each jurisdiction. Furthermore, the harmonization model promotes allocational efficiency by restraining the barriers based on territory or residence of issuers and investors. Empirical evidence and cost-benefit analysis support the superiority of the harmonization model.\textsuperscript{31}

1.4 Implementation of harmonization model

\textsuperscript{28} See supra note3
\textsuperscript{29} Chapter 4 will consider the reasons for preferring harmonization at greater length.
\textsuperscript{31} Chapter 4 will consider the results of these studies in more detail.
Despite substantial agreement on the preferable normative model, there is scant literature on the implementation of such model. This thesis claims that the academic conversation will be more productive if the debate moves beyond the normative realm to address mechanisms to concretize the preferred normative choice. To be sure, the setting up a structure at an international level will constitute a daunting task. But if any practical benefit is to be drawn from the normative and academic debate, it is necessary to move forward and discuss an implementation strategy.

This thesis proposes a new regulatory framework based on the selection of harmonization as the preferred normative policy. This framework will use the World Trade Organization (WTO) structure and, especially, the General Agreement on Trade in Services (GATS). In this respect, my area of research adopts an interdisciplinary approach: it lies at the intersection of securities regulation and international trade regulation.

The securities sector is one of the three pillars of the financial services sector (the other two being banking and insurance) encompassed under GATS. One of the advantages of using the WTO/GATS umbrella to implement the harmonization model is the legitimacy that the WTO provides since its membership consists of States. The WTO/GATS framework hence constitutes the right balance between constraining domestic political sovereignty and addressing issues that entail ramifications beyond the exclusive territories of individual states. 32

Using an already available framework also reins in the negotiation efforts of agreeing on one as well as the financial costs of setting it up. Moreover, using the WTO

32 Trebilcock & Howse, supra note 30 at 19; See also John Fontecchio, “The General Agreement on Trade in Services: Is it the Answer to Creating a Harmonized Global Securities System?” (1995) 20 NCI Int’l L & Com Reg 115 at 117: WTO membership is “comprised of world governments” and this gives agreements created through the GATS process “a measure of respectability and influence.”
framework will allow Member States to have the comfort of other provisions which allow, for instance, for waiver from certain commitments in case of “necessity”.

1.5 Thesis outline

This thesis is arranged in the following manner. Chapters 2 to 4 will consider the academic debate between proponents and opponents of regulatory competition. Chapter 2 will discuss six alternative approaches to international securities regulation. These approaches are privatization, competition, centralization, convergence, mutual recognition and harmonization. I will describe the operation of each of these models and their application to the field of international securities regulation.

Chapter 3 will analyze the proposition in favour of regulatory competition and the limitations of this model. I will argue that regulatory competition is not apt to address the challenges of international securities markets, namely incoherence in the regulatory activity of different jurisdictions in terms of regulatory duplication and gaps, systemic risk and negative externalities. The competition regime will also constitute a threat to investor protection and give rise to collective action problems.

In chapter 4, I will discuss the regulatory harmonization model. I will detail the features of the model and argue in favour of adopting this regime as the preferred model. In the absence of any regulatory structure applying the harmonization regime at a global level, I will consider the Canadian Passport System, the Multijurisdictional Disclosure System (MJDS) and the EU framework as comparables at a federal, bilateral and regional block level respectively. I will argue that the benefits and experience from these three systems can be extrapolated to support the beneficial effects of the harmonization model.
Chapter 5 will analyze the implementation of the harmonization model using the WTO/GATS framework. I will provide an overview of GATS with emphasis on the financial services sector as the latter encompasses the securities sector under the WTO framework. I will also discuss the relative advantages of using this framework as opposed to other alternatives such as the International Organization of Securities Commissions (IOSCO). The chapter will then propose a regulatory framework under the aegis of the GATS to implement the harmonization model.

Chapter 6 will offer some concluding remarks.
Chapter 2:
ALTERNATIVE APPROACHES TO
INTERNATIONAL SECURITIES REGULATION

2.1 Role and function of securities regulation

Securities regulation plays an essential role in any economy. It seeks to assist markets in allocating capital efficiently to where it is most needed. Where a market exhibits allocational efficiency, the cost of capital is lower for the more efficient issuers seeking market finance while higher capital costs are imposed on underperforming issuers.

Securities regulation serves two essential functions. It facilitates contracting among issuers, investors and financial intermediaries by providing a standardized set of rights and obligations. Such laws aim at reducing transaction costs especially where contracting parties are widely dispersed and both writing complete contracts ex ante and renegotiating ex post are difficult. The second role of securities regulation is to “restrict contracting by limiting the set of legally available terms.” Such laws aim at addressing the risk of market failures arising out of externalities, ‘investor irrationality’, abuse of investor rights, unscrupulous issuers, information asymmetries and inadequacies, anti-competitive behavior, or misuse of market power. These laws are hence preventive and prudential in nature. When failure cannot be averted, prudential rules seek to avoid a

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2 Ibid.
4 Ibid. at 325
5 Consumer protection serves both an economic and a social objective. From an economic perspective, if investors do not perceive ex ante that they will benefit from some protection in case of a failure, they will not invest, thus thwarting the capital market. From a social perspective, investor protection may be motivated by goals of redistribution – for example through the creation of consumer support schemes or compensation funds where operators have to contribute to the fund as a prerequisite to being licensed: See Panagiotis Delimatis, International Trade in Services and Domestic Regulations: Necessity, Transparency and Regulatory Diversity (New York: Oxford University Press, 2007) at 87 [Delimatis]
6 Mahoney, supra note 3 and Delimatis, supra note 5
domino effect and minimize the systemic impact of the failure, as well as soften its more immediate impact on investors and their assets.  

Empirical evidence links the strength of investor protection in a country to the strength of that country's securities market, and further links investor protection and the strength of securities markets to the economic growth of the country. In a series of papers based on empirical research, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV) find that protection of investor rights positively influences stock market capitalization. Using a different sample of countries, Levine confirms the LLSV correlation between investor rights and stock market capitalization: “Countries where legal codes stress the rights of shareholders and where the regulatory system rigorously encourages corporate information disclosure tend to have better developed financial markets.”

Critics of regulation however claim that laws and regulations may be used to further economically and socially inefficient goals such as protecting the vested interests of certain market players. Nevertheless, I argue that the possibility of such adverse use of regulations should not deter from regulating the market altogether. Such a stance would preclude the advancement of beneficial objectives of regulation:

The benefits of global securities trading activity are not limited to particular persons, sectors or nations. Corporations, investors, brokers, dealers, advisers, markets and the economies of countries benefit from this activity. Corporations are able to broaden their ownership, investors are able to

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7 Moloney, supra note 1 at 460
diversify their investment portfolios and reduce risk and brokers, dealers and advisers are able to extend their product range and provide a more extensive service. … This effective market for transactions in global and national securities has benefits for the national economy as corporations and participants have ready access to a wider range of resources necessary for their business advancement.11

2.2 Models of securities regulation for international markets

The rationale of securities regulation can be transposed to the international level. In an ‘ideal’ international securities market, issuers will be equally capable of raising capital from investors of their own country and investors of other countries.12 Similarly, investors will be equally capable of purchasing comparable securities from a foreign counterparty as from an issuer of their own country.13

For more than a decade, there has been an illuminating academic conversation on regulatory approaches suitable for this new field of international securities markets. The academic literature can be divided into those who favour regulatory competition and those who favour regulatory cooperation. However, a third strand is emerging in the literature: those who argue in favour of a hybrid regime combining features of both regulatory competition and cooperation.

Six models of regulation have emerged out of this normative debate: privatization, competition, centralization, convergence, mutual recognition and harmonization.14

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13Ibid.
14 The appellation of these six models derive from Eric C Chaffee, “Finishing the Race to the Bottom: An Argument for the Harmonization and Centralization of International Securities Law” (2010) 40 Seton Hall L Rev 1581 at 1595 [Chaffee]. However, the description and content of the models in this thesis differ from Chaffee (as I explain in this chapter).
Privatization and regulatory competition adopt a competition rationale. On the other hand, centralization constitutes a pure cooperation model. Convergence, mutual recognition and harmonization are hybrid regimes. Though each model may be analyzed distinctly, there can be some overlap between them, as the ensuing discussion will reveal. In order to have a clearer understanding of the models, I propose a diagram representing them in the form of a spectrum.

1. Privatization – refers to a model promoting competition among securities exchanges at an international level.

2. Competition – refers to a model where the issuer chooses the competent regulator, irrespective of the residence of the issuer or the investor or the location of the capital-raising transaction.

Kuras identifies only two regulatory models of what she terms “international harmonization”: reciprocity (which is equivalent to mutual recognition in Chaffee’s classification) and commonality (which may be the equivalent collectively of harmonization and centralization): Ruth O Kuras, “Harmonization of Securities Regulation Standards between Canada and the United States” (2004) 81 U Det Mercy L Rev 465 (HeinOnline);

Manning G Warren III, “Global Harmonization of Securities Laws: The Achievements of The European Communities” (1990) 31 Harv Int Law J 185 also identifies these two approaches for harmonization, i.e. reciprocity and commonality;


Chaffee, supra note 14 at 1595 places the six models on “a spectrum”, which is an indication of the absence of a clear demarcating line between the models. The classification of the models on the spectrum is based on the degree of international cooperation and coordination each require to be put in place and maintained.

Sykes, who analyzes the models using different terminologies, shares the view that the line of demarcation between these categories “can be fuzzy at times”: Alan O Sykes, “Regulatory Competition or Regulatory Harmonization? A Silly Question?” (2000) 3 J Int’l Econ L 257 at 258 [Sykes]
3. Convergence - By drawing inspiration from a hegemon or from non-binding standards, States “naturally” adopt similar or comparable standards.

4. Mutual recognition – Equivalent to harmonization but at bilateral level or involving few nations. Also a formal agreement on minimum or comparable norms is not indispensable.

5. Harmonization – States formally and multilaterally agree to adopt minimum, essential or comparable norms and preserve the choice of unilaterally upgrading to more stringent norms.

6. Centralization – May take two distinct forms: (a) States formally agree to devolve their authority for regulating transnational securities transactions to a singular body; (b) States formally and multilaterally agree to adopt identical and equivalent norms (homogenization)

I will now describe each of these six models. As a note of caution, I wish to point out that the terms privatization, regulatory competition, centralization, convergence, mutual recognition and harmonization have been used in different scholarly pieces to mean different things. Hence, the description of the models assumes particular importance to understand the model I recommend in the thesis.

2.2.1 Privatization

The privatization model proposes that securities exchanges should be the primary source of securities regulation.16 The model, whose main proponent is Mahoney, applies a regulatory competition rationale.17 The distinction with the regulatory competition model considered below is that competition in the privatization model takes place, not among states, provinces or nations, but among Exchanges which are

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16 Private exchanges act as regulators in many legal systems, but they generally do so based on their recognition as self-regulatory organizations by the State regulator. Hence, they are not primary regulators as the privatization model advocates.

private entities. In their aim to maximize profits, these private entities compete to attract issuers, irrespective of the issuer’s domicile.

Although tailored as a new scheme to regulate international securities markets, having securities exchanges as the regulators of markets is one of the oldest models of regulation. This model had fallen into disrepute because of its inaptness to prevent financial crises, especially the Great depression of the 1930’s: “[A]dvocating the full privatization of securities regulation, would, in the United States, turn back the clock nearly a full century, not just before the New Deal\(^{18}\), but further back, before the dawning of the first Blue Sky laws of the early 1900s.”\(^{19}\)

A significant difficulty with having an exchange as regulator is the intricacy in enforcing its decision against an issuer (or the officers and other representatives of the issuer).\(^{20}\) This difficulty is naturally amplified in a case where an issuer is in a foreign jurisdiction.

The critique about the race to the bottom that I will develop in relation to the regulatory competition model applies with even greater force to the privatization model.\(^{21}\) The recent wave of securities exchange demutualization has transformed securities exchanges into for-profit entities.\(^{22}\) In their bid to maximize profits for their own shareholders, these exchanges are willing to seek new opportunities to canvass issuers, regardless of whether the issuers are foreign or domestic.\(^{23}\) Such private bodies cannot

\(^{18}\) The New Deal was a series of economic programs implemented in the United States between 1933 and 1936, leading to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 which created the US Securities and Exchange Commission.

\(^{19}\) Howell E Jackson, “Centralization, Competition, and Privatization in Financial Regulation” (2001) 2 Theoretical Inq L 649 at 661

\(^{20}\) In the Canadian context, see Taub v Investment Dealers Assn of Canada (2009) ONCA 628, [2009] OJ No 3552

\(^{21}\) See 2.2.2 below


\(^{23}\) Chaffee, supra note 14 at 1589; see also Donald C Langevoort, “Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment” (2000) 63 Law & Contemp Probs 45 at 49
be wholly entrusted with the public functions of protecting investors, ensuring that markets are fair, efficient and transparent and reducing systemic risk. Even at a national level, the role of exchanges as a Self-regulatory Organization (SRO) cum regulator is recognized within restricted precincts and with important caveats. In Re HudBay Minerals Inc., the Ontario Securities Commission held:

There is an important policy reason why the Commission retains this discretion in the public interest. The Commission has stated [in Trizec] that:

We believe that the public will support the role of self-regulatory organizations provided that the standards applied by the self-regulatory organizations are or can be made the subject of an appeal to the Securities Commission, the government appointed overseer of the operation of self-regulatory organizations, on the basis that the Commission's perception of the public interest of a particular case should prevail.

In my view, using a private exchange as regulator will also leave away an important part of securities dealings which do not use such platform – e.g. exempt market transactions and private placements – but which are presently under the purview of national regulators. The inability of a private exchange to address systemic risks is also flagrant.

For these reasons, this thesis does not consider privatization as a valid model.

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(2000): “[I] fear the exchange as a standard-setter or enforcer given the conflicting interests of its member-owners. To the extent that multi-service securities firms have significant political influence at the exchanges, there is considerable tension in their preferences.”

(2009), 32 OSCB 3733; 2009 LNONOSC 269 at para 110 citing with approval Re Trizec Equities Ltd. (1984), 7 OSCB 2034 at 2040
2.2.2 Regulatory Competition

Regulatory competition is “an economic theory of government organization that equates decentralization with efficient results.” It seeks to promote economic growth and efficiency by eliminating or minimising the distorting impact of laws, regulations and administrative policies on competition. Competitive pressures compel governments to produce their ‘regulatory products at competitive prices’. Governments hence change their domestic laws “in response to the actual or expected impact of cross-border mobility of goods or services on national economic activity.” The two dominant models which have used regulatory competition as an underlying rationale are the issuer-choice model and the portable-reciprocity model.

To the extent that regulatory competition is the dominant paradigm in academic literature as the alternative (rival) regime to harmonization, I will consider it in detail in chapter 3. I will argue that the regulatory competition model is not suitable for regulating international securities markets.

2.2.3 Centralization

Centralization depicts the model where all States formally agree to devolve their authority for regulating those parts of the securities market which is transnational to a singular body: “[u]nder a regulatory centralization approach, nations would join together to create an international organization that would have monitoring, regulatory, and/or enforcement responsibilities relating to the emerging global capital markets.”

27 Chaffee, supra note 14 at 1600. Chaffee’s understanding of centralization however seems to be broader. He encompasses different degrees of cooperation under this heading - for instance, “creating and enforcing a baseline of regulation from which participating nations could opt to upwardly depart.”
Centralization relies on the premise that divergent regulatory strategies and approaches across jurisdictions is a hindrance to economic integration. According to Chaffee, “a centralized global securities regulator with robust monitoring, regulatory, and enforcement powers” will “minimize systemic risk, increase efficiency of the emerging global capital markets, and pool the expertise and experience of the world's securities regulators.”

In my view, from a practical standpoint, centralization in relation to the regulation of international securities markets is a utopia. Past experiences of centralization have proved to be a failure. Attempt at centralization and harmonization at a high level of detail at the level of the European Community was not successful. Empirical evidence also suggests that aiming at complete conformity through application of identical rules globally does not lead to the expected results:

The latter type of cooperation rather forms part of the harmonization model which I discuss later. Hence, my dismissive approach to centralization is restricted to the fully homogenized model.

In a comment which is not limited to securities regulation but rather considers a wide array of regulatory contexts, Sykes notes at the outset that ‘homogenization’ of regulatory policies across all jurisdictions should be a very exceptional case: Sykes, supra note 15 at 257.

See also Jeffrey G MacIntosh, “International Securities Regulation: Of Competition, Cooperation, Convergence, and Cartelization” (1995) [unpublished, archived at Bora Laskin Law library] at 19 (abstract available at SSRN): “There is little reason to believe that complete regulatory convergence will ever be achieved.” [MacIntosh]

The same point is made in Tzung-bor Wei, “The Equivalence Approach to Securities Regulation” (2007) 27 Nw J Int’l & Bus 255 at 259: “In actuality, however, full harmonization is rarely possible. Despite the best efforts of regulators to harmonize, differences between regulatory regimes usually remain. This may be because there is political opposition to legal reform, or it may be because the situation is such that it is preferable to converge only core principles and to allow slight variations in details.” (Note however that ‘harmonization’ is used by Wei as meaning ‘centralization’ as per the classification of my thesis, and equivalence is used to mean ‘harmonization’ as per this thesis classification.)

Moloney, supra note 1 at 9. Moloney however notes that pursuant to the EC Financial Services Action Plan (FSAP), the EC “changed the character of EC securities regulation from a minimum harmonization/mutual recognition-based regime to a regime of unparalleled regulatory detail which, for the most part, ousts national rules and policy in the areas harmonized:” Ibid. at 10. I do not consider post-FSAP initiatives in this thesis as these initiatives assume an already harmonized system, which is not the case in the international securities regulation context.

See also Giandomenico Majone, “International Regulatory Cooperation: A Neo-Institutionalist Approach” in George A Bermann & al, eds, Transatlantic Regulatory Cooperation: Legal Problems and Political Prospects (Oxford: Oxford University Press, 2000)119 at 133: “By the mid-1970s the limits of total harmonization had become clear. As the [European] Commission was to write some years later, ‘[e]xperience has shown that the alternative of relying on a strategy based totally on harmonization would be over-regulatory, would take a long time to implement and could stifle innovation’.” (footnote omitted) [Majone]
[T]here is strong evidence of hysteresis. Countries with weaker securities regulation do not catch up with stronger countries. In fact, our results imply that the two EU directives\textsuperscript{31} had the opposite effect. They illustrate that imposing the same regulation on countries with disparate prior conditions can make countries diverge more, not less, and point to the difficulty of harmonizing markets globally through regulatory reforms.\textsuperscript{32}

Having regard to the practical difficulties in implementing securities regulation at a national or federal level, the challenges to implement and enforce securities law in an internationally centralized model constitutes a formidable and unachievable hurdle. A centralized structure is also prone to a “Christmas tree” effect, i.e. it becomes ineffective as a result of being burdened with too many responsibilities of diverse nature and focus.

\textsuperscript{31} These two Directives are the Market Abuse Directive which addresses insider trading and market manipulation and the Transparency Directive which addresses corporate reporting and disclosure.

\textsuperscript{32} Hans B Christensen, Luzi Hail & Christian Leuz, “Capital-Market Effects of Securities Regulation: Hysteresis, Implementation, and Enforcement” (2011) Chicago Booth Research Paper No. 12-04 at 6 (Available at SSRN); See also a discussion on the impact of hysteresis or path dependency on Canadian securities regulations in Anita Anand & Peter Klein, “Inefficiency and Path Dependency in Canada’s Securities Regulatory System: Towards a Reform Agenda” (2005) 42 Can Bus LJ 41: “[W]hy hasn’t Canada adopted a uniform structure to regulate its capital markets (what we may term “national convergence”) and why hasn’t it converged with securities law regimes in place in other countries (what we may term “international convergence”)? A powerful answer to these questions is that Canada is “locked in” to the current system because of historical events. The notion of being locked into a certain set of circumstances is sometimes described as “path dependency”. Path dependency posits the importance of historical events in analyzing present circumstances.” See another perspective of path dependence in Mark Gillen, “The Role of Securities Regulation in Promoting a Competitive Capital Market”, Research Study commissioned by the Task Force to Modernize Securities Legislation in Canada (2006), online: <http://www.tfmsl.ca/docs/V4(1)%20Gillen.pdf> “With similarities in approaches to securities regulation in many major capital markets around the world, and with the degree of internationalization of securities markets that has become prevalent in recent years, it would be difficult for any jurisdiction to radically change its securities regulatory regime without risking a significant loss of both issuers who may prefer to raise capital in other jurisdictions and investors who may prefer to invest in other jurisdictions. Thus, there may now be a degree of path dependence in securities regulation around the world. We may no longer be able to realistically get to radically different securities regulatory regimes even where those regimes might indeed, in the long run, prove to be significantly better.”
From a normative perspective, centralization totally sacrifices any arguable advantage of decentralization. To be sure, proponents of decentralization have valid arguments which, it seems to me, should not be rebuffed. In essence, decentralization helps in responding to geographic, political and cultural diversity across societies. Decentralization is more apt to “[keep] government close to the people whose lives are affected by the choices made.”

In view of the various limitations mentioned above, I claim that the centralization model is not proper for the purpose of regulating international securities markets.

2.2.4 Convergence

The demarcating characteristic of the convergence model is the absence of any compulsion or binding norm. The convergence model can exist in two variations: one where there is no communication between countries and any understanding which may exist is tacit; secondly where there are agreements, express or even formal, but which are not binding.

In its first variation, countries “naturally” adopt similar or comparable standards. They may do so through inspiration from the regulatory model of a dominant jurisdiction (a hegemon) or for any other reason. Each jurisdiction acts independently but tacitly works towards a convergent set of standards.

This form of convergence has several weaknesses. It will usually not function in the absence of a hegemon or where there are two or more dominant jurisdictions adopting divergent regulatory approaches. Furthermore, in the absence of any undertaking or

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34 Chaffee, supra note 14 at 1597
agreement, this form of convergence has no element of certitude. It neither has a structure institutionally nor an implementation mechanism. These features make it difficult to determine when a convergent norm has evolved. Moreover, in the absence of a common understanding between various jurisdictions, the norms which develop may be imprecise in nature.

The second variant of the convergence model relies on ‘soft laws.’ ‘Soft laws’ consist of non-binding standards, principles and best practices. It encompasses formal agreements that are understood not to be ‘binding’ under international law, as well as agreements that may be ‘binding’ but that are essentially hortatory or ‘aspirational’; in other words, agreements which are not enforceable and justiciable.35 Standard-setting organizations like the International Organization of Securities Commissions (IOSCO) operate on the basis of this variant of the convergence model.

This variant of the model is better when compared to the first one. However, it still lacks any compulsion or certitude. Each country can freely adopt or reject the standards and principles or may elect to apply a modified version of the standards and principles without prior coordination with other countries. Moreover, if there are no appropriate consultative processes among members of the standard-setting organization, certain members may be reticent to adopt these practices if they have not participated in their formulation.36

Karmel and Kelly’s proposition to allow ‘soft laws’ to evolve adopt a convergence paradigm. However, the authors suggest that as the convergence process evolves, the “soft law may ultimately harden once normative positions and rationalistic preferences

36 Ibid. at 885
have moved sufficiently to make a binding commitment politically acceptable."\textsuperscript{37} Hence, their model is not restricted to convergence. Rather, it envisages an evolution towards harmonization in the form I discuss below. It is also apposite to recall here that the presentation of the models in the form of a spectrum itself suggests that the demarcation lines between them are not etched in stone.

The characteristics of the convergence model discussed above clearly divulge the shortcomings of the convergence model. Hence, my thesis does not consider this model as robust enough for the purpose of regulating international securities markets.

2.2.5 Mutual Recognition

In a mutual recognition scheme, jurisdictions agree on principles of deference or delegation. Compliance with the regime of the home country is deemed to be compliance with the host country regulations. Mutual recognition allows the issuer of one State (home state) to distribute its shares in another State (host state) by complying only with the regulatory regime of the home state. In other words, the issuer does not have to comply with the regulations of the State where it is actually distributing its securities.

If the description of mutual recognition is limited to mere exemption from complying with the host state regime, it will not differ from the issuer choice and portable reciprocity models. These models also call for an adjustment of choice of law rules to favour the issuer’s home country rules as opposed to the host country rules.\textsuperscript{38} However,


\textsuperscript{38} I will discuss both the issuer-choice and portable reciprocity models in Chapter 3 – see part 3.2.
the competition model adopts a *laissez-faire* approach allowing a free choice of jurisdiction as opposed to a ‘managed’ choice in the mutual recognition model.\textsuperscript{39}

Mutual recognition presupposes that “the underlying principles and policies and the overall practices and substantive standards of securities regulation” in the host and home countries are comparable.\textsuperscript{40} Academic literature consistently acknowledges this feature of mutual recognition.\textsuperscript{41} Trebilcock warns about the risk likely to arise in the absence of the comparability feature:

[The mutual recognition principle], if unqualified,… creates the risk that exporting [home] countries may have incentives to adopt lax regulatory regimes that externalize the negative consequences of ineffective regulation to importing [host] countries, for example with respect to prudential requirements for financial institutions, or licensing


\textsuperscript{41} See MacIntosh, supra note 29 at 29 on the relative benefits of mutual recognition, but also its limited scope: “Despite the important difference between mutual recognition and harmonization in promoting regulatory competition, mutual recognition has sometimes arisen in response to the difficulties of achieving harmonization. Line-by-line harmonization has proved extremely problematic... Mutual recognition overcomes the difficulties of line-by-line harmonization by ignoring differences in regulatory schemes and treating substantial compliance with domestic law as complete compliance. ... Precisely because mutual recognition only works where regulatory schemes share a common underlying purpose and a relatively high degree of technical similarity, however, the reach of mutual recognition schemes has largely been restricted to cognate regulatory systems.”

See also Anand & Klein, supra note 32 at 64:“One may further argue that, in fact, the passport system provides an incentive towards harmonization, which certainly appears to be what is occurring in the EU under the passport system. This conclusion would be based on the reasoning that the more securities laws across jurisdictions are harmonized on a substantive basis, the more workable the system will be. In other words, it is much easier for a jurisdiction to mutually recognize laws that are similar or identical to its own than it is to recognize laws that are significantly less developed.” (emphasis added)

Majone, supra note 30 at 125 proposes a slightly different perspective of mutual recognition “[M]utual recognition provides a framework of general rules within which different regulatory philosophies can compete. Competition among rules should drive out rules that offer protection which consumers do not, in fact, require. The end result is *ex post* or bottom up harmonization achieved through market-like processes rather than being imposed by public authorities as in the case of *ex ante*, or top down, harmonization.” Further down, the author notes: “[B]oth the opinion of the [European] Court of Justice and the interpretation of that opinion by the [European] Commission make clear that ‘mutual recognition’ really means ‘mutual recognition of equivalent rules’…. [M]utual recognition cannot work in an integrated market unless certain ‘essential requirements’ are harmonized.”
requirements for professionals, and may precipitate a race to the bottom. Hence, in practice, the Mutual Recognition Principle is typically accompanied, as it has been in the [European Union], with an ambitious agenda for setting minimum harmonized standards for cross-border trade in services.42

A commonly cited example of the mutual recognition approach is the Multi-Jurisdictional Disclosure System (MJDS) between Canada and the United States. The MJDS was a joint initiative that was implemented in 1991 by the Canadian Securities Administrators and the Securities and Exchange Commission of the United States to reduce duplicative regulation in cross-border offerings, issuer bids, take-over bids, business combinations and continuous disclosure and other filings.43 I will consider the MJDS in more detail in chapter 4.44

A more recent example of mutual recognition initiative is the Trans-Tasman Mutual Recognition of Securities Offerings scheme between Australia and New Zealand. Since 2008, Australian and New Zealand issuers may use their domestic (home) offer documents when offering securities in the other jurisdiction, with limited additional entry and ongoing requirements.45 The scheme hence “greatly reduces the compliance cost burden on issuers wishing to offer products in both jurisdictions.”46 It recognizes that although the details of Australian and New Zealand securities law differ, the underlying goals are the same.47

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42 Michael J Trebilcock, Understanding Trade Law (Cheltenham: Edward Elgar, 2011) at 123
44 See part 4.2.2
46 Edward Bibko & al, “International securities and capital markets” (2009) 43:2 The International Lawyer 613 (HeinOnline)
47 Stranaghan, supra note 45
Mutual recognition (predicated on prior harmonization) is a proper mechanism to boost cooperation. Its benefits are common to the harmonization model. However, its reach is generally limited. Most often it concerns two or a few countries which formally adopt some mechanism for the scheme to work.\textsuperscript{48} Nevertheless, both mutual recognition and harmonization share similar features.

\subsection{2.2.6 Harmonization}

As mentioned earlier, the term ‘harmonization’ has been used by different authors in different contexts to mean significantly different things. Even in Chaffee’s classification, whose appellation of the six different models I have used in the thesis, ‘harmonization’ has a meaning different to that I ascribe for the purposes of my thesis.\textsuperscript{49}

It is therefore apposite to clearly delineate the harmonization model I propose. Harmonization, as used in this thesis, consists of an agreement between various jurisdictions on minimum or essential regulatory requirements, or basic norms. Any jurisdiction can “upwardly depart,”\textsuperscript{50} in other words, any jurisdiction has the liberty to

\textsuperscript{48} In practice, mutual recognition is harmonization at a bilateral level or involving few countries only. Though minimum or comparable norms between the participating counties are required, a formal agreement setting these norms is not indispensable.

\textsuperscript{49} See Chaffee, supra note 14 at 1600. In Chaffee’s classification, harmonization consists of the adoption of “identical and equivalent” regulatory systems by all or multiple States as a consequence of treaty or other agreement obligations. Chaffee uses another term in his classification: strong form convergence. He distinguishes harmonization from strong form convergence on the basis that strong form convergence does not require identical systems but rather agreement on essential norms. In the strong form convergence model, each jurisdiction has the liberty of designing its own regulatory system as long as the agreed essential norms among all participating jurisdictions are met. Harmonization, on the other hand, does not allow “the ability to experiment in how to achieve the norms underlying the regulatory system.” There is however an apparent contradiction in Chaffee’s description of the models insofar as harmonization may, but need not, adopt a comprehensive identical model. Harmonization may set minimum norms and nations may legislate beyond this limit. With a view to avoid any confusion, I accordingly propose to delimit harmonization differently. Harmonization, as used in this thesis, will therefore be more akin to the strong form convergence discussed earlier. It consists of agreement between various jurisdictions on minimal or essential requirements or basic norms. Harmonization does not entail “identical and equivalent” requirements. This is in fact part of the centralization model to which I am not favourable.

\textsuperscript{50} Ibid.
regulate beyond the minimum agreed threshold. Moreover, the model I propose does not make a significant distinction between mutual recognition and harmonization. When ‘mutual recognition’ becomes pervasive and binds several countries as opposed to two or few, it is better qualified as harmonization.

I will elaborate and analyze the regulatory harmonization model in chapter 4. I will argue that this model is the most suitable for the purpose of regulating international securities markets.

2.3 Conclusion

In this chapter, I have enumerated six models which can be used to regulate international securities markets: privatization, competition, centralization, convergence, mutual recognition and harmonization. I have elaborated on three of them: privatization, centralization and convergence. I have argued that these models are not suitable for regulating international securities markets. In the next two chapters, I will respectively deal with regulatory competition (chapter 3) and harmonization (chapter 4). Having presented mutual recognition as being similar to harmonization (though with a relatively limited reach), I will also deal with mutual recognition in chapter 4.
Chapter 3:
THE REGULATORY COMPETITION MODEL

Having considered six models which can potentially be used to regulate international securities markets in the previous chapter, this chapter will elaborate on one them: regulatory competition. I deal with this model in detail in this separate chapter insofar as it is the dominant alternative paradigm in academic literature to the regulatory harmonization model I recommend in this thesis.

Regulatory competition is “an economic theory of government organization that equates decentralization with efficient results.”¹ It is premised on regulatory arbitrage.² In this chapter, I will start by providing an overview of the history of this theory and the scope of its application. I will then discuss how this theory has been applied in the securities law domain. I will dispute the applicability of the purported success of the competition model in the field of tax law and corporate charter, which are the two fields on which proponents of regulatory competition rely the most. Finally, I will consider the advantages and limitations of the theory when applied to securities law.

3.1 Historical perspective and scope of application of regulatory competition theory

Charles Tiebout is generally attributed the paternity of the concept of regulatory competition.³ In a seminal article in 1956, he argued that efficient outcome results from

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a decentralized governmental system with horizontally arrayed jurisdictions which compete to attract residents on the basis of differing tax and benefit structures.\textsuperscript{4}

Competitive pressures compel governments to produce their ‘regulatory products at competitive prices’. Governments hence change their domestic laws “in response to the actual or expected impact of cross-border mobility of goods or services on national economic activity.”\textsuperscript{5} The objective is to offset the benefits of governmental intervention against the costs of such intervention, failing which the governments lose their ‘customers’, be it citizens or businesses. It is claimed that regulation produced in this context enhances economic welfare because competitive conditions curb the influence of interest groups and fosters innovation.\textsuperscript{6} Proponents of regulatory competition view centralized systems of standard setting as regulatory cartels which “inhibit the operation of the market, raise prices, and reduce economic efficiency.”\textsuperscript{7}

Whereas Tiebout developed his theory in relation to tax law\textsuperscript{8}, this theory has also been transposed to regulatory competition in diverse fields. Academic literature has adapted the theory, \textit{inter alia}, to corporate law\textsuperscript{9}, takeovers\textsuperscript{10}, banking and financial services\textsuperscript{11}.

\begin{footnotes}
\item[7] Daniel C Esty & Damien Geradin, “Regulatory Co-Opetition” in Esty & Geradin 30, supra note 3 at 33
\item[8] For other works using the regulatory competition theory in tax law, see Daniel Shaviro, “Some observations concerning Multijurisdictional Tax Competition” in Esty & Geradin 49, supra note 3; William Bratton & Joseph McCahery, “Fiscal Federalism, Jurisdictional Competition, and Tax Coordination: Translating Theory to Policy in the European Union” in Esty & Geradin 157, supra note 3
\item[10] Lucian Arye Bebchuk & Allen Ferrell, “Federalism and Takeover law: The Race to Protect Managers from Takeover” in Esty & Geradin 68, supra note 3
\end{footnotes}
competition law\textsuperscript{12}, pensions law\textsuperscript{13}, intellectual property\textsuperscript{14}, telecommunications\textsuperscript{15} environment\textsuperscript{16}, labour\textsuperscript{17}, biotechnology\textsuperscript{18} and same-sex marriage\textsuperscript{19}.

The scope of regulatory competition has further been widened through its application at different levels of government. Proponents of this theory argue that competition can take place between states or provinces of the same country as in the US and Canada or between different countries forming part of a regional block like the European Union or globally between distinct countries.

\textsuperscript{11} Jonathan R Macey, “Regulatory Competition in the US Federal System: Banking and Financial Services” in Esty & Geradin 95, supra note 3; and Gerard Hertig, “Regulatory Competition for EU Financial Services” in Esty & Geradin 218, supra note 3
\textsuperscript{13} Graham Moffat, “European Integration and Pensions Problem: Copping with a Chameleon” in Bratton & al. 323, supra note 6
\textsuperscript{15} Colin Scott, “Institutional Competition and Coordination in the Process of Telecommunications Liberalization” in Bratton & al. 379, supra note 6; Klaus W Greulich, “Telecommunications and ‘Cyberspace’: Transatlantic Regulatory Cooperation and the Constitutionalization of International Law” Bermann & al. 273, supra note 12
\textsuperscript{17} Katherine Stone, “Labour in the Global Economy: Four Approaches to Transnational Labour Regulation” in Bratton & al. 443, supra note 6; and Brian A Langille, “Competing Conceptions of Regulatory Competition in Debates on Trade Liberalization and Labour Standards” in Bratton & al. 477, supra note 6; Mark Barenberg, “Labour Federalism in the United States: Lessons from Coordinated Decentralization in Supranational Regimes” in Esty & Geradin 111, supra note 3; Brian Bercusson, “Regulatory Competition in the EU System: Labour” in Esty & Geradin 241, supra note 3; David Charny, “Regulatory Competition and the Global Coordination of Labour Standards” in Esty & Geradin 311, supra note 3
\textsuperscript{18} Matthias Herdegen, “Biotechnology and Regulatory Risk Assessment” in Bermann & al. 301, supra note 12
\textsuperscript{19} Jennifer G Brown, “Competitive Federalism and Legislative Incentives to recognize Same-Sex Marriage” in Bratton & al. 257, supra note 6
3.2 Application of regulatory competition theory to securities law

Having regard to the very wide range of fields where the regulatory competition has been applied, it is no surprise that securities law has not been spared. The discussion has appealed to authors in the securities law domain in Canada especially in the wake of repeated attempts to centralize securities law across the federation. The interest is in no less part due to the increasing internationalization of the securities markets as well.

Competition among securities regimes in fact finds a prominent place in the literature. The two dominant models which have used regulatory competition as an underlying rationale are the issuer-choice model and the portable-reciprocity model. These models argue in favour of competition among state/provincial or national governments. This thesis focuses on the interaction between national governments at the international level.

3.2.1 Issuer-choice model

The issuer-choice model has been proposed by Romano. She initially proposed the regime as applicable to competition among states in the US, in the same way as in

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20 The decision of the Supreme Court of Canada in Reference re Securities Act, 2011 SCC 66, [2011] 3 SCR 837 can be seen as the culmination of these attempts to harmonize the law. The expert witnesses’ opinions (especially Frank Milne and Michael Trebilcock for the Attorney General of Canada, and Stephen Choi and Jonathan Macey for the Procureur General of Quebec) produced in this case provide further material on the Canadian aspect of this debate. Jeffrey G MacIntosh is a prominent advocate of regulatory competition among provinces in Canada. See his column “Let provinces run it” in Financial Post (26 Jan 2012); “Ideally, the [securities regulation] system should ... cede to market actors the choice of regulator, creating constructive pressure for value-generating innovation - just as the ability to choose one’s corporate law domain has spawned value-enhancing innovation in states such as Delaware. Even without actor choice of regulator, however, the survival of a number of committed and well-resourced regulators will avoid the perils of a regulatory monopolist, with all the concomitant dangers of ossification, over-regulation and insensitivity to local interests.”; See also Jeffrey G MacIntosh, “A National Securities Commission? The Headless Horseman Rides Again” in Anita I Anand, ed, What Next for Canada? Securities Regulation after the Reference (Toronto: Irwin Law, forthcoming in 2012)
corporate law. She later extended the model to competition at the international level among countries. In the issuer-choice model, the choice of the competent regulator is independent of the residence of the issuer or the investor, or the location of the capital-raising transaction. It depends on the choice made by an issuer.

Hence, an issuer located in jurisdiction A can raise capital in jurisdiction A by marketing to investors in jurisdiction A but choose the laws of jurisdiction B as the applicable law. Such choice is purely potestative: in other words, it depends exclusively on the will (whim) of the issuer. Similarly, since issuers have an initial choice while remaining in the jurisdiction, investors will have a choice in due course. In other words, with the presence of issuers having chosen different applicable laws, investors will have a choice among these applicable laws irrespective of any other factors.

The gist of Romano’s proposition, which draws from the regulatory competition paradigm applied in other areas, is: “only when parties to a securities transaction are able to select their regulatory regime without restriction will government authorities be subject to meaningful competitive pressure.”

3.2.2 Portable reciprocity model

The second model relying on a regulatory competition rationale is the portable reciprocity model proposed by Choi and Guzman. In a normal reciprocity regime,

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23 Ibid. at 392
24 Ibid.
25 Stephen J Choi & Andrew T Guzman, “Portable Reciprocity: Rethinking the International Reach of Securities Regulation” (1997) 71 S Cal L Rev 903 [Choi & Guzman]
there is ‘mutual recognition’\textsuperscript{26} between two jurisdictions. Hence a country may allow a foreign issuer to sell securities within its domestic jurisdiction while complying with the regulations of the issuer’s own jurisdiction. ‘Portable reciprocity’ goes further. It allows issuers to select the law of any participating country regardless of the physical location of the securities transaction. Under this regime, an issuer is able to distribute its securities under the laws of any country, and regardless of what country is chosen, the securities can be traded in all jurisdictions.

Despite their different names, there is no real difference between Romano’s issuer-choice model and the subsequent portable reciprocity model proposed by Choi and Guzman. The portable reciprocity model also allows an issuer a free choice of the governing law irrespective of the residence of the issuer or the investor, or the location of the capital-raising transaction. Choi and Guzman recognize that their proposal is “virtually identical” to the issuer-choice model.\textsuperscript{27} The two “significant differences” which they single out to distinguish their model from Romano’s one are no longer applicable after Romano’s 2001 article in which she develops the issuer-choice model and extends it to competition at the international level.

The first difference they mention is that, unlike their portable reciprocity model, the issuer-choice model links the choice of applicable securities regime to the state of incorporation. As mentioned earlier, Romano does not link the choice of law to any factor, not even the state of incorporation of the issuer. The second difference claimed by the portable reciprocity model is that this model applies at the global level whereas the issuer-choice model considers the US market. However, even Romano’s 1997 article, in which she first proposed the issuer choice model, did not purport to limit its

\textsuperscript{26} ‘Mutual recognition’ here must not be interpreted as the mutual recognition model discussed in chapter 2 because in the present case it is not based on comparability of the two regulatory systems involved in the recognition.

\textsuperscript{27} Choi & Guzman, supra note 25 at 948. For a critical view of Choi & Guzman’s tergiversations before adopting the regulatory competition perspective, see the almost one-page long footnote no. 216 in Romano (1998), supra note 21 at 2425
reach to the US market: “The jurisdictional principle applicable to domestic securities transactions is equally applicable to international securities transactions.” At any rate, the 2001 article leaves no doubt that Romano seeks to apply the issuer-choice model to the international securities market.

It is therefore clear that despite the difference in nomenclature, both the issuer choice model and the portable reciprocity model are essentially the same. Even their sources of inspiration are the same: the Tiebout model and US corporate charter competition. In the next part, I will consider these sources and dispute their applicability to competition in international securities law.

3.3 Transposition of Tiebout model and US corporate charter competition model to international securities regulation

Romano, as well as Choi and Guzman, draws inspiration for her model from two important sources: the Tiebout model applied to tax law and US corporate charter competition. The Tiebout model is not expressly acknowledged as an inspiration, but as seen in the first part of this chapter, the very idea of regulatory competition originates from Tiebout’s works.

On the other hand, the corporate charter paradigm is expressly recognized as a source of inspiration for proposing competition in international securities regulation. In the words of Romano: “The market approach to securities regulation is a natural extension of the literature on state competition for corporate charters…”28 Choi and Guzman contend: “With respect to state competition for corporate charters, substantial evidence exists that there is a race-to-the-top.”29

28 Romano (1998), supra note 21 at 2363
29 Choi & Guzman, supra note 25 at footnote 57
Romano and Choi and Guzman seek to transpose the claimed success of the Tiebout model of inter-jurisdictional competition in tax law and US inter-State corporate-charter competition to regulation of international securities markets. However, even if one assumes (for the sake of the present discussion) that the two paradigms on which the issuer choice model and portable reciprocity model are mapped have been successful, it is questionable that this success can be transposed to regulation of international securities markets.

The Tiebout model requires five conditions to produce optimum results (known as Pareto efficient in economic jargon). Trachtman enumerates these five conditions and justifies why none of them are likely to be met in the international securities context.\(^{30}\) In brief, the Tiebout model requires: (i) an optimal size jurisdiction, whereas in international securities context there is no optimal size since the jurisdiction consists of the globe; (ii) a perfect elasticity of supply of jurisdictions with each replicating all the attractive economic features of its competitors, whereas it is difficult to replicate such elasticity in the absence of sufficient homogeneity of resources in the international setting; (iii) costless mobility of households among jurisdictions, whereas mobility of issuers to other jurisdictions entail substantial costs, at least in the searching and analyzing of the different jurisdictions’ regimes; (iv) households are fully informed about the attributes of competing jurisdictions which is doubtful in the securities context; and (v) absence of jurisdictional externalities whereas the “very existence of securities law …. indicates that variations in securities regulation” would lead to such externalities.\(^{31}\)

Insofar as the corporate charter competition paradigm is concerned, assuming that “[t]here is no reason to expect state competition to operate differently for securities law

\(^{30}\) Joel P Trachtman, “Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation” in Esty & Geradin 289, supra note 3 at 304 [Trachtman]

\(^{31}\) Ibid.
than it does for corporate law”\textsuperscript{32} can be a fallacy. As Tung puts it: “Reliance on [the US corporate charter competition model] glosses over important differences in political economy as between US states in a federal system and independent nations in an anarchic global environment.”\textsuperscript{33} He points out two main differences between the charter competition and competition in international securities regulation: (i) US states have been able to coordinate choice of law issues using the US internal affairs doctrine whereas no similar rule exists in international securities regulation, where the basic rule is territoriality; and (ii) few, if any, countries would have sufficient incentive and sufficient capacity to compete over securities law.\textsuperscript{34}

3.4 Claimed benefits of regulatory competition

The three beneficial effects claimed by the regulatory competition model are: (a) disciplining of national regulators and governments; (b) potential for experimentation and innovation in regulation to improve the quality of the regulatory product; and (c) restraining regulatory capture and customizing consumer choice. I will consider each of them in turn and discuss their relative validity.

3.4.1 Disciplining of national regulators and governments

A regulatory competition set-up increases mobility of issuers and investors since regulators compete with other jurisdictions to attract these issuers and investors. The increased mobility serves a dual purpose. First, the readily discernible change in inflow and outflow of both issuers and investors provides a prompt feedback about the state of regulation of a jurisdiction.\textsuperscript{35} Secondly, mobility amplifies the “costs of regulatory

\textsuperscript{32} Romano (1998), supra note 21 at 2385

\textsuperscript{33} Frederick Tung, “Lost In Translation: From US Corporate Charter Competition to Issuer Choice in International Securities Regulation” (2005) 39 Ga L Rev 525 at 531 (HeinOnline)

\textsuperscript{34} Ibid.

\textsuperscript{35} Romano (2001), supra note 22 at 390, 393
mistakes.” Any regulatory mistake may adversely, and sometimes irreversibly, affect the competitiveness of a jurisdiction. Hence, regulatory competition disciplines regulators and legislators and allows policy makers to correct any mistake more promptly.

Even if from a public choice perspective, competition is expected to result in greater discipline of government, I argue that competition also adversely affects the capacity of governments and regulators (public authorities) to discharge their functions. In fact, from a public interest lens, regulatory competition weakens the authority of governments and regulators. Whatever the view of public authorities of what is required in the best interest of the industry, investors or any other stakeholder, they will always have to factor in how their fellow governments and regulators (with whom they are competing) respond in order to avoid compromising their place in that competitive environment. For instance, a ‘cartel’ of issuers may hold the public authorities of a jurisdiction hostage to their interests by threatening to withdraw from that jurisdiction if the said jurisdiction favours investors’ best interest, thus compelling the public authorities to backpedal on their initiatives. In turn, the weakened authority of the public authorities leads to jeopardizing their ability to maximize public interest in its wider sense.

Moreover, the information pipeline provided by inflow and outflow data as mentioned above may be of limited use. It cannot be assumed that any change in inflow and outflow necessarily indicates a regulatory mistake or a sub-optimum level of regulation. It is therefore doubtful that issuers and investors will ‘price’ competing regimes

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37 Trachtman, supra note 30 at 304
38 Ibid.
rationally.\textsuperscript{39} At any rate, small and developing States may start at a disadvantage in a competition regime.

### 3.4.2 Potential for experimentation and innovation in regulation to improve regulatory product quality

Regulatory-competition proponents claim that the self-correcting mechanism of the model fosters experimentation and innovation, and promotes discovery as each jurisdiction will strive to improve their system.\textsuperscript{40} Harmonization, they claim, may hinder regulatory innovation due to the model’s inflexibility. Harmonization may also impose excessive costs by limiting the extent to which markets can tailor their regimes to meet the needs of different market participants and transaction profiles.\textsuperscript{41}

I claim that the incentives of the regulatory competition model for innovation are uncertain insofar as the possibility of ‘intellectual property piracy’ may suppress innovation. If a jurisdiction is not confident, first, of making the most of its first-mover advantage by setting up an improved regulatory regime and, second, recovering the sunk costs of establishing the regime, it may not have the incentive \textit{ex ante} to invest in the new regime.\textsuperscript{42} The model which starts on a competition footing may hence end up being a monopoly or at best a cartel. Competition in the corporate charter context provides an illustration of the lack of incentive to innovate. Despite having a free choice, most corporations incorporate in Delaware.

I further argue that the harmonization model does not preclude experimentation and innovation. The possibility to surpass the minimum agreed standards with varying

\textsuperscript{39} Donald C Langevoort, “Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment” (2000) 63 Law & Contemp Probs 45 at 49
\textsuperscript{40} Romano (1998), supra note 21
\textsuperscript{41} Moloney, supra note 2 at 28
\textsuperscript{42} Trachtman, supra note 30 at 304
extents preserves the prospect of innovation. In fact, if innovation is meant to require “trial and error” which may put investors’ financial resources and the economy’s financial stability at stake, it is clearly not a laudable objective. If innovation is meant to improve the system, such improvement can also be achieved in the harmonization model. Indeed, harmonization provides greater economies of scale in analysis and innovation.43

3.4.3 Restraining regulatory capture and customizing consumer choice

Regulatory competition is hailed as an antidote to regulatory capture. Regulatory capture describes a situation where a state agency which is supposed to regulate a sector is manipulated by the regulated entities of that sector, hence impeaching its independence.44 Regulation made by such an agency is characterized by “suboptimality.”45 Stigler, who is credited with identifying this phenomenon and developing the theory, claimed that “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.”46

In a regulatory competition set-up, as a response to the sub-optimal regulation, proponents of regulatory competition claim that there is a capital movement out of the jurisdiction.47 To avoid such movement, regulators are compelled “to abandon the manipulation of regulatory mechanisms for private gain (‘capture’)”.48 They strive to come up with optimal regulations, without paying heed to entities seeking to ‘capture’ them. The model also purports to promote consumer choice by customizing regulatory

43 Ibid. at 305
47 Ibid.
48 Daniel C Esty & Damien Geradin, “Regulatory Co-Opetition” in Esty & Geradin, supra note 3 at 33
products to the need of issuers and investors.\textsuperscript{49} In a more political language, it allows a ‘government close to the people’.\textsuperscript{50}

The rhetorical response to this is “To which people is government close?”\textsuperscript{51} I claim that regulatory competition allows a disproportionate role to issuers and accordingly has a great propensity for ‘regulatory capture’. Behind the response of governments in a regulatory competition set-up in terms of alteration of national rules, “one may find complex business-government interactions.”\textsuperscript{52} Even in the “market-driven law-making process,” interest groups like issuers exert disproportionate influence, preventing the process from reaching “the ideal result of legislation based solely on the exogenous preferences of individuals.”\textsuperscript{53} Hence “[j]urisdictions with costly regulations may find businesses pressing for reductions in their regulatory burden when faced with import competition from jurisdictions with ‘light’ regimes.”\textsuperscript{54}

In fact, I argue that the harmonization model may lead to a lesser risk of regulatory capture. A local stakeholder which may have a local base to influence its own regulator and legislator may not have the same influence at the international level. In other words, the government that may have been ‘captured’ will have to influence the collegiality of all governments. This is obviously more difficult than independently

\textsuperscript{49} Moloney, supra note 2 at 28-29
\textsuperscript{50} Trachtman, supra note 30
\textsuperscript{51} Ibid.
\textsuperscript{52} Jacques Pelkmans, “Mutual Recognition in Goods and Services: An Economic Perspective” (2003) ENEPRI Working Paper No. 16 at 22 [Pelkmans]; But see Lawrence G Baxter, “‘Capture’ in Financial Regulation: Can we channel it toward the Common Good?” (2011) 21 Cornell JL & Pub Pol’y 175 at 178: “Capture is offered as an antidote to the supposed political naïveté of the “public interest” theory of policy formation. Yet the notion of an opposing, public interest theory is itself largely a straw man set up by capture theorists to advance their models.”
\textsuperscript{53} William Bratton & Joseph McCahery, “Regulatory Competition as Regulatory Capture: The case of Corporate Law in the USA” in Bratton & al. 207 supra note 6 at 213. This article explains the success of Delaware in corporate charter competition using capture theories. The threat of exit to reincorporate in a different state gives managers an edge over lawmakers, having regard especially to the dependence of Delaware on charter revenues.
\textsuperscript{54} Pelkmans, supra note 52 at 22
implementing the demands of the powerful stakeholder of the regime at the domestic level.

Moreover, as argued under the previous subtitle on experimentation and innovation, the harmonization model does not negate the potential of regulatory competition to enhance preference revelation. Hence, the harmonization model can actually rely on the possibility of competition beyond the minimum agreed standards to “provide valuable evidence on how harmonization should proceed, where clear evidence emerges of market support of particular regulatory choices.”

3.5 Limitations of regulatory competition model

The regulatory competition model jeopardizes two core motivations for regulating international securities markets: first, promoting investor protection, be it at a domestic or international level; and, second reducing systemic risk by addressing negative externalities and collective action problems. I will now discuss each of these reasons for regulation and how the competition model will undermine them.

3.5.1 Threat to investor protection

The claimed success of competition in corporate law has been strongly debated in academic literature. Proponents of competition argue that corporate charter competition leads to a “race to the top” which benefits shareholders. On the other hand, critics

55 Moloney, supra note 2 at 29
argue that the competition in fact leads to a “race to the bottom” which only benefits “self-serving firm managers.”  

Transposed to the securities domain, “race to the bottom” depicts a trend where each jurisdiction seeks to incentivize and attract issuers. In doing so, the competing jurisdictions are tempted to sacrifice prudential norms. Irrespective of whether there is a ‘race to the bottom’ in the corporate competition, I suggest that such a phenomenon occurs in the international securities context because of the divergence in the issuer’s and investor’s interests.

The non-alignment of interests is blatant: if the entity to be regulated chooses the regulatory regime, can it be expected to balance its interest and that of the chosen jurisdiction on the one hand with the interest of the investor and that of the jurisdiction where the transaction takes place? In my view, the prospect of doing so successfully is minimal. What is more probable from the perspective of a rational issuer is to opt for a regime requiring a level of regulation and supervision which is less than what is socially desirable because its private cost of compliance with the norms is greater than


It is also important to read claims about regulatory competition in context. For example, Pelkmans, supra note 52 at 23 writes: “Initial fears in the Community that regulatory competition would create a ‘regulatory gap’ … or a race to the bottom have not been borne out.” This seems to contradict the view I express. However, the author clarifies the point he is making in the following paragraph where he states: “This is indeed what proper understanding of mutual recognition – the prerequisite of regulatory competition – would lead one to expect. After all, mutual recognition only applies if the objectives or effects of regulations in different member states are equivalent. A race to the bottom, removing regulation justified by market failure would clearly violate the equivalence test.”

59 James D Cox, “Regulatory Duopoly in US Securities Markets” (1999) 99 Colum L Rev 1200 at 1244 [Cox]: “Thus, the history of the blue sky laws dramatically documents that the natural tendency of state regulatory competition is a race to the bottom.”
the social costs of such compliance. Regulatory competition hence constitutes a threat to investor protection.

One argument proposed by those who favour competition is that issuers have an incentive to choose an adequately regulated jurisdiction. This is because “[i]nvestors who perceive ex ante that a particular market poses a higher instance of fraud manipulation, unfairness or general uncertainty regarding the trustworthiness of financial information for securities will discount the price of each security in that market by a greater amount than a comparable security in a market where they believe there is a lower incidence of such abuses or disclosure deficiencies.” This argument mistakenly assumes that the market for locational rights operates efficiently on the basis of perfect information (information efficient). It is doubtful that investors will ‘price’ competing regimes rationally. Such an argument also begs the question: why regulate the securities market in the first place if investors are already equipped to assess each market and prevent any abuse?

The difficulties which investors will encounter to enforce their rights are also eminently serious. Romano admits that regulatory competition may be the source of “new complications for investors.” Choi & Guzman also admit this shortcoming of the competition model. Referring to the critics of normal reciprocity regimes who argue that reciprocity may “lead to great confusion among investors,” Choi and Guzman confess that portable reciprocity “multiplies the potential number of regimes investors

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60 See generally Fox, supra note 58; see also Cox, supra note 59 at 1233: “[T]here is reason to doubt that conditions are ripe for regulatory competition with respect to competing disclosure policies. There are also several other negative features of allowing more than one disclosure standard within a single market. These features draw into question the attractiveness of the regulatory hierarchy model championed by those who prefer multiple disclosure standards.”

61 Cox, supra note 59 at 1201; see especially James D Cox, “Rethinking US Securities Regulation in the Shadow of International Regulatory Competition” (1992) 55 Law & Contemp Prob 157


63 Romano (2001), supra note 22 at 401
must track.” Since the courts of the State chosen by the issuer will have jurisdiction to determine disputes, the physical absence of the issuer and the investor from that State creates a series of practical and legal hindrances to the enforcement of the investor’s rights.

While acknowledging this risk, Romano proposes three measures to protect investors: first, disclosure of the regime regulating the securities both for primary and secondary market transactions; second, shareholders’ approval in the event of a proposed midstream change in the chosen jurisdiction; and third, recognition by the judiciary (of the States where the investors and the issuers are located or where the transaction takes place) of the parties’ choice to submit disputes to arbitration and of forum selection clauses. In the forthcoming parts, I will dispute the efficacy of these measures. I will address the first two together, and then the third one briefly.

3.5.1.1 Disclosure of regime and approval of midstream change in chosen jurisdiction

The solution proposed by Romano fails to recognize the information asymmetry between the issuer and the investor, especially in this case where the issuer will be in a foreign jurisdiction. Moreover, investors are already subject to an overload of disclosures in documents which are becoming more bulky and more frequent over

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64 Choi & Guzman, supra note 25 at 924 under sub-heading “Information Overload”
65 Romano (2001), supra note 22. Romano has the merit of responding to the shortcoming she acknowledges. On the other hand, Choi & Guzman do not provide any solution. For them, the information on the jurisdiction chosen by the issuer will just add up to the “myriad of factors” which investors consider when determining the value of a security: Choi & Guzman, supra note 25 at 925
66 Cox, supra note 59 at 1234: “Certainly the evidence amassed by researchers suggesting that capital markets are noisy markets, i.e. that stock prices do not on average reflect a security’s intrinsic value, does not support subjecting investors to multiple disclosure standards.” (footnote omitted)
See also First Annual Report of the OSC Investor Advisory Panel submitted in August 2011: “The current balkanization [in Canada] into multiple regulatory regimes allows for regulatory arbitrage and a “race to the bottom.” Too often products of very similar return and risk characteristics are regulated completely differently because of their different origins or other quirks. Investors are frequently confused and ill-served by these multiple jurisdictions.” (Online: Ontario Securities Commission <http://www.osc.gov.on.ca>)
time. If the assumption of the competition model (that disclosure will suffice for an investor to provide an ‘informed’ consent) proves to be unfounded, the consequences on the fairness, efficiency and liquidity of the markets will be harsh.

More importantly, merely mentioning that a particular security is subject to a specified regime conveys very little to the investor. First, the investor may not have the ability or resources to understand the different regimes. Second, even if she has the ability and resources, the ‘costs of learning’ multiplies with different regimes regulating haphazardly, given that the investor will still need to study and understand the regulatory regime of each country in whose issuer’s shares she intends to invest. The investor’s understanding of the chosen jurisdiction’s regime may have to extend to other areas of that jurisdiction’s laws. If an issuer chooses to be regulated only by the securities legislation of a country, this may be incomplete if for instance the securities regime of that country is complemented by business and corporate law, criminal law or insolvency and bankruptcy law.

As a response to the limited use of the mere disclosure of the chosen jurisdiction, Romano proposes that in case the domicile of the securities does not provide for issuer liability for fraud, or for financial disclosure, the disclosure to investors should also mention this feature. Moreover, where such liability or requirement for disclosure exists but the regime lacks capacity to prosecute issuers violating these requirements, this must also be disclosed to investors.

It seems to me that this latter solution to the investor protection challenge is so convoluted that it is incapable of being implemented. It poses more questions than provides answers. Who polices the disclosure? It cannot be the regulator of the

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68 Trebilcock Reply 2010, supra note 62 at para 13
69 Choi & Guzman, supra note 25 at 935 under sub-heading “Overlapping regulations”
investor’s domicile given that the underlying premise of the issuer choice model is that the competent regulator is the regulator of the issuer’s domicile. Who then assesses the lack of capacity to prosecute and with what degree of objectivity: the regulator of the issuer’s domicile? Is the issuer’s regulator expected to compel the issuer to disclose that the said regulator has no capacity to prosecute or regulate the market effectively? Expecting so appears unrealistic.

In the light of these arguments, I claim that both the disclosure of the regime chosen by the issuer and the requirement for shareholders’ approval of a midstream change in the chosen jurisdiction are of very limited value.

3.5.1.2 Role of the state judiciary

The regulatory competition model proposes a free choice for the competent jurisdiction to the issuer. This choice can give rise to complex conflict of law issues in cases where the issuer and the investor are not in the same jurisdiction, or where the issuer and investor are in the same jurisdiction but the issuer chooses the regime of another country to regulate the transaction.

Romano acknowledges this difficulty but attempts to side-track this problem by proposing arbitration as a mode of dispute settlement. She further suggests that courts must recognize the parties’ choice to submit disputes to arbitration and also recognize the forum chosen by them.

However, arbitration is not recognized in all jurisdictions. Moreover, even where it is recognized, courts have been quite weary of bequeathing their jurisdiction. This reticence of the judiciary, and in many cases of the legislature itself, is more pronounced when it comes to consumer issues – as many of the unsophisticated
investors’ dealings may be qualified. Accordingly, the solution proposed by Romano is of limited relevance.

### 3.5.2 Systemic risk arising from negative externalities and collective action problems

Before elaborating on this limitation of the regulation model, it is apposite to define the terms ‘systemic risk’, ‘negative externalities’ and ‘collective action problems’.

#### 3.5.2.1 Definition of terms

**Systemic risk**

Systemic risk is the risk of break down among jurisdictions, regulators, institutions and other stakeholders in the market “in a chain-like fashion that has the potential to affect the entire financial system negatively.” While the definition systemic risk varies depending on the context of a discussion, the risk of a ‘domino effect’ is central to the concept.

**Negative externalities**

The bottom-line of a negative externality is the dissociation between the entity that makes a decision and the entities that bear the costs of that decision. The following extract provides an adequate summary of the concept of ‘negative externalities’:

> Externality is a term used by economists to describe situations in which an entity (a person, a corporation) does not bear all of the costs, or

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receive all of the benefits, of decisions they take. In cases of negative externalities, some or all of the costs of a decision are borne by another entity; in cases of positive externalities, some or all of the benefits of a decision are received by another party. The basic idea behind an externality is that the disjuncture between the entity that makes a decision and the entities that bear the costs or receive the benefits of a decision means that that decision is made differently than it would be where the costs and benefits were strictly private. In cases of negative externalities, because costs can be shifted onto other entities, an entity may engage in more of an externality-causing activity than they otherwise would. The opposite is true for positive externalities.73

Collective action problems

In simple terms, collective action problems are problems arising when the decision of one participant impacts the decision of another participant and, in the absence of coordination between these participants, both parties are ‘worse off’ as a result of their decisions. Two of the most common collective action problems are the “Prisoner’s Dilemma” and the “Tragedy of the Commons.”74

In the words of Spiro, “[a] Prisoners' Dilemma is a noncooperative ‘game,’ or situation, in which strategies leading to the best outcome for all players are not in the individual interest of each player.”75 As for the “Tragedy of the Commons”, it relates to a situation where “a resource controlled or owned by no one is portrayed as vulnerable to overuse

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74 For a general overview of these notions, see Michael J Trebilcock, “The Lessons and Limits of Law and Economics” in Pierre Nadeau, ed, In the Eye of the Beholder (Montreal: Université de Montréal, 2007)
by individually rational actors collectively creating destruction in no one’s long term
interest, to the ultimate ruin of the resource.”

3.5.2.2 Application of concepts to the regulatory competition model

In the international securities context, a negative externality refers to a situation where
a country takes a decision for which it does not have to bear the full cost. In other
words, it does not bear the consequences alone. Other countries bear adverse
consequences of the decision. The decision-making country therefore does not take
responsibility for the part which affects other countries. It is a consequence of lax
regulation resulting from the fact that the enacting jurisdiction does not have to bear the
consequences of the failure of the legal regime. Market failures resulting from cross-
border externalities extend beyond national boundaries and cannot be corrected by the
action of individual States.

In the issuer choice and portable reciprocity models, the complete disconnect between
investor, issuer and chosen jurisdiction is likely to give rise to negative externalities.
Given the possibility that foreign (host) states will enjoy the benefits of regulation in a
regulatory competition model, rather than the decision-maker (home) state, home states
are likely to under-invest in regulation. This reduces the welfare of other countries.
Since the chosen jurisdiction has no stake other than attracting issuers to its jurisdiction

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78 Moloney, supra note 2
79 Trachtman, supra note 30 at 306
80 For a response to arguments made by regulatory competition proponents against the importance of considering negative externalities in securities regulation, see Trebilcock Reply 2010, supra note 62 at para 2: “It is not helpful to trivialize [the jurisdictional externalities] point, as Professor Choi [expert witness for Quebec and Alberta] does, by arguing that many mundane daily activities, e.g., eating fatty foods, or not exercising, involve externalities that we often ignore. Obviously an exercise of judgment is called for as to how substantial and extensive externalities are in seeking to internalize them. As my Report indicates, in the securities field jurisdictional externalities are the norm not the exception.” (footnotes omitted)
and obtaining regulatory fees, it is not subject to any significant political discipline. Moreover it has no incentive in internalizing costs generally associated with the use of regulation of the securities market. Conversely, there can be under-utilization of jurisdictions favouring investor-protection and fostering fair, efficient and competitive capital markets. Issuers, and more specifically their managers, may prefer countries which “cheat in this competition” by tolerating “managerial opportunism” and promoting issuers’ private interests.81

Regulatory competition can also give rise to collective action problems, namely the Prisoner’s Dilemma and Tragedy of the Commons, given that no particular jurisdiction or authority will have any coordination role. Each jurisdiction will have an incentive to make an abuse of the available international capital markets to derive short-term profit, recognizing that the resource will not survive for long in this state of anarchy. Even ‘right-thinking’ jurisdictions, i.e. those which recognize that it is in each State’s best interest to regulate adequately, may not find the impetus to use the resource cautiously. They will find it in their best interest to defect rather than cooperate in the absence of any framework.

Both negative externalities and collective action problems in turn lead to systemic risks. The 2008 financial crisis has provided a costly lesson on the systemic risk arising from a competition approach: “The financial crisis that began in 2008 evidences the systemic risk that is created if the world takes a regulatory competition approach to international securities law. As the financial crisis demonstrates, patchwork regulation does not provide an optimal level of regulation for the emerging global securities markets.”82

81 James D Cox, Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition (1992) 55 Law & Contemp Probs 157 at 165
In international securities markets, “the benefits of exploiting finite capital resources accrue to individual [jurisdictions], each of [which] is motivated to maximize use of the resource, whereas the costs of exploitation are distributed more widely.”\textsuperscript{83} As observed by Anabtawi and Schwarcz, “[t]his can not only result in a failure to identify or fully appreciate the correlations but also, more significantly, a failure to fully appreciate the possibility that the correlations may combine to produce a systemic crisis.”\textsuperscript{84}

The absence of any mechanism in the regulatory competition model to internalize the externalities and to avoid collective action problems increases the risk of default by any country. This risk of default amplifies systemic risks which impact the ability of other jurisdictions to regulate their own markets, setting off a chain of negative economic consequences that pervade the global financial system.

### 3.6 Conclusion

After analyzing the regulatory competition model and the arguments marshalled in its favour by its supporters, this chapter has provided ample reasons for rejecting this model in the context of international securities regulation. In the following chapter, I will elaborate on the regulatory harmonization model and argue that this model is the most suitable for the purpose of regulating international securities markets. As it may be expected, there will be some parallel between chapters 3 and 4 insofar as many limitations of the competition model which are addressed by the harmonization model thus constitute the benefits of the harmonization model. Similarly, many benefits of the harmonization model point toward the shortcomings of the competition model.

\textsuperscript{83} Iman Anabtawi & Steven L Schwarcz, “Regulating Systemic Risk: Towards an Analytical Framework” (2011) 86:4 Notre Dame L Rev 1349 at 1375

\textsuperscript{84} Ibid.
Chapter 4:
THE REGULATORY HARMONIZATION MODEL

In the previous chapter, I analyzed the pure regulatory competition model and explained why it is not an appropriate model for regulating the international securities markets. In chapter 2, I carried out a similar exercise in relation to the other models and elaborated on the reasons for rejecting them. In this chapter, I will discuss and elaborate on the harmonization model and the reasons for recommending it as the preferred model.

To be sure, none of the six alternative regulatory models is perfect, as is often the case in most spheres. The question is certainly not whether the harmonization model is flawless, but rather how does it compare to the others. Indeed, from a policy perspective, “[r]ecognizing the unavoidable nature of … trade-offs [between conflicting goals] is an essential first step in identifying realistic policy options.”\(^1\) After balancing the relative advantages against the drawbacks of harmonization, I argue that it is the best available alternative. In fact, any drawback of this model can be constrained within reasonable limits to avoid any significant adverse effect.

I situate my proposition in the “third-generation scholarship,”\(^2\) which favours a synthesis of views to attain a preferable solution and is open to more flexibility. This third-generation advocates in favour of “enough interjurisdictional cooperation to ensure that transboundary externalities and other market failures are addressed, but with a sufficient degree of regulatory competition to prevent the resulting governmental

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structure from becoming an untamed, overreaching, or inefficient Leviathan.” Its objective is “to identify the variables that determine the optimal mix of competitive and cooperative forces.” However, this philosophy is of general application to multiple instances where the debate between regulatory competition and cooperation has subsisted. The purpose of my project is to adapt this line of thinking specifically to the theme of regulating international securities markets.

At the outset, it may be helpful to reiterate my vision of harmonization. It consists of an agreement between various jurisdictions on minimum or essential requirements, or basic norms. Any jurisdiction can “upwardly depart”, i.e. it can regulate beyond the agreed minimum norms. The first limb is based on a ‘positive integration’ approach which preconizes that “as economic integration proceeds, divergent regulatory strategies and approaches across jurisdictions can become a major source of trade tension.” The second limb of the definition seeks to capture the benefits of regulatory competition, but at the same time avoid its adverse effects. It is based on a political economy perspective which “tracks geographic and political diversity, accommodates the divergence of values across societies, and fulfils the civic republican ideal of keeping government close to the people whose lives are affected by the choices made.”

4.1 Views of regulatory-competition proponents on harmonization

Before considering the actual evidence supporting the superiority of the harmonization model, a closer look at the propositions of advocates of regulatory competition is quite

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3 Ibid. at xxvi
4 Ibid. at xx; see also Michael J Trebilcock, “National Securities Regulator Report” (2010) I Reference Record 222 at para 13 where the author distinguishes between negative integration approach (which emphasizes the prohibition of discriminatory measures by one party against another) and positive integration approach (where the focus is on “removing or reducing regulatory divergences that create multiple compliance or transaction costs, creating barriers of entry for parties … from one jurisdiction seeking to undertake economic activities in another.”) [Trebilcock (2010)]
5 Esty & Geradin, supra note 2 at xx
revealing. As seen earlier, the harmonization model consists of the determination of essential or minimum standards, and multilateral agreement on such standards.

Proponents of regulatory competition object to both to the idea of having uniform minimum standards and to the idea of multilateral agreement at governmental level. However, they concede that the models they propose may end up with uniform standards. They equally concede that their own models require multilateral agreement to operate.

As Romano puts it, in relation to uniform standards:

[I]f substantial regulatory diversity is not preferred by issuers and investors, then competition will produce uniform regulatory outcomes without a need for governmental agreements mandating harmonization. In the United States, for instance, there is considerable uniformity across state corporate law, notwithstanding the competition for corporate charters.6

Romano equally makes it clear that her model requires inter-governmental agreement:

It is not possible … to establish a fully competitive international regime without multilateral government action. Nations must agree to alter their present territorial jurisdictional approach to securities regulation and recognize instead a statutory securities domicile, as selected by the issuer.7

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6 Roberta Romano, “The Need for Competition in International Securities Regulation” (2001) 2 Theoretical Inq L 387 at 396 [Romano (2001)]. This can be referred as “market driven regulatory convergence.”

Douglas J Cumming & Jeffrey G MacIntosh, “The Role of Inter-Jurisdictional Competition in Shaping Canadian Corporate Law” (2000) 20:2 Int’l Rev L & Econ 141 provides an interesting analysis of this topic in the Canadian context. The authors write: “[P]erfect competition will tend to lead to perfect uniformity of laws.”

7 Romano (2001), supra note 6 at 396

She discusses few possible ways to circumvent the need for such agreement but concedes that these ways are not satisfactory. Hence, the issuer-choice model still requires an inter-governmental agreement to operate.

Choi and Guzman also recognize the importance of inter-governmental agreement. Their portable reciprocity system requires “treaty agreements,” also referred to by them as “a portable reciprocity treaty”, to operate.⁸ Throughout the description of their model, they speak of “participating countries,” i.e. countries which agree by virtue of a treaty or agreement to recognize the regulatory regime of another country.

4.1.1 Three observations on the dilemma of regulatory-competition proponents

The above views of regulatory-competition advocates call for three observations. First, it seems to me that any criticisms that proponents of the competition model may level against having uniform standards or about inter-government agreement on a regulatory model holds little water. Recall that the harmonization model requires nations to “agree to alter their present territorial jurisdictional approach to securities regulation and recognize instead a statutory securities domicile,” just as preconized by Romano in the above quote. However, harmonization further requires nations to agree, as a condition precedent to the agreement on the jurisdictional issue, on uniform minimum or essential standards.

Second, the need for cooperation between jurisdictions constitutes an anathema to the regulatory competition model. It cannot be reconciled with the model’s pessimism that “the product of international negotiations over regulatory cooperation will be even less

forms that parties can manipulate…. [U]nless some shared commitment to rules such as these exists, cooperative competition becomes difficult if not impossible.”

⁸ Stephen J Choi & Andrew T Guzman, “Portable Reciprocity: Rethinking the International Reach of Securities Regulation” (1997) 71 S Cal L Rev 903 at 932 [Choi & Guzman]
responsive to investor interests than domestic legislation.” It is worthy of note that this pessimism is based on a public-choice consideration of regulators and lawmakers.

The public-choice theory of regulation assumes as a fundamental tenet that regulators and legislators “will not agree to enter into international agreements unless it is in their (private) interest to do so.” Intuitively, one is left to wonder the rationale for a country to opt in a competition agreement and forego all the benefits it derives from the regulation of its own securities market. Why will regulators and legislators (additionally backed by interest groups such as lawyers, accountants, underwriters and stock exchanges) agree to subject themselves to competition and choice of law rules which will enable both issuers and investors easy exit from existing territorial monopolies?

Relying on public-choice assumptions, it can only be posited that regulators and legislators will fear loss of business if issuers and investors elect to move out of the jurisdiction. Even if the regulators take a selfless view and consider only investor protection or the efficiency of the capital market, the regulators may see the choice made by the issuer in an unrestricted competition scenario as “profoundly inadequate to protect their domestic constituencies.” The fundamental assumptions of regulatory competition that internationally-agreed standards are sub-optimal, on the one hand, and

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9 Romano (2001), supra note 6 at 390
11 After discussing the need for every nation to adopt a choice of law rule that recognizes the choice made by the issuer and the outcome of dispute resolution conducted cross-borders, as a prerequisite for competition, Sykes laconically remarks: “To my knowledge, not one [nation] has arrived at it yet:” Alan O Sykes, Regulatory Competition or Regulatory Harmonization? A Silly Question?” (2000) 3 J Int’l Econ L 257 [Sykes]
13 Sykes, supra note 11
the requirement for international agreement to put the regulatory competition model, on the other hand, are hence irreconcilable.

Third, the critique of proponents of regulatory competition about the domestic democratic accountability for international harmonization agreements and the slow process in reaching such agreement applies equally to regulatory competition models as these models also require inter-governmental agreements: “[P]roblems exist with obtaining portable reciprocity agreements and implementing enforcement across several different countries…”

MacIntosh, although being a vocal advocate of regulatory competition in the Canadian securities regulation context, also acknowledges the virtue of combining competition with cooperation:

While harmonization sterilizes regulatory competition and mutual recognition advances it, the experience of the [European Community (EC)] shows that it is possible to combine harmonization and mutual recognition approaches. The basic approach in the [EC] Directives has been to specify minimum standards that must be adopted by member states, coupled with mutual recognition of the regulatory standards of other member states. The combination of the two approaches concedes something to all corners of the debate about how international markets ought to be regulated. Those who trumpet investor protection as the end of securities regulation, for example, can point to the specification of minimum standards as a defence against a ‘race to the bottom’. While these advocates of investor protection might prefer fully harmonized law,

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15 Choi & Guzman, supra note 8 at 951
they would recognize that the EC solution of combining harmonization and mutual recognition avoids the insuperable difficulties of securing line-by-line harmonization. On the other side, those who commend the virtues of regulatory competition can point to the fact that member states retain a significant degree of latitude to shape their laws as they will, and thus engage in regulatory competition. Precisely because it offers something for everyone, the EC solution has much to recommend it.  

In the light of these observations, I argue that the criticisms of regulatory-competition advocates against the harmonization model must significantly be watered down.

### 4.2 Evidence supporting superiority of harmonization model

In the absence of a system at the international level, I will rely on reported empirical studies on harmonization initiatives implemented at three other levels and attempt to extrapolate their conclusions: a national/federal level, a bilateral level and a regional bloc level. These initiatives are the Canadian passport system, the Multi-Jurisdictional Disclosure System (MJDS) and the European Union (EU) model respectively. I will argue that the relative success of these initiatives demonstrates the superiority of the harmonization model and such superiority can be transposed to harmonization at an international level.

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17Jeffrey G MacIntosh, “International Securities Regulation: Of Competition, Cooperation, Convergence, and Cartelization” (1995) [unpublished, archived at Bora Laskin Law library] at 30; see also David W Leebron, “Lying down with Procustes: An Analysis of Harmonization Claims” in Jagdish Bhagwati and Robert E Hudec (eds), Fair Trade and Harmonization: Prerequisites for Free Trade?, Vol 1: Economic Analysis (Massachusetts: MIT Press, 1996) 41 at 88: “There are important differences between harmonization … and centralization. Harmonization, unlike centralization, is not inconsistent with localism to the extent that the local unit retains final authority over whether to adopt the harmonization proposal. Insofar as it continues to respect the distinct sovereignty of its adherents, harmonization maintains the potential for competition and difference.”
Before undertaking this analysis, I wish to mention two things. First, truly empirical studies are scarce in this field. This leaves no better choice than rely on heuristics in certain cases. Secondly, I remain alive to the limitations of such comparison and extrapolation as highlighted in a recent article:

[L]egal rules and norms create a kind of regulatory “path dependence” in which the past shapes and limits one’s understanding of the present and vision for the future in ways that may not be fully rational from an economic policy perspective… One possible transnational consequence of this type of cultural bias or path dependence is that economic actors, regulators and we, as economic policy analysts, may tend to over-generalize from the fact that a particular rule or regulatory regime works well in one context, to a conclusion that it will work equally well in other contexts or that regimes that seem to increase general welfare in one context will lead to increased social welfare in others. This kind of thinking can sometimes be seen in the notion that one dominant or familiar regulatory practice is, in fact, ‘best practice’ and therefore should be adopted by others around the globe.  

Comparison with existing models is nevertheless interesting since there is no alternative method which can supplant this comparative exercise or produce better results. Indeed, the above article goes on to admit “the enormous complexity” of assessing the relative economic effects of legal rules in the global economy. Having regard to this ‘complexity’, the article itself seeks to use alternative techniques. The more optimistic note of the article provides a proper guidance and spirit of the comparison exercise: “The challenges of undertaking such a broad research agenda on a global scale are truly daunting. Yet, if we are to begin to incorporate the complexity

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18 Dan Danielsen, “Economic Approaches to Global Regulation: Expanding the International Law and Economics Paradigm” (2011) 10 J Int’l Bus & L 23 at 72 [Danielsen]
19 Ibid. at 74
20 Ibid. at 74
and diversity we see all around us into our analyses of law in the global economy, we must endeavor to try.”\textsuperscript{21}

My goal in proposing harmonization as a superior framework is also realistic. Advocating in favour harmonization is not claiming that it will eradicate all problems which have been identified with the present system. Harmonization will certainly minimize these problems to negligible or at least acceptable levels. As pointed out by Stephan, this realism is important “because scepticism towards regulatory cooperation too easily can lead to a form of market nihilism.”\textsuperscript{22}

4.2.1 Canadian passport system

In a 2003 study prepared for the Wise Persons’ Committee by Anand and Klein entitled “The Costs of Compliance in Canada’s Securities Regulatory Regime”, the authors compare the then system of securities regulation in Canada consisting of 13 regulators which operated in a fragmented fashion with three alternative models: a passport system of regulation, application of a uniform piece of securities legislation administered separately by the thirteen regulators and, thirdly, a centralized model administered by a single national regulator.\textsuperscript{23} The ‘fragmented’ system of regulation is comparable to the one presently applicable on the international stage, with each jurisdiction administering their own laws without much coordination with other jurisdictions. On the other hand, the passport model is comparable to the harmonization model I propose insofar as, relying on the similar or comparable essential features of different laws, compliance with the laws of the home jurisdiction (referred as “primary”

\textsuperscript{21} Ibid.
\textsuperscript{22} Stephan, supra note 7 at 189
jurisdiction in the study) constitutes deemed compliance with the laws of the host jurisdiction.24

The authors report that “[t]he feedback we received indicated that market participants strongly believe that the duplication and lack of harmonization inherent in the current regulatory regime are onerous and do not strike an appropriate balance between stakeholder protection and commercial needs.”25 After an examination of the cost of compliance of the then fragmented system of regulation and the three alternative models they were considering, Anand and Klein conclude that “any of the three alternative regulatory models will reduce or eliminate material incremental costs and opportunity cost risk” when compared to the fragmented system.26 In other words (and for the purposes of this thesis), the harmonization model is more cost-efficient than the fragmented system of uncoordinated regulation.27

Even Choi, an avowed supporter of regulatory competition, admitted the virtues of the harmonization model in his expert opinion submitted on behalf of opponents of a single national regulator in Reference Re Securities Act:

“No one is proposing a move to a completely uncoordinated decentralized system of securities regulation for Canada. The choice facing Canada is between the proven and effective Passport regime, embodying a highly harmonized system of provincial level securities regulation that allows for

24 Trebilcock (2010), supra note 4 at para 59: “A full passport system is predicated on a high degree of substantive securities regulation harmonization in that provinces are unlikely to agree to delegate their regulatory functions to a primary regulator if major divergences exist between the laws in place in the jurisdiction of the primary regulator and those in the delegating provinces, or their interpretation or enforcement.”

25 Anand & Klein (2003), supra note 23 at 522

26 Ibid. See however a critique of this view in Jonathan Macey, “An Analysis of the Canadian Federal Government’s Initiative to Create a National Securities Regulator” (2010) XII Reference Record 37 at 53-55. As I observe in the following paragraph of the thesis, the expert evidence submitted on behalf of opponents of a national securities regulator did not undermine the passport model embodying a harmonized system, but rather criticized the centralization model.

27 It may be noted that the study does not identify any of the three alternative models it considers (i.e. passport system, uniform laws administered independently by each regulator and a centralized system with a single regulator) as most preferred: “Therefore, on the basis of our cost analysis, we cannot conclude that one of the alternative regulatory models reduces incremental costs more than any other.”
a constrained amount of experimentation and local tailoring, and an uncertain and untested national securities regulatory regime. While far from being a purely competitive model, the Passport regime retains many of the benefits of flexibility and innovation similar to that under a competitive regulatory regime. While it is true that the limited choice in the Passport regime is not cost-free, it is not cost-prohibitive either. The passport regime represents a hybrid, offering a large degree of harmonization and consistency coupled with the safety valve of choice leading to much greater competitive pressure than under a national securities regulator.”28 (Emphasis added)

In a later paper, Anand and Klein expand their analysis.29 “[O]n the basis of empirical evidence,” they argue that the fragmented Canadian regime “is burdened by four types of cost inefficiencies: lack of harmonization, duplication, opportunity cost risk and uncertainty.”30 They also factor in another element to compare the alternative models: dynamic efficiency. Dynamic efficiency assesses the ability of a system to adjust with changes through time to maintain its efficiency.31

On the criteria of cost-efficiency, the authors assess the passport system as “a second best alternative” to the centralized regulatory model spearheaded by a single regulator.32 They however hasten to add that the passport system is best when assessed on the criteria of dynamic efficiency.33 The authors assert that while “[a] regulatory monopoly … may be a sound choice in terms of cost efficiency, [it] may not be sufficiently flexible to ensure that this efficiency is maintained as markets (including

29 Anita Anand & Peter Klein, “Inefficiency and Path Dependency in Canada’s Securities Regulatory System: Towards a Reform Agenda” (2005) 42 Can Bus LJ 41
30 Ibid. at 41
31 Ibid.
32 Ibid. at 62
33 Ibid.
issuer and investor demands) evolve."34 Moreover, even at a national level, Anand and Klein deprecate the costly implementation of a centralized system “because of the vast structural change that would be required, such as the formation of a national regulator of some sort as well as a single securities statute among other things."35

By extrapolation, Anand and Klein’s works support the harmonization model I propose in the following four ways: (i) the harmonization model is more cost-efficient than the current fragmented regime applicable internationally where each regulator functions without any coordination with other regulators to administer disparate laws; (ii) lack of harmonization, duplication, opportunity cost risk and uncertainty constitute four of the costs of the present fragmented system and the harmonization model will reduce these costs; (iii) to the extent that the regulatory competition model also proposes maintaining a fragmented regime where each regulator functions without any coordination with other regulators to administer disparate laws (with the only added element of mutual recognition of the choice of the issuer of the laws of any country), the harmonization model is more cost-efficient than the regulatory competition model; and (iv) the harmonization model is more dynamically efficient than a centralized model with a single regulator (the more so when considering that the single regulator will have to administer, not a federal securities market, but a single uniform international securities market.)

4.2.2 The Multi-Jurisdictional Disclosure System (MJDS)

The MJDS is a joint initiative implemented since 1991 by the Canadian Securities Administrators (CSA) and the Securities and Exchange Commission (SEC) of the United States “to reduce duplicative regulation in cross-border offerings, issuer bids, take-over bids, business combinations and continuous disclosure and other filings”

34 Ibid. at 50
35 Ibid. at 72
between Canada and the US. It is “intended to remove unnecessary obstacles to certain distributions of securities” of issuers in the host jurisdiction and to facilitate take-over and issuer bids and business combinations involving securities of issuers having less than a specified percentage of security holders of the host jurisdiction, while ensuring that investors of the host jurisdiction remain adequately protected. The MJDS permits public distributions of securities in the host jurisdiction on the basis of disclosure documents prepared in accordance with the home jurisdiction’s securities laws. Issuers may make a public distribution of securities under the MJDS in both the home and host jurisdictions or in the host jurisdiction only.

The MJDS is a prime example of a mutual recognition model which relies on the similarity or comparability of “the underlying principles and policies and the overall practices and substantive standards of securities regulation” between Canada and the US. As such, I claim that the MJDS is a prototype of the harmonization model and the lessons from its study can be extrapolated to provide insights about the actual harmonization model.

Puri and Sen have conducted a cost-benefit analysis of the use of the MJDS by Canadian issuers. The study compares the MJDS-scenario, i.e. a case where an issuer uses the MJDS for distribution of its securities, and a non-MJDS-scenario, i.e. where an issuer does not use the MJDS for the distribution. The non-MJDS scenario is analogous to the present day regulatory model applicable to cross-border distribution of securities where each jurisdiction regulates its own affairs independently in a disparate and uncoordinated fashion.

36 The MJDS is provided in Canada through National Instrument 71-101. See also Companion Policy 71-101 and Rule 71-801. The description of the MJDS above is drawn from these sources.
37 National Instrument 71-101
39 Ibid.
The study identifies five main benefits derived by Canadian issuers through the MJDS. First, the MJDS provides a more streamlined process insofar as Canadian regulatory requirements on short form prospectus may allow for incorporation by reference. Second, when Canadian issuers use the MJDS, there is an absence of review or, at most, a limited review by the SEC. Third, the exemption from review or limited review allows for a shorter time-frame and increased certainty for the public offering. Fourth, the shorter time-frame and increased certainty in turn increases the potential of taking advantage from “windows of opportunity” to raise capital on favourable terms. Fifth, the exemptions from complying with certain US regulatory requirements results in substantial savings of professional fees, be it legal fees or accounting fees, and continuous disclosure fees.

Using “fundamental and widely accepted principles of public economics analysis,” Puri and Sen compare the costs incurred by Canadian issuers in an MJDS and a non-MJDS scenario.\textsuperscript{40} They find substantial gains arising from the use of the MJDS which range from USD 1.6 billion to USD 3 billion:

Our cost benefit analysis reveals that the Net Present Value of aggregate cost savings to Canadian MJDS Issuers from (a) using Forms F-9\textsuperscript{41} and F-10\textsuperscript{42} for U.S. public offerings; (b) using MJDS forms for meeting U.S. continuous disclosure obligations; and (c) minimizing lost “windows of

\textsuperscript{40} Ibid. at 13, 27 (Table 3)
\textsuperscript{41} Ibid.: “A Canadian issuer is eligible to use MJDS Form F-9 to make a public offering in the U.S. of investment grade debt and preferred stock if it has a twelve-month reporting history in Canada; if the securities are convertible after one year, the issuer must also have a public float of U.S.$75 million.”
As per Release No. 33-9245 of the US SEC dated July 27, 2011, SEC announced that, effective as of December 31, 2012, it will be rescinding Form F-9. Since Canadian issuers will no longer need to perform a US-GAAP reconciliation once they have fully transitioned to reporting under the International Financial Reporting Standards (“IFRS”) pursuant to the CSA’s adoption of rules that will require Canadian reporting companies to prepare their financial statements pursuant to IFRS beginning in 2011, the primary difference between Form F-9 and F-10 will be eliminated.
\textsuperscript{42} Ibid.: “A Canadian issuer is eligible to use MJDS Form F-10 to make public offerings of any security in the U.S. if it has a market capitalization of U.S.$75 million and a twelve-month reporting history in Canada.”
opportunities”, ranges from US$1.6 billion to US$3 billion over a ten year period, assuming a discount rate of 7%.

Puri and Sen’s works support, by extrapolation, the harmonization model I propose in the following six ways: (i) the harmonization model is more cost-efficient than the current fragmented regime applicable internationally; (ii) the harmonization model will allow a more streamlined process than the current system; (iii) the streamlined process made possible by the harmonization model will allow securities to be distributed cross-border within a shorter time-frame and with increased certainty; (iv) the harmonization model will provide additional ‘windows of opportunity’ for distribution to issuers, given the exemption from compliance or limited compliance with the host country’s laws required before distribution in the host country; (v) the harmonization model will allow substantial gains in professional fees, including legal and accounting fees; and (vi) the harmonization model will significantly reduce continuous disclosure fees since disclosure with the home regulator is deemed as disclosure in the host country.

4.2.3 The European Union (EU) model

The EU model provides a case-study of the harmonization model applied at a regional bloc level. After attempts at centralizing regulations failed, the EU switched to harmonization, which is also referred as approximation in the EU context. The EU

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43 *Ibid.* at 3
44 Jacques Pelkmans, “Mutual Recognition in Goods and Services: An Economic Perspective” (2003) ENEPRI Working Paper No. 16 at 2 [Pelkmans]: “Approximation is the adaptation of national laws in such a way and to such a degree that cross-border trade is no longer hindered in a direct or indirect way. This approximation avoids, therefore, centralised rules but aims to bring national laws into ‘harmony’ (hence, the French wording ‘harmonisation’ ... where the English text speaks of ‘approximation’”).
45 Moloney, supra note 14 at 9-10. Moloney however notes that pursuant to the EC Financial Services Action Plan (FSAP), the EC “changed the character of EC securities regulation from a minimum harmonization/mutual recognition-based regime to a regime of unparalleled regulatory detail which, for the most part, ousts national rules and policy in the areas harmonized.” at 10. I do not consider post-FSAP initiatives in this thesis as these initiatives assume an already harmonized system, which is not the case in the international securities regulation context.
harmonization model, which became the “touchstone” of the European securities regulation, operated in the same way as the harmonization model I propose: agreement on a minimum level of mandatory requirements such as consumer protection rules and public interest rules, coupled with a degree of regulatory competition above the minimum level.

The model allocated primary regulatory control for cross-border market activities to the home State. Very broadly, the home State was the Member State in which the issuer or regulated party was resident or registered. Regulatory competition above the minimum level “in principle, accommodated flexibility, innovation, and … local market sensitivity whereas prior inter-State agreement on minimum norms provided the basis for mutual recognition and “was designed to place a limit on prejudicial regulatory competition.” An issuer which complied with the minimum agreed standards imposed by the issuer’s home State could distribute its securities to all EU States forming the ‘single market’.

In 1995, Sun and Pelkmans carried out a “comparative, qualitative cost/benefit analysis” of harmonisation and regulatory competition in the EU. Their analysis resulted in two key conclusions: first, the claimed benefits of regulatory competition in academic literature, which are essentially inspired from the literature on economic regulation and the economics of federalism, “may well be out-weighed by its practical costs”; and, second, the costs of the harmonization model (i.e. the model constituting of agreed minimum norms with the possibility of competition beyond that minimum level) “have dramatically reduced, and in commensurate fashion, so have its disadvantages relative to regulatory competition.” The study “casts serious doubt on the general empirical validity of the results from economic theories of regulatory competition.” Sun

46 Ibid.
47 Ibid.
and Pelkmans note, as “the most interesting aspect” of the study that regulatory competition and cooperation act as complements and not substitutes in the EU harmonization model given that “beyond the ‘essential requirements’ in EC directives, regulatory competition is allowed, if not implicitly encouraged.”

In 2003, Pelkmans reviewed and maintained the findings of the 1995 study. He notes that the “relative attraction of regulatory competition has decreased since the new regulatory strategy of the EU,” which is the harmonization model, has been accepted. Adopting the harmonization model hence at once neutralizes the costs of harmonization and competition and consolidates the benefits of the two models.

Sun and Pelkmans’s works support the harmonization model I propose in the following three ways: (i) the theoretical virtues of regulatory competition may not be borne out empirically; (ii) regulatory competition and cooperation are not substitutes but complements; and (iii) the harmonization model constitutes a good mix of competition and cooperation, which maximizes the benefits of both regimes and reduces the impact of their adverse consequences.

4.3 Why is regulatory harmonization preferable to regulatory competition?

In this part, I will analyze the relative advantages of having a harmonization model which constitutes a hybrid of cooperation and competition as compared to a pure competition model. In this endeavour, it is apposite to seek inspiration from the field of accountancy (which has been a pioneer in many respects when it comes to harmonization initiatives) and draw some parallels to understand the potential gains from harmonization in the area of securities regulation:

49 Pelkmans, supra note 44 at 24
50 Ibid.
The economic potential of the global convergence of accounting standards can hardly be overestimated. At bottom, multinational companies will slash their accounting budgets, while competing for capital anywhere in the world. But the true effects of convergence will be felt by investors, who at last will be able to easily comprehend and compare the financial health of companies the world over. They will have the tools to make more prudent investment decisions than ever before. The world's supply of capital will be allocated with optimal efficiency. The global capital market will be an unprecedented dynamo of prosperity.  

The advantages discussed in this part strengthen, complement or elaborate on those which have been presented in the previous part of this chapter which assessed the Canadian passport system, the MJDS and the EU model.

4.3.1 Mechanism to address systemic risk through reduction in negative externalities and prevention of collective action problems

I have defined and dealt with the concepts of systemic risk, negative externalities and collective action problems in chapter 3.  

The harmonization model calls for all jurisdictions to agree on minimum standards required to maintain an optimum regime. The minimum standards of the harmonization will internalize the costs of spillover effects. By implementing these minimum standards, each jurisdiction will be bound to internalize the costs of these externalities in its respective regulatory regime. Harmonization thus reduces the risk of negative

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52 See part 3.5.2
externalities. As a consequence, harmonization reduces the risk of prejudice to investors and third parties in the form of fraud.

The harmonization model will also address the collective action problems associated with regulatory competition, more particularly Prisoner’s Dilemma and Tragedy of Commons (Commons problem) which have been discussed in chapter 3. Harmonization agreements offer governments a means to escape from the Prisoner’s Dilemma and the Commons problem by incorporating reciprocal reduction in barriers to trade and avoiding trade policies that externalize a high proportion of the costs of these trade policies onto foreign countries.53

Harmonization carried out under the aegis of the World Trade Organization (WTO) (as proposed in chapter 5) will also be a mechanism to address systemic risk. This will move regulation to a macro-prudential level through the coordination of the regulatory efforts of distinct regulators, which nevertheless operate in an interconnected space:

If we agree that systemic risk may in fact require regulation, then we move into the sphere of “macroprudential regulation,” a term that refers to a definite intention by regulators to respond to systemic risk (above and beyond merely identifying it).54

The task of addressing systemic risk can also benefit from data collection and sharing under the WTO aegis. Indeed, “[r]egulating systemic risk requires deep information channels into local markets.”55 As observed by the International Organization of Securities Commissions (IOSCO) in a 2010 report:

53 Michael J Trebilcock, *Understanding Trade Law* (Cheltenham: Edward Elgar, 2011) at 5-6
As the [2008 financial] crisis unfolded and regulators sought solutions, it also became clear that some of this incomplete information resulted from the global nature of many modern market participants, with information critical to not just regulators but also markets scattered throughout the world.\textsuperscript{56}

However, the WTO will in no way substitute itself to national regulators with a view to regulating systemic risk. The framework merely provides the tools and the coordination necessary for this task.

\textbf{4.3.2 Investor protection}

Investor protection is one of the cardinal purposes of securities regulation: “the central pillar of modern securities regulation since its inception.”\textsuperscript{57} Investor protection maintains confidence in the financial system and is important to ensure there is efficient allocation of capital.\textsuperscript{57}

The harmonization model does not threaten investor protection, unlike the competition model which I discussed in chapter 3.\textsuperscript{58} In fact, investor protection is one of the key areas where the harmonization model must provide for agreed minimum standards. This will be in line with the very rationale of regulating securities.

\textsuperscript{56} IOSCO, “Final Report - Principles Regarding Cross-Border Supervisory Cooperation” 2010, online:<www.iosco.org>


\textsuperscript{58} See part 3.5.1
4.3.3 Economies of scale on cost of compliance

Harmonization results in economies of scale on the cost of compliance. If an issuer must adjust its distribution of securities to comply with diverse regulatory requirements in individual markets, say for compulsory disclosures in a prospectus, the resulting costs per share are likely to increase. This increases the cost of capital and precludes ‘junior issuers’ from accessing the international markets. By allowing an issuer to distribute securities in any jurisdiction based on compliance with the laws of the home jurisdiction, harmonization reduces the regulatory cost.

4.3.4 Enhancement of allocational efficiency

Allocational efficiency is “the effectiveness with which a market channels capital to its highest, most productive uses.”59 The harmonization model promotes allocational efficiency by restraining the barriers based on territorial belonging between issuers and investors.

The assurance of complying with the minimum standards in the harmonization model incites countries to operate in an atmosphere of mutual cooperation. This atmosphere prompts jurisdictions to minimize protectionist barriers and thus improve market access. Foreign issuers benefit from the same treatment as domestic ones, commonly referred as national treatment, and can freely market their securities in any jurisdiction. Issuers hence benefit from wider possibilities for raising capital.

From the investors’ perspective, they can trade in securities issued in any jurisdiction and hence have increased opportunities for portfolio diversification. The aggregate cost

of equity capital falls when a country opens its stock to foreign investors. Providing access to foreign investors in a market also enhances the processing and diffusion of global information significantly, especially for stocks in emerging markets. Access to foreign investors therefore contributes to the incorporation of such information into stock prices, yielding informationally more efficient stock prices in emerging markets. Harmonization thus promotes free movement of capital and allocational efficiency.

4.3.5 Reduction of risk of regulatory gaps

In the current regulatory framework, laws, legal practices, requirements and pitfalls relevant to cross-border securities trading and transactions are mainly national in character. This has given rise to an increasingly complex branch of private international law relating to securities.

The internationalization of securities law also brings along a lot of uncertainty and often leaves regulatory gaps. One case which illustrates such a gap is *Morrison et al. v. National Australia Bank Ltd. et al* [Morrison]. In *Morrison*, the US Supreme Court affirmed the “longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.” It hence ruled that a US law at issue in that case did not provide a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges.

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Regulatory gaps are partly due to the fact that cross-border securities transactions have been driven by economic actors rather than “a deliberate and legally framed political decision of governments and international organizations.”67 A clear regulatory environment where market players operate with a reasonable degree of certainty concerning the rules which apply avoids regulatory gaps. The harmonization model reduces regulatory gaps by providing a strategic global approach to regulation with enhanced emphasis on regulatory communication and cooperation accompanied by a clear allocation of regulatory responsibilities and determination of governing laws.68

4.3.6 Reduction of information costs

Information costs include the costs of evaluating the technical impact of foreign regulations, translating and disseminating information, training of experts.69 They also include the ‘cost of learning’ new regulations for different systems and to track amendments to these regulations.70 Information costs especially affect issuers, but investors also incur some types of such costs. Information costs are high in a regulatory competition model because issuers and investors must grasp the disparate laws of multiple jurisdictions and constantly keep up with any changes brought to these laws.

Harmonization reduces the information costs in two ways. First, the minimum requirements for all jurisdictions are similar or comparable. Hence, learning the laws of one jurisdiction is adequate to operate in the system. Second, and more importantly, the model requires a total grasp of the laws of only one jurisdiction: the home jurisdiction.

68 “International Agenda” (October 2010), online: Financial Services Authority (of Great Britain), <http://www.fsa.gov.uk>
70 Trachtman (2000), supra note 62 at 241
This is because the home laws will apply to distribution even in foreign (host) jurisdictions.

4.3.7 Greater ease of comparability and analysis

In a harmonization model, investors, analysts and other stakeholders have better comparison between securities of different jurisdictions given that all these jurisdictions will adhere to common minimum standards regarding disclosure. Common or comparable standards will allow investors a better assessment of securities emanating from different issuers. Harmonization also increases the potential of benefitting from network externalities. Network externalities (also known as network efficiencies) arise when the value of adopting a particular measure increases with the number of jurisdictions which adopt the same measure.

Easier comparability and analysis is, in fact, more conducive to competition – among jurisdictions to some extent, but especially among issuers: “From a political economy perspective, some degree of harmonization of substantive rules may also facilitate competition. Establishing a common baseline - a set of minimum requirements - among states may enable political deals that allow competition as to remaining aspects in an area of regulation.” Recall that any jurisdiction may transcend the agreed minimum level in the harmonization model. Competition between jurisdictions will hence take place on whether a jurisdiction departs from the minimum threshold and, if so, to what extent.

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72 Joel P Trachtman, “Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation” in Esty & Geradin, supra note 2 at 305
4.4 Conclusion

In this chapter, I have discussed the merits of the harmonization model at great length. I have justified this model as the preferred one among the alternative regulatory models in three ways. I have first exposed certain facets of the competition model which either ironically support the claim for regulatory harmonization or share the same challenges that proponents of the competition model claim the harmonization model faces. Secondly, I have considered three regulatory systems (the Canadian passport system, the MJDS and the EU model) which have already adopted the harmonization model, albeit not at the international level as this thesis proposes. I have argued that the success of these systems can be extrapolated to the international level. Thirdly, drawing from the academic literature, I have discussed the advantages of adopting the harmonization model to regulate international securities markets. In the next chapter, I will discuss the implementation of the harmonization model.
Chapter 5: USING THE WTO/GATS FRAMEWORK TO HARMONIZE REGULATION OF INTERNATIONAL SECURITIES MARKETS

After discussing the normative aspect of the debate in relation to the optimum regulatory system and recommending harmonization as the preferred model in the previous chapters, I will now discuss an implementation strategy for the harmonization model. I will argue that the WTO/GATS framework is apt for this purpose.

It is apposite at this juncture to set the parameters of the discussion below. There is a whole body of law relating to the World Trade Organization (WTO) and the General Agreement on Trade in Services (GATS). This chapter can definitely not address all the issues and challenges which the WTO/GATS framework faces. I equally do not seek to under-estimate or iron out these challenges as the Doha Round negotiations are under way.

The objectives of this chapter are, first, to identify the WTO/GATS framework as a compelling paradigm for liberalization in the securities sector and, second, to discuss how this framework can be used to implement the harmonization model in order to achieve the liberalization objective. I will thus limit this chapter to issues which are of peculiar interest for these two purposes.¹

5.1 Introductory comments on the WTO, GATS and the Financial Services Agreement

In 1995, the WTO succeeded the 1947 General Agreement on Tariffs and Trade (GATT 1947) by virtue of the Marrakesh Agreement (the Final Act) concluded during the Uruguay Round negotiations. GATS forms part of the Marrakesh Agreement establishing the WTO and also results from the Uruguay Round negotiations. It became operational in January 1995.

Being the first multilateral and legally enforceable agreement covering trade and investment in services, GATS marks a watershed and a shift towards ‘juridification’ of trade relations.2 It is symbolic of the international economic interdependence between States and the increasing impact of rules as opposed to power and hegemony in a multilateral trading system.3 All Members of the WTO are signatories to GATS and are required to assume the resulting obligations.4

At the time GATS came into force, negotiations over financial services commitments were incomplete. GATS however already had two annexes on financial services: the more popular one actually called ‘Annex on Financial Services’ and the second referred as ‘Second Annex on Financial Services’.5 GATS also had an Understanding on Commitments in Financial Services.

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3 *Ibid.* at 5

4 As at May 10, 2012, the WTO has 155 Members and 29 observer States: (source, online: WTO <http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm>). Only 14 States and two territories have no official interaction with the WTO yet: (source, online: Wikipedia <http://en.wikipedia.org/wiki/World_Trade_Organization>)

5 Mention of “Annex on Financial Services” in the thesis refers to the first annex, unless otherwise specified.
Negotiations on commitments in financial services were completed in December 1997 with the conclusion of the Financial Services Agreement (FSA). Many countries made commitments designed to allow the commercial presence of foreign financial service suppliers in the securities sector, as well as in the two other major financial services sectors, namely banking and insurance. These commitments were incorporated and bound in the Fifth Protocol of GATS. The FSA entered into force on March 1999.6

Admittedly, the structure of the FSA is quite complex. This is largely due to the history of its adoption. The FSA, though an Agreement on its own, is still under the ‘auspices’ of GATS, meaning that GATS remains the framework agreement.7 Moreover, the FSA is not a single agreement or document but composed of different parts. These parts include GATS itself, the Annex on Financial Services and the Understanding on Commitments in Financial Services.8 The FSA is intended to clarify some core GATS provisions as they apply to financial services.

To the extent that GATS remains the framework agreement, I generally refer to GATS or the specific part of the FSA where relevant, such as the Annex on Financial Services, instead of the FSA in this thesis. In fact, reference to the FSA appears quite rarely in academic literature, with more frequent references to the specific documents which, as I mentioned earlier, together form the FSA.9

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7 The term ‘auspices’ is borrowed from Sauvé & Steinfatt, supra note 6 at 351
8 Wagner, supra note 6
9 See sources mentioned in note 1. Even the WTO website, which is full of resources and contains all WTO legal texts, makes almost no reference to the FSA: online: WTO <www.wto.org>
5.2 Trade Liberalization

As international trade has evolved, it is increasingly recognized that permitting finance to flow freely towards its best use in an international market enhances worldwide welfare.\textsuperscript{10} Econometric evidence strongly suggests that openness in the financial services sector leads to long run growth performance.\textsuperscript{11}

Recent (post-2008 financial crisis) data do not depart from the correlation between liberalization of the services sector and economic growth.\textsuperscript{12} Building on the extant body of empirical evidence showing that services liberalization increases the productivity of the economy as a whole, Tarr reports that the liberalization of barriers against foreign investors in services leads to estimated welfare gains which are “several multiples of the estimated gains of models without foreign direct investment in services and endogenous productivity effects.”\textsuperscript{13} The importance of services has in fact expanded “from a broader global policy perspective in the aftermath of the 2008 financial crisis.”\textsuperscript{14} Specifically, countries with more active stock markets grow faster (even after controlling for many other factors underlying economic growth).\textsuperscript{15}

\textsuperscript{13} Tarr, supra note 12 at 3
\textsuperscript{15} Ross Levine,“Financial Development and Economic Growth: Views and Agenda” (1997) 35 J Econ Lit 688
The benefits of trade liberalization are manifold.\textsuperscript{16} Trade liberalization provides the opportunity for States to specialize in the production of goods and services for which its resources, labour or capital (referred to as ‘factors of production’) are relatively better adapted, and to exchange this production against imports. Thus freer trade results in production of a greater amount of goods and services for a given amount of resources, labour or capital utilized, which in turn allows a better satisfaction of the needs and wants of society on average. Moreover, trade liberalization results in increased global competition, compelling domestic firms to gear toward additional or new sources of efficiency gains — thereby generally helping to raise standards of living through a more efficient use of resources.

Trade liberalization for goods under GATT has a longer history than liberalization in the field of services under GATS. Discussion to include the services sector in the multilateral trading system arose in view of the growing importance of this sector. One author estimates that total measurable trade in services as defined by GATS is USD 2.17 trillion, which represents 7.6 percent of world trade.\textsuperscript{17} Another author reports that “[a]ll the empirical studies explicitly indicate that for the past two decades trade in services has grown faster than, or at least as fast as, merchandise trade.”\textsuperscript{18} It has also been reported that services “account for more than half of the GDP of almost all countries, and more than 75 percent in high-income countries” but “cross-border trade in services is generally no more than 20 percent of all trade for a country.”\textsuperscript{19} Another publication reports that services account for more than 70 percent of production and

\textsuperscript{16} These beneficial effects are generally recognized and analyzed in various sources. I have particularly referred to Daniel Schwanen, “Trade Liberalization and Inequality in Canada in the 1990s”(2001) 1 Review of Economic Performance and Social Progress 161. For classic criticisms of trade liberalization and an apt response to these critics, see Trebilcock & Howse, supra note 6 at 9-20


\textsuperscript{18} Delimatis (2007), supra note 2 at 10

\textsuperscript{19} Hoekman & Mattoo (2011), supra note 14; Michael J Trebilcock, \textit{Understanding Trade Law} (Cheltenham: Edward Elgar, 2011) at 112 mentions similar figures.
employment in advanced industrial societies and many of the developing world’s emerging economies are also fast approaching these levels.\textsuperscript{20}

GATS has a significant potential to facilitate securities trading across borders. The example of China is telling. In December 2001, China officially became a member of the WTO “after 15 years’ preparation”.\textsuperscript{21} Its commitment in the area of securities is expected to lead to new breakthroughs:

China’s WTO commitment on the securities market has started a new chapter in the opening up of China’s securities market. The implementation of the commitment by the securities law and regulations on the QFII scheme\textsuperscript{22}, joint venture fund management companies\textsuperscript{23} and joint venture securities companies\textsuperscript{24} will have an unprecedented impact on China’s securities market and economy…. [A] total of US$3.7 billion foreign exchange quota has been allocated to 26 qualified QFIIs by the end of March 2005. The investment of large amount of funds in shares and various government and enterprise bonds has increased the supply of capital to the market.\textsuperscript{25}

\begin{footnotesize}
\begin{itemize}
  \item[22] QFII Scheme is the Qualified Foreign Institutional Investors Scheme which allows selected QFIIs to invest in China’s securities market.
  \item[23] In section 7 of the Schedule of Specific Commitments on Services, China pledged to permit joint ventures with foreign investment to conduct domestic securities investment fund management business of up to 33% (which may be increased to 49% within 3 years after China’s accession).
  \item[24] Within 3 years of accession, foreign securities were permitted to establish joint ventures with a foreign minority ownership not exceeding one third of the equity and to launch investment funds.
\end{itemize}
\end{footnotesize}
5.3 Barriers to trade

The benefits of trade liberalization have prompted the WTO to take initiatives to curb barriers to trade. Two of the main WTO instruments are General Agreement on Tariff and Trade 1994 (GATT 1994) and GATS. Both GATT and GATS have a shared objective: eliminate or minimize barriers that “hinder the use of capital to its most advantageous end.”

In relation to goods, the barriers are mainly tariffs, but can also be non-tariff such as import and export licenses, quotas, subsidies, technical or local content requirements, embargoes and currency devaluation. In relation to services, the barriers depend on the mode of supply of the particular service.

Four modes of supply for the delivery of services are covered under GATS - mode 1: cross-border supply, mode 2: consumption abroad, mode 3: commercial presence and mode 4: presence of a natural person. Hence, for example, in the case of consumption abroad or where the presence of a natural person is essential for delivery of a service, the immigration policy of the country where service is sought to be consumed or delivered can constitute a barrier to trade. Cross-border trading of securities can use one or more of the four modes of supply. For instance, under mode 3, a State may require an issuer to have a commercial presence or its registered office in that State to distribute its securities to its citizens.

However, the focus of this thesis is on mode 1, which is cross-border supply of securities. Immigration policy and the like are not relevant as barriers in this mode.

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27 Trebilcock & Howse, supra note 6 at 351.
this mode of supply, the most significant barrier to cross-border trading of securities is the requirement to comply with divergent regulations of different states.

From an economic point of view, regulatory heterogeneity, be it discriminatory or not, may constitute a substantial barrier to international trade in services due to the cost of complying with multiple regulatory environments. The diversity in regulations presents a barrier to the movement of capital inter-jurisdiction. I do not claim however that the diversity should be substituted by homogenous regulation. Acknowledging that elimination is not a realistic or even optimum result, the claim is for a reduction of trade impediments while at the same time allowing for flexibility to protect legitimate regulatory objectives.

A distinction is also made between discriminatory and non-discriminatory barriers in services trade. Discriminatory barriers depend on the origin of the services. They are essentially addressed by national treatment obligations which I will discuss in part 5.6 of this chapter. Non-discriminatory barriers are origin-neutral: they apply irrespective of the origin of the service. Diversity in domestic regulations of different States falls in this category. Even when regulatory measures apply in a non-discriminatory manner, differences in regulatory measures across countries may hamper trade. Market access obligations deal with both discriminatory and non-discriminatory obligations.

28 Delimatsis (2007), supra note 2 at 74
30 Delimatsis (2007), supra note 2 at 74
31 Delimatsis & Sauvé, supra note 12 at 851: “In GATS-speak, domestic regulation, as defined in Article VI:4, relates to national measures aimed at ensuring the quality of the service supplied and which do not discriminate (and thus do not fall under the national treatment obligation of GATS Article XVII) nor do they constitute quantitative limitations (and thus do not come under the market access obligation of GATS Article XVI).”
32 Delimatsis (2007), supra note 2 at 116
33 Ibid. at 131: “While Article XVI [Market access] primarily addresses the use of discriminatory and non-discriminatory quantitative restrictions affecting trade in services, and Article XVII [National Treatment] comes to grips with any measure that discriminates against foreign services and service
5.4 GATS and the harmonization model

In the previous chapter, I elaborated on the normative preference for regulatory harmonization. Harmonization will address the regulatory diversity by creating an internationally-agreed common minimum standard based on which securities issued in one jurisdiction can be distributed in other jurisdictions without complying with additional requirements. However, harmonization based on an internationally-agreed standard cannot take place in the absence of an overarching framework. It is in this respect that GATS becomes relevant to cross-border trading of securities.

Although GATS has been in force since 1995, the prospect of using GATS for the regulation of the international securities market remains largely unexplored.\(^{34}\) GATS has the objective of “[establishing] a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization.”\(^{35}\) Having regard to its nature as a framework agreement, GATS is sufficiently broad to encompass this emerging area of international securities. More specifically, the Annex on Financial Services provides for trading of transferable securities. As per clause 5(a) of the Annex on Financial services, “financial services” include trading of transferable securities for one’s own account or for the account of customers, whether on an exchange, over-the-counter or otherwise. Also included in the definition are participation in issues of all kinds of securities and suppliers in favour of like services or service suppliers of national origin, Article VI [Domestic Regulation] aims to deal with non-discriminatory veiled impediments to trade in services.”

\(^{34}\) *Ibid.* at 117: “For many, the GATS is the natural, multilateral forum in the field of trade in services to promote minimum harmonization efforts, lend credibility to the results achieved through legally binding commitments and to the consequential domestic regulatory reform endeavours, and to alleviate domestic opposition.” This source however does not cite who constitutes or is included in the “for many”. Nevertheless, see *ibid.* at 165: “Clearly, the GATS does not call for harmonization [used here as meaning complete homogeneity or centralization] of domestic regulations; this is, in fact, not desirable at all. What is expected in the aftermath of the GATS is that regulators see the public interest and the concept of regulation in a wider context that takes into account the growth of international trade, and notably trade in services. According to the GATS, it is feasible for a regulator to guarantee a certain minimum level of quality of the supply of a service and thus protect the public interest domestically, or achieve its national policy objectives, and still have a not-more-trade-distortive-than-necessary attitude.”

\(^{35}\) Preamble to GATS
underwriting as well as settlement and clearing services for securities, derivative products and other negotiable instruments.

Apart from enacting rules or harmonizing different national rules, regulation of the international securities market requires “an administrative infrastructure for rule enforcement and adjudication.” The GATS structure will be valuable at three levels: determining the common minimum standard quintessential for the harmonization model; ensuring that the agreed standard is uniformly implemented and applied by all Member States (providing technical assistance where required in the process); and providing an adjudication and enforcement mechanism in case of dispute between Member States or where a Member reneges its obligations. It will certainly comfort the skeptic that using the WTO framework to set minimum standards is not a novelty. My proposition to use GATS to do so will emulate previous experiences like the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs), the Agreement on Technical Barriers to Trade and the Agreement on Sanitary and Phytosanitary Measures.

Reducing trade impediments through harmonization of minimum regulatory standards in turn reduces the risk of negative externalities. In fact, free trade in services without prior agreed minimum thresholds “may actually result in a net reduction in aggregate global economic welfare.” An obvious example is fraud perpetrated on investors of

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37 Joel P Trachtman, “Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation” in Daniel C Esty & Damien Geradin, Regulatory Competition and Economic Integration: Comparative Perspectives (Oxford: Oxford University, 2001) 289 at 303. Trachtman proposes the extension of previous equivalence experiences to the securities law field: “While there is no structure in the securities law field that would provide for [judicial examination of equivalence] today, the WTO Agreement on Technical Barriers to Trade, the WTO Agreement on Sanitary and Phytosanitary Measures, and other international mechanisms provide for such review in other sectors. It is feasible that these disciplines could be extended to the securities law field. The result would be that recognition would only be required where the host state’s regulatory goals are met by the home state regulation.”

38 Trebilcock & Howse, supra note 6 at 352-3
state A by an issuer of state B (who is regulated by state B) which imposes significant costs on the public authorities of State A. As a result, “the gains from free trade are more than outweighed by the reduction in global welfare due the opportunities for externalizing the costs of domestic regulatory approaches abroad that are created by liberalization.” The harmonization model I propose reduces the prospect of such negative externalities and is hence likely to increase global welfare.

5.5 GATS and the sovereign right to regulate

As seen earlier, the general philosophy of GATS, in line with that of the WTO generally, is to promote progressive liberalization and reduce trade barriers. Regulatory divergences can amount to non-tariff barriers given that the costs they represent for market participants can obstruct access to other Member States’ markets. However, contrary to the views of critics of liberalization, GATS (and the WTO) does not require homogeneity in regulation of services. In fact, GATS specifically recognizes the right of Member States to regulate. It seeks to establish a proper balance between different policy goals: to minimize the negative trade effects of regulatory barriers and maximize the economic advantages of liberalization while preserving the legitimate right of Members’ to regulate their economies to meet legitimate national policy objectives and have the prudential regime they select.”

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40 The claim that reducing trade impediments increases global welfare is also made in Delimatsis (2007), supra note 2 at 74
41 Niamh Moloney, EC Securities Regulation, 2d ed (New York: Oxford University Press, 2008) at 7; Delimatsis (2007), supra note 2 at 74
42 Trebilcock & Howse, supra note 6 at 9-20
The Preamble of GATS expressly provides for Members’ right to regulate and introduce new regulations to meet national policy objectives. The principle of progressive liberalization through negotiated commitments and its inherent limitations also assist in achieving a balance between the diverging policy goals.

By virtue of Article VI:4 GATS, the Council for Trade in Services shall develop any necessary discipline to ensure that technical standards and licensing requirements do not constitute unnecessary barriers to trade in services. More specifically, the technical standards and licensing requirements must be “based on objective and transparent criteria” and “not more burdensome than necessary to ensure the quality of the service.” Article VI:4 accordingly aims at “positive integration and minimum harmonization attempts … in the long run, since Members negotiate at the multilateral level with a view to establishing a common regulatory framework on these specific regulatory areas.”

Unlike other subsections of Article VI which speak of “sectors where specific commitments are undertaken,” Article VI:4 makes no such mention. It hence “appears to be applicable regardless of the member’s commitments” and is forward-looking in nature. The language can be contrasted with Article VI:1 of GATS, which provides that “in sectors where specific commitments are undertaken”, each Member shall...
ensure that all measures of general application are administered in a reasonable, objective and impartial manner.

Article XIV GATS on general exceptions which are applicable to all the provisions and existing commitments under GATS is another important instrument in reconciling the conflicting policy goals. Article XIV is inspired by Article XX GATT 1994 which has been “the cornerstone of the multilateral trading system allowing for the pursuit of other legitimate non-economic policy goals and, at the same time, avoiding the use of general exceptions to pursue rent-seeking, protectionist policies, undermining existing obligations and commitments.”

By exempting a Member State from complying with its obligations in specified cases, Article XIV provides leeway to accommodate other policy goals pursued in line with domestic law and policy choices made in accordance with societal values and preferences. In fact, the US relied on this provision in the US-Gambling case, on which I elaborate later in this chapter, to justify its laws and measures which were challenged by Antigua. While exceptions claimed by Members vary depending on each Member’s agenda, GATS offers a “common framework to which domestic policies and law need to respond and comply with in order to establish overall WTO compatibility of measures taken.”

Apart from Articles VI and XIV GATS, Article XIX GATS duly acknowledges the disparity in the level of development of States. Article XIX:2 GATS recognizes the need to respect “national policy objectives and the level of development of individual Members” and to allow “appropriate flexibility for individual developing country

47 Thomas Cottier, Panagiotis Delimatsis & Nicolas F Diebold, “Article XIV GATS: General Exceptions” (2008) in Rüdiger Wolfrum et al., eds., Max Planck Commentaries on World Trade Law, WTO - Trade in Services (Available at SSRN) 2 [pinpoint refers to SSRN version]
48 Ibid.
49 Ibid. at 2
Members” in the process of liberalization. Article XIX thus provides sufficient room for least developed countries to choose an incremental and cautious approach to liberalization. Such countries may even elect for a special temporary carve-out if they require prior regulatory adjustments before fully engaging in international markets.\(^{50}\)

More focused on the trading of transferable securities, the Annex on Financial Services contains a “prudential carve-out” as one of its central element.\(^{51}\) In essence, it confirms that, “notwithstanding any other provisions of the Agreement”, WTO Members are free to take prudential measures to protect investors or to ensure the integrity and stability of the financial system:\(^{52}\)

While there is no WTO jurisprudential guidance regarding the interpretation of the prudential carve-out, its wording clearly suggests that the prudential carve-out is an exception provision with a function similar to that found in Article XX GATT or Article XIV GATS. This means that derogations from any obligation enshrined in the GATS can be justified if the conditions laid down in Paragraph 2 are met. The carve-out covers a potentially broad range of measures so long as it can be shown that they are adopted for prudential purposes.\(^{53}\)

Having regard to all these provisions, it can safely be argued that GATS is not a threat to a State’s ability to address challenges to its public policy autonomy. In fact, it

\(^{50}\) As mentioned in note 45 supra, the particular need of developing countries in the WTO context is a wide and thriving topic which is beyond the scope of this thesis.

\(^{51}\) GATS Training Module, online, WTO: <http://www.wto.org/english/tratop_E/serv_e/cbt_course_e/intro1_e.htm>

\(^{52}\) Art 2 of the Annex stipulates:

(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policyholders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

(b) Nothing in the Agreement shall be construed to require a Member to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

\(^{53}\) Delimatis & Sauvé, supra note 12 at 850
recognizes that “to respect a WTO Member’s national regulatory autonomy in the world trading system is essential to ensure WTO’s long term success.”

5.6 Specific commitments under GATS

To understand GATS, it is important to make a distinction between two categories of principles: those that are generally binding on all WTO members (like the Most Favoured Nation Treatment, subject to the temporary ‘opt-out’ possibility of taking exemptions for non-confirming measures) and those that are only binding if, and to the extent that, a Member State has made a specific commitment. The latter category is an opt-in one. The two principal types of obligation under the second category are market access and national treatment commitments.

The obligation of national treatment prohibits the discriminatory treatment of foreign services and services suppliers when compared to domestic services and services suppliers. National treatment commitments are not directly relevant for the harmonization model given that harmonization does not seek to uniformize the treatment of foreign and national issuers or investors but rather recognize the home country regime, whether this recognition results or does not result in similar treatment. In fact, if Members regulate beyond the minimum norms of the harmonization model, the treatment of issuers and investors in different States will not be similar.

A market access approach, on the other hand, is called for in the securities field given that many of the barriers to trade in services result from fundamental choices of regulatory instrument by individual countries or from regulatory diversity itself. Market access restrictions encompass quantitative restrictions such as limitations on the

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55 Trebilcock & Howse, supra note 2 at 357
number of services suppliers, total value of services transactions or assets, total number of services operations, the total quantity of services output, the total number of persons that may be employed, as well as measures restricting or requiring specific types of legal entity or joint venture, and foreign equity limitations. Harmonization of minimum standards can in fact complement and facilitate market access commitments.

5.7 Relationship between the right to regulate & specific commitments on national treatment and market access

The relationship between Article VI (Domestic Regulation), Article XVI (Market Access) and Article XVII National Treatment has been described as “the thorniest systemic issue in the GATS today.”56 This is in part due to the provisional nature of GATS, to the extent that many aspects are still subject to negotiations in the current Doha Round.57 Another source of this grey area is the interpretation of these provisions by the Panel and the Appellate Body in the case of United States –Measures Affecting the Cross-Border Supply of Gambling and Betting [US-Gambling].58

56 Delimatsis (2007), supra note 2 at 86; also Nancy J King & Kishani Kalupahana, “Choosing Between Liberalization and Regulatory Autonomy under GATS: Implications of US-Gambling for Trade in Cross Border E-Services” (2007) 40 Vand J Transnat’l L 1189 at 1289 [King & Kalupahana]: “In GATS, the boundary between multilateral liberalization and regulatory autonomy is more easily conceived in the abstract than in practice.” See also Pierre Sauvė & Aaditya Mattoo, “Domestic Regulation and the GATS: Untangling the Issues” reproduced in Pierre Sauvė, eds, Trade Rules Behind Borders: Essays on Services, Investment and the New Trade Agenda (London: Cameron May, 2003) 113 at 113: “There can be little doubt that one of the most important and difficult issues in international trade today concerns the relationship between trade and investment liberalization and domestic regulatory autonomy.”

57 For a discussion on why international agreements are drafted in ‘loose’ language, see Henrik Horn, Giovanni Maggi & Robert W Staiger, “Trade Agreements as Endogenously Incomplete Contracts” (2010) 100:1 Am Econ Rev 394; see also Ming Du, supra note 55 at 652: “WTO texts are inherently indeterminate and vague, for two basic reasons. First, ...there is tension between on the one hand, the willingness of legislators to draft laws using all encompassing language in order to subsume the maximum number of transactions, and, on the other hand, the limits inherent in our human nature to predict future events on which we have, at the stage of drafting, imperfect information. This tension is particularly present in a contract such as the WTO, which is not meant to be transaction-specific, but as a global meta-regulation, i.e. rules governing how states should regulate... Second, multilateral treaties always have ambiguities and gaps. The gaps are necessary in order to get the consent required to come to resolution. Many times the diplomats gloss over real differences with language that both sides can interpret the way they want to in order to reach a meeting of the minds as to language.” (footnotes omitted)

US-Gambling is the only case to date which has interpreted the relationship between these provisions. The case concerned a challenge by Antigua of several US laws regulating internet gambling. Antigua alleged that these laws violated US market access commitments under Article XVI of GATS. In defence, the US argued that these laws were justified under Article XIV (a) and (c) as they were necessary to protect public morals and maintain public order. Both the Panel and the AB found that the US was in violation of its market access commitments. The Panel and AB however reached diametrically opposed conclusions on the US defence based on Article XIV. The Panel rejected the US defence whereas the Appellate Body upheld the defence. Many aspects of the decisions of the Panel and the Appellate Body have been criticized in the literature.59

One of most significant criticism concerns the interaction between Articles VI, XVI and XVII GATS. The Panel in US-Gambling ruled that that “Articles VI:4 and VI:5 on the one hand and XVI on the other hand are mutually exclusive.” This finding was not reviewed by the Appellate Body given that none of the parties appealed the Panel’s decision on this ground.

It is worthy of note that Article VI forms part of Part II of GATS entitled “General Obligations and Disciplines” whereas Articles XVI and XVII are found in Part III entitled “Specific Commitments”. It has thus been argued that “the obligation to minimize the trade-restrictive elements of domestic regulatory measures that may undermine the value of market access or national treatment commitments freely entered

into by a Member is [nonetheless] a general obligation which is subject to the disciplines to be developed under Article VI:4.\textsuperscript{60}

Even before the \textit{US-Gambling} decision, Krajewski argued in favour of the mutual exclusive character of these provisions:

\[A\]n overlap between Article VI:4 disciplines and scheduling requirements according to Article XVI and XVII may not be advisable. First, it may create legal uncertainty… Second, the general structure of the GATS and the different purposes of the general obligations and specific commitments also justify mutual exclusiveness between the scopes of article VI:4 disciplines and Articles XVI/XVII.\textsuperscript{61}

However, Delimatsis strongly disputes the Panel’s finding in \textit{US-Gambling} about the mutually-exclusive nature of these provisions:

[T]he Panel set up a false dichotomy between Articles VI and XVI. The Panel was wrong to end its analysis at that point [when it determined they were mutually exclusive] once it had raised the issue in the first place. Rather, it should have continued to demonstrate that, in the absence of an overlap, Articles XVI and VI are complementary. More generally, the relationship between Articles VI, XVI, and XVII is one of complementarity with all three provisions tackling restrictions on trade in services…[W]hereas Article VI was not designed to cope with measures scheduled in line with Articles XVI and XVII, any procedures

\textsuperscript{60} Delimatsis (2007), supra note 2 at 149, See also King & Kalupahana, supra note 57 at 1291: “Article VI takes a generally permissive view of domestic regulation, permitting WTO members to regulate services as long as such regulations are administered in a “reasonable, objective manner” and are, broadly speaking, “not more burdensome than necessary”. \textit{U.S.-Gambling} establishes that such qualitative regulations are not subject to review under Article XVI, which remains focused on quantitative-type restrictions on market access. [Para 248 of AB Report]”

administering quantitative restrictions of Article XVI … or discriminatory requirements scheduled under Article XVII column … could still be subject to Article VI disciplines as regards their regulatory elements…” 62

The practical effect of the unclear demarcation between the purview of regulatory autonomy and the specific commitments on market access and national treatment is that members may seek ways to categorize measures as being subject to Article VI rather than Article XVI:

Measures falling within the scope of Article XVI of GATS form the subject matter for multilateral negotiations on market access and must be eliminated unless scheduled in accordance with Article XVI:2 of GATS. While domestic measures relating to qualification and technical requirements and licensing procedures are still subject to the criteria referred to in Article VI:5, until Article VI:4 ‘disciplines’ are developed, members retain the sovereign right to maintain such regulations or introduce new regulations within the parameters of Article VI. 63

In the absence of any other Panel or Appellate Body decision of the interaction between the domestic regulatory provision and the specific commitments ones, the grey area subsists. However, this temporary uncertainty does not affect my more profound point that the WTO/GATS framework can be used to implement the harmonization model. Many aspects of this framework are in fact very conducive for the implementation of the model and constitute advantages when contrasted with other implementation strategies.

62 Delimatsis (2007), supra note 2 at 153. See also King & Kalupahana, supra note 57 at 1291: “[T]here is some doubt over the correctness of the latter ruling [about Articles XVI and VI:4-5 being mutually exclusive].”
63 King & Kalupahana, supra note 57 at 1290
5.8 Mechanisms for GATS to promote harmonization and advantages of using the GATS framework

5.8.1 Recognition

Article VII GATS expressly identifies ‘recognition’ and ‘harmonization’ as a means of economic integration. However, this provision appears more geared toward service suppliers. The more relevant provision for the theme of this thesis is clause 3 of the Annex on Financial Services. Clause 3 specifically cites prior harmonization as a means to engage in recognition but nevertheless leaves the avenues for such recognition open: “through harmonization or otherwise” and “based upon an agreement or arrangement with the country concerned or … accorded autonomously”. This provision can serve “as a way of facilitating trade in financial services, promoting regulatory convergence and reducing the scope for trade tensions.”

Clause 3(a) provides that a Member may recognize the prudential measures of any other country in determining how the Member’s measures relating to financial services (including securities trading) shall be applied. Clause 3(b) is particularly interesting for the purpose of the harmonization model I propose insofar as it provides the framework for extending existing agreements to other parties: a Member that is a party to an agreement or arrangement under subparagraph (a), “whether future or existing, shall afford adequate opportunity for other interested Members to negotiate their accession to such agreements or arrangements, or to negotiate comparable ones with it, under circumstances in which there would be equivalent regulation, oversight, implementation of such regulation, and, if appropriate, procedures concerning the

64 Delimatis & Sauvé, supra note 12 at 853
sharing of information between the parties to the agreement or arrangement.” (emphasis added)

Hence, the tools for implementing the harmonization model already exist in the WTO/GATS framework.

5.8.2 Harmonization versus Convergence

GATS further has the prime advantage of being a legally enforceable agreement. It is not merely hortatory or ‘aspirational’. It carries the virtue of being able to act as a motor for harmonization instead of merely aiming at a weak form convergence which lacks structure and certitude.

Accordingly, if Member States agree to use the GATS framework to conduct harmonization of securities regulation, the criteria to be fulfilled by regulatory measures can be enforced. For instance, the requirement for measures to be administered in a “reasonable, objective and impartial manner” in sectors where specific commitments are undertaken under Article VI:1 GATS, may be used as “a yardstick in WTO dispute settlement to impose substantive obligations in connection with domestic regulation in accordance with the principle of proportionality.”

Although Article VI:1 focuses on the manner in which measures are administered and not generally on the regulations themselves, “the EC—Selected Customs Matters case is the perfect example for illustrating the difficulty of attempting to draw in practice the dividing line between substance and administration of a given measure.”

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65 Delimatsis (2007), supra note 2 at 102
66 Ibid. In EC – Selected Customs Matters, the Appellate Body considered appeals from both the United States and the European Communities. The Panel was established to consider a complaint by the United States concerning the European Communities’ system of customs administration, inter alia, under Article X:3(a) of GATT 1994. Article X:3(a) GATT provides: “Each contracting party shall administer in a uniform, impartial and reasonable manner all its laws, regulations, decisions and rulings …”
5.8.3 Institutional framework

As observed earlier, the advantage of using GATS and the WTO structure is not limited to the set of rules in the Agreement per se. The institutional framework provided for harmonization to take place demarcates the WTO/GATS structure from other possible forums. In-built in GATS is an elaborate mechanism to achieve progressive liberalization through negotiated commitments over time (and by the same token, the harmonization I propose) and secondly a dispute settlement mechanism.

5.8.3.1 Progressive liberalization

In relation to progressive liberalization, Article XIX GATS provides that in pursuance of the objectives of this Agreement, Members shall enter into successive rounds of negotiations with a view to achieving a progressively higher level of liberalization. Such negotiations shall be directed to the reduction or elimination of the adverse effects of measures as a means of providing effective market access, on a mutually advantageous basis.

True it is that the time frame for the liberalization process in the services sector has not been thoroughly adhered to. However, this is not a result of the ineffectiveness of the institutional framework. The fact that liberalization is not taking place as scheduled

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Adjudicating the contention of the US that the Panel erred in its interpretation of the term “administer”, the Appellate Body held (at para 200): “Under Article X:3(a), a distinction must be made between the legal instrument being administered and the legal instrument that regulates the application or implementation of that instrument. While the substantive content of the legal instrument being administered is not challengeable under Article X:3(a), we see no reason why a legal instrument that regulates the application or implementation of that instrument cannot be examined under Article X:3(a) if it is alleged to lead to a lack of uniform, impartial, or reasonable administration of that legal instrument.”

67 For a discussion about the reasons of the lack of progress in negotiations during the current Doha Round, see Hoekman & Mattoo (2011), supra note 19 at 22: “WTO negotiations on trade in services have not made much progress. Part of reason for this is the decision by Ministers that the primary focus was to be on agriculture and [Non-Agricultural Market Access], and that only once modalities were agreed for reducing barriers to trade in goods would attention center on services. This arguably was a mistake in that it resulted in much less attention being given to an area where the gains from reform are
does not lessen the force of this thesis’s claim that, upon identifying securities regulation as a viable sector for liberalization, the existing institutional framework can be utilized to achieve the goal of harmonization.

5.8.3.2 Dispute settlement mechanism

In relation to the dispute settlement mechanism, the general dispute settlement provisions of the Dispute Settlement Understanding (DSU) apply to financial services disputes.68 The DSU is thus incorporated by reference into GATS. The DSU requires the complaining Member to use informal consultations or mediation with the party whose measures are in dispute to attempt to resolve disputes. If such efforts fail, the complaining Member can request the establishment of an ad-hoc Panel. Members can be comforted by the specific requirement mentioned in the Annex on Financial Services which seeks to ensure that Panels for disputes on prudential issues and other financial matters have the necessary expertise relevant to the specific financial service under dispute.69

The Panel’s functions are to make an objective assessment of the facts and the applicability of relevant agreements to the facts. The Panel then presents its findings and recommendations to the Dispute Settlement Body (DSB). The DSB must adopt the Panel Report unless there is a ‘negative consensus’ favouring rejection of the report. A ‘negative consensus’, also referred to as ‘reverse consensus’ means that the Panel Report will be adopted unless there is a consensus among the Member States to block potentially greatest. But another part of the reason is that negotiating the liberalization of services is complicated. Adequate national regulation and international regulatory cooperation will often be necessary. A concerted effort is needed by governments to strengthen and improve service sector regulation and implementing institutions, as well as to cooperate with each other where there are significant regulatory externalities.”

68 Art XXIII:1 GATS provides: If any Member should consider that any other Member fails to carry out its obligations or specific commitments under this Agreement, it may with a view to reaching a mutually satisfactory resolution of the matter have recourse to the DSU.

69 Clause 4 of Annex on Financial Services
the decision. In other words, any Member intending to block the decision to adopt the Report has to persuade all other Members (including the adversarial party in the case) to join its opposition or at least to stay passive. Therefore, a negative consensus largely remains a theoretical possibility and has never occurred to date.

The Panel’s decision can also be appealed to the Appellate Body on matters of law. The Appellate Body Report is subject to the same adoption procedure as the Panel Report before the DSB. In case of non-compliance by the Respondent Member, the DSB may authorize retaliatory trade sanctions which normally involve the withdrawal of equivalent trade concessions.

**5.8.4 Disciplining effects on provincial or local governments and SROs**

Art I:3(a) GATS provides:

For the purposes of this Agreement “measures by Members” means measures taken by:

(i) central, regional or local governments and authorities; and

(ii) non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities;

in fulfilling its obligations and commitments under the Agreement, each Member shall take such reasonable measures as may be available to it to ensure their observance by regional and local governments and authorities and non-governmental bodies within its territory.

Hence, GATS brings under its purview rules made by provincial or local governments as well as rules made by self-regulated organizations (SROs) like Exchanges. The

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70 “WTO Bodies involved in the Dispute Settlement Process”, online: WTO <http://www.wto.org/english/tratop_e/dispu_e/dispu_settlement_cbt_e/c3s1p1_e.htm>

71 Ibid.

72 See Ming Du, supra note 55 at 648: “A reflection of the huge success of the WTO dispute settlement system has been its frequent use by WTO Members to solve successfully a large number of trade disputes.”
technique of making the central government answerable and accountable for the activities of these entities is a demarcating feature of GATS.

In the field of securities regulation, many rules which may potentially be barriers to trade are made, not by the central government, but by regulators or SROs or, in federal states like Canada, by provincial governments. If central governments could repudiate their international obligations by laying the blame on these lower levels of administration and government, this would have reduced GATS’ potential to become an effective instrument to implement the harmonization model.

5.8.5 High governmental level representation

GATS provides a framework with political representation at a very high governmental level. The strength and consistency of support at the highest political level has been qualified as “the most important ingredient for successful regulatory reform.”73 This interaction at governmental level demarcates the WTO/GATS framework from other possible strategies to concretize harmonization like using the International Organization of Securities Commissions (part 5.8.5.1). Using an existing framework also avoids the expense of financial and human resources in creating another body or framework (part 5.8.5.2).

5.8.5.1 WTO/GATS and IOSCO

The WTO/GATS framework is not the only available one for regulating the cross-border trade of securities. Another alternative may be to empower the International Organization of Securities Commissions (IOSCO). IOSCO has the advantage of being a specialized body dedicated to securities. Over the years, it has established a sound

reputation as the international standard setter for securities markets. The coordination which it has made possible among securities regulators has allowed the streamlining of process and a thorough reflection on common concerns in the field of securities regulation.

However, IOSCO faces a legitimacy deficit. Its membership is composed primarily of securities commissions (or a similar government or statutory regulatory body that has primary responsibility for securities regulation) and self-regulatory bodies, such as stock exchanges. It is a standard setter and its work is essentially at the technical level.

Nevertheless, IOSCO’s work can be used in establishing the essential harmonization required in my model. GATS provides the necessary tool to tap into the expertise of IOSCO: Article VII:5 GATS provides that Member States may work in cooperation with intergovernmental and non-governmental organizations towards the establishment and adoption of common international standards and criteria for recognition. In fact, the prospect of successfully implementing harmonization is greater where international standards have influenced national regulatory regimes. Using IOSCO’s expertise within the GATS framework will tackle “[t]he political obstacles to finding ‘hard law’ solutions that would allow for both common standard-setting and dispute resolution on sensitive matters of cross-border importance.”

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74 “Membership Categories and Criteria”, online: IOSCO <http://www.iosco.org/about/index.cfm?section=membership>
75 Joel P Trachtman, “Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation” in Daniel C Esty & Damien Geradin, Regulatory Competition and Economic Integration: Comparative Perspectives (Oxford: Oxford University, 2001) 289 at 303 makes a slightly different point using the same argument.
76 Moloney, supra note 42 at 27 cites the harmonization of international accounting standards as an example of this success.
77 Donald C Langevoort, “Global Securities Regulation after the Financial Crisis” (2010) 13:3 J Int’l Econ L 799 at 800
On this aspect, I submit that inspiration from the constructivist approach to international law is helpful. According to constructivists, legal norms acquire persuasiveness when a wide variety of participants in a legal system participate in its creation. As Brunnée and Toope put it, “[l]egitimacy is rooted in a ‘thick’ acceptance of the need for emerging norms, an acceptance promoted by reference to past practice, contemporary aspirations and the deployment of reasoning by analogy.” Furthermore, accommodating a previous system with a new approach may lead to additional support for the new regulatory strategy in the present case:

A global regulatory strategy should not totally replace existing approaches to establish a normative framework for international financial relations but it should accommodate such approaches. What seems to be essential – above all – is to establish a forum which brings together the various regulatory institutions and bodies, national, regional and global, in order to co-ordinate their approaches and strategies. Merely factual co-ordination will neither provide the necessary legal certainty for a further growth in a global financial market nor will it handle pertinent risks effectively. Whether for this purpose, use is made of an existing forum is of secondary importance.79

The possibility of recognizing the standards established by specialized bodies is not new for the WTO.80 For food safety standards, it has recognized the standards of the Codex Alimentarius Commission. For general products standards, the WTO has

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79 Brunnée & Toope, supra note 79 at 22
cooperated with the International Organization for Standardization (ISO). More recently in the services sector, the WTO recognized the accounting standards by the International Federation of Accounting, the International Accounting Standards Committee and IOSCO. Similarly, the Agreement on Technical Barriers to Trade encourages Members to use existing international standards for their national regulations.81

Using the expertise of IOSCO also allows the WTO to reconcile its trade liberalization objective with legitimate regulatory concerns particular to the securities domain.82 The WTO does not have specific expertise in setting standards. Cooperation through IOSCO will also be cheaper and more effective insofar as it avoids the costs of setting a separate WTO-specific standard setter.

IOSCO has already generated substantial agreement on core principles of securities regulation. More than a decade ago, in 1998, it had come up with a comprehensive set of ‘Objectives and Principles of Securities Regulation’. Implementation by IOSCO’s members provides a degree of consistency in securities regulation principles, having regard to the fact that IOSCO’s Members regulate “more than 95% of the world's securities markets” and are “regulate, over 100 jurisdictions”.83

To assist in the implementation of the ‘Objectives and Principles of Securities Regulation’, IOSCO has endorsed “a comprehensive methodology (IOSCO Principles Assessment Methodology) that enables an objective assessment of the level of implementation of the IOSCO Principles in the jurisdictions of its members and the

81 According to Art 2.5 of the Technical Barriers to Trade Agreement, technical regulations in accordance with relevant international standards are “rebuttably presumed not to create an unnecessary obstacle to international trade.”
82 Trachtman (2000), supra note 29 at 231
83 online: IOSCO <http://www.iosco.org>
development of practical action plans to correct identified deficiencies.” Assessment of the observance and implementation of IOSCO Objectives and Principles of Securities Regulation by individual States also form an essential part the Financial Sector Assessment Program of the International Monetary Fund (IMF). Therefore, there is already an elaborate mechanism for the assessment and Country Reports are prepared by the IMF in collaboration with stakeholders such as the regulators of the State being assessed.85

Some jurisdictions have already started moving in the direction of exempting certain securities transactions based on adherence to IOSCO standards. This is the case for the Ontario Securities Commission (OSC). OSC Staff Notice 21-702 entitled “Regulatory approach for foreign-based stock exchanges” provides for the possibility of exemption from seeking OSC’s recognition. The Staff Notice states the underlying rationale in the following terms:

Staff acknowledge that most foreign-based stock exchanges are already subject to a regulatory regime in their country of origin (home jurisdiction). Full regulation, similar to that applied to domestic exchanges, may be duplicative and inefficient when imposed in addition to the regulation of the home or another jurisdiction.

National Instrument 21-101 on ‘Marketplace Operation’ also provides for dealing in “foreign exchange-traded security”. To qualify under this regime, the security must be listed on an exchange “regulated by an ordinary member of the International Organization of Securities Commissions.” Compliance with IOSCO standards again provides assurance of compliance with minimum standards.

84 “Historical Background”, online: IOSCO <http://www.iosco.org>
I must however add that the harmonization model I propose does not assume any optimal minimum level of regulation. While I suggest using IOSCO standards as a starting point, I do not exclude using other methods and empirical evidence to decide on this minimum level.

5.8.5.2 GATS v Stand-alone multilateral agreement on securities

Another alternative is to have a stand-alone agreement dedicated exclusively to securities regulation. This separate agreement may be administered by a new international entity or by the WTO. I argue that the WTO/GATS framework is a superior choice insofar as it already has an elaborate structure and institutions. This framework consists, *inter alia*, of the Ministerial Conference, the Council for Trade in Services and Expert Committees and Working Panels of the Dispute Settlement Body. These bodies are likely to facilitate the institutional operation of the model I propose. It also economizes on negotiation efforts on all the already available setup.

Apart from the institutional structure, the WTO/GATS framework also offers an elaborate set of rules which provides for many issues which need to be addressed in a comprehensive framework. Many rules are not peculiar to securities regulation but rather form part of ‘horizontal’ approaches.\(^{86}\) Any stand-alone agreement will have to duplicate these rules and rival “WTO agreements in detail and complexity”.\(^{87}\) In the same vein, the WTO provides the ability to facilitate cross-sectoral negotiations and gives the opportunity of cross-sectoral retaliation and sensitivity to trade effects.\(^{88}\)

\(^{86}\) In GATS-jargon, ‘horizontal’ is often contrasted with ‘sectoral’. Horizontal commitments for example are commitments which apply to all sectors, as opposed to being sector-specific.

\(^{87}\) Alan O Sykes, “Regulatory Competition or Regulatory Harmonization? A Silly Question?” (2000) 3 J Int’l Econ L 257 at 261

\(^{88}\) Trachtman(2000), supra note 29 at 242
Moreover, GATS has already been tailored to a large extent to suit the specific needs of the financial services sector. As seen earlier, the WTO has voted the Financial Services Agreement, which includes, *inter alia*, the Annex on Financial Services and the Understanding on Commitments in Financial Services. These ‘specific laws’ instruments adapt and clarify some core GATS provisions as they apply to financial services.

I therefore argue that the existing WTO/GATS framework is already well-adapted for the purpose of my model. It has the huge advantage of being available as an off-the-shelf set of rules. There will be no transaction cost and negotiating effort in creating a framework starting from scratch.89

5.9 Conclusion

Using a trade perspective, this chapter has proposed the WTO/GATS framework for the implementation of the harmonization model. I have discussed the relative advantages of using this framework and the reasons for not creating a new agreement for the particular purposes of harmonizing the regulation of international securities markets. I have however argued that the expertise of IOSCO can be accommodated within the WTO/GATS structure. Having IOSCO on board in the harmonizing project will lead to greater acceptance of this project.

89 Fontecchio, supra note 26 at 135: “[I]t is an agreement that is ready to be utilized. It provides for future discussions to improve the present system, as well as a means to settle disagreements over the commitments made under the Agreement. This makes the GATS the logical approach to pursue harmonization of the global securities markets.”

Majone, supra note 37 at 142 classifies these costs in three broad categories: search and information costs; bargaining and decision costs; and policing, enforcement and measurement costs.
Chapter 6:
CONCLUSION

The saying “when the US sneezes, the world gets a cold” needs to revisited! Today, it’s not only when the US sneezes that the world catches a cold. Rather, many events occurring in one part of the world or even one country have global economic ramifications. There is daily news about stocks rallying or plunging and exchange rates fluctuating following such events. These are indications of the interconnectedness of the global economy. One important sector of the global economy is international securities markets.

As aptly observed in a recent publication:

International harmonization of financial markets regulation, including the regulation of securities and derivatives markets, is now long overdue. The current crisis has demonstrated the need for greater cooperation and harmonization of rules, laws and regulation with financial markets, financial products and services and large interconnected firms. Without international harmonization of regulatory and supervisory frameworks, structural weaknesses and vulnerabilities will continue to exist and pose a threat to the financial stability of international financial markets. The recent [Global Financial Crisis] has demonstrated vividly how problems in one jurisdiction can spill over to adversely affect other jurisdictions.”

I had set two objectives for the thesis: first, discuss the regulatory model best adapted from a trade perspective to regulate international securities markets; and second, to discuss the implementation of this regulatory framework using the WTO/GATS

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structure. The thesis has adopted an interdisciplinary approach, drawing from both a securities regulation perspective and an international trade perspective. I have engaged with the scholarly literature on the normative model which is most suited for the rapidly-developing area of international securities regulation. Six alternative regulatory models have been considered: privatization, centralization, convergence, regulatory competition, mutual recognition and harmonization. Out of these models, I elaborated on the two dominant ones, namely regulatory competition (chapter 3) and harmonization (chapter 4).

The regulatory competition model relies on the assumption that decentralized regulation leads to greater efficiency. Law is seen as an economic product. Every jurisdiction will compete to propose the best regulatory system in a bid to attract issuers and investors. Two models which have applied the regulatory competition theory to international securities regulation are the issuer-choice model and the portable reciprocity model. A closer look at these two models has shown that, despite their different names, the two models are almost identical.

Regulatory harmonization constitutes a hybrid model which seeks to promote international cooperation but at the same time leaving the opportunity for a reasonable degree of competition among jurisdictions. The harmonization model consists of internationally agreed minimum standards of regulation which are mandatory. Beyond these standards, jurisdictions are free to depart, differentiate, innovate and customize their regulatory system to according to their distinct needs. The harmonization model thus constitutes a synthesis of cooperation and competition and seems to be emerging as the preferred model for regulation.

After due consideration of these models, I have justified the choice of harmonization as the preferred model to regulate international securities markets. The reasons for
retaining harmonization as the preferred model have been analyzed and discussed in chapter 4. The advantages of the harmonization model have been drawn from academic literature which present a theoretical perspective but also from empirical studies carried out at other levels of government. Harmonization reduces the risk of negative jurisdictional externalities and other market failures and provides the tools to address systemic risk. It reduces costs of compliance, information costs and regulatory gaps, and amplifies network externalities and allocational efficiency.

While acknowledging the utility of the normative debate, this thesis has argued that the academic discussion should evolve toward implementation of this preferred model. An analysis of the implementation strategy will bring value to the normative debate. It will also allow the normative debate to enter the policy space and make a real difference to stakeholders in the international securities markets. Admittedly, discussion of an implementation strategy will add on to the challenges that the normative debate already faces. This thesis has considered an implementation strategy which is appropriate for the harmonization model in international securities regulation.

The implementation strategy I have proposed consists of using the WTO/GATS framework. The GATS structure will contribute in the implementation at three levels: determining the common minimum standard which will form the basis of the harmonization model; ensuring that the agreed standard is uniformly transposed in domestic laws and applied by all Member States; and providing an adjudication and enforcement mechanism in case of dispute.

The strategic advantages of using this framework are worth spelling out once again: political representation at high governmental level confers added legitimacy and domestic accountability to agreements negotiated and signed under WTO/GATS auspices; commitments of Member States result in binding obligations which are
legally enforceable; possibility to balance the conflicting objectives of market access commitments and domestic regulatory autonomy; in-built mechanism in GATS to achieve progressive liberalization through negotiated commitments over time; in-built dispute settlement mechanism; in-built mechanism for recognition and harmonization as a means of economic integration, possibility of taking on board contribution of international standard-setters like IOSCO; rules made by provincial or regional governments, local governments as well as self-regulated organizations like Exchanges also have to comply with obligation undertaken under GATS; and cutback on transaction and institutional costs to set a new body to achieve the goal of liberalization and harmonization.

**Future Directions**

**Determining the minimum standards**

As seen in this thesis, an essential part of the harmonization model is an agreement on minimum standards. I have suggested that works done by IOSCO constitute a fertile point of departure for a discussion on these standards. However, a thorough consideration about the content of the common minimum standards is beyond the scope of the current thesis. Undoubtedly, consideration of this aspect constitutes a challenging project on its own. Application of techniques and theories like the expected utility model can also be useful.

**Strategy for implementation of reform / Feasibility of proposed reform**

This thesis does not seek to minimize the challenges that agreement on and implementation of minimum standards at an international level can entail. It however
proposes strategies to meet those challenges. Further study on how to ensure the success of the implementation of harmonization will be helpful.

The present international stage does not seem to be prepared for a regulatory evolution which may require extra resources and willingness. However, the history of regulation abounds of examples where a regulatory overhaul has taken advantage of, what has been termed, a “window of opportunity”, that is a ‘critical juncture’. The depression of 1933 brought in the US Securities Act of 1933 and the Securities Exchange Act of 1934, the 9/11 terrorist attack in the US brought the PATRIOT Act and enactment of anti-money laundering and terrorist-financing legislation worldwide, major corporate and accounting scandals (Enron, WorldCom, etc) made sweeping changes through the Sarbanes–Oxley Act of 2002 more digestible, and the late-2000s recession provided the necessary impetus to accept the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2009.

Prado and Trebilcock discuss strategies to counter the need for a dramatic conjecture to incite such reforms, if such conjecture is not forthcoming:

> Are reformers, then, left only with windows of opportunity (critical junctures) in which major reforms can be successfully implemented? Is there any way that reformers can account for the lessons of path dependence theory without being caught in a potentially eternal waiting period for the right moment? … There are two potential (and complementary) strategies for dealing with this conundrum. First, reformers may be able to identify some institutions that can be more easily detached from a broader mutually reinforcing institutional matrix or can be created de novo… The second strategy is to reform existing interconnected and mutually reinforcing

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2 Mariana Prado& Michael Trebilcock, “Path Dependence, Development, and the Dynamics of Institutional Reform”(2009) 59:3 University of Toronto Law Journal 341

3 Ibid.
institutions in a time-sensitive manner by prioritizing a sequence of reforms, beginning with certain core reforms but recognizing that further complementary reforms will be necessary in the future to reinforce initial reforms.”

Prado and Trebilcock’s works are of general application to any reform. Analyzing the particular case of reforming international securities regulation and tailoring the factors and guidelines for reforms is a future ambitious project on its own.

Impact on other areas of law: Regulation of intermediaries, regulation of futures, options and derivatives and private international law

Financial intermediation is closely related to the growth of capital markets. While investors may benefit from the expertise of intermediaries such as brokers, advisers and mutual fund sales personnel, they also need to be protected from the risk that these professionals will be tempted by the possibilities for advancing their own personal interest at the expense of their clients. Reduction in trade barriers and the possibility to issue securities in a host state while being regulated by the home state will definitely impact regulation of market intermediaries. The regulation of these intermediaries will also require more profound analysis in future works.

If using the WTO/GATS structure proves successful for harmonization in the area of international securities regulation, a similar structure and framework can be analyzed to regulate futures and options. It is generally acknowledged today that failures on

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5 Mary G Condon, Anita I Anand & Janis P Sarra, Securities Law in Canada – Case and Commentary, 2d ed (Toronto: Edmond Montgomery, 2010) at 2
6 For preliminary works on regulation of intermediaries at the international level, see James S Rogers, “Conflict of Laws for Transactions in Securities held through Intermediaries” (2006) 39 Cornell Int’l LJ 285
regulating these instruments had a significant adverse effect in the 2008 financial crisis.\textsuperscript{7}

Implementation of the harmonization model will affect the rules on private international law applicable in the securities field as well. This calls for a closer interdisciplinary assessment and the deepening of preliminary works on the subject.\textsuperscript{8}

\textbf{Concluding remarks}

This thesis seeks to contribute in providing an international trade perspective to the regulation of international securities markets. Internationalization of the securities markets is not the result of decisions by policy makers and law makers. It is more of a done deal, a \textit{fait accompli}, which policy makers must face. I have suggested that the best response to this internalization is not to leave it unattended like a rudderless ship as proposed by advocates of the regulatory competition model. The best response is to bring it to bear through the harmonization model. The bright side of the story is that the harmonization model can benefit from the existing structures of the WTO/GATS for its due implementation.


\textsuperscript{8} For works involving securities regulation and private international law, see Michael D Diathesopoulos, “Interests in Securities: Private International Law Issues according to European Regulation and Hague Securities Convention” (2010) (Available at SSRN)
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