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# CONTEMPLATING THE ENDGAME: AN EVOLUTIONARY MODEL FOR THE HARMONIZATION AND CENTRALIZATION OF INTERNATIONAL SECURITIES REGULATION

*Eric C. Chaffee**

## I. INTRODUCTION

Chess is a game of stages and transitions consisting of an opening, a middlegame, and an endgame. In *Last Lectures*, former world chess champion José Raúl Capablanca writes, "[I]n order to improve your game, you must study the endgame before anything else; *for, whereas the endings can be studied and mastered by themselves, the middlegame and the opening must be studied in relation to the endgame*."[1] This concept can be applied to any transitional process that involves various stages. One must begin by contemplating the desired conclusion, and then one must determine the path to that conclusion. Using this process, desired ends are more likely to be achieved, and they are likely to be achieved more easily. Put another way, simply living in the now during a transitional process can have negative consequences because one has not contemplated desired goals or the best path to achieving them.

Yet, in the realm of international securities law, many regulators and commentators are satisfied with simply living in the now without determining what an ideal system of international securities law should look like or how such a system of law could be achieved. Of course some regulators and commentators are satisfied with the current system of international securities law that has evolved in the past few decades.[2] However, many believe that this model of regulatory competition is

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1. JOSÉ RAÚL CAPABLANCA, LAST LECTURES 19 (1966) (providing a world chess champion's views on the game of chess).

2. *See generally* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387 (2001) (arguing for a regulatory competition approach to international securities regulation).

simply an unfortunate byproduct of the nationalistic and protectionist attitudes of many nations, and a reality that cannot be overcome.[3]

Although some benefits exist to the regulatory competition that is occurring among individual nations attempting to attract issuers, investors, and a variety of other market participants, the harms created by such a model of international securities law far outweigh those benefits.[4] This is because patchwork regulation does not work to effectively and efficiently regulate securities markets. This was proven in the United States during the 1920s when a patchwork of state law was used to regulate the national securities markets.[5] This patchwork proved ineffective resulting in the stock market crash of 1929 and the Great Depression.[6] In response to these events, Congress enacted the Securities Act of 1933[7] and the Securities Exchange Act of 1934.[8] Because of the harmonized and centralized system of national securities regulation created by these acts, the United States' national markets enjoyed relative stability for the remainder of the twentieth century.

The financial crisis that began in 2008 also evidences that patchwork regulation is ineffective in regulating securities markets. In the past few decades, global securities markets have begun to emerge, and national and regional based systems of securities law have created a patchwork of securities regulation on the international level.[9] This patchwork of regulation has created competition among nations and regions to attract issuers, investors, and other market participants.[10] In terms of the financial crisis that began in 2008, this created a race-to-the-bottom in international securities regulation in which no nation wanted to ratchet up the level of regulation or enforcement relating to the mortgage-backed securities that were at the heart of the crisis, fearing that it would render their nation or region less competitive.[11] Because of this, the

3. *See* Eric J. Pan, *Single Stock Futures and Cross-Border Access for U.S. Investors*, 14 STAN. J.L. BUS. & FIN. 221, 236 (2008) ("Foreign jurisdictions historically have expressed hostility to any extension of U.S. trading and liability standards to their markets, and the SEC has expressed skepticism about the standards of most prominent foreign exchanges.").

4. *See infra* Part II.C (explaining the dangers of transitioning to a regulatory competition model of international securities regulation).

5. *See infra* Part IV.A (providing an overview of the development of securities regulation in the United States).

6. *See infra* Part IV.A.

7. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

8. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006).

9. *See infra* Part II.A (discussing the reasons for the emergence of global securities markets).

10. *See* Chris Brummer, *Stock Exchanges and the New Markets for Securities Law*, 75 U. CHI. L. REV. 1435 (2008) (arguing that regulatory competition is the foundation of the emerging model of international securities law).

11. *See* Donald C. Langevoort, *U.S. Securities Regulation and Global Competition*, 3 VA. L. &

financial crisis that began in 2008 ensued.[12] In addition to similar causes, the Great Depression and the financial crisis that began in 2008 are similar in terms of severity. Notably, the financial crisis that began in 2008 has been referred to as the "most severe financial crisis since the Great Depression,"[13] the "Great Recession,"[14] and even a depression itself.[15] Put simply, regulatory fragmentation creates a race-to-the-bottom in any system of securities regulation that generates dire results. Although some benefits may exist to regulatory competition, these benefits are outweighed by this reality.[16]

Ideally, the world should adopt an approach to international securities regulation that is similar to the approach used by the United States in response to the stock market crash of 1929 and the ensuing Great Depression. The securities laws throughout the world should be harmonized to allow for the creation of a centralized global securities regulator with monitoring, regulatory, and enforcement powers. This centralized global securities regulator should then set a baseline of regulation from which individual nations or regions can choose to upwardly depart, if desired. Such a system of international securities regulation will prevent a race-to-the-bottom in international securities law and avoid other collective action problems by creating a floor for regulation and a centralized actor to enforce this baseline system of securities law.[17]

The problem is that this is a drastic and unrealistic proposal in the short-term because of the nationalistic and protectionist tendencies of

BUS. REV. 191, 193 (2008) ("The global scale of the current troubles shows that other countries have been too lax as well, so that there should be a ratcheting up of securities regulation not only in the United States, but worldwide.").

12. *Id.*

13. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 2 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (discussing the financial crisis that began in 2008).

14. *But see* Catherine Rampell, *'Great Recession': A Brief Etymology*, N.Y. TIMES ECONOMIX (Mar. 11, 2009, 5:39 PM), http://economix.blogs.nytimes.com/2009/03/11/great-recession-a-brief-etymology ("Nobody can take credit for coining the term 'The Great Recession' . . . . Why? Because the 'Great Recession of 2008' is not the first recession to be slapped with the lofty title. *Every* recession of the last several decades has, at some point or another, received this special designation.").

15. *See* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION x (2009) ("It is the gravity of the economic downturn, the radicalism of the government's responses, and the pervading sense of crisis that mark what the economy is going through as a depression.").

16. *See infra* Part II.C (discussing the dangers of transitioning to a regulatory competition model of international securities regulation).

17. *See infra* Part III (discussing the benefits of an approach based on harmonization and centralization in international securities law, including that such an approach helps to stabilize the emerging global securities markets, benefits market participants, and assists the United States in maintaining a dominant role as a securities regulator).

many securities regulators.[18] Although the emerging global capital markets have begun to fuel the convergence of many business norms,[19] the world does not seem ready for a centralized global securities regulator with robust monitoring, regulatory, and enforcement powers. This reality drives some commentators and regulators to simply live in the now without hope for obtaining the benefits that harmonization and centralization would provide.

In this Article, I argue that the harmonization and centralization of international securities law should and must occur through a slow evolutionary process, rather than a rapid revolutionary process, because only under these circumstances will a centralized global securities regulator be able to emerge. In other articles, I have discussed the opportunity that the financial crisis that began in 2008 presents for reforming international securities regulation,[20] the necessity for comprehensive domestic and international regulatory reform to prevent future financial crises,[21] the need for harmonization and centralization of international securities law,[22] the government's role in the harmonization and centralization of international securities regulation,[23] and the need for a centralized global securities regulator.[24] This Article extends that previous scholarship in three main ways. First, it advocates for long-term planning in the area of international securities regulation, rather than simply existing in the now. Second, it addresses one of the most commonly cited barriers to harmonization and centralization, which is that the current nationalistic and protectionist tendencies of most securities regulators will not allow for harmonization and centralization of international securities law. Third, this Article details a

18. *See infra* Part II.C (discussing the dangers of transitioning to a regulatory competition approach to international securities regulation).

19. *But see* George W. Madison & Stewart P. Greene, *TIAA–CREF Response to A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 99, 100 (2007) ("Still, as a result of both historical and cultural influences, other countries may have differing standards for disclosure that are either less stringent or based on different assumptions than those found in the U.S. markets. For example, some foreign markets may have different cultural or legal views towards insider trading.").

20. *See* Eric C. Chaffee, *A Moment of Opportunity: Reimagining International Securities Regulation in the Shadow of Financial Crisis*, 15 NEXUS 29 (2010).

21. *See* Eric C. Chaffee, *A Panoramic View of the Financial Crisis that Began in 2008: The Need for Domestic and International Regulatory Reform*, 35 U. DAYTON L. REV. 1 (2009).

22. *See* Eric C. Chaffee, *Finishing the Race to the Bottom: An Argument for Harmonization and Centralization of International Securities Law*, 40 SETON HALL L. REV. 1581 (2010).

23. *See* Eric C. Chaffee, *The Internationalization of Securities Regulation: The United States Government's Role in Regulating the Global Capital Markets*, 5 J. BUS. & TECH. L. 187 (2010).

24. *See* Eric C. Chaffee, *Evolution, Not Revolution, in International Securities Regulation: A Modest Proposal for a Global Securities and Exchange Commission* (Jan. 1, 2011) (unpublished manuscript, on file with the author).

mechanism for moving toward harmonization and centralization, i.e., a long-term approach that allows for international regulation to evolve along with the emerging global capital markets.

The remainder of this Article is structured as follows. Part II discusses the current state of international securities regulation and the need for a new approach to international securities law by focusing on the globalization of securities markets, the spectrum of approaches to international securities law, and the dangers of transitioning to a regulatory competition approach to international securities regulation. Part III explains the benefits of the harmonization and centralization of international securities law, including that such an approach helps stabilize the emerging global securities markets, benefits market participants, and assists the United States in maintaining a dominant role as a securities regulator. Part IV describes the evolutionary process through which the harmonization and centralization of international securities can be achieved by providing two case studies of the use of such an evolutionary process, providing a comparative analysis of both those case studies, and describing possible paths toward a harmonized and centralized system of international securities regulation. This Article concludes that harmonization and centralization offers the best approach to international securities law, and that the long-term evolutionary process toward a harmonized and centralized system must be started.

## II. THE CURRENT STATE OF INTERNATIONAL SECURITIES REGULATION AND THE NEED FOR A NEW APPROACH

An evolutionary approach to international securities regulation is necessary because securities markets are evolving, transitioning from being national or regional in nature to being global. A new approach to international securities law is needed to meet the challenges presented by these emerging global securities markets. In this Part, the reasons for the transition to global securities markets, the possible models for international securities regulation, and the dangers of adopting a regulatory competition approach to international securities law will be explored. Ultimately, international securities law will have to evolve to meet the realities of the emerging global securities markets. With that said, the evolution of regulation should be in the direction of harmonization and centralization.

### A. The Emergence of Global Capital Markets

For much of the twentieth century, the United States was viewed as having the world's premier capital markets and premier system of securities regulation.[25] From this position of dominance, the United States was able to fuel convergence in international securities regulation by convincing other nations and regions to adopt securities laws that mirrored the securities laws in the United States.[26] With the advent of the twenty-first century, however, the United States' dominance has waned as global securities markets have emerged because of the rise of strong securities markets throughout the world, the evolution of securities trading, the evolution of securities exchanges, and concerns over aggressive regulation in the United States.

In the past few decades, global securities markets have begun to emerge because of the rise of strong national securities markets throughout the world. For much of the twentieth century, the capital markets in the United States were unique in terms of the breadth and depth of available capital.[27] During the twenty-first century, however, the securities markets in the United States have been challenged by strong markets in Asia, Europe, and South America.[28] The capital

25. *See* Howell E. Jackson, *A System of Selective Substitute Compliance*, 48 HARV. INT'L L.J. 105, 119 (2007) ("For much of the twentieth century, the Commission justly considered itself to be the world's premier securities market regulator. But with the passage of time, the capital markets of many other countries have developed and the supervisory capabilities of many jurisdictions have expanded—often with the assistance of advice from the SEC or the International Organization of Securities Commissions. Today, a number of these jurisdictions provide capital market oversight that is substantially equivalent to SEC supervision.").

26. *See* Roberta S. Karmel, *The EU Challenge to the SEC*, 31 FORDHAM INT'L L.J. 1692, 1711 (2008) ("Since the SEC has served as the gold standard of securities regulation, it is not surprising that as the EU has striven to improve and integrate European capital markets, it has looked to U.S. securities regulation as a model. Yet, changing economics, and in particular the migration of many international issuers to the London markets, has given the EU more power in influencing the SEC. The SEC can no longer take a unilateralist approach to securities regulation and assume that the U.S. markets will remain the premier capital markets.").

27. *See* Madison & Greene, *supra* note 19, at 100 ("The SEC performs its task admirably—and sets the standard against which all other regulators around the globe are judged. . . . The SEC, with its track record and high standards for protecting investors, has historically been a leader in setting benchmarks for market regulation."); Robert G. DeLaMater, *Recent Trends in SEC Regulation of Foreign Issuers: How the U.S. Regulatory Regime is Affecting the United States' Historic Position as the World's Principal Capital Market*, 39 CORNELL INT'L L.J. 109, 109 (2006) ("Since World War II, the United States has been the world's principal capital market. This market has been uniquely broad and deep, with substantial retail participation by individual investors and small institutions, plentiful capital for equity financing and a willingness to hold long-term debt securities, with tenors [sic] of thirty years beings common even for corporate issuers.").

28. *See* DeLaMater, *supra* note 27, at 117 ("The securities markets outside the United States have grown in breadth and depth of their own over the past twenty years and now afford issuers in their home countries significant opportunities for financing that did not previously exist.").

markets in the European Union have grown in both size and sophistication,[29] and the markets in Brazil, Russia, India, and China, which are often referred to as "BRIC countries," offer new opportunities for investment and raising capital.[30]

The rise of strong securities markets has helped fuel an evolution in securities trading. Retail and institutional investors now look globally for investment opportunities as a means of portfolio diversification and to offset currency fluctuations.[31] Moreover, issuers now have the ability to raise capital on a global basis and make decisions based on where capital can be obtained at the lowest cost.[32] Broker–dealers, investment advisors, and other market participants continue to adapt to securities markets that have begun to transcend national borders.[33] The role of technology in this process cannot be understated. The internet and other forms of communication make investment opportunities available on a global basis, rather than confining their availability to any particular nation or region.[34]

29. *See infra* Part IV.A (discussing the efforts of the European Union to build a common capital market among its member states); *see also* Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355, 363 (2007) ("The European markets have matured to a point where capital can be raised there to meet the needs of most companies. Foreign, and even some U.S. companies, engaging in IPOs or stock exchange listings have done so in Europe, rather than in the United States.").

30. *See* Karmel, *supra* note 26, at 1711–12 ("The EU is not the only challenge to the SEC, however. The new strong capital markets in Asia and South America, and in particular in the so-called BRIC countries (Brazil, Russia, India, and China), challenge both the EU and the SEC to shape their regulatory approaches to foreign issuers and foreign financial institutions so as not to lose their competitive places as market regulators.").

31. *See* Edward F. Greene, *Beyond Borders: Time to Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85, 85–86 (2007) ("Investing in non-U.S. markets is no longer the exclusive province of megainstitutions or the ultrawealthy; it is an essential component of prudent portfolio diversification for all [U.S.] investors.").

32. *See* Karmel, *supra* note 26, at 1711 ("U.S. investors are buying foreign securities in record numbers and foreign issuers no longer believe they need to make offerings in the U.S. to raise capital.").

33. *See* Jackson, *supra* note 25, at 107 ("[I]ssuers are not the only entities with mobility in modern capital markets: investors, exchanges, brokerage houses, and a wide range of professional service providers can and do move around the world.").

34. *See* Greene, *supra* note 31, at 86 ("The rise of the internet has given investors a new window on the world and access to almost limitless information. A natural outgrowth of this technological revolution, coupled with increasing investor sophistication and the need for financial diversification that transcends home country borders, is the understandable desire of investors to communicate and effect transactions directly with market participants located in other jurisdictions."); Susan Wolburgh Jenah, *Commentary on a Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 69, 69–70 (2007) ("Globalization is a fact. Innovative technologies are driving faster and more efficient trading, and they do not recognize national borders. . . . The impact of these changes is profound and not yet fully realized."); Madison & Greene, *supra* note 19, at 99 ("The rapid pace of technological advances is bringing us closer to the reality of a seamless global capital market. In such a world, investors would have access to increased liquidity, greater diversification, and a wider range of investment options regardless of their location. Capital would be more efficiently

The emergence of global securities markets has also been fueled by the evolution of securities exchanges. In the past two decades, a wave of securities exchange demutualization has transformed many exchanges into for-profit entities.[35] The pressures created by for-profit status have caused many exchanges to eschew previous nationalistic and protectionist tendencies to explore profit-making opportunities on a global basis.[36] The wave of securities exchange demutualization has led to a wave of securities exchange consolidation.[37] On April 4, 2007, the merger of the New York Stock Exchange and Euronext gave birth to the world's first transnational stock exchange.[38] In the past few years, the push for stock exchange consolidation has continued to aid in the breaking down of national and regional capital markets and the building up of global ones in their place.[39]

The United States is also fueling the emergence of global capital markets by pursuing aggressive regulation of its securities markets. Many issuers, investors, and other market participants have begun seeking opportunities in other nations because of the United States' culture of aggressive shareholder litigation and history of aggressive enforcement by the Securities and Exchange Commission (SEC).[40] In addition, the Sarbanes–Oxley Act of 2002[41] (Sarbanes–Oxley) placed significant new corporate governance requirements on entities wishing to issue securities in the United States, which has limited the number of foreign initial public offerings within its borders.[42] Aggressive

allocated throughout the global economy to the benefit of all participants.").

35. *See* Karmel, *supra* note 29, at 356 ("Another factor in the inevitable globalization of exchanges is that exchanges have demutualized and become public companies. They need to please their shareholders as well as their customers. Further, in the process of moving from mutual not-for-profit citadels of capitalism to public companies, national exchanges have lost their exclusivity and their mystique.").

36. *Id.*

37. Eric J. Pan, *A European Solution to the Regulation of Cross-Border Markets*, 2 BROOK. J. CORP. FIN. & COM. L. 133, 136 (2007) ("Demutualization and increased competition has led to a wave of consolidation by the European exchanges.").

38. *See generally* Sara M. Saylor, Note, *Are Securities Regulators Prepared for a Truly Transnational Exchange?*, 33 BROOK. J. INT'L L. 685 (2008); Bo Harvey, Note, *Exchange Consolidation and Models of International Securities Regulation*, 18 DUKE J. COMP. & INT'L L. 151 (2007).

39. *See* Jenah, *supra* note 34, at 71 ("This chess game of proposed exchange mergers, capital tie-ups, and alliances being played out on the global stage bears witness to the truism that capital markets are global.").

40. *See* Karmel, *supra* note 29, at 356–57 ("[T]he primary reasons why the NYSE has been losing listings is that foreign issuers are disenchanted with the U.S. stock market because of the costs of compliance with the requirements of the Sarbanes–Oxley Act of 2002 (Sarbanes–Oxley) and because of the U.S. culture of shareholder litigation.").

41. *See* Sarbanes–Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201–7266 (2006)).

42. *See* DeLaMater, *supra* note 27, at 118 (reporting on the limited number of initial public

regulation in the United States has helped speed the emergence of global capital markets. Even if the United States weakened the regulation of its securities markets, however, the emergence of global capital markets seems impossible to stop.

### *B. The Spectrum of Approaches to International Securities Law*

The emergence of global capital markets offers the opportunity to re-imagine international securities regulation. Although the world has started drifting toward a regulatory competition model of international securities law, this does not mean that it is the ideal system of regulation. In this Part, six possible models for international securities regulation will be explored. These six approaches are privatization, regulatory competition, regulatory convergence, mutual recognition, regulatory harmonization, and regulatory centralization. These six approaches to international securities law can be placed on a spectrum based on the amount of international cooperation and coordination required to bring each of them into being. Privatization would be at one end of the spectrum because it requires the least international cooperation and coordination, and centralization would be at the other end of the spectrum because it requires the most. In traveling from privatization to centralization on the spectrum, one would pass through regulatory competition, convergence, mutual recognition, and harmonization. Obviously, these approaches can overlap and blur.

Under a privatization approach to international securities regulation, private actors would be responsible for regulating the emerging global capital markets. In most models of privatization, securities exchanges are the private actors that are responsible for both regulation and enforcement. Although this model might seem to be a radical approach to securities regulation, the United States actually employed this approach domestically prior to the adoption of state securities laws, i.e. the so-called blue sky laws, in the 1910s and 1920s.[43] Although a privatization approach to international securities regulation could have some benefits, this type of approach is unlikely to emerge on the

offerings from Europe and Asia after the adoption of Sarbanes–Oxley). *But see* Jackson, *supra* note 25, at 108 ("Although many have pointed to the passage of the Sarbanes–Oxley Act of 2002 as damaging the ability of U.S. exchanges to compete for foreign cross-listings, there is ample evidence that the erosion of U.S. market power for foreign listings was already underway well before 2002.").

43. *See* Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES L. 649, 661 (2001) (explaining that "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, but further back, before the dawning of the first Blue Sky laws of the early 1900s").

international level. Most securities regulators, issuers, investors, and other market participants have become comfortable with securities regulation by governmental entities, which means that the privatization of international securities regulation is likely infeasible.

Regulatory competition constitutes a second approach to international securities regulation. Under a regulatory competition approach, individual nations or regions adopt systems of securities regulation and then compete to attract issuers, investors, and other market participants. The world is currently transitioning to a regulatory competition approach to international securities law. As explained in the next Part, a regulatory competition approach is not the best model to regulate the emerging global capital markets because patchwork regulation creates a race-to-the-bottom in terms of international securities law, produces various regulatory and enforcement gaps, and generates various collective action problems.[44]

Regulatory convergence offers a third approach to international securities regulation. Convergence can be divided into weak and strong forms. Under a weak regulatory convergence approach, nations gravitate toward similar systems of securities regulation. If a dominant actor exists and that actor is willing to invest adequate resources into the development of its system of securities law, a race-to-the-top may occur. If a dominant actor does not exist, nations will compete, and a regulatory competition model will emerge. As previously explained, this will generate a race-to-the-bottom, although quality regulation may still be adopted in certain discrete instances.[45] For much of the twentieth century, the United States was able to fuel convergence of the world's securities laws because the United States was viewed as having the world's premier capital markets and premier system of securities regulation.[46] The United States is still trying to fuel convergence through various efforts, including the SEC's International Technical Assistance Program.[47] However, the dominance of the United States is waning as global capital markets emerge.[48] Thus, the United States no

44. *See infra* Part II.C (explaining the dangers of transitioning to a regulatory competition approach to international securities regulation).

45. *See* Jenah, *supra* note 34, at 77 ("The challenge . . . is to strike the right balance between a healthy degree of regulatory competition and proverbial 'race to the bottom.'").

46. *See supra* notes 25–26 and accompanying text.

47. U.S. Sec. & Exch. Comm'n, Securities and Exchange Commission's International Technical Assistance Program, http://www.sec.gov/about/offices/oia/oia_emergtech.shtml (last visited June 22, 2010) ("Utilizing a faculty of senior SEC and industry officials, and seasoned practitioners, the technical assistance program provides training to nearly 2000 regulatory and law enforcement officials from over 100 countries.").

48. *See* Greene, *supra* note 31, at 85 ("There can be no argument that the securities markets are

longer has the same ability to fuel convergence.

Under a strong regulatory competition approach to international securities regulation, nations agree to certain regulatory norms via treaty or other agreements. The signatories then adopt systems of securities regulation that codify these norms. Although this type of approach can create a relatively consistent level of regulation, the actual codification of the norms can vary greatly. In addition, this approach also leaves regulatory and enforcement gaps between nations. The effectiveness of this approach to transnational securities regulation remains open to question because of the variation in regulation that it generates and the potential for lack of consistent enforcement.[49]

Regulatory mutual recognition offers a fourth approach to international securities regulation. Under a mutual recognition approach, nations enter into treaties or other agreements under which compliance with one signatory's securities laws is viewed as compliance with all signatories securities laws. The United States has flirted with a mutual recognition approach to international securities regulation. In 2007, Ethiopis Tafara and Robert Peterson, two staff members in the SEC's Office of International Affairs, published *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework* in the *Harvard International Law Journal*.[50] Tafara and Peterson proposed a framework to allow foreign financial service providers, i.e., foreign exchanges and foreign broker–dealers, access to the United States without having to register with the SEC, although they would remain subject to the anti-fraud provisions of United States securities law.[51] The proposed framework was based upon a system of substitute compliance under which exemption from registration would be permitted only when the financial service provider's home country's securities laws and enforcement policies were comparable to those in other participating nations. The proposed framework was warmly received by the SEC under the leadership of Chairman Cox, and various meetings were held to determine how the proposal might be

now global and that the dominance of the United States as the leading player in the global marketplace is being challenged.").

49. *See* Jackson, *supra* note 25, at 115 ("[C]ountries with quite similar regulatory systems may expend very different amounts of resources on supervisory oversight.").

50. Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

51. *Id.* at 32 ("This Article proposes a new framework to apply to foreign financial service providers accessing the U.S. capital market. . . . Rather than requiring such foreign stock exchanges and foreign broker–dealers to register with the SEC, as is currently the case, the proposed framework relies on a system of substituted compliance with SEC regulations.").

implemented.[52] Since the confirmation of Chairman Schapiro at the beginning of 2009, however, enthusiasm for the proposal has cooled, and the proposal appears to have been tabled.[53]

Regulatory harmonization offers a fifth approach to international securities regulation. Under a regulatory harmonization approach, nations agree via treaties or other agreements to adopt identical or substantially similar systems of securities regulation. Regulatory harmonization can be used either to set a minimum level of regulation or to set forth a comprehensive system of securities regulation. The European Union has used a regulatory harmonization approach to attempt to create a consistent system of securities regulation in its member states.[54] European Union directives are enacted that require member states to create regulation to achieve a particular result without mandating the mechanism for achieving that result.[55] Although regulatory harmonization is similar to strong regulatory convergence, harmonization is different because it does not give nations as great of an opportunity to experiment with how to achieve regulatory goals. The ability to experiment is curtailed because harmonization requires systems of securities regulation be identical or at least substantially similar.

Regulatory centralization provides a final approach to international securities law. Under a regulatory centralization approach, a centralized regulator is created with monitoring, enforcement, and regulatory powers. The United States used this approach domestically in the wake of the stock market crash of 1929 when it enacted the Securities Act of 1933,[56] enacted the Securities Exchange Act of 1934,[57] and created the SEC. This approach provided relative stability to the capital markets in the United States for the remainder of the twentieth century. An economic calamity similar to the Great Depression occurred only when

52. *See* Karmel, *supra* note 26, at 1708–09 ("Following the publication of the Tafara article and favorable comments upon it, the SEC held a Roundtable on Mutual Recognition. . . . Mutual recognition of foreign markets and broker–dealers was also promoted in speeches by the Director of the Division of Market Regulation."); Pan, *supra* note 3, at 223 ("Since the publication of this proposal [by Tafara and Peterson], SEC Chairman Christopher Cox and other senior SEC officials have openly discussed and endorsed the merits of mutual recognition, and the SEC has held public meetings to discuss how such a proposal should be implemented.").

53. *See* Dan Jamieson, *Schapiro Cool to 'Mutual Recognition' Efforts*, INVESTMENTNEWS (Feb. 1, 2009), http://www.investmentnews.com/article/20090201/REG/302019997 ("Bold efforts by the Bush administration Securities and Exchange Commission to open the doors to foreign brokerage firms are likely to be put on hold by new Chairman Mary Schapiro.").

54. *See generally* RALPH H. FOLSOM, PRINCIPLES OF EUROPEAN UNION LAW (2d ed. 2009).

55. *Id.*

56. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

57. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006).

regulatory fragmentation and competition emerged on the international level as the result of globalization of capital markets.

### *C. The Dangers of Transitioning to a Regulatory Competition Model in International Securities Regulation*

Regulatory competition is often touted as helping to produce an optimal level of regulation because innovation occurs as a result of the tensions that exist among regulators to produce an optimal level of regulation. In some areas, regulatory competition is especially useful because the parties being regulated do not have the lobbying power to pressure regulators to work toward a more efficient regulatory system. For example, in the area of criminal law, no politician ever runs on a pro-crime platform, so penalties tend to increase unless some state or the federal government experiments and finds a lower level of punishment has greater benefits. In the context of securities regulation, however, issuers and investors put pressure upon regulators to innovate and provide an optimal level of regulation, and therefore, regulatory competition is less necessary, although it still may provide some benefits. In the context of international securities regulation, even if a regulatory competition approach might provide some benefits, these benefits are offset by the fact that regulatory fragmentation of securities law produces a race-to-the-bottom, regulatory and enforcement gaps, and collective action problems. Of course, even in a harmonized and centralized system, most of the benefits regulatory competition can still be maintained if the centralized regulator simply sets a basic level of regulation from which individual nations can upwardly depart, if they desire.

A regulatory competition approach to international securities regulation produces a race-to-the-bottom in international securities law. Although a myriad of causes exist for the financial crisis that began in 2008, one of the central causes was the under-regulation of the mortgage-backed securities that were held by a variety of financial institutions at the time the crisis began. Regulators in the United States did not want to ratchet up the level of regulation on the mortgage-backed securities fearing that it would add to the waning dominance of the United States' capital markets.[58] Regulators in other nations did not want to ratchet up the level of regulation on the mortgage-backed securities fearing that it would disadvantage their particular nation's ability to participate in the economic prosperity of the early years of the

58. *See supra* notes 9–12 and accompanying text (explaining the race-to-the-bottom in international securities regulation that helped give birth to the financial crisis that began in 2008).

millennium.[59]

The Obama Administration has admitted that the financial crisis that began in 2008 was partially the result of a race-to-the-bottom in international financial regulation. In June 2009, the United States Department of the Treasury issued its white paper report on the financial crisis, *Financial Regulatory Reform: A New Foundation* (the Report).[60] The drafters of the Report state the following about the evils of regulatory fragmentation:

> As we have witnessed during this crisis, financial stress can spread easily and quickly across national boundaries. Yet, regulation is still set largely in a national context. Without consistent supervision and regulation, financial institutions will tend to move their activities to jurisdictions with looser standards, creating a race to the bottom and intensifying systemic risk for the entire global financial system.[61]

Although the Obama Administration acknowledged the dangers of fragmented financial regulation in the Report, it failed to include a recommendation for the harmonization and centralization of international securities law.[62] As a result, a race-to-the-bottom in international securities law will continue to exist until harmonization and centralization occurs.

A regulatory competition approach to international securities law also produces regulatory and enforcement gaps because of the patchwork of regulation that it creates. Although some gaps can be filled by international agreements and extraterritorial application of securities laws, patchwork regulation still leaves barriers to the development of a seamless global system of regulation. In addition, even if all nations adopt similar systems of securities regulation, this does not ensure a consistent level of enforcement. Regulatory and enforcement gaps can be filled only by the creation of a harmonized and centralized system of securities law to provide consistent monitoring, regulation, and enforcement.

A regulatory competition approach to international securities regulation also creates various collective action problems. Any

59. *See infra* notes 60–61 and accompanying text (detailing the Obama Administration's acknowledgement that the financial crisis that began in 2008 was partially the result of a race-to-the-bottom in international securities regulation).

60. U.S. DEP'T OF THE TREASURY, *supra* note 13.

61. *See id.* at 80 (discussing the need to raise international regulatory standards and improve international cooperation in response to the financial crisis that began in 2008).

62. *See id.* at 80–88 (explaining the Obama Administration's proposals for raising international regulatory standards and improving international cooperation in response to the financial crisis in 2008, which does not include a proposal for the harmonization and centralization of international securities law).

fragmented system of regulation creates free rider problems in which some actors will fail to invest in adequate levels of regulation and enforcement based on the belief that other actors will address any issues that arise. In addition, regulatory fragmentation can also create a bystander effect in which various actors witnessing the same issue fail to act because of the belief that other actors will address the issue. A harmonized and centralized system approach to international securities law remedies these and other collective action problems by creating a centralized salient entity to be a driving force in monitoring, regulation, and enforcement.

## III. THE BENEFITS OF THE HARMONIZATION AND CENTRALIZATION OF INTERNATIONAL SECURITIES LAW

Ideally, the world should adopt a system of international securities law based on harmonization and centralization. Nations throughout the world should harmonize their systems of securities law to allow for the existence of a centralized global securities regulator, and then these nations should negotiate treaties or other agreements to bring such a regulator into being. The centralized global securities regulator should have robust monitoring, regulatory, and enforcement powers allowing it to replace the current patchwork of regulation. The centralized global securities regulator should set a baseline of regulation from which nations could choose to upwardly depart.

Although such an approach might seem drastic and unrealistic because of the current nationalistic and protectionist attitudes of most countries, harmonization and centralization offers the best approach to international securities law because it minimizes systemic risk in the emerging global capital markets, benefits market participants, and allows the United States to retain a central role in international securities regulation. With that said, the emergence of harmonization and centralization in international securities law is likely to be a long-term evolutionary process, rather than a short-term revolutionary process, because a significant amount of time will be required to allow the current nationalistic and protectionist attitudes of most countries to dissipate.

### *A. Harmonization and Centralization Minimizes Systemic Risk in the Emerging Global Capital Markets*

The emerging global capital markets allow capital to flow throughout the world more efficiently, which creates a plethora of opportunities for

issuers, investors, and other market participants.[63] As evidenced by the financial crisis that began in 2008, however, the emergence of global capital markets creates new risks because any future financial crisis is likely to be global.[64] The harmonization and centralization of international securities law offers the best method for minimizing the new global risks created by the emerging global capital markets. This is because harmonization and centralization ends the international race-to-the-bottom in securities regulation, eliminates regulatory and enforcement gaps, and increases investor confidence.

Harmonization and centralization of international securities law would end the race-to-the-bottom that has emerged as the world has begun to transition to a regulatory competition approach to international securities regulation. As previously explained, one of the major causes of the financial crisis that began in 2008 was that no nation wanted to ratchet up the level of regulation on the mortgage-backed securities that were at the heart of the crisis. The United States did not want to ratchet up the level of regulation fearing that it would hurt economic growth in the United States and that it would lead to a loss of dominance in terms of its capital markets. Other nations did not want to ratchet up the level of regulation on mortgage-backed securities fearing that it would disadvantage their nation or region from reaping the benefits of the mortgage-backed securities. Under a model based on harmonization and centralization of international securities law, this race-to-the-bottom would be prevented. Securities regulators would no longer opt for suboptimal levels of regulation in hopes of attracting issuers, investors, and other market participants to their particular nation or region because a centralized global regulator would exist to set a consistent level of regulation.

Harmonization and centralization of international securities law also helps minimize the global systemic risk created by the emerging global capital markets because they eliminate the regulatory and enforcement gaps created by the current patchwork of national regulation. In the previous Part, six possible approaches to international securities law were discussed.[65] In the approaches based solely on privatization,

63. *See* Madison & Greene, *supra* note 19, at 99 ("The rapid pace of technological advances is bringing us closer to the reality of a seamless global capital market. In such a world, investors would have access to increased liquidity, greater diversification, and a wider range of investment options regardless of their location. Capital would be more efficiently allocated throughout the global economy to the benefit of all participants.").

64. *See* Roberta S. Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANSNAT'L L. 9, 33 (1999) ("Stock market crashes and financial firm failures have become international, just like trading markets.").

65. *See supra* Part II.B (discussing six possible models for international securities law, including

competition, convergence, mutual recognition, and harmonization, regulation remains fragmented between securities regulators, which allows for regulatory and enforcement gaps.[66] These regulatory and enforcement gaps are not only created by territoriality issues but also from various collective action problems that occur in the absence of a dominant actor. For example, each of these five approaches generates free rider problems in which nations are likely to attempt to be free riders, rather than investing the time and resources to work for an optimal level of international regulation and enforcement.[67] Moreover, without a dominant actor, each of these five approaches permits a bystander effect in which nations witnessing international regulatory and enforcement issues assume that other nations will address the problem.[68] When harmonization is coupled with centralization, however, the regulatory and enforcement gaps vanish because regulation is no longer fragmented. Hence, under a harmonization and centralization model, the emerging global capital markets and the newly-created transnational exchanges can be consistently and completely regulated.

A harmonization and centralization model of international securities law also helps minimize the global systemic risk created by the emerging global securities markets because it increases investor confidence. Securities markets are largely confidence driven.[69] Major fluctuations in investor confidence can lead to bubbles or depressions.[70] A relatively high and stable level of investor confidence is optimal because it motivates investors to invest and motivates investors to hold their investments.[71]

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privatization, competition, convergence, mutual recognition, harmonization, and centralization).

66. *See also* Karmel, *supra* note 64, at 39 ("In globalized capital markets, many violations of securities laws are transnational. This means that unless national laws are given extraterritorial effect, there will be inadequate law enforcement, but if laws are applied extraterritorially, there will be conflict between regulators and confusion on the part of regulated persons as to what are the proper rules.").

67. *See* Langevoort, *supra* note 11, at 204 ("When trading is heavily fragmented, no nation is able to capture enough of the benefits from investments in quality regulation. It is a classic free rider problem.").

68. See Tal Z. Zarsky, *Thinking Outside the Box: Considering Transparency, Anonymity, and Pseudonymity as Overall Solutions to the Problems of Information Privacy in the Internet Society*, 58 U. MIAMI L. REV. 991, 1008 (2004) (describing the "bystander effect" as a phenomenon in which entities "do not rush to assist others in danger or need, especially when there is no clear indication that it is their duty to do so").

69. *See* Paul D. Cohen, *Securities Trading Via the Internet*, 4 STAN. J.L. BUS. & FIN. 1, 11 (1999) ("Securities markets play a significant role in the economic life of the U.S. and the world. The growing importance of the securities markets is a direct result of investor confidence in those markets.").

70. *See generally* Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 419 (2006) (providing an analysis of the role of confidence and trust in the creation of bubbles and recessions).

71. *See id.* at 419 (explaining that the concept of "investor confidence . . . captures a deeper insight that a functioning market depends on investor trust in the integrity of that market and its

Patchwork regulation does not create a relatively high and stable level of investor confidence. Most investors will choose not to invest or will choose to sell investments quickly if they believe that: (1) they have inadequate information; (2) they are going to be the victim of fraud; or (3) they are going to lose their investment based on unforeseen market fluctuations.[72] Patchwork regulation promotes all of these beliefs. First, patchwork regulation encourages the belief among investors that they have inadequate information because it adds information gathering costs and makes understanding the regulatory environment more difficult.[73] Second, patchwork regulation encourages the belief among investors that they are going to be the victim of fraud or other abuse because patchwork regulation allows for regulatory and enforcement gaps between nations.[74] It also allows issuers and broker-dealers to choose regulatory regimes that are most favorable to themselves, rather than investors.[75] Third, patchwork regulation encourages the belief among investors that they are going to lose their investment based on unforeseen market fluctuations because no centralized, salient entity exists to monitor the entire global capital market and take action, if needed.[76] A model of international securities law based on

institutions").

72. *See id.* ("If investors fear being defrauded by issuers, broker dealers, exchanges or other market intermediaries, or that the investment odds are otherwise rigged, they will no longer invest in the stock market."); Elizabeth A. Nowicki, *A Response to Professor John Coffee: Analyst Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 U. CIN. L. REV. 1305, 1312 (2004) ("Investor confidence is, in part, built on assurances of honesty and full disclosure. If investors believe that the information incorporated into the prices of stocks in the market is suspect, and if investors believe that stock prices are based on biased, inaccurate information, who will continue to invest in the market?").

73. *See* Tafara & Peterson, *supra* note 50, at 48 ("[W]hile current U.S. laws and securities regulations do not directly limit U.S. investor access to foreign investment opportunities, in practice, access is constrained by . . . [a] lack of information about foreign investment opportunities because foreign financial service providers (and issuers) are not able to directly solicit American retail investors and U.S.-registered broker–dealers are unable to offer American investors information about or research on foreign investment products unless investors directly (and specifically) request such information.").

74. *See id*. at 32 ("As foreign markets develop and adopt higher regulatory standards, U.S. investors predictably are looking at them as potential investment opportunities. However, the current international environment has enforcement and oversight gaps that present risks that do not exist in a domestic context.").

75. *See* Pan, *supra* note 3, at 235 ("A . . . concern is that any difference in regulatory standards between the United States and the foreign jurisdiction will give rise to regulatory arbitrage. Less rigorous foreign regulation will favor foreign exchanges and broker–dealers over U.S. exchanges and broker–dealers and encourage U.S. market participants to establish operations abroad to take advantage of the regulatory differences.").

76. *See* Tafara & Peterson, *supra* note 50, at 42 ("For the past seventy two years, investors (both American and foreign) have expected U.S. capital markets to be overseen by a regulator with strong enforcement powers and be subject to corporate disclosure requirements based on a robust, high-quality, comprehensive set of accounting standards. . . . This is not always the case abroad, particularly in markets lacking adequate liquidity, where the public float of most traded companies is small, or where

harmonization and centralization offers the best solution to stabilizing the emerging global securities markets and minimizing the systemic risk created by those markets because it would promote investor confidence by creating a cohesive system of regulation that would be monitored and enforced by a centralized, salient entity.

### *B. Harmonization and Centralization Benefits Market Participants*

Beyond helping minimize the systemic risk created by the emerging global securities markets, a model of international securities law based on harmonization and centralization would also help benefit market participants in a variety of other ways. Such a model would create a cohesive system of international securities law that would replace the current patchwork of international securities regulation.[77] This cohesive system of international securities law would help market participants by reducing transaction costs, increasing market efficiency, and reducing the spillover risk of localized market failures.

Harmonization and centralization of international securities law would help reduce transaction costs for exchanges, investors, broker–dealers, issuers, and market regulators. In regard to securities exchanges, the completion of the merger between the New York Stock Exchange and Euronext on April 4, 2007 started a wave of transnational securities exchange consolidations.[78] Without harmonization and centralization, however, costly barriers remain to the full integration of these exchanges because the consolidated exchanges remain subject to the localized securities laws of the countries in which they operate.[79] Moreover, in the absence of harmonization and centralization, issuers face added transaction costs to obtain the benefit of cross-border financing because they must adhere to the laws of each jurisdiction in which they choose to sell securities.[80] Similarly, broker–dealers, who

laws against market manipulation are poorly enforced.”).

77. *See supra* Part II.B (discussing six possible models for international securities regulation).

78. See *supra* notes 38–39 and accompanying text (discussing the merger between the New York Stock Exchange and Euronext and the wave of transnational securities exchange consolidations that occurred after the merger was completed).

79. *See* Greene, *supra* note 31, at 97 (“The SEC must acknowledge that the securities markets have evolved beyond jurisdictional borders and that its current regulatory regime has resulted in barriers to competition and placed roadblocks in the way of investor access to cross-border investment opportunities that have contributed to increased cost and market inefficiencies.”); Pan, *supra* note 37, at 137 (“The utmost economic benefits of the [New York Stock Exchange and Euronext] merger will be realized only if the exchanges are able to consolidate trading into one platform with a single order book, thereby achieving economies of scale and maximizing liquidity.”).

80. *See* Jackson, *supra* note 25, at 118 (“To date, most economic research on globalization of capital markets has explored the benefits of cross-border financings to issuers. Hence, a common

choose to operate in multiple jurisdictions, also face the added expense of complying with the securities laws of each of these jurisdictions.[81] These added expenses of issuers and broker–dealers are of course passed along to investors.[82] Investors also face the added burden of gathering and interpreting information in a fragmented regulatory regime,[83] and investors must pay the expense of complying with a patchwork of regulation when they choose to sell their securities.[84] Moreover, securities regulators shoulder the added expense of operating in a fragmented regulatory regime that creates a multitude of issues with effective monitoring, regulation, and enforcement. Harmonization and centralization would eliminate many of these costs by creating a cohesive and understandable system of international securities regulation.

Under a model of international securities law based on harmonization and centralization, market participants also benefit from the increased efficiency of the emerging global capital markets. Such a model increases market liquidity, which deepens the pool of capital available to issuers and reduces the cost of obtaining that capital.[85] Transactions between issuers and investors can be quickly and easily completed, and a seamless global capital market could emerge.[86]

Finally, a model of international securities regulation based on harmonization and centralization also benefits market participants because it reduces the potential spillover risk of localized market failures

measure of the benefits of globalization is the reduction in the cost of capital for issuers.”).

81. *See also* Greene, *supra* note 31, at 86 (“The current U.S. regulatory scheme makes cross-border investment costly and inefficient.”).

82. *Id.*

83. *See also* Jackson, *supra* note 25, at 111 (“Aside from technical barriers, U.S. retail investors face serious problems receiving information about foreign investment opportunities. Most notably, foreign broker dealers are prohibited from soliciting most U.S. retail investors unless those firms comply with SEC registration and compliance requirements.”).

84. *See also* Tafara & Peterson, *supra* note 50, at 48 (“[O]ver the past two years, U.S. retail investment abroad has surged dramatically, mostly as a result of investors seeking higher overseas returns made possible by the devaluation of the U.S. dollar. However, the process can be cumbersome and comparatively expensive.”).

85. *See* Greene, *supra* note 31, at 88 (“Issuers, both within and outside the United States, will gain access to a wider pool of investors and benefit from a reduced cost of capital.”). *But see* Jackson, *supra* note 25, at 118 (“While lower capital costs presumably benefit consumers through higher economic growth, the benefits are not entirely obvious to the consumers in countries like the United States where foreign issuers come to raise their capital. Indeed, foreign issuers could end up competing with domestic firms for scarce domestic capital and forcing local firms to pay more for their capital.”).

86. *See* Greene, *supra* note 31, at 88 (“Breaking down the barriers between U.S. financial markets and comparably regulated non-U.S. financial markets will benefit both U.S. and non-U.S. market participants. U.S. investors will benefit from more efficient execution of transactions in non-U.S. securities. Non-U.S. investors will similarly benefit from more efficient execution of transactions in U.S. securities.”).

or other financial crises. As previously discussed, the capital markets are now global. As the world becomes increasingly interconnected, any future financial crisis is likely to be global as well.[87] This also means that localized market failures or other financial crises can easily spillover and have global consequences.[88] The creation of a centralized global securities regulator reduces this risk because such a regulator would provide additional monitoring of the world's financial markets and would have the power to act globally to prevent or reduce the impact of any localized market failure or other financial crisis.

### *C. Harmonization and Centralization Allows the United States to Maintain a Central Role in International Securities Regulation*

An additional benefit of a model of international securities law based on harmonization and centralization is that it would allow the United States to maintain a central role in international securities regulation. Of course, allowing the United States to maintain a central role in international securities regulation benefits the United States because it would give the United States power in a harmonized and centralized system of international securities law, instead of allowing its influence to continue to dwindle under the emerging international system of regulatory competition. Allowing the United States to play a central role in international securities regulation also benefits the rest of the world because it gives the world the benefit of the United States' experience as a securities regulator and allows the United States to export its theories of market regulation. Hence, the current patchwork of inconsistent international securities regulation would be replaced with a system of cohesive regulation with similarities to the system of regulation that kept the capital markets in the United States relatively stable for much of the twentieth century.

A model based on harmonization and centralization would allow the United States to shape the global markets based on its experience as a securities regulator. For much of the twentieth century, the United States was viewed as having the world's premier capital markets and the world's premier system of securities regulation. During the twentieth century, the United States transitioned from a system of regulatory competition among state regulators to a system of centralized regulation

87. *See* Jackson, *supra* note 25, at 112 ("An interesting challenge in the regulation of foreign investments is the possibility of spillover effects in the United States when things go wrong overseas, like the Parmalat scandal or the Asian financial crisis of 1997.").

88. *Id.*

with the enactment of the Securities Act of 1933[89] and the Securities Exchange Act of 1934.[90] This transition resulted from the stock market crash of 1929 and the Great Depression.[91] The financial downturn that began in 2008, which arguably should be characterized as a depression, came into being in part because of the globalization of financial markets and the development of a patchwork of regulation on the international level. A harmonized and centralized model of international securities regulation would provide a similar solution to the regulation of the emerging global capital markets as the approach that worked to keep the securities markets relatively stable in the United States for much of the twentieth century. In structuring this harmonized and centralized system, the world would gain the benefit of the United States' experience during the twentieth century.

A harmonized and centralized system of international securities regulation would permit the United States to export its theories of market regulation as it negotiated with other securities regulators throughout the world to allow for the existence of a centralized global securities regulator. The United States would be able to play a leading role in international securities law by allowing its voice to be heard in this process. Although the United States was able to fuel weak regulatory convergence in international securities regulation during much of the twentieth century because of having the world's premier capital markets and premier system of securities regulation, the United States' dominance is now waning. Its best hope to maintain a leading role in international securities regulation is to advocate for harmonization and centralization. Ultimately, playing a role in this process will benefit the rest of the world because harmonization and centralization based on the market regulation theories used by the United States during much of the twentieth century offer the best hope for minimizing the systemic risk in the emerging global securities markets.

## IV. AN EVOLUTIONARY MODEL FOR THE HARMONIZATION AND CENTRALIZATION OF INTERNATIONAL SECURITIES LAW

Although a strong argument exists for the harmonization and centralization of international securities law, two complaints are

89. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

90. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006).

91. *See also* Eric C. Chaffee, *Beyond* Blue Chip*: Issuer Standing to Seek Injunctive Relief Under Section 10(b) and Rule 10b-5 Without the Purchase or Sale of Security*, 36 SETON HALL L. REV. 1135, 1139 (2006) (discussing Congress's reasons for passing the Securities Act and the Exchange Act, including preventing "national emergencies created by unreasonable fluctuations in security prices").

commonly made against such an approach, which can be rebutted. First, opponents of harmonization and centralization argue that such an approach prevents the regulatory innovation that is yielded through regulatory competition. However, the tensions among regulators, issuers, and investors create pressures to find an optimal level of regulation because each group has the political power to push for either regulation or deregulation. In addition, under the model of harmonization and centralization proposed in this Article, regulatory competition is not completely prohibited because the centralized global regulator would create only a baseline of regulation from which individual nations could upwardly depart. Second, opponents of harmonization and centralization and those who simply resign themselves to the current system of international securities law argue that harmonization and centralization is not feasible because most regulators would be unwilling to eschew current nationalistic and protectionist tendencies to allow such a system of international securities regulation to come into being. Although harmonization and centralization may be a drastic and unrealistic approach in the short-term, such an approach becomes feasible if it is allowed to emerge through a long-term evolutionary process. In this Part, two case studies of long-term evolutionary institution building will be presented; the commonalities between these case studies will be discussed; and a number of possible paths toward the harmonization and centralization of international securities law will be explored.

### *A. Two Case Studies Illustrating the Value of an Evolutionary Approach to Institution Building*

A long-term evolutionary approach to the development of a harmonized and centralized system of international securities regulation might seem odd in comparison to the relatively rapid pace at which global capital markets have developed.[92] However, such an evolutionary approach offers the best and perhaps the only way that such a system of international securities law might emerge. Often, the building of institutions takes a series of stages and transitions prior to the emergence of an effective and lasting body. The development of securities regulation in the United States and the development of securities regulation in the European Union offer two case studies illustrating the value of an evolutionary approach to institution building.

The development of securities regulation in the United States reflects

92. *See supra* Part II.A (describing the emergence of global capital markets).

an evolutionary process involving a variety of stages and transitions. During the 1700s, the 1800s, and the first decade of 1900s, the United States did not have codified systems of securities law. Instead, the United States employed a privatization approach to securities regulation under which securities exchanges determined rules governing issuers, investors, and other market participants. In addition, general provisions of tort and criminal law were used to prohibit fraud in the purchase or sale of securities. This approach to securities regulation proved ineffective in preventing fraud, and in 1911, Kansas passed the first state statute providing for securities regulation.[93] This statute became commonly referred to as a blue sky law, along with all other subsequently passed state statutes that focus on securities regulation.[94] Throughout the 1910s and 1920s, as the United States took a regulatory competition approach to securities law, "blue sky laws" began to appear throughout the United States and formed a patchwork of regulation that was largely ineffective in preventing securities fraud.[95] Although federal securities regulation was discussed during this period, it was viewed as unrealistic until the stock market crash of 1929.[96] In response to the stock market crash, Congress adopted a harmonized and centralized approach to security law and passed the Securities Act of 1933[97] and the Securities Exchange Act of 1934.[98] Notably, § 4(a) of the Securities Exchange Act of 1934 created the SEC, a centralized administrative agency charged with overseeing the regulation and enforcement of securities laws in the United States.[99] As a result of this harmonized and centralized approach, the markets in the United States remained relatively stable until the financial downturn that began in 2008, which arguably occurred because of regulatory fragmentation on

93. 1 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.2[2] (6th ed. 2009) ("[I]n 1911, Kansas passed the first state securities statutory regulatory scheme. This, like subsequent securities legislation in other states, has come to be known as a 'blue sky law.'").

94. *Id.*

95. *See also* Eric C. Chaffee, *Standing Under Section 10(b) and Rule 10b-5: The Continued Validity of the Forced Seller Exception to the Purchaser–Seller Requirement*, 11 U. PA. J. BUS. L. 843, 851 (2009) ("Prior to the Securities Act and the Exchange Act, individual states were the main forces in regulating securities. The state statutes were and are commonly referred to as 'blue sky laws,' and prior to the Securities Act and the Exchange Act, the state statutes created an inconsistent patchwork of securities regulation that was largely ineffective in preventing fraud.").

96. *See* HAZEN, *supra* note 93, § 1.2[2] ("Following enactment of the early state securities laws, federal legislation was successfully resisted for a while. However, the stock market crash of 1929 is properly described as the straw that broke the camel's back. The era that followed ushered in federal securities regulation.").

97. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

98. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006).

99. 15 U.S.C. § 78d(a) (2006) (providing for the establishment of the SEC).

the international level.

The development of securities regulation in the European Union offers a second example of the value of an evolutionary approach to institution building. Securities regulation in Europe dates back to at least the thirteenth century.[100] Despite this long history, securities regulation and securities markets in Europe remained a national phenomenon until the second half of the twentieth century.[101] In 1957, the Treaty Establishing the European Community (EC Treaty) helped found the European Communities, which was the predecessor to the European Union, and stated that one of its purposes was the "abolition, as between Member States, of the obstacles to the free movement of persons, services and capital."[102] Despite this mandate, interest in the development of transnational securities markets in Europe remained limited until the mid-1980s.[103] In 1985, the Commission of the European Communities issued its white paper report, *Completing the Internal Market*.[104] This report led to the Single European Act, which amended the EC Treaty to make it easier to pass directives to member states requiring them to harmonize their securities laws.[105] The completion of a transnational securities market did not occur until after the Treaty on European Union, also known as the Treaty of Maastricht, was signed in 1992.[106] In November 1999, the European Commission issued an action plan noting several shortcomings of the existing system of securities regulation in the European Union.[107] In July 2000, based on the information contained in the action plan, the European Council appointed the Committee of Wise Men on the Regulation of European Securities Markets.[108] Ultimately, the Committee of Wise Men

100. *See* HAZEN, *supra* note 93, § 1.2[1] (describing the development of securities regulation in England, including that "[r]egulation of securities brokers dates back to the thirteenth century").

101. *See* DeLaMater, *supra* note 27, at 110 (explaining that for much of the twentieth century the securities markets in Europe were "fragmented, relatively uninterested in equity securities—especially at the retail level—and not receptive to long-term debt financing").

102. Treaty Establishing the European Economic Community art. 3(c), Mar. 25, 1957, 298 U.N.T.S. 11.

103. *See supra* note 101 and accompanying text.

104. Comm'n of the European Communities, *Completing the Internal Market: White Paper from the Commission of the European Council*, COM (1985) 310 final (June 14, 1985).

105. Single European Act, 1987 O.J. (L 169) 1, 25 I.L.M. 503 (1986).

106. Treaty on European Union, Feb. 7, 1992, 1992 O.J. (C 224) 1, 31 I.L.M. 247 (1992).

107. *Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232 final (May 11, 1999).

108. *See* Caroline Bradley, *Consumers of Financial Services and Multi-Level Regulation in the European Union*, 31 FORDHAM INT'L L.J. 1212 , 1220 (2008) ("The Economic and Financial Affairs Council [of the Council of the European Union] . . . appointed a Committee of Wise Men, led by Baron Lamfalussy, to rethink the EU's processes for developing financial policy, and this committee proposed a new system which would distinguish framework measures and detailed implementing rules.").

recommended the creation of the Committee of European Securities Regulators (CESR).[109] On July 6, 2001, acting upon this advice, the European Commission decided to create CESR to serve as a centralizing force in securities regulation in the European Union.[110] As outlined on its website, CESR's role was to:

> - Improve co-ordination among securities regulators: developing effective operational network mechanisms to enhance day to day consistent supervision and enforcement of the Single Market for financial services . . .
>
> - Act as an advisory group to assist the EU Commission: in particular in its preparation of draft implementing measures of EU framework directives in the field of securities;
>
> - Work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States . . .[111]

As a result of the financial downturn that began in 2008, a successor to CESR was proposed.[112] CESR was replaced by the European Securities and Markets Authority, an entity with more robust regulatory powers, which increased the harmonization and centralization of securities regulation in the European Union.[113]

### *B. The Common Characteristics of the Two Case Studies*

Although the development and the political climates of the United States and the European Union vary dramatically, certain commonalities emerge from studying the evolution of their systems of securities regulation. These commonalities include evolution based on political

109. Comm. of Wise Men, *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, at 19 (Feb. 15, 2001), *available at* http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf.

110. Commission Decision 2001/527, Establishing the Committee of European Securities Regulators, 2001 O.J. (L 191) 43, 44 (EC).

111. *CESR in Short*, http://www.cesr-eu.org/index.php?page=cesrinshort&mac=0&id= (last visited June 22, 2010).

112. *Proposal for a Regulation of the European Parliament and of the Council Establishing a European Securities and Markets Authority*, COM (2009) 503 final (Sept. 23, 2009).

113. Regulation 1095/2010 of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331) 84. *See also* ESMA, About Us, http://www.esma.europa.eu/index.php?page=cesrinshort&mac=0&id= (last visited Jan. 18, 2011).

stress, evolution based on the failure of institutions to achieve their intended goals, and a consistent trajectory toward harmonization and centralization. These commonalities suggest a path for international securities regulation toward harmonization and centralization that may ultimately be a natural progression, although recognition and understanding of it may help make the transition to a harmonized and centralized system of international securities regulation easier.

In both the United States and the European Union, securities regulation has evolved based on political stress. The United States transitioned from a privatized system of securities regulation to a system of regulatory competition based on state law because of fears of fraud within the privatized system.[114] Then, the United States transitioned from a regulatory competition approach to securities regulation to a system of centralized regulation based on outcry over the stock market crash of 1929 and the Great Depression.[115] Similarly, the European Union transitioned from a system of regulatory competition among member states to a harmonized system of securities regulation based on outcry over failing to meet the edicts of the EC Treaty to achieve a common market among member states,[116] and then transitioned to a harmonized and centralized approach with the creation of CESR when the creation of a common market continued to be elusive.[117] Finally, the European Union is moving toward greater centralization with the creation of the European Securities and Markets Authority because of the financial crisis that began in 2008.[118] For both the United States and the European Union, political stress was required to reach the next evolutionary stage.

For a harmonized and centralized system of international securities regulation to emerge, political stress will need to fuel the process. For this to occur, widespread concern over fraud in the global securities markets or a series of financial crises will likely need to occur. Crisis has traditionally created change in securities regulation. With that said, the nationalistic and protectionist tendencies of most securities regulators throughout the world are deeply engrained. For example, although the financial crisis that began in 2008 has generated increased interests in global entities, such as the International Organization of Securities Commissions, it has not fueled a major push toward harmonization and centralization on the international level. A series of

114. *See supra* notes 93–95 and accompanying text.
115. *See supra* notes 96–99 and accompanying text.
116. *See supra* notes 102–106 and accompanying text.
117. *See supra* notes 107–111 and accompanying text.
118. *See supra* notes 112–113 and accompanying text.

crises will likely be required for harmonization and centralization to become the dominant model of international securities law.

The evolution of securities regulation in both the United States and the European Union also required failure of various institutions to meet their intended goals. In the United States, failure of securities exchanges to effectively address fraud in the securities markets caused a transition to regulatory competition among the states. The failure of the states to provide stability to the national securities markets led to the centralization of securities regulation in the United States through the enactment of the Securities Act of 1933,[119] the enactment of the Securities Exchange Act of 1934,[120] and the creation of the SEC.[121] The story is similar in the European Union. The failures of the European Communities to achieve the edicts of the EC Treaty in part led to the creation of the European Union, and the failure of the European Union to achieve a common securities market led to the creation of CESR. Finally, the failure of CESR to prevent the financial crisis that began in 2008 has led to a push for greater centralization with the creation of the European Securities and Markets Authority.

The experiences of the United States and the European Union suggest that various failures will occur on the path to the harmonization and centralization of international securities regulation and that these failures are likely a necessary part of the evolutionary process. To achieve harmonization and centralization, the willingness to move slowly across the spectrum of approaches to international securities regulation will be required.

Finally, both the experiences of the United States and the European Union demonstrate a consistent progression toward the harmonization and centralization of securities regulation. The United States transitioned from privatization to regulatory competition to centralization, and for most of the twentieth century its capital markets remained relatively stable. The European Union has taken a similar trajectory by transitioning from regulatory competition to harmonization and centralization of its securities laws. The United States and the European Union are now part of a global patchwork of securities laws, and as a result of this patchwork, they are again faced with the dangers of regulatory competition. The United States, the member states of the European Union, and the other nations of the world must begin anew the slow evolutionary process toward harmonization and centralization.

119. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

120. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006).

121. 15 U.S.C. § 78d(a) (2006) (providing for the establishment of the SEC).

### *C. Possible Paths to the Harmonization and Centralization of International Securities Law*

A slow evolutionary process offers the best chance that the harmonization and centralization of international securities law will occur. The issue that lingers is what the next step should be in the process toward such a system of securities law. In fact, a myriad of potential next steps exist. Any sort of action on the part of securities regulators that fuels cooperation and coordination moves the current system of international securities law based on regulatory competition toward a system based on harmonization and centralization. Three possible options include adopting a mutual recognition approach to international securities regulation; developing multinational task forces to assist in transnational enforcement of securities laws; and endowing the International Organization of Securities Commissions (IOSCO) with more robust monitoring, regulatory, and enforcement powers.

One potential step toward the harmonization and centralization of international securities law is to adopt the mutual recognition model of securities regulation that was proposed by Tafara and Peterson.[122] As previously explained, the proposed framework would allow foreign securities exchanges and foreign broker–dealers access to the United States without having to register with the SEC.[123] The foreign securities exchange and foreign broker–dealer would be eligible for exemption from registration only if its home country's securities laws and enforcement policies were comparable to those of the other participating nations. Although this proposed framework would not create a harmonized and centralized system of international securities law, the framework would be a step toward such a system because of the increased cooperation and coordination that would be created among securities regulators participating in the mutual recognition framework.

A second potential step toward the harmonization and centralization of international law would be to create multinational task forces to assist in the transnational enforcement of securities regulation. Under this model, nations would come together to create task forces that would be composed of national securities regulators and would work to monitor transnational securities issues. These task forces would be created by treaties or other agreements and could be given investigatory power and the standing to initiate suit in the event that a securities law violation is

122. *See supra* notes 50–53 and accompanying text (discussing proposal by Tafara and Peterson for a mutual recognition framework).

123. *See supra* note 51 and accompanying text (providing an overview of the mutual recognition framework proposed by Tafara and Peterson).

believed to have occurred. This model falls short of a harmonized and centralized system of international securities regulation because the task forces would have to obey and enforce the national securities laws in each jurisdiction in which it operated. However, this type of approach could be an important step toward the eventual adoption of a harmonized and centralized approach to international a securities law.

A third potential step toward the harmonization and centralization of international law would be to endow the International Organization of Securities Commissions (IOSCO) with more robust monitoring, regulatory, and enforcement powers. IOSCO was created in 1983 when securities regulators from eleven countries in North and South America decided to transform an inter-American association of securities regulators into a global body.[124] Today, IOSCO is composed of regulators from over 100 jurisdictions who regulate more than ninety-five percent of the world's securities markets.[125] IOSCO serves monitoring and coordinating functions, rather than being a centralized body for the creation and enforcement of securities law.[126] Compliance with IOSCO's efforts is voluntary unless an individual nation chooses to adopt them.[127] One step toward a harmonized and centralized system of international securities law would be to endow IOSCO with more robust monitoring, regulatory, and enforcement powers. IOSCO has the potential to be a force in the harmonization and centralization of international securities law, but as currently composed, IOSCO has too little power to serve this function.

Ultimately, anything that fuels the process toward harmonization and centralization of international securities law is a positive, and no single path to such a system of securities law is required. With that stated, however, the world has begun to develop a seamless global capital market. The end of international securities regulation must be to

124. *See* OICV–IOSCO, IOSCO Historical Background,, http://www.iosco.org/about/index.cfm?section=background (last visited Jan. 20, 2011) ("[IOSCO] was created in 1983 with the decision to change from an inter-American regional association (created in 1974) into a global cooperative body. Eleven securities regulatory agencies from North and South America took [sic] this decision in April 1983 at a meeting in Quito, Ecuador.").

125. *Id.* ("Its membership regulates more than 95% of the world's securities markets and it is the primary international cooperative forum for securities market regulatory agencies. IOSCO members are drawn from, and regulate, over 100 jurisdictions and its membership continues to grow.").

126. *See* OICV–IOSCO, About Us, http://www.iosco.org/about (last visited Jan. 20, 2011) (providing an overview of IOSCO's main purposes).

127. *See*, *e.g.*, INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (1998), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf; INT'L ORG. OF SEC. COMM'NS, MULTILATERAL MEMORANDUM OF UNDERSTANDING CONCERNING CONSULTATION AND COOPERATION AND THE EXCHANGE OF INFORMATION (2002), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf.

develop a seamless global system of securities law to regulate that market.