

# REPORT

## CAPITAL MARKETS AND STOCK EXCHANGES IN THE BALTIC SEA REGION

*Consequences of stock market  
concentration in Europe  
for the Baltic Sea Region*

*How to ensure an efficient and adequate capital allocation  
as a driver of transition in an enlarged Europe*

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# **Capital Markets and Stock Exchanges in the Baltic Sea Region**

**Consequences of stock market concentration  
in Europe for the Baltic Sea Region**

**How to ensure an efficient and adequate capital allocation  
as a driver of transition in an enlarged Europe**

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## 1. Introduction

The Baltic Development Forum, Copenhagen, Denmark took the initiative to have this report written. It defined the subject and in mid April 2000 it asked us - two researchers in the field of law and two economists - to write a report with the working title “Consequences of stock market concentration in Europe for the Baltic Sea Region. How to ensure an efficient and adequate capital allocation as a driver of transition in an enlarged Europe?”

The report should be an official summit document and intended to serve as a background paper for the session: “Hello Frankfurt - Consequences of stock market concentration” at the 2<sup>nd</sup> annual Baltic Development Forum Summit to be held in Malmö, Sweden 17-19 September 2000.

The first draft of the report was presented and discussed at a roundtable discussion held in Copenhagen by The Baltic Development Forum on 26 June 2000. Participants in the roundtable discussion were:

Robert Dornau, Market Policy, Deutsche Börse AG, Germany

Viktors Gustsons, Chairman Securities Market Commission, Latvia

Jesper Lau Hansen, Associated Professor, Department of Law, University of Copenhagen, Denmark

Christen Boye Jacobsen, Chief Advisor (Balticum), Ministry of Foreign Affairs, Denmark

Saulius Malinauskas, Director Listing Department, National Stock Exchange of Lithuania, Lithuania

Rolf Skog, Sekreteare, Justitiedepartementet, Aktiebolagskommittén, Sweden

Gert Tiivas, Managing Director, Tallinn Stock Exchange, Estonia.

Anne Dorte Riggelsen, Director, Baltic Development Forum

Henrik Casper, Analyst, Baltic Development Forum

We have taken the fruitful comments from the roundtable discussion into account when making the final report. However, the analyses and recommendations of the report are the sole responsibility of the authors. The final report was handed over to The Baltic Development Forum on 11 August 2000.

The purpose of the report is to define and discuss the most important implications of the development on the European capital markets and the consequences hereof for the market and future structure of stock exchanges in the Baltic Sea Region. A basic question is how the Baltic Sea Countries and their stock exchanges can adjust to the present concentration and integration on the European stock markets? Pros and cons of different kinds of co-operation between stock exchanges within the region and externally in relation to possible partners outside the region will be analysed. The conclusions and recommendations will be handed over to the decision makers in the Baltic Sea Region.

The report focuses on the market for listed securities (stocks) and the regulation hereof and deals primarily with the problems and challenges that the existing stock exchanges have been and will continue to be facing. Markets for bonds and derivatives are not dealt with and the market for venture capital is only dealt with to a limited extent. In a broader financial and capital market perspective clearly other elements are relevant, but the size of the report and the time has forced some limitations on subjects to be made.

Besides an executive summary in Section 2 the report contains four sections dealing with different legal and economic aspects deemed to be of relevance by the authors.

Section 3 describes the development which today forms the basis for the existing stock exchanges' situation in the Baltic Sea Region. This is partly made through a description of the capital market and the stock exchanges and partly by describing the regulatory development which has contributed to promote the internationalization of the securities market.

Section 4 deals with key elements and trends in the development of the securities markets and the regulation hereof in the Baltic Sea Countries. In light of the rapidly growing globalization of the securities markets and the international competition among marketplaces it will be discussed whether the markets of the Baltic Sea Countries are suitable for their own national strategy with respect to the future development of the market, or whether some kind of co-operation or alliances between the stock exchanges within the Baltic Sea Region is a prerequisite for being an attractive marketplace in an international perspective.

Section 5 forms the basis for a discussion on whether to enter into a co-operation between some of the stock exchanges in the Baltic Sea Region. Different ways of co-operation will be discussed and existing co-operations mentioned.

Finally Section 6 adds a more general perspective to the discussion as to whether the Baltic Sea Region or parts hereof can or should be regarded as and relied upon as one regional market. Reservations are made in that respect.

In the following the term Baltic Sea Countries includes: Sweden, Norway, Denmark, Finland, Estonia, Latvia, Lithuania, Russia, Poland, and Germany.

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## **2. Executive summary**

The international development in the stock exchange area is in turmoil and no one can forecast the future with any degree of certainty. Different national stock exchanges are trying to co-operate at the same time as completely new players are entering the market thanks to the technological development. Today two large co-operations exist in Europe. Deutsche Börse and the London Stock Exchange have agreed to merge and create iX international exchanges. The Paris Stock Exchange, the Brussels Stock Exchange and the Amsterdam Stock Exchange intend to merge and create EuroNext. For the time being Norex, the co-operation between the Stockholm and Copenhagen Stock Exchanges is the only alliance that is working in practice. Oslo, Iceland, Tallinn, Riga, and Lithuania stock exchanges have signed letters of intent to join Norex.

The use of language is rather loose in this area. In general, one tends to use the word “merger” for what is often only close co-operation in many aspects. From an academic point of view a full scale merger has certain advantages as it would create common regulation, a common supervision etc. So far there has been very few examples of such mergers, and therefore, their possible benefits and disadvantages are hard to determine. It is still too early to determine if the planned iX and EuroNext merger will be successful. Norex is, at least for the time being, not a merger, but a co-operation between stock exchanges to use one common trading system, with a goal of harmonisation of stock exchange regulations and common clearing and settlement. But seen from a user’s point of view, close co-operation can work just as well as a formal merger.

Due to the fact that most countries only have one or two stock exchanges a few large stock exchanges dominate the global picture. Stock exchanges are best analysed in terms of market value of all companies on the stock exchange, as data for turnover are very bad. Table 0 shows the market capitalisation of the 10 largest stock exchanges in the world, of the two large European planned mergers and of Norex. Even though Norex encompasses 7 countries it is still a small stock exchange (technically Norex is not one stock exchange but different stock exchanges with one trading system). In the medium long run Norex may have to co-operate with other stock exchanges outside the Baltic Sea Region.

Table 0 Market capitalisation of shares of domestic companies in 1999

Stock exchanges	Billion of USD
NewYork	11.438
Nasdaq	5.205
Tokyo	4.455
London	2.855
Paris	1.503
Deutsche Börse	1.432
Toronto	789
Italy	728
Amsterdam	695
Switzerland	693
iX: London and Deutsche Börse	4.288
Euronext: Paris, Amsterdam and Brussels	2.382
Norex today: Stockholm and Copenhagen	479
Norex according to letter of intent: Stockholm, Copenhagen, Oslo, Iceland, Tallinn, Lithuania and Riga	550

The size and the complexity of the problems with international stock exchange mergers are difficult to overestimate. There are problems as to

- Technique (technical questions are interesting not only to the stock exchanges as such, but also for the brokers and institutional investors who trade on the stock exchanges and have invested in IT)
- Regulation (which rules should apply when a French investor buys stocks from an American in a German firm listed in London as to rules of conduct, disclosure requirements, and mandatory take over bids and so on)
- Settlement (settlement of international trades, that is payment and registration of ownership transfers, can be quite expensive. A merger wave is expected in this area as well as in the stock exchange area). The question is to what extent one has to look upon mergers in these two areas as dependent on each other

A stock exchange has two different functions. On one side it is a market place where trade takes place. On the other side it is a regulator and supervisor with respect to the regulation of the market. Few Swedish investors care very much if trade in Swedish stocks “physically” happens in a computer in Sweden or in Germany. However, as to the actual regulation and supervision feelings are stronger and the advantages of being “in the country” are larger.

No obvious optimal stock exchange region exists nor is there any reason to have firm expectations as to how many stock exchanges will exist in the future or what regions they may encompass. It is by no means certain that the existing or planned co-operation between the existing exchanges will exist in the medium term future. This is an argument as to why interference by governments and legislators in this area should be minimised. They are good at long-term decisions but less good in situation where fast adaptation to changed circumstances is necessary. The main role of legislators is to create the legal and regulatory basis for well-functioning national and international markets. A major mistake would be if governments and



legislators due to political reasons put weight on co-operation between certain countries (as for instance the Baltic Sea Countries) and conclude that it was a “must” with stock exchange co-operation in this region.

The development in the clearing and settlement area is in the same turmoil as the stock exchange area. A few years ago there was a widespread feeling that stock exchanges and Central Securities Depositories (CSDs) should merge nationally to ease the coming international co-operation in both these areas. But the development has shown that the barriers to international co-operation are very different in the stock exchange area and in the CSD area. Therefore, it might be best to let stock exchanges and CSD’s each choose their way to international integration independent of each other. A “forced marriage”-strategy nationally might very well end up in delaying the international integration in both areas.

The Baltic Sea Region can not be described as an optimal or even logical region as far as stock exchanges are concerned. The Baltic Sea Region includes Germany, Russia, Poland, Sweden, Norway, Finland, Denmark, Estonia, Latvia, and Lithuania. By far the most important player, Germany, has for the time being chosen co-operation with England. For Germany to choose a leading role of the Baltic Sea Region instead of trying to become member of a world alliance (London and Frankfurt negotiating with Nasdaq) would hardly be optimal seen from a German point of view. Russia is a long way from entering EU and thus for implementing EU rules. Furthermore, currently the Russian legal system does not live up to the demands set by Western stock exchanges. Thus Norex would risk “contamination” if Russia joined Norex. Poland has succeeded in establishing a quite successful national stock exchange. But the most likely alliances for Poland may well be with Hungary and the Czech Republic or with Germany/England.

According to letter of intents the Norex alliance encompasses Sweden, Denmark, Norway, Estonia, Latvia, Lithuania and Iceland. The only obvious new candidate from the Baltic Sea Region is Finland.

In general governments and legislators have often taken too large an interest in stock exchanges, given the macroeconomic influence today on of the efficiency of stock exchanges in the individual countries. Historically, governments and legislators have often been initiators in the creation of stock exchanges. However, with increasing competition the development of stock exchanges might probably with advantage be left to the market. An inefficient local stock exchange is a smaller problem today than 20 years ago, since the competitive pressure both from foreign and from alternative national trading systems has grown. Initiatives for new stock exchanges (stock exchanges for small companies, stock exchanges for growth companies and so on) are among the areas that could be left to the market. There is lack of neither capital nor expertise. Even though stock exchanges have not yet merged internationally to a large degree, capital markets are already integrated, and that is what is most important for macroeconomic efficiency. Investors invest internationally and there are many international mergers between companies. The real significant gains in this area have come from the abolishment of capital restrictions that took place from 1980 and onwards. Mergers between stock exchanges will hardly have the same large effect. In that connection it should be mentioned that national stock exchanges already have become more efficient in the later years due to international pressure and the fear of losing large companies to other stock exchanges. The large companies in Sweden and Finland could just as well be traded in London.

A consequence of the growing internationalisation in this area is that the individual country has a de facto decreasing degree of freedom concerning regulation (disclosure, take over bids, insider trading, and so on). There is a growing advantage in choosing international influenced standard rules used by the largest stock exchanges since a growing part of all investors are internationally oriented. Generally speaking, what matters is not so much what the rules are but more that they are the same. It is just as with railway tracks. The width of the tracks is not important; what is important is that all countries use the same width. Furthermore, national regulation is becoming easier to circumvent due to internationalisation of stock trade. Individual countries have limited reasons to have strong preferences as to the exact stock exchange regulation. Therefore, legislators should as a minimum implement existing EU regulation and in general try to implement the rules most likely to be standard (London rules). Such implementation could be done nationally, under the auspices of the EU or as co-operation between countries within a certain region, e.g. between some of the Baltic Sea Countries. In most cases local stock exchanges will recommend such a policy. However, one cannot rule out the possibility that some stock exchanges (or rather the decision makers, be it owners, members of the stock exchange or employees of the stock exchange) might have other interests, for instance to keep a lucrative and inefficient monopoly or to hide limited ability to implement new rules. Therefore, one cannot as a rule without exception conclude that legislators should follow the recommendations from stock exchanges.

The existing Norex co-operation is natural, given the situation today. The ongoing merger between Deutsche Börse and London Stock Exchange leaves little room for small and medium-sized countries to try to join this merger in the near future, should they wish to do so. And especially for small countries to keep their national stock exchange with no co-operation at all is hardly a good idea. There is a large risk that stocks in large national companies would be traded elsewhere.

## **Recommendations**

1. *Everybody (governments, legislators, practitioners and academics) should be very careful to have too strong ideas as to optimal policy in the stock exchange area.* Stock exchanges/clearing companies are rather complicated businesses. An obvious risk is that people focus on one or two aspects of interest to them selves and based on this form a firm opinion as to the optimal strategy to follow.
2. *The Baltic Sea Countries and their stock exchanges should each strive to implement in law and practice the EU regulation.* It is of paramount importance that rules and regulations are not only "paper" but that they are enforced rigidly. The first step in participating in international stock exchange co-operation is to have a well functioning regulation and supervision of the market. There is a substantial risk that the reputation of one participant rubs off on others and no one wants to cooperate with countries and stock exchanges with problems with respect to regulation or supervision.
3. *Legislators should create the legal and regulatory basis for the development of internationally orientated stock markets in the Baltic Sea Region. However, the detailed regulation and development hereof should be left to the stock exchanges.* For small and medium sized countries and stock exchanges the time for a local policy as to rules and regulations are past. The advantages of standardisation are so large that individual

countries should instead try to implement the rules that are gaining international acceptance.

4. *Stock exchanges should concentrate on short-term strategy as the long run development is extremely unclear.* No one can yet with any confidence say what the structure in European/American stock exchanges will be in the years to come as the different alliances are somewhat unstable and the effect of the existing and planned mergers and co-operation still has to be seen. Stock exchanges should concentrate on trying to co-operate with one or several other stock exchanges to get economies of scale. Thoughts as to the long-term structure are probably a waste of time. Choice of partners should not be made based on a theory of "natural geographic partners".
5. *Legislators should be reluctant to interfere as to co-operation between stock exchanges and clearing organisations.* A tempting policy is to force national mergers between clearing organisations and stock exchanges to ease later international mergers between stock exchanges to ensure co-operation between clearing organisations and stock exchanges. The development in other areas has been to let the market decide the development. However, governments and legislators should take all the necessary steps to ensure that stock exchanges and clearing organisations are limited companies so that they are able to participate in mergers.

### **3. The international challenge**

The background for the present situation on the securities markets in the Baltic Sea Countries can be related to various different conditions. Within the last 15 years many reforms have been carried out by the European legislators and other regulators, new technological development have changed the way securities are traded, and furthermore, the transnational trade with securities has increased dramatically. This development has caused an internationalization of the securities markets. As a consequence the traditional national stock exchanges are exposed to competition from other stock exchanges and from new alternative trading systems.

In the same period the Baltic Sea Countries have seen many changes which have had great influence on their securities markets. Finland and Sweden have become members of the EU and Norway member of the EEA. Due to the political revolutions in Eastern Europe and Russia, completely new securities markets have developed. This development has meant that all the Baltic Sea Countries have been exposed to the international competition as mentioned above.

The purpose of this section is to describe the development which today forms the basis for the existing stock exchanges' situation in the Baltic Sea Countries. This is partly made through a description of the capital market and the stock exchanges and partly by describing the regulatory development which primarily has been caused by the promotion of internationalization of the securities market.

#### **3.1. Capital markets and stock exchanges**

National capital markets are already to a large extent integrated cross borders whereas only the beginning of stock exchange integration has been seen.

The quality of the statistics varies from country to country, but there is no doubt that investors increasingly invest in foreign stocks rather than domestic stocks (either directly or indirectly).<sup>1</sup> This development has several explanations. It is important to bear in mind that up to 1980 (the year differs from country to country) capital restrictions stopped many investors from investing internationally. Another reason is that large investors (especially pension funds) play an increasing role on the stock market. They have both the knowledge and the economies of scale that makes investing abroad sensible. For private investors the growing internationalisation has mainly come through the growth of mutual funds. Last but not least due to increasing internationalisation in the product markets many companies have bought large shares of companies in other countries as a way of building links. In the telecommunication industry, for example there are large cross-border stockholdings where companies own stock in other companies. One reason for this development is of course decreasing costs of trading and owning foreign stocks compared to costs of trading and owning domestic stocks, however one should not overestimate this influence. Costs of trading and owning foreign stocks compared to domestic stocks has not been that high for large investors such as mutual funds, pension funds or large companies.

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<sup>1</sup> Cf. Fese (1998)

### 3.1.1. Stock exchanges, internationalisation and concentration

In this section we will give an overview over stock exchanges globally. In appendix 1 (available at The Baltic Development Forum's home page: [www.bdforum.org](http://www.bdforum.org)) we have included a number of tables. However the most important tables will be shown in the main text. It is rather difficult to get consistent data regarding the stock exchanges in the ten countries in the Baltic Sea Region not to mention the stock exchanges in the rest of the world. Two types of data sources are found.

The first is FIBV (International Federation of Stock Exchanges). The advantage of using statistics from this source is that data are supposed to be consistent and it is possible to make cross boarder comparisons and thereby get an idea of where stock exchanges are similar and where they differ. The primary disadvantage is that not all ten countries are included in the statistics (no data at all for exchanges in Russia, and only some of the relevant data for Tallinn, Riga, and Lithuania are reported).

The second type of data source is statistical information from each of the relevant exchanges. Unfortunately we have been unable to get any relevant data for Russia.

Data problems are considerable. We will focus on data from FIBV and data problems will not be discussed further.

FIBV divides exchanges into 3 groups:

- Traditional (mature) stock exchanges.
- Stock exchanges for small and medium sized enterprises (SME).
- Emerging markets stock exchanges.

Table 1 shows the number of domestic companies and the market capitalisation of their stocks in 1999 on these 3 different kinds of exchanges.

Table 1. Different stock exchanges and their combined capitalisation in 1999

	Market value (1.000 billion USD)	Number of companies (1.000)
Mature stock exchanges	35,0	28,5
Stock exchanges for SME	0,3	2,1
Emerging stock markets	1,4	12,0
Total	36,7	42,6

Note: 1.000 billion USD =  $1 \cdot 10^{12}$  USD.

- Six of the ten Baltic States have a stock exchange included in the mature stock exchanges: Copenhagen, Deutsche Börse, Helsinki, Oslo, Stockholm and Warsaw.
- Four of the ten Baltic States have a stock exchange included in the stock exchanges for SME: Deutsche Börse: Neuer Markt, Helsinki: I List and NM List, Stockholm: OTC list and "O-list" and Warsaw: Parallel and Free Markets.
- Four of the ten Baltic States have a stock exchange included in emerging markets: Lithuania, Riga, St. Petersburg and Tallinn.

It should be noted, however, that the statistics in the table above might be misleading. The definition of a stock exchange is “fluid”. A stock exchange has two main functions, regulation (in a wide sense) and trading.

The statistics above are relevant when we look at stock exchanges from a regulation point of view. However, if we look at things from a trading point of view the picture is different. We show no statistics as to trade on different stock exchanges. One of the main reasons is that statistics concerning stock trade are very unreliable and depend on the way an exchange is organised.

However, what is obvious from table 1 is that the mature stock exchanges completely dominate the picture.

### 3.1.2. Mature stock exchanges

We distinguish between five main areas:

- North America (8 exchanges)
- South America (5 exchanges)
- Africa and Middle East (3 exchanges)
- Europe (23 exchanges)
- Asia and Pacific (13 exchanges)

The market capitalisation of shares of domestic companies listed on one of the 52 mature stock exchanges was 35 thousand billion USD in 1999. 50,3% hereof was located on exchanges in North America, 28,5% in Europe, and 19,4% in Asia and Pacific.

Table 2. Ten largest stock exchanges in the world by market capitalisation of stocks of domestic companies in 1999

#	Stock Exchange	Billion of USD
1	New York	11.438
2	Nasdaq	5.205
3	Tokyo	4.455
4	London	2.855
5	Paris	1.503
6	Deutsche Börse	1.432
7	Toronto	789
8	Italy	728
9	Amsterdam	695
10	Switzerland	693
	Total	29.794

The market capitalisation of stocks of domestic companies listed on the top ten stock exchanges in the world is 81,2% of the total market capitalisation of all stock exchanges in the world in 1999. No European stock exchange belongs to the top three. However, six out of the ten stock

exchanges are European. That several of the European "Mega-exchanges" are trying to co-operate in creating common trading platforms says something about the economies of scale in this area.

Table 3. Market capitalization of shares of domestic companies for potential future European stock exchanges in 1999

Potential future European stock exchanges	Billion of USD
♦ iX: London and Deutsche Börse	4.288
♦ Euronext: Paris, Amsterdam and Brussels	2.382
♦ Baltic Sea Region: Deutsche Börse, Stockholm, Helsinki, Copenhagen, Oslo, Warsaw, Tallinn, Riga, and Lithuania	2.357
♦ Norex: Stockholm, Copenhagen, Oslo, Iceland, Tallinn, Riga, and Lithuania	550

Note: Market capitalisation for stock exchanges for SME is not included.

Table 3 shows market capitalisation of stocks of domestic companies for four potential stock exchanges. Neither iX nor Euronext will be in the top three. We have calculated the market capitalisation of stocks for the Baltic Sea Region and for the Norex Alliance based on the letter of intents signed by the seven stock exchanges.

Table 4. Market capitalisation of shares of domestic companies in each of the 6 Baltic Sea Countries stock exchanges in 1999

Stock Exchange	Market capitalization of shares of domestic companies (billion USD)
Copenhagen	105,3
Deutsche Börse	1.432,2
Helsinki	349,4
Oslo	63,7
Stockholm	373,3
Warsaw	29,6
Lithuania	1,1
Riga	0,4
Tallinn	1,8

Table 4 shows market capitalisation of stocks of domestic companies for the 9 stock exchanges in the Baltic Sea Region except for Russia. In a global setting they are small.

Many stock exchanges have hundreds of companies listed (see appendix 1 for statistics). However, normally a large part of market capitalisation is due to very few companies.<sup>2</sup> This is interesting as it gives an idea of the vulnerability of a stock exchange if a few large companies should choose to delist in favour of another stock exchange. But even if a company do not delist, there is a risk that all trade in the stocks of the company might be traded on a foreign stock exchange because the domestic exchange is not efficient enough.<sup>3</sup>

What proportion of market capitalisation of stocks of domestic companies does the value of the largest 10 domestic companies amount to for each of the mature stock exchanges? The result is shown in table 5 where we have ranked European stock exchanges according to concentration. On the Amsterdam stock exchange the combined value of the 10 largest domestic companies amounts to 91,5% of the total value of all listed companies. Athens is lowest with 34,1%.

Table 5. Ranking of European Stock Exchanges according to Concentration Ratio

Stock exchange	Market value of 10 largest domestic companies in percent of total capitalization
Amsterdam	91,5%
Helsinki	87,4%
Luxembourg	80,9%
Irish	79,5%
Brussels	74,9%
Switzerland	74,6%
Bilbao	70,4%
Barcelona	69,0%
Warsaw	68,2%
Lisbon	66,1%
Copenhagen	65,3%
Ljubljana	61,8%
Stockholm	60,6%
Madrid	60,2%
Istanbul	60,0%
Vienna	59,0%
Italy	54,8%
Deutsche Börse	53,5%
Oslo	48,8%
Paris	41,8%
London	37,5%
Athens	34,1%

One can argue whether the comparison is valid since the number of listed companies on different stock exchanges differ, but the picture is clear: Very few companies stand for the bulk of total

<sup>2</sup> E.g. the Fact Book 1999 HEX reports that Nokia Corporation constitutes 60 percent of the total market capitalization on Helsinki Stock Exchange.

<sup>3</sup> This was seen in the late 80's where SEAQ International took over a substantial part of the trade in stock of the Continental European companies, cf. sec. 3.2.2 and 4.1.2.



market capitalisation. Public debate has a tendency to concentrate on small and medium sized companies without acknowledging their relative share in the economy.

Very often it is argued that markets for small stocks are too “thin” (low liquidity) and that the reason is that the stock exchange is not functioning well enough. However, the market for stocks in companies with low capitalisation should be thin. It would be a waste of resources if society (investors and analysts) used a lot of time and money to analyse continually companies with a market capitalisation of maybe 100 million dollars.

Ideally, we would have preferred the median as the location measure (because the distribution is skewed) but we did not have the data. Therefore, we have calculated two sorts of location measures. The first is the market capitalisation of shares of the average domestic company. The second is the average market capitalisation of stocks of the 95% smallest domestic listed companies.

The market capitalisation of shares of the average domestic company on the 52 mature exchanges is 1,2 billion USD. The average company in Europe has a market capitalisation of 1,3 billion USD, whereas the average North American company has a market capitalisation of 2,0 billion USD.

Within Europe huge differences exist. Three exchanges have companies with an average market capitalisation of approximately 2,9 billion USD: Amsterdam, Switzerland and Italy. On Helsinki and Deutsche Börse the average market capitalisation is 2,3 billion USD and on London, Paris, Stockholm and Brussels it is approximately 1,4 billion USD. At the other end of the scale Oslo has an average market capitalisation of 300 million USD and Warsaw of 100 million USD.

One could argue that the average market capitalisation is a poor location measure for the ‘typical’ company on each of the stock exchanges because a few very large companies may bias the picture. We have used information in the FIBV tables to calculate the average market capitalisation of stocks of the 95% smallest domestic companies in table 6.

Table 6. Average market capitalization of stocks of the 95% smallest domestic companies

Stock exchange	Average market capitalization of stocks in the 95% smallest domestic companies (million USD)
NYSE	1.517,4
Nasdaq	313,8
London	340,4
Deutsche Börse	523,8
Copenhagen	143,4
Oslo	176,2
Stockholm	445,0
Warsaw	41,8

We will return to this average market capitalisation of stocks of the 95% smallest domestic companies in the next section because it is relevant to compare this number to the average

domestic company on the 21 European exchanges specialised in small and medium sized companies.

### **3.1.3. Markets for small and medium-sized companies**

According to FIBV 2,1 thousand domestic companies are listed on such exchanges around the world and 1,6 thousand of these companies are listed on European exchanges. Of the 21 European exchanges which have this sort of market 6 have more than 100 domestic companies listed:

- ◆ Paris: Second Marché,
- ◆ London: AIM,
- ◆ Stockholm: OTC List and 'O-List',
- ◆ Deutsche Börse: Neuer Markt,
- ◆ Paris: Nouveau Marché, and
- ◆ Ljubljana: Free Market.

In market value terms the two important exchanges are Deutsche Börse and Stockholm (approximately 75 billions USD). Total market value of shares of domestic companies on European stock exchanges for SME is 274 billion USD in 1999.

Newly admitted European domestic companies raised 9,3 billion USD in 1999 of which 7,1 billion USD was raised on Neuer Markt.

The market capitalisation of shares of the average domestic company on the 21 European exchanges is 0,2 billion USD. However, the number is higher (0,4) on the two most important exchanges regarding market capitalisation: Deutsche Börse and Stockholm.

It is interesting to note that if you compare the market capitalisation of shares of the average domestic company on the SME exchanges with the average market capitalisation of shares of the 95% smallest domestic listed companies for the traditional or mature stock exchanges they are not that far apart. What is termed small and medium on one exchange is listed on the traditional exchange elsewhere.

### **3.1.4. Emerging markets**

Almost 12 thousand domestic (and no foreign) companies are listed on exchanges in emerging markets, hereof more than 9 thousand are listed in Asia and Pacific. Europe has 1 thousand domestic companies listed on emerging markets. Lithuania, Latvia and Estonia are characterised as emerging markets and approximately 50 domestic companies are listed on each of the three exchanges.

## **3.2. The regulatory background**

The regulatory development is based on a combination of directives passed by the EEC/EU and national securities markets reforms. To a great extent the national reforms have been a reaction

to the EU harmonization. The following sections will illustrate the development by focussing hereon.<sup>4</sup>

The EU harmonization is not only important to the Baltic Sea Countries which are members of the EU. As a member of EEA Norway has implemented the directives, too.<sup>5</sup> The applicant states have to implement the existing directives as part of the condition for membership, and as it is seen from Section 4 this work has already started.<sup>6</sup> Thereby, the EU harmonization has direct importance for the regulation in all the Baltic Sea Countries except from Russia.

### **3.2.1. The emerging European securities market system**

Up until the mid 80's the national stock exchanges in Europe had not seen many changes. In order to prevent that Europe should fall behind in competition with the US and Japan, the Commission initiated the creation of the Internal Market (also named the Single Market). In the White Paper on Completing the Internal Market from 1985 the Commission emphasized that an Internal Market also implied the creation of a European securities markets system. The Commission declared:

“This work is designed to break down barriers between stock exchanges and to create a Community-wide trading system for securities of international interest. The aim is to link stock exchanges electronically, so that their members can execute orders on the stock exchanges offering the best conditions to their clients. Such an interlinking would substantially increase the depth and liquidity of Community stock exchange markets, and would permit them to compete more effectively not only with stock exchanges outside the Community but also with unofficial and unsupervised markets within.”<sup>7</sup>

This political vision - which today seems much closer than at that time - was in the White Paper linked to some harmonization directives. Apart from a harmonization concerning the free movement of capital, banks, and insurance companies it was planned to harmonize the regulations on investment service and certain parts of the regulation of the stock exchanges and other regulated markets.

The harmonization concerning stock exchanges had already begun during the late 70's. The first directive from 1979 coordinated the conditions for admission of securities to official stock exchange listing.<sup>8</sup> This directive also imposed a continuing obligation on issuers to publish without delay information on any important new development which might have an impact on the price of listed stocks. The next directive from 1980 on listing prospectuses coordinated

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<sup>4</sup> The EU is not the only international organization which is involved in the regulation of securities markets. International Organization of Securities Commission (IOSCO) is another important organization which in the last few years has issued many reports and resolutions. However, they are not legally binding in the same way as the EU harmonization and thereby they do not have the same impact.

<sup>5</sup> Cf. agreement on the European Economic Area signed in Oporto on 2 May 1992, published with corrections in O.J. 1994 L 1/572. The EEA members' obligations concerning implementation of directives relating to stock exchanges and securities are defined in the agreement Art. 36(2) cf. Annex IX, subsection III.

<sup>6</sup> The relevant agreements are published in: Poland, O.J. 1993 L348/1, Latvia, O.J. 1998 L26/1, Lithuania, O.J. 1998 L 51/, and Estonia O.J. 1998 L68/1.

<sup>7</sup> Cf. further COM (85) 310, para. 107.

<sup>8</sup> Cf. directive 79/279/EEC, O.J. 1979 L 66/21 amended by directive 82/148/EEC, O.J. 1982 L 62/22.

information to be disclosed at the time of admission of securities to an official stock exchange.<sup>9</sup> This directive was supplemented in 1987 with a directive which introduced the very important concept of mutual recognition that had already been used in other areas of harmonization.<sup>10</sup> This principle meant that a prospectus drawn up according to the rules in one Member State must be acknowledged in other Member States as a basis for listing. The purpose was to give companies listed on one stock exchange easy and less costly access for listing in other countries and thereby making room for new ways of co-operation such as the Eurolist project, cf. below in Section 5.

Furthermore, there are directives dealing with information to be disclosed to the market. It includes a directive specifying the demands to half-yearly reports from 1982 and a directive from 1988 on information to be disclosed when major holdings in listed companies are acquired or disposed of.<sup>11</sup> These two directives supplemented the original directive from 1979 which prescribed the continuing obligation to disclose price relevant information.<sup>12</sup>

Finally, in 1989 a directive on insider dealing was adopted.<sup>13</sup> The directive applied to securities listed or traded on a regulated market within the EU, and primary and secondary insiders were prohibited from trading as long they were in possession of insider information. Primary insiders were also prohibited from passing on insider information.

Consequently the current harmonization has only touched on certain aspects of the regulation of the stock exchange and securities markets in general. Furthermore, it is a minimum harmonization which means that the Member States can introduce additional and stricter rules. In many cases the Member States have introduced more extensive rules, for instance concerning disclosure of price relevant information. The Commission estimated that by introducing such minimum rules and the principal of mutual recognition, the result would be integration of the European stock exchanges and markets. Today this approach may seem less appropriate,<sup>14</sup> however, it is a fact that at the same time as this harmonization was introduced many national securities reforms were carried through which in fact contributed to an integration of the European securities markets.

### **3.2.2. European Stock Exchanges take up the challenge**

The reformation of the European stock exchanges began in United Kingdom where the so-called Big Bang reform from 1986 caused a reconstruction of London Stock Exchange (LSE). The reform meant that the traditional division of labour between brokers and jobbers was repealed.

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<sup>9</sup> Cf. directive 89/390/EEC, O.J. 1980 L 100/1.

<sup>10</sup> Cf. directive 87/345/EEC, O.J. 1987 L 185/81. There are some other directives which deal with the regulation of prospectuses, cf. directive 90/211/EEC (amending directive 80/390), O.J. 1990 L 112/24, directive 94/18/EC (amending directive 80/390), O.J. 1994 L 135/1 and directive 89/298/EEC (on prospectus for public offerings), O.J. 1989 L 124/8.

<sup>11</sup> Cf. directive 82/121/EEC, O.J. 1998 L 48/26 and directive 88/627/EEC, O.J. 1988 L 348/62.

<sup>12</sup> Another aspects of companies' obligation to disclose were harmonized by some directives on companies' annual accounts and consolidated accounts. Cf. the so-called 4th and 7th Company Law directive (directive 78/660, O.J. 1978 L 222/11 and 83/349, O.J. 1983 L 193/1).

<sup>13</sup> Cf. directive 89/592, O.J. 1989 L 334/30.

<sup>14</sup> For a critical remark to the method see *Steil* (1996), p. 114 and *Ferrarini* (1994), p. 573.

Access to the market making was liberalized and the entry of foreign institutions was allowed. Brokerage commissions were liberalized and the screen-based system SEAQ, modelled on the US Nasdaq system, was introduced. A similar screen-based system, SEAQ International (SEAQ-I) was introduced to extend the London market trade in non-UK stocks. At the same time UK engaged in tax competition as they halved the “stamp duty” (turnover tax) on UK equity trade and eliminated the stamp duty for foreign trade.

The reform turned out to be effective especially because SEAQ-I attracted much trade with non-UK stocks. Part of the reason for this was that many institutional investors, particular US-based funds began diversifying into European stocks. This success continued right up to the beginning of the 90’ when some continental exchanges succeeded to regain the trade.<sup>15</sup>

The Big Bang reform and the following development in the trade on London Stock Exchange caused several reactions on the other European stock exchanges. In the end of the 80’s the Paris Bourse carried large reforms through. This secured the introduction of an order-driven screen-based trading system (CAC) and a deregulation which should attract better capitalized intermediary to replace the former publicly appointed brokers, and the elimination of fixed commission. Similar regulations were carried out in other European countries, and rather late - in the 90’s similar regulations were carried out in the Nordic countries, cf. further below Section 4.

### **3.2.3. Investment services**

The greatest step in the harmonization process in the EU took place in 1993 when two directives concerning investment services were passed. As mentioned above the earlier efforts of harmonization had been aimed at securing common minimum standards especially concerning the conditions for admission to the stock exchange and disclosure obligations. The new harmonization dealt with the intermediates’ dealing on the stock exchanges - in the directives termed investment firms and credit institutions.

The two directives are the Capital Adequacy Directive (CAD) and the Investment Services Directive (ISD).<sup>16</sup> CAD aims to ensure that both investment firms and credit institutions hold sufficient capital to cover markets risks to which they are exposed to as providers of investment services. Apart from ensuring the same standards for supervision with respect to investment firms in all Member States the directive also aimed to ensure equality in treatment of credit institutions and investment firms.

The regulation of ISD goes further in order to ensure the possibilities for transnational trade in stocks. The directive regulates some important aspects concerning the function of stock exchanges. Only a few aspects of ISD will be discussed in this report.

The main objective of ISD was to allow investment firms authorized in one Member State and supervised by the competent authorities of their home Member States to establish branches and provide services freely in other Member States. In order to achieve this goal it was necessary to introduce the principles on mutual recognition and home-state control which means that Member

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<sup>15</sup> For further information of the British regulation and its consequences, see *Steil* (1996) pp. 4 and *Pagano* in *Ferrarini* (1998), pp. 179 and *Scott-Quinn* in *Steil* (1994) pp. 124.

<sup>16</sup> Cf. directive 93/6, O.J. 1993 L 141/1 and directive 93/22, O.J. 1993 L 141/27.

States must recognize investment firms from other Member States. They must also accept that they are subject to control in their home Member State even though they are doing business in other Member States.

Market access is regulated in ISD Art. 15. According to this provision the Member States must ensure that an investment firm - authorized by their home Member States to provide investment services - can either directly or indirectly become member of or have access to regulated markets and relevant clearing and settlement systems in other Member States. Art. 15(4) includes the important “remote access rule”. This rule ensures that regulated markets operating without the requirement for a physical presence must give investment firms from other Member States right to access without any establishment in the host Member State being necessary. For regulated markets with electronic trading systems, the consequences of this provision is that investment firms can be connected from their home Member State without any presence in the host Member State. The regulation in Art. 15 is said to produce a “European single passport” for investment firms.

Even though ISD was to be introduced by 1 July 1995 the directive had already before that date influenced the regulation in many countries. As noted in the previous section several securities market reforms were carried out in the late 80's and the early 90's. These reforms have reduced the requirements for being a member of national stock exchanges. This was a very important part of the Big Bang reform in UK. In 1995, Stockholm as the first European stock exchange successfully introduced the possibility for remote foreign membership.<sup>17</sup>

The principle of mutual recognition means that a Member State must accept the supervision carried out by the home Member State of the investment firm. CAD ensures that all investment firms fulfil certain minimum demands, and therefore, this directive is an important prerequisite for the Member States to accept supervision by the home Member State. ISD Art. 10 provides that each home Member State shall draw up prudential rules which investment firms must observe to get access to the markets, but the directive sets only certain minimum demands to this regulation. “Rules of Conduct” i.e. rules that ensure that investment firms act honestly and fair and with due skill, care, and diligence when acting on a particular market is regulated in Art. 11. Art. 11 provides that it is left with the host Member State to determine and to enforce these rules. This means that the host Member State has certain possibilities for regulating foreign investment firms when such firms exercise on the market of the host Member State. However, it may be difficult to draw an exact line between rules covered by Art. 10 (home Member State) and Art. 11(host Member State) and the directive might be difficult to apply in this respect.<sup>18</sup>

One of the questions, which gave rise to discussion, was the determination of guidelines for market transparency. ISD Art. 21 is a compromise between Member States favouring full and immediate price transparency and Member States, especially UK that favours a delay as to post-trade disclosure. The controversy was connected to different trading systems used by the Member States: Dealer markets opposed to auction markets. In the discussion of the regulation of this question it was considered what possible effect demands of disclosure would have on a competition between stock exchanges in the EU. Demands for an early disclosure make it more

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<sup>17</sup> Cf. *Steil* in *TemaNord* 1999:976 p. 25.

<sup>18</sup> Cf. e.g. *Runge Nielsen* (1996-97) pp. 987 and *Ferrarini* (1994) pp. 1305.

difficult for dealer markets to compete with auctions market.<sup>19</sup> Based on Art. 21 the compromise allows for a reasonably early disclosure but at the same time it is so flexible that it can be applied by all Member States including those operating a dealer market.<sup>20</sup>

Another controversial subject in the preparation of ISD was the question on the so-called “concentration provisions”. At that time some Member States (France, Belgium, and Italy) had provisions which required listed securities to be traded on the relevant national stock exchange except where exceptions were provided. Other Member States such as the UK and Germany did not impose concentration provisions and accepted that investors and investment firms traded off-market. The French delegation insisted that the Member States must be allowed to uphold such provision whereas other Member States attacked these provisions on competition grounds.<sup>21</sup> Again a compromise was found which allowed concentration provisions which require that certain transactions must be conducted on a regulated market. This compromise means that a Member State cannot demand that the trade must be conducted on a national regulated market as all regulated markets are accepted as equal.<sup>22</sup> Furthermore, according to Art. 14(4) a Member State invoking concentration provisions must give domestic investors the right to authorize transactions on their behalf to be carried out outside a regulated market. Thereby, it is obvious that traditional concentration provisions are not in accordance with ISD.<sup>23</sup>

By using the concept of “regulated markets”, ISD has foreseen that each Member State may have more than one exchange dealing in securities. According to Art. 15(5) of the directive it is up to the Member States to authorize the creation of new markets within their territories. Actually, in many Member States the national stock exchanges have been deprived of their monopoly so that other exchanges for securities can be developed, cf. further below Section 4. Potentially the stock exchanges are now exposed to competition not only from abroad but also competition from other national exchanges. In the Baltic Sea Countries, apart from Germany, Russia, (and Sweden) the trade in securities is concentrated on one national stock exchange and no other national market seems to be developing. In these countries the competition is seen as competition from foreign stock exchanges and not from other national markets.

By ensuring the investment firms’ access to trade abroad, the ISD has opened the competition between the stock exchanges for offering the best condition for trading. The directive contains only a sporadic regulation of the stock exchanges and is burdened by compromises. Nevertheless, ISD must be seen as the most important step towards the establishment of a common European securities market.

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<sup>19</sup> Cf. *Ferrarini* in *Ferrarini* (1998) pp. 265-266, *Scott-Quinn* in *Steil* (1994) pp. 136-140 and *Steil* (1996) p. 121.

<sup>20</sup> Cf. *Ferrarini* (1999) p. 581.

<sup>21</sup> For a more detailed discussion of this problem, see *Houghton* (1992) pp. 747 and *Steil* (1996) pp. 116.

<sup>22</sup> The Member States which preferred concentration provisions, i.e. especially France, thought that SEAQ-International could not fulfil the demands for a regulated market, and therefore, they probably hoped that with such a provision it was possible to withdraw the trade in French securities from London, cf. *Quinn* in *Steil* (1994) p. 140.

<sup>23</sup> At several points the wording of Art. 14 is vague and cannot be excluded that the Member States can oppose an erosion of the concentration provisions, cf. *Steil* (1996) pp. 128 and *Ferrarini* (1999) p. 585.

### 3.2.4. Further harmonization

In 1998 the EU enacted a directive on settlement finality in payment and securities settlement system - the so-called finality directive<sup>24</sup>.

The aim of the directive is to contribute to an efficient and cost effective operation of cross-border payment and securities settlement arrangements within the EU. The regulation of the Member States shall minimise the disruption to settlement system caused by insolvency proceedings against a participant in the system.

The Commission has in 1999 published an Action Plan for Financial Services which was endorsed by the Cologne European Council in June 1999.<sup>25</sup> In this plan five imperatives for action are highlighted:

- the EU should be endowed with a legislative apparatus capable of responding to new regulatory challenges;
- any remaining capital market fragmentation should be eliminated thereby reducing the cost of capital raised on EU markets;
- users and suppliers of financial services should be able to exploit freely the commercial opportunities offered by a single financial market, while benefiting from a high level of consumer protection;
- closer co-ordination of supervisory authorities should be encouraged; and
- an integrated EU infrastructure should be developed to underpin retail and wholesale financial transactions.

More specific, the Commission anticipates that some Company Law Directives must be passed, especially the 13th directive on takeover bids. The latest proposal is a so-called 'framework' directive setting up certain minimum rules for the Member States' regulation of public takeover bids and the protection of minority shareholders in connection with transfer of control in listed companies. This directive has been pending as a proposal since the end of the 80's but it is expected that the directive will be passed during the summer of 2000.<sup>26</sup>

Furthermore, the Commission wants to further the proposal for a European Company Statute and a directive on cross-border mergers, and a directive on companies transfer of seat from one Member State to another. These proposals shall ensure that it is possible for companies to move their headquarters from one Member State to another. If the mobility of companies is improved in this way it must be assumed that the European securities market will be further integrated.<sup>27</sup>

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<sup>24</sup> Cf. directive 98/26. O.J. 1998 L 166/45.

<sup>25</sup> Cf. COM (1999) 232.

<sup>26</sup> For an analysis of the directive and its impact on the present regulation in the EU Member States, see *Jul Clausen and Engsig Sørensen* (1999).

<sup>27</sup> On the company law harmonization and its present status, see e.g. *Edwards* (1999) and *Villiers* (1998).



Finally, the Commission suggests a harmonization of ISD, the directives on prospectus, the directives on accounting, and other directives related to the stock exchanges with a view to reach the goal of a common European securities market.<sup>28</sup>

It is understood that the process of harmonization towards a European securities market will continue. However, the Commission's proposals are relatively marginal as they can be seen as a supplement to the harmonization already carried out.

### 3.3. Preliminary conclusion

Already the White Paper from 1985 emphasized that an aim for the harmonization was the creation of a competition between stock exchanges. Today this competition is a reality and furthermore, many elements indicate that competition will be increased in the future:

- The ISD is still relatively new and has not yet obtained its full impact. It is also to be expected that the revision planned by the Commission will increase the harmonization.
- New technological progress including the possibility of trading in securities on the internet is expected to increase transnational trade.<sup>29</sup>
- In the future it may be expected that pension funds will increase the international trade in securities. First, it must be expected that the move away from state pensions towards private pensions through fully funded schemes will increase the funds' volume of trade.<sup>30</sup> Furthermore, a liberalization of those restrictions concerning investments which the pension funds are subject to can be expected, and by this they will get better opportunities for investing in foreign securities.<sup>31</sup>
- Finally it is expected that the implementation of the EMU will result in an extended competition between the stock exchanges.<sup>32</sup>

The increased competition between the national stock exchanges may have different impacts. One impact is that the single stock exchange may loose trade and new listings of companies. Theoretically, some companies may delist from one stock exchange in favour of another, however, this may not be very likely, given the low cost of continuing being listed and the inconvenience of moving to another stock exchange.

This may cause the stock exchanges to consider co-operation with other stock exchanges. The harmonization by the EU does not aim at certain form of co-operation as it actually leaves it to the market forces to decide in what direction the development will go.

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<sup>28</sup> Changes of the regulation of the prospectus shall especially contribute to implement the Commission's wish for a developed market for risk averse capital, cf. the report "Risk-capital: a key for job-creation in the EU", COM (1998) 552.

<sup>29</sup> Further information on questions on regulatory issues which arise from the increased internet trade, see e.g. the report by the Technical Committee under IOSCO: Securities Activities on the Internet, Sept. 1998.

<sup>30</sup> Cf. Röell in *Ferrarini* (1998) p. 221 and *Scott-Quinn* in *Steil* (1994) p. 160.

<sup>31</sup> It has previously been considered to harmonize the regulations concerning supervision of pension funds, cf. *Zavvos* (1994).

<sup>32</sup> Cf. *Biais* in *Dermine & Hilton* (1999) pp. 237.

Another impact of the competition could be that a regulatory competition may arise in which the single Member State or stock exchange tries to reform its securities regulation for a better competitiveness. A regulatory competition and the possible consequences hereof has been much discussed in the legal and economic literature with respect to different areas of regulation. In general it is difficult to predict whether the result will be a better or worse legislation and whether the result may be a race to the top or a race to the bottom. However, with respect to the securities regulation it might be a problem if countries will reduce their listing and disclosure requirements in order to attract new companies on their stock exchanges. On the other hand it can be argued that if it is left to the market forces, the regulations most beneficial for the investors will emerge.<sup>33</sup> As the market situation has developed in recent years, one can hardly imagine that smaller markets, like most of the markets in the Baltic Sea Region can develop their own regulatory standard. The predominant “standard setter” in securities markets are the internationally oriented markets participants and the international markets. If a smaller market wishes to attract internationally oriented investors, the regulatory standard must follow the predominant markets. A race to the top is the most likely result.<sup>34</sup>

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<sup>33</sup> It is especially the American literature which has analysed this problem. See in general *Romano* (1998), *Huddard, Hughes & Brunnermeier* (1999), *Charny* (1991), and *Fox* (1997). The USA has a federal body SEC which issues stock exchange regulation and therefore, today there is only a limited possibility of a regulatory competition. It has been considered whether the EU should have a similar central regulation body, but so far most scholars reject this idea, cf. the discussion in *Scott-Quinn* in *Steil* (1994) pp. 151-154, *Steil* (1996) pp. 134-136 and *Lee* in *Buxbaum, Hertig, Hirsch & Hopt* (1996) pp. 187-204.

<sup>34</sup> Cf. *Jul Clausen* (2000) pp. 43.

## **4. The national starting point for securities regulation and securities markets**

This section deals with some of the key elements and trends in the development of the securities markets and the regulation hereof in the Baltic Sea Countries. In light of the rapidly growing globalization of the securities markets and the international competition among marketplaces it will be discussed whether the markets of the Baltic Sea Countries are suitable for a national strategy with respect to the future development of the market, or whether some kind of co-operation or alliances between stock exchanges within the Baltic Sea Region is a prerequisite for being an attractive stock market in an international perspective.<sup>35</sup>

As an introductory remark it shall be pointed out that a distinction between the Western European and the post-communist countries must be borne in mind in the following, due to the fact that the starting point of the domestic securities markets and the regulation hereof differs considerably between the countries.

### **4.1. Background and development of regulation in the Baltic Sea Region**

#### **4.1.1. Regulatory approach - General observations**

In the last decades the regulation of securities markets has developed very rapidly and grown considerably all over Continental Europe. Previously regulation of the stock market primarily focussed on organisational and functional issues related to a national stock exchange, whereas issues like investor protection and market integrity in general, disclosure, insider dealing, market manipulation, and the regulation of market intermediaries only briefly, if at all, were touched upon in the regulation.

Nowadays securities regulation or securities law can be seen as an independent legal discipline covering a wide range of issues: The organisation and functioning of stock exchanges and market intermediaries; governmental and other supervision of the market and its participants; sophisticated and detailed regulation of issue and trade in listed securities in the primary and the secondary market; and clearing and settlement.

A similar approach towards regulating securities markets has existed in the United States for a long period of time. The basic US Acts, the Securities Act of 1933 and the Securities Exchange Act of 1934, were the political response to the collapse of the Wall Street in 1929. These Acts strongly focus on the need for creation of investor protection and market confidence through regulation and require registration of securities with the Securities Exchange Commission (SEC).<sup>36</sup>

There is no doubt that US securities regulation and also the regulation in the UK in the last decade have played and will continue to play an important role in developing securities regulation in Continental Europe, including the Baltic Sea Countries.

Even though regulation of the securities markets nowadays may be regarded as an independent legal discipline facilitating the special need of a well-functioning securities market and investor

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<sup>35</sup> Cf. *Jul Clausen* (2000) pp. 43.

<sup>36</sup> See for details, e.g. *Cox, Hillman, and Langevoort* (1997) pp. 3.

protection, the securities regulation in general and single elements hereof must be related to general commercial and criminal law of each country. Of particular interest is the regulation on contracts, sales of goods, consumer protection, and companies. As mentioned, the influence in securities regulation in general is Anglo-American and based on a common law approach. By contrast, commercial law in general and company law in particular of the Baltic Sea Countries, except for Russia, have common features with the regulation and the basic philosophy of German law, and is based on a civil law approach.<sup>37</sup>

The potential conflict between the underlying rationale of the Anglo-American securities regulation and that of a German inspired commercial and company law must be taken into account when examining the development in the regulation of the securities markets in the Baltic Sea Countries and the future regulation hereof.

Another notable thing with respect to the regulation of securities markets is the question as to what kind of the regulatory body should set and develop the standard for market behaviour. Whereas regulation through Acts, Orders e.g. enacted by the traditional legislative body or issued by a governmental agency under the law is predominant in areas of commercial law. Self-regulatory bodies, like stock exchanges or organisations representing interest groups of the market, have played an important role setting the standard for trade in listed securities. Codes of Ethics and Recommendations on specific topics to be followed on a more or less voluntary or contractual basis are part of the regulation of the stock market.

It has been pointed out that self-regulatory bodies better suit the market's need for a flexible regulation which in accordance with the rapid changes in the market can be changed easily and not being forced to follow traditional and usually slow legal procedure. Further, representatives from the interest groups of the market may add market expertise to the regulatory body, and hence, generally be accepted by the market participants as sound and reasonable. On the other hand it has been argued that regulation by self-regulatory organisation may not be able to establish the necessary procedure and due process in relation to enactment and enforcement of its rules. Further, due to the voluntarily status of such regulation sufficient and effective legal sanctions may lack. Misbehaviour and fraudulent conduct in the market may only be met by the reaction of the other market participants, and from a legal point of view only governed by general provisions in civil and criminal law. Such regulation does not necessarily reflect the need for investor protection and market integrity, which is crucial in the area of securities regulation.<sup>38</sup>

Some countries in the Baltic Sea Region, like Sweden and Germany<sup>39</sup> have relied heavily on self-regulatory bodies in securities regulation. E.g. the Swedish regulation on takeovers and the supervision hereof is left to a self-regulatory organisation, Näringslivets Börskommittee. To a great extent the Swedish self-regulatory structure and the contents of the takeover-regulation has

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<sup>37</sup> For a detailed discussion, see *Coffe, Jr.* (1999) pp. 25.

<sup>38</sup> Objectives and Principles of the regulator in securities markets are found in part II of a report by the International Organization of Securities Commission (IOSCO), Objectives and Principles of Securities Regulation, September 1998 pp. 10.

<sup>39</sup> Cf. *Scott-Quinn* in *Steil* (1995) pp. 128.

been inspired by the UK Takeover Panel and the City Code on Take-overs.<sup>40</sup> Previously, the German regulation on insider dealing was not statutorily based either, and until 1988 Germany was against requiring a legal binding regulation on insider dealing. But to some extent the regulation by the EU requires the Member States to implement legally binding regulation. The EU directive on insider dealing of 1989 does not leave room for self-regulation of insider dealing, as it requires the prohibition on insider dealing to be supervised by a public authority and followed by sufficient penalty to make the insider regulation efficient.<sup>41</sup> Therefore, the German insider dealing regulation, including federal supervision hereof is now found in the Securities Trading Act of 1994 (Wertpapierhandelsgesetz).<sup>42</sup>

By contrast e.g. Norway and to some extent Finland have for a longer period of time relied more heavily on a statutorily based regulation of the securities market with substantial rules and sanctions laid down in the Act, leaving little room for regulation by the stock exchange.<sup>43</sup>

Finally, it shall be noted that in the first years after establishing a free market economy, no or only little statutorily regulation of the securities market was found in the post-communist countries. Public offering in listed securities, therefore, heavily relied on self-regulation by the stock exchanges.<sup>44</sup>

When discussing the future regulation of the securities market, including need for adjusting rapidly to market changes and international standards it must be decided to what extent regulation must be laid down in statutes involving the legislators, or left to some kind of self-regulatory bodies with some or no statutorily based regulatory power. The relationship between statutorily or statutorily based regulation, self-regulation, supervision and effective sanctions must be taken into account, too.

#### **4.1.2. Elements of recent reforms of the securities regulation**

The regulatory bodies of the securities markets in the Baltic Sea Countries have over the last two decades been confronted with a variety of challenges that have required changes in existing rules.

First, as pointed out above different EU directives have required changes in the laws, cf. further above Section 3.2. This was the case after the enactment of the Insider Dealing Directive to be implemented by 1992. Almost all countries had to change their laws. As the directive, despite its broad area of application, was a minimum directive some countries enacted stricter rules, e.g. Norway and Sweden requiring primary insiders to register the shareholding and trade. Denmark applied the rules to all insiders and did not distinguish between primary and secondary insiders. The regulation and prohibition of insider dealing and other kind of market manipulation have

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<sup>40</sup> This too has been the case in Germany where the takeover regulation until recently was left to the self regulatory body, Börsensachverständigenkommission (Übernahme-kommission). Until recently, Sweden, Germany, and England have also been against the proposal for a 13th Company Law Directive on Take-overs in the EU, as such a directive may require a statutorily based regulation. Cf. *Jul Clausen and Engsig Sørensen* (1999) pp.182.

<sup>41</sup> Cf. *Hopt* (1990) pp. 76.

<sup>42</sup> Cf. *Scott-Quinn in Steil* (1994) pp. 154.

<sup>43</sup> Cf. *Jul Clausen and Engsig Sørensen* (1998) pp. 27 with respect to the takeover regulation.

<sup>44</sup> Cf. *Burke* (1996) pp. 236.

continuously let to amendments to the law. Finland has very recently tightened its regulation on flagging and criminal sanction in relation to insider dealing and market manipulation. In Norway a proposal for new insider regulation has just been presented.

Likewise enactment of the Investment Services Directive (ISD) and the Capital Adequacy Directive by 1995 required substantial changes both with respect to licensing and supervision of investment service firms to be carried out by the home Member State, and the regulation by the host Member States of both domestic and foreign companies with a European single passport acting on the market of the host state.

It should be noted that before becoming members of the EU, Poland, Estonia, Latvia, and Lithuania must comply fully with the securities markets directives. Parts hereof have already been implemented.<sup>45</sup>

Also in areas where the EU has not been able to reach a final agreement on a directive, there are evidence that regulators have responded to different proposals for directives from the EU, and to the international regulatory trend in specific areas. This is clearly the case with respect to the regulation on takeovers, where the UK based regulation on takeovers through the Takeover Code has been extremely influential. Over the years, e.g. Norway, Denmark, and Germany have set out different kinds of takeover regulations, and as in the proposals for a directive on takeovers and the UK Code on Takeovers the rules require a mandatory bid to be made to the remaining shareholders, when control of the target company is transferred.<sup>46</sup> Despite its previous strong opposition against a mandatory bid rule,<sup>47</sup> In 1999 Sweden added such requirement to its Recommendations on Takeovers referring to changes in the Swedish and international market.<sup>48</sup> Latest Latvia has regulated takeover bids.<sup>49</sup> This trend towards a common acceptance of a mandatory bid requirement has dominated the regulators despite the fact, that it has been much debated, primarily among economists to what extent such rules facilitates a market for corporate control.<sup>50</sup>

Secondly, a characteristic feature of securities regulation is that minor changes occur very frequently, e.g. with respect to details of disclosure requirements. Specific cases where the existing rules have been deemed insufficient to ensure necessary investor protection or equal opportunity for market participants may trigger such changes. This clearly indicates that here is a need to establish a flexible regulatory structure not depending too much on slow legal procedures.

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<sup>45</sup> For a status on implementation in Estonia, Latvia, Lithuania, and Poland see COM (1999) 504 fin., COM (1999) 506 fin., COM (1999) 507 fin., and COM (1999) 509 fin, respectively. Generally see the progress report COM (1999) 500 fin.

<sup>46</sup> Cf. *Jul Clausen and Engsig Sørensen*, (1999) pp. 188.

<sup>47</sup> Most recently Governmental Report on the capital of the company SOU 1997:22 p. 287 and *Skog* (1995).

<sup>48</sup> Further, see the introductory chapter to the Recommendation on Takeover of April 1999 issued by the self-regulatory organization Näringslivets Börskommittee.

<sup>49</sup> Order No. 277/1999 as amended by Order No. 297/1999 of the Securities Market Commission. The rules are applicable by 1 September 2000.

<sup>50</sup> See further *Wymeers* in *Hopt and Wymeers* (1992) pp. 360 and *Bergstrom* (1995) pp. 512.

Also changes in the regulation in neighbouring markets or international trends may force the regulators of a particular market to change its regulation. An example hereof is the fact that almost all Baltic Sea Countries over the last couple of years have required the listed companies to disclose quarterly reports. Even Denmark only having a strong recommendation on quarterly reports referred to the international standard when changing the requirement in the fall of 1999.

Thirdly, even though some reforms and changes in the securities regulation can be seen as a result of implementation of EU directives, there is no doubt that the most significant and influential factor in securities law reforms in the Baltic Sea Countries over the last decades has been changes in market conditions. Regulators, both legislator and other regulatory bodies, have in relation to regulatory power, structure of the regulation, and contents hereof been under constantly pressure to fulfil the needs of a market that changes rapidly and becomes more and more globalized and competitive.

The influence of market conditions may be illustrated by the development in the Scandinavian countries that despite a long tradition for common regulation in areas of commercial law and company law have different approaches and traditions with respect to regulation of securities markets. The differences relate both to the detail level, contents, and structure of the acts, and to the regulatory competence and power.

The driving force of securities reforms in the mid 80's in the Scandinavian countries was a wish to facilitate and support the national stock exchange which had a legal or actual monopoly to organize a market for listed securities. The stock exchange was seen as *the* market for transfer of capital between domestic stock- and bond-issuers and domestic investors involving only domestic intermediaries. The reforms should encourage transparency and liquidity in the domestic market. Hardly, if any, reference to international aspects and international competition, was mentioned. The Norwegian and the Danish reforms of 1985 and 1986, respectively, are examples hereof.

In the late 80's the Scandinavian stock exchanges faced the first real threat due to international competition. London's SEAQ International was very successful attracting trade in stocks of Continental European, including Scandinavian companies without actual listing the stocks. Further clearing and settlement was also to a great extent taking place abroad. Euroclear and Cedel challenging domestic central securities depositories, see further above Section 3.2.2.<sup>51</sup>

To a great extent, trade in and pricing of stocks in major Swedish companies took place in London and not Stockholm. The regulatory response was a major change in the regulation of the securities market, including a privatization of the Stockholm Stock Exchange. Stockholm Stock Exchange succeeded getting trade back to Stockholm and was the first stock exchange in Europe successfully to solicit remote foreign membership.<sup>52</sup>

Also Germany responded to the market changes in the late 80's and the beginning of the 90's. Deutsche Börse AG was formed in 1993 and owned by the market participants. Deutsche Börse promote should promote co-operation between the various regional stock exchanges in Germany

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<sup>51</sup> Generally on the market development in Europe and the Continental European response to the increasing trade in London, see *Pagona* in *Ferrarini* (1998) pp. 179.

<sup>52</sup> Cf. *Steil* in *TemaNord* 1999:576 pp. 25.

and became the holding company of the German Securities Deposit.<sup>53</sup> The regulatory response included enactment of a new Securities Trading Act in 1994 with the following principal elements: establishment of a supervisory authority at federal level; statutory prohibition on insider dealing; improving ownership transparency by requiring notification and disclosure; regulation on financial intermediaries' duty to act in the client's best interest. Hereby, Germany implemented the EU directive on insider dealing, the major shareholding directive, and parts of the investment service directive. Finally, a Securities Council was to be established.<sup>54</sup> This response indicates that Germany was focussing on its own national system before moving on to the international arena.<sup>55</sup>

The major securities law reform in Denmark in 1996 was also primarily a response to changes in the international market situation with more Danish stocks and bonds being traded including clearing and settlement outside Denmark. One Act - the Securities Trading Act - was enacted regulating not only public offer and trade in securities, but also clearing and settlement. The Act is a 'framework' act setting up general principles and fundamental requirements for the functioning of the market. The detailed regulation is by statutory provisions placed with The Danish Securities Council and the stock exchange. The Act emphasises that the "Danish Securities Council shall be instrumental in promoting a smooth Danish securities market which is so efficient, transparent and competitive that it will be attractive to issuers, investors and securities dealers and which will comply with international standards."<sup>56</sup> A privatisation and revoking of the legal monopoly of the Copenhagen Stock Exchange was another key element of the reform. A similar development happened in Norway and Finland.

The legal history and development of securities regulation in the post-communist countries are by all means different. In the legal process of readjustment to a free market economy regulation and supervision directly linked to the privatization had first priority. Company and insolvency law, and establishing a supervisory authority of banks were important areas of regulation. Consequently, in the beginning public offering of securities, mostly issued by banks was mostly regulated by rules and recommendations set up by stock exchanges.<sup>57</sup>

During 1993-95 Estonia, Latvia, and Lithuania enacted different Acts regulation securities markets, primarily to attract foreign capital.<sup>58</sup> Key elements of this first generation of securities laws were registration of any primary public offering of securities, authorization and supervision of securities professional, and establishing a securities board. To a great extent the elements and

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<sup>53</sup> Cf. *Ferrarini* (1998) pp. 248.

<sup>54</sup> Cf. *Scott-Quinn* in *Steil* (1995) pp. 154 and *Pagano* in *Ferrarini* (1998) pp. 184, the latter pointing out that the German response to the market crisis was less radical than other Continental European countries.

<sup>55</sup> Cf. *Lee* (1998) pp. 72 drawing this conclusion based on a case study of the German response to Euroquote.

<sup>56</sup> See Sec. 83, 1 of the Danish Securities Trading Act.

<sup>57</sup> Cf. *Burke* (1996) p. 236 finding it debatable whether a statutory regulation was necessary in Estonia to achieve economic growth and honest business practice. See generally *Burke* (1994) pp. 545, too.

<sup>58</sup> Cf. *Philbrick* (1994) pp. 571 and *Burke* (1994) pp. 552.



structure of the regulation were inspired by the securities regulation in the United States.<sup>59</sup> Of course the regulation lacked the sophisticated and detailed regulation that the SEC has issued to supplement the general principle of the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>60</sup>

At the doorstep of the EU one possible consequence of the US-inspired securities regulation is that essential elements of EU securities directives may not have been fully implemented. This is the case with the Insider Dealing Directive and the Investment Service Directive.<sup>61</sup> Furthermore, supervision of the market and its participants may not fulfil the requirements of the EU.<sup>62</sup>

Poland was among the first post-communist countries to open a stock exchange. The privatization process and the role of the Warsaw Stock Exchange has been successful. It has been pointed out that the Polish regulation of the securities market played an important role in this respect.<sup>63</sup> Not only did Poland impose high disclosure standards from the very beginning including quarterly reporting,<sup>64</sup> but it also created a governmental SEC-like agency to enforce the laws. Disclosure provision required ownership transparency, and finally Poland followed the UK model on takeovers with a mandatory bid rule.<sup>65</sup>

The development of securities market and the regulations hereof in Russia in many respects differ considerably from the other countries in the Baltic Sea Region. The government has over the years struggled with the regulation of the market. Under the Act on Securities Market enacted in 1996 the Federal Securities Commission has the primary responsibility for the regulation of the securities market. The Act provides a comprehensive legal basis for the development of stock exchanges, issuing of securities, and the regulation of market participants. Federal Securities Commission has established numerous regional offices and issues regulation for securities' operation and grants license for enterprises operating in the market. A concept of disclosure to the market has been introduced including a requirement that companies issuing securities have prepared quarterly report. A separate Act on Joint Stock Companies, which also took effect in 1996, includes provisions to protect shareholders' right. However, although these laws in

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<sup>59</sup> Generally on the US support to the post-communist countries with respect to the development on a legal and institutional system under a free market economy, see *deLisle* (1999) pp. 179.

<sup>60</sup> Cf. *Burke* (1994) pp. 569.

<sup>61</sup> Cf. *Burke* (1994) p. 548 in general and p. 586 on the lack of insider dealing provision in Estonia.

<sup>62</sup> On Estonia, see Accession Partnership 1999, Estonia p. 5 under free movement of service stating: "reinforce supervision of financial sector, in particular of securities markets."

<sup>63</sup> See for a detailed discussion, *Coffee, Jr.* (1999) comparing the development in Poland and the Czech Republic.

<sup>64</sup> EBRD Transition Report, Nov. 1998 rated Poland and Hungary as the two Central European countries closest to fulfilling the IOSCO standards.

<sup>65</sup> Cf. *Coffee, Jr.* (1999) pp. 17.

principle protect shareholders and investors of the market, lack of efficient enforcement of the rules are significant.<sup>66</sup>

## **4.2. Integration of stock exchanges in the Baltic Sea Region and other regions**

The Baltic Sea Region is not in any significant way an obvious region when talking about stock exchanges.

The Baltic Sea Region encompasses the following countries: Denmark, Norway, Sweden, Finland, Estonia, Latvia, Lithuania, Russia, Poland and Germany. What these countries have in common is that they border on the Baltic Sea. That was significant at the times of the Hanseatic towns where sea transport was very important and time to travel depended primarily on the distance. At that time the island of Bornholm could be said to be central in the Baltic Sea Region since it is situated not very far from all these countries. Today, where people travel by plane, Bornholm is more remote than any capital in the above mentioned countries. To go to Bornholm, most people have to fly to Copenhagen and from there to Bornholm. It is important that these simple facts are not forgotten.

What is a region? One can have several points of view:

- A region could be defined geographically.
- A region could be defined culturally.
- A region could be defined linguistically.
- A region could be defined politically (countries which shared the same philosophy with respect to regulation for instance, or maybe countries of the same size (in some areas same size makes agreements easier as no partner is dominant)).
- A region could be defined economically. However, this can be understood in many ways: a region could be defined as countries having the same level of GDP per inhabitant, as they would tend to demand similar products. It could also be countries that traded very much with each other or it could – in connection with stock exchanges – be countries that invested heavily in each other.
- A region could be defined by techniques and systems used in stock trading, clearing and settlement.
- A region could be defined from the investors' point of view (one possible way of defining a region is use of a common currency e.g. Euro).

Few relevant arguments in favour of the Baltic Sea Countries being a region exist when we look at the question from a stock exchange's point of view – or indeed any other point of view. To some extent one can argue that the Nordic countries can be labelled a region, but the arguments are not that strong. It is quite as easy to argue that Denmark is part of a region encompassing Germany. The Nordic countries have invested relatively heavily in Estonia, Latvia, and Lithuania (the statistics are not very good), and one might therefore argue that these three Baltic Countries and the Nordic countries are one. But the argument is not very convincing. Seen in the long run the association will probably not be that strong. Historical factors connected with the break-up of communism have made the connection stronger than the expected long-term connection. As

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<sup>66</sup> Cf. International Securities Regulation - Russia Federation (1999), Investment guide for the Russian Federation (1996) pp. 99. See also *Coffee, Jr.* (1999) pp. 20 and *Janda*, (1995) pp. 262 both being very critical with respect to the Russian securities market.

to Russia its sheer size makes it easy to say that it is a region with everybody on which it borders. As to Poland the economic ties will probably be with Germany more than the rest of the Baltic Sea Countries (never forgetting the problems of defining the ties as the result depends very much on the measure used).

As to economic development, culture, language, political system and regulation it is difficult to argue that there is a Baltic Sea Region.

At the roundtable discussion Christen Boye Jacobsen, Chief Advisor (Balticum), Ministry of Foreign Affairs, Denmark gave a (subjective) evaluation of the Baltic Sea Countries' capability to participate in co-operation as to stock exchanges. It is obvious from the table that very large differences exist even when we do not consider language and currency.

Table 7. Capability of Baltic Sea Countries' market-places to participate in serious and lasting co-operation?

<i>Does this market place have:</i>	<b>Kbh.</b>	<b>Oslo</b>	<b>Sthlm.</b>	<b>H:ki</b>	<b>St.P:bg</b>	<b>Tallinn</b>	<b>Riga</b>	<b>Vilnius</b>	<b>W:wa</b>	<b>Frankf.</b>
<i>A well-functioning Market</i>	Yes	Yes	Yes	Yes	No	Yes	Partly	Partly	Partly	Yes
<i>Technical Well-functioning Marketplace</i>	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Partly	Yes
<i>A good and modern Securities legislation</i>	Yes	Yes	Yes	Yes	No	No	Partly	Partly	Partly	Yes
<i>A good and modern Business law system</i>	Yes	Yes	Yes	Yes	No	Partly	Yes	Partly	Partly	Yes
<i>A decent consumer protection</i>	Yes	Yes	Yes	Yes	No	No	Partly	No	Hardly	Partly
<i>A working competition system</i>	Yes	Yes	Yes	Yes	No	Partly	Yes	Yes	Partly	Yes
<i>A compatible size compared to the other exchanges</i>	Yes	Yes	Yes	Yes	Dubi-ous	Yes	Very small	Very small	Dubi-ous	Clearly Too big
<i>Freedom from alliances or other restrictions to its freedom</i>	No (Kbh-Sthlm)	Yes	No (Kbh-Sthlm)	Yes	Dubi-ous	Yes	Yes	Yes	Dubi-ous	No (iX)
<i>A corruption-free environment</i>	Yes	Yes	Yes	Yes	No	Partly	Partly	Partly	Partly	Yes
<i>EU membership</i>	Yes	No	Yes	Yes	No	Coming	Coming	Coming	Coming	Yes
<i>A good supervision</i>	Yes	Yes	Yes	Yes	No	No	Yes	Partly	Partly	Yes, but an iX question
Score (max.33)	30	30	30	33	2	19	28	25	21	28

*Note 1: The weighing attributed is: Yes = 3; Partly and the like remarks = 2; Hardly or Dubious = 1; No = 0.*

*Note 2: The iX alliance renders basically all the other questions on Frankfurt irrelevant.*

The Nordic countries are probably the ones that can be said with some reason to be a region.

There are at least four different arguments for Nordic countries being a region of which two arguments unfortunately contradict each other: The first argument is that foreign investors look at the Nordic countries as one region and therefore are interested in being able to trade in all Nordic stocks from one trading platform. The second argument is that investors in the Nordic countries want to invest in each other's shares.

The problem with these arguments seen together is of course that if the Nordic countries are one region we would expect that Nordic investors did not want to invest in each other's shares as they

do not get any significant risk reduction from diversification. Therefore both arguments cannot be right.

Furthermore, there is no reason – at least in the long run – to assume that foreign investors look at the Nordic countries as one region. The companies – and the size of the companies – are rather different. Increasingly, foreign investors do not concentrate on countries but on sectors. With increasing integration in Europe, with all countries having more or less the same inflation and level of interest, and with the Euro becoming more dominant than ever, the arguments for being interesting in the individual countries as such instead of the individual business becomes ever smaller.

The third and fourth argument is that Nordic countries to a large extent share philosophy as to regulation and that the countries are of more or less the same size (except Iceland) which makes co-operation more easy as there is no dominant partner.

Especially the equal size argument is probably more popular with politicians and individual stock exchange directors than it is with facts. An obvious problem with the "equal partner philosophy" is that it makes it more complicated and time-consuming to make decisions. That is easier with one dominant partner. And there is a possible "principal-agent"-problem with stock exchange management trying to keep their position. In general we see that management in small companies have a tendency to resist mergers and acquisitions where they are "eaten" by larger companies even if they bring obvious gains to their shareholders.

However, all this does not mean that it is a mistake to co-operate within the Baltic Sea Region. The point is only that one should take care of not being misled by wrong arguments.

In the long run we will see a lot of co-operation, alliances and mergers between national stock exchanges. Common trading platforms will be the rule and not the exception. All countries, large and small, have to find partners. And the process will be a continuing one. The alliances and mergers we see today are not the final ones. The consolidation will go on.

If we look at the Baltic Sea Countries, Deutsche Börse has chosen to merge with London Stock Exchange and create iX international exchanges. At the end of 1999 iX constitutes 43 percent of the market capitalisation of mature European exchanges. If the merger is approved iX will become a very important – if not the most important – exchange within the European time zone and a very attractive partner for a major American exchange (a memorandum at understanding with Nasdaq has already been signed, cf. Section 5). The rest of the Baltic Sea Countries might try to join this coalition. For the rest of the exchanges in the Baltic Sea Region it is not realistic to try to join iX now. That would probably be fruitless. Therefore the optimal strategy for each of these exchanges is probably to start co-operating with other exchanges. Such co-operation does not rule out that e.g. Norex will join in an even larger co-operation at some later date (e.g. iX or Euronext depending on their success). The version of Norex based on current letters of intents makes sense. But other co-operations might be just as sensible.

### **4.3. Preliminary conclusion**

As pointed out in the previous sections the securities markets and regulations hereof differs considerably within the Baltic Sea Countries. Some of the countries have markets that are so much different from the others, that there is no reason to believe that the Baltic Sea Region as such may be regarded as one market with common features. A potential co-operation between stock exchanges within the region can not be expected to include all the Baltic Sea Countries.

Firstly, the securities market and the regulation hereof in Russia differs substantially from the other countries. Due to the size of the Russian market, Russia should be able to develop a market independent of the Baltic Sea Region, and furthermore, such a large market may create problems for the smaller markets in the region. The fact that Russia is not and will probably not be a member of the EU also distinguishes Russia from the other countries in the region and may create problems with respect to the EU regulation on supervision, EU-passport e.g. The differences between the other countries in the Baltic Sea Region are so substantial that Russia cannot be part of a potential market in the Baltic Sea Region.

Secondly, Germany has over the last years taken an approach trying to become one of the leading markets in Europe, now in co-operation with London Stock Exchange. This approach means that Germany can be expected to strengthen and develop its own national profile trying to become the leading European stock exchange. In the short run Germany is not to be considered as part of a regional market to be developed in the Baltic Sea Region. On the other hand a German market and stock exchange with global importance may turn out to be attractive for some of the Baltic Sea Countries individually or for an alliance between some of the stock exchanges in the region. But such co-operation or links to the German market will primarily be based on German premises.

Thirdly, as noted previously the securities market and the regulation hereof in Poland has been considered as one of the most successful in the post-communist countries, and Poland has been able to establish a domestic market for listed securities. The most likely co-operation or alliances for Poland may be with other European countries to the south like the Czech Republic, Hungary e.g. and/or Germany. Therefore, co-operation with other markets in the Baltic Sea Region may not have high priority.

If co-operation between the stock exchanges in the Baltic Sea Countries should be considered a possibility for future developments in the area of securities markets such an alliance may therefore only include the following countries: Sweden, Norway, Denmark, Finland, Estonia, Latvia, and Lithuania, and maybe from outside the region Iceland. But even within these countries differences exist as well as to the market structure and development and regulation hereof. However, it is not certain that such a reduced market in the Baltic Sea Region may develop.

The following section deals with different aspects of co-operation and alliances that may be of interest for the just mentioned countries. Further, it will be discussed and emphasized which minimum requirement must be fulfilled before going further with the idea of an alliance between the countries and their stock exchanges.

## 5. Co-operation between stock exchanges

Based on the international challenges described in Section 3 and 4 one may assume that the stock exchanges in the Baltic Sea Countries in the future will see major changes in the way of doing business. They can either try to improve their own international competitiveness or enter into new alliances with other stock exchanges. In the last decade and especially within the last few years the development in Europe has shown that many stock exchanges have chosen to aim at different types of alliances or co-operation. This section primarily deals with the legal aspects of co-operation and alliances. A broad perspective from an economic point of view is found in Section 6 below.

This section may serve as a basis for discussions of whether to enter into co-operation. The section will also analyse different ways of co-operation. Pros and cons will be pointed out but the aim is not to make any final conclusions for/or against co-operation. The present documentation and theory do not give basis for final conclusions and only future developments of the market will show which stock exchanges and which alliances will survive.

It must be emphasized that there are certain legal aspects which must be considered before it can be expected that the stock exchanges in the Baltic Sea Countries will engage themselves in such co-operation.

### 5.1. The prerequisites for co-operation

Some stock exchanges may choose a strategy in which they will oppose the international competition by relying on their own national strength. Whether such a strategy will become successful depends first of all on the market position of the stock exchange and its competitiveness. However, it must be emphasised that only a few legal instruments are at hand protecting a stock exchange from competition. As it is discussed in Section 3, ISD ensures to a certain extent that foreign investment firms can get access to all stock exchanges within the EU. A Member State cannot introduce a so-called concentration provision which will ensure that the securities of companies incorporated in a Member State only can be traded on a certain stock exchange. A Member State might demand that a company incorporated in the said country must have its securities listed on a certain stock exchange, but it cannot prevent the company having their securities listed on foreign stock exchanges. Furthermore, it cannot prevent trading in listed companies on other regulated markets.<sup>67</sup> It has been discussed if the possibility of preventing new stock exchanges can be used by countries to prevent that trade with listed securities is transferred abroad. So far this has only been seen as a theoretical possibility.<sup>68</sup> Altogether, no effective legal instruments are found that can protect a national stock exchange from being exposed to international competition.

With a view to create optimal conditions for co-operation it must be considered whether the present stock exchanges have the right structure. This includes considerations of the ownership structure of the stock exchanges. In 1993 the Stockholm Stock Exchange was the first to be

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<sup>67</sup> See also *Steil* in *TemaNord* 1999:576 p. 24.

<sup>68</sup> Cf. *Scott* in *Ferrarini* (1998) pp. 292 and *Steil* (1996) pp. 129.

privatised, and following that many other stock exchanges have been privatised.<sup>69</sup> A demutualization might result in stock exchanges becoming more willing to enter into co-operation on commercial conditions.<sup>70</sup> Furthermore, it must be a condition for certain forms of co-operation that the stock exchanges have slimmed so that they only comprise core activities. It has also been asserted that stock exchanges successfully can separate the activities connected with clearing and settlement and maybe information systems.<sup>71</sup>

Finally, it should be mentioned that establishment of co-operation can only be successful if the stock exchanges want to cooperate. There are no regulations which can force the stock exchanges to cooperate. Some of the unsuccessful alliances which will be discussed in the following show that co-operation demands full commitment by all involved exchanges.

## 5.2. Existing alliances - an overview

The last two decades have seen many examples of co-operation between stock exchanges in Europe and some of them will be discussed in the following. However, only a few attempts of co-operation has turned out to be viable as most of them either have not been realised or later abandoned. The different alliances between the stock exchanges in Europe have turned out to be very changeable, and the commitment of the involved parties questionable. In order to get a perspective it is reasonable to describe the most important alliances which the Baltic Sea Countries today participate in. The contents of the alliances will not be discussed in detail as this will be done in the following sections.

### Norex

The Norex-co-operation is so far the peak of different co-operation between Nordic stock exchanges. The Norex-co-operation (Nordic Exchanges) was established in January 1998 as co-operation between Copenhagen Stock Exchange and OM Stockholm Stock Exchange. The aim is that each exchange retains its separate identity but that there is one common market place for securities. The co-operation contains many stages. At the first stage both exchanges use the Swedish trading system SAX (now SAXESS). Clearing and settlement continue to take place locally. As part of stage one a jointly owned company (Nordic Exchange A/S) is set up dealing primarily with marketing and product development. Further goals of the Nordic Alliance are a harmonization of stock exchange regulations and a common clearing and settlement.<sup>72</sup>

In 1999 the Nordic Council published a report which discussed the possibilities for co-operation between the Nordic stock exchanges and the exchanges in Estonia, Latvia, and Lithuania.<sup>73</sup> This report supports such co-operation and afterwards a working committee has been appointed. This working committee shall analyse relevant areas of legislation to be harmonized and thus the said harmonization process may have begun.

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<sup>69</sup> Helsinki (1995), Copenhagen (1996) and Iceland (1999), cf. on this development *Onado* in *Ferrarini* (1998), pp. 238 and *Ferrarini* in *Balling* (1998) pp. 139.

<sup>70</sup> Cf. *Steil* (1996) pp. 42-43.

<sup>71</sup> Cf. *Ferrarini* in *Ferrarini* (1998) p. 246.

<sup>72</sup> See Copenhagen Stock Exchange, Fact Book 2000, p. 28.

<sup>73</sup> See the report TemaNord 1999.576, Prerequisites for Increasing Nordic and Nordic-Baltic Securities Market Co-operation.



Furthermore, the Norex co-operation is aimed at having more members. In November 1999 the Oslo Stock Exchange signed a letter of intent to join Norex, and Iceland Stock Exchange followed in March 2000. In May 2000 letters of intent was signed by Vilnius, Riga, and Lithuania stock exchanges and it is hoped that they will be trading on the shared platform by mid-2001. By this it is only Helsinki which is remaining outside the co-operation as so far it has said that it considers other alliances.<sup>74</sup>

Already before they joined Norex, co-operation was established between the exchanges in Estonia, Latvia, and Lithuania. The chairman of the Securities Commission in the three states meet regularly and are working towards facilitating market integration.<sup>75</sup>

### **iX international exchanges**

On 3 May 2000 Deutsche Börse and London Stock Exchange announced their intention to merge and create a new company called iX international exchanges. In addition a memorandum of understanding was made with Nasdaq on a development of a pan-European, high growth market. On 7 July 2000 the two exchanges published the Information Documents which gives details on the creation of iX international exchanges. The shareholders of the two exchanges will vote on the merger on 14 September 2000.

The two European exchanges will transfer their activities (except from Deutsche Börse's 50 per cent stake in Clearstream) to the British company iX-international exchanges plc, which will be owned jointly by the two exchanges with 50 per cent each. iX will be based and managed from London and it is estimated that iX will handle 53 per cent of the total European share trading volume. iX will develop a pan-European blue chip market under UK regulatory regime and a pan-European high-growth market under the German regulatory regime. Companies will be able to use their home country listing when admitted to trading on iX's new markets. It is the ultimate aim to form a long-term relationship on a global basis with Nasdaq including substantial cross-shareholdings in each other. Further the stock exchanges of Milan and Madrid have indicated that they will negotiate with iX international exchanges to become part of the group.

Trading will be based on an upgraded version of Frankfurt's Xetra electronic trading system. Deutsche Börse's stake in Clearstream (jointly owned with Cedel International) is not included in the merger and clearing and settlement will continue to be provided by Clearstream and CrestCo limited. However, it is the declared intention that settlement should ultimately be delivered on a consolidated pan-European basis.

The plans of establishing iX was published shortly after an alliance between the stock exchanges in Paris, Brussels, and Amsterdam was announced. This alliance called EuroNext was declared to be the first merger of stock exchanges in Europe. Further, in the fall of 1999 eight stock exchanges (including the two exchanges in iX and the three in EuroNext) announced to have signed a common market model for the most liquid European securities with common functionality, supported by harmonised rule books.

### **NEWEX**

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<sup>74</sup> Cf. AFX Europe, May 3, 2000

<sup>75</sup> Cf. TemaNord 1999:576 p. 100.

The creation of New Europe Exchange (NEWEX) was announced in February 2000 and will be starting trading by 3 November 2000. NEWEX is a 50-50 joint venture of Deutsche Börse and Wiener Börse set up under Austrian law and with its registered office in Vienna. The new exchange will operate under the German trading platform Xetra, which are also used at Wiener Börse. Settlement will be handled by Clearstream, a joint subsidiary of Deutsche Börse and Cedel International.

It is the aim to establish a trading and financing platform for start-up companies and reconstruction of companies in Central and Eastern Europe, and hence give such companies access to international capital. Focus is especially on companies in Poland, Hungary, the Czech-Republic, and Russia. The intention is to have the companies listed on both NEWEX and on their home stock exchange and the companies must adopt international accounting standards, report figures on a quarterly basis and hold meetings for analysts.

A press release of 8 August 2000 NEWEX indicated that trading is to begin with about 10 listed companies in two quality segments and more than 100 companies are to be quoted in other segments.

NEWEX have held talks with several national exchanges on possible co-operation, but so far most Central and Eastern European exchanges remain sceptical. They seem concerned that NEWEX will become a serious competitor and take away a big slice of liquidity. So far NEWEX have signed a letter of intent on co-operation only with the Russian stock exchange MICEX (Moscow Interbank Currency Exchange). The two exchanges aim to achieve dual listing of Russian stocks on NEWEX and MICEX, and the admission criteria of NEWEX shall apply on MICEX, too.

### **5.3. The legal forms for co-operation**

Co-operation could legally be constructed in different forms. The most simple form of co-operation could be established on the basis of contracts where the parties either verbally or by an agreement commit themselves to co-operation. Often agreements are not made but only letters of intent which express the parties' intention to cooperate. These letters of intent are not legally binding and therefore stock exchanges can and have negotiated with other stock exchanges even if letters of intent existed.<sup>76</sup> As emphasized above most of the co-operation established so far has not been legally binding and the parties' commitment have been weak.

Ambitious forms of co-operation will often try to commit the parties further by involving arrangements concerning the stock exchanges' ownership structure. Therefore it may be a necessity for some forms of co-operation that the stock exchanges' ownership structure allows for such co-operation. In practice different constructions are applicable:

1. From other areas the most common form of establishing a transnational co-operation is made by an acquisition whereby one company acquires the majority of stocks in another company. So far such acquisitions have not been seen with respect to stock exchanges. The ownership structure of most exchanges may be the reason.<sup>77</sup> For example the banks which

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<sup>76</sup> E.g. the stock exchanges in Milan and Madrid seem to continue negotiations about links to other stock exchanges even though they have signed a letter of intent with iX, cf. thus AFX (UK), May 4th, 2000.

<sup>77</sup> Cf. Steil (1996) p. 63.

own Copenhagen Stock Exchange have entered into a shareholder agreement which gives the banks a mutual pre-emption right. So far this agreement is in force until ultimo 2001, and therefore, in this period the stock exchange cannot be taken over. It has been asserted that this agreement was entered into in order to prevent the Swedish OM from buying shares in Copenhagen Stock Exchange with a view of merging the stock exchanges in Stockholm and Copenhagen.<sup>78</sup> It should be mentioned that Stockholm Stock Exchange at present has a unique position as the stock exchange is owned by OM, listed on the exchange.

2. Another method is to establish a cross-holding whereby the cooperating stock exchanges mutually exchange shareholdings. Such cross-holdings are not in itself the only basis for co-operation but consolidate agreed co-operation, cf., e.g., the contemplated extension of the co-operation between iX international exchanges and Nasdaq.
3. Finally a joint venture construction is applicable for different forms of co-operation. The construction involves that the common activity is placed in a company jointly owned and controlled by the parties. This construction gives the parties the possibility for co-operation on certain limited activities, e.g. the Norex co-operation where the joint company is responsible for product development and marketing. In EuroNext the joint venture construction is used for extensive co-operation when the parties involved transfer all or most of their activities to the joint company. Therefore, the joint venture construction is flexible but sometimes complicated to make as activities must be transferred, and further agreement on how to carry out joint control must be set up.
4. Sometimes the daily press writes about mergers between national stock exchanges, the latest case being EuroNext and iX. In legal terms it is not necessarily a merger but merely construction which to some extent ensure merging of stock exchanges. Actually, it is only in a very few cases possible to make a transnational merger as the company rules regarding merger has not yet been harmonized within the EU. In the following the word merger will be used in a broad sense as used by the daily press.

In relation to this report it is not necessary to specify the legal construction which is behind the different forms of co-operation. The comments above only serve the purpose to illustrate that this aspects of co-operation in itself can be complicated and justify legal considerations. To get successful co-operation the condition is very often a thorough legal basis, which is sufficiently clear and sufficiently binding for the parties in order to optimise the yield.

Finally, it must be mentioned that the competition rules in the EU and the national legislation on competition may limit the possibilities for co-operation. Competition rules prohibiting the abuse of a dominant position and prohibiting certain cartels and mergers might dictate that certain forms of co-operation or merger cannot be carried out. This problem will not be discussed further.

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<sup>78</sup> Cf. *Espen Bull* in Børsen, 11 June 1999.

## 5.4. Areas of co-operation

Co-operation between stock exchanges may have many forms and may involve different aspects of the activities carried out on an exchange or in connection hereto. The purpose with the following discussion is to comment on the different aspects of co-operation to assess pros and cons and with a view to assess if such co-operation implies that the legislators are involved in its implementation.

### 5.4.1. Common information and trading systems

One of the key elements and prerequisites for co-operation or alliances between stock exchanges is common information systems. Such system may not only include information on prices, volume and other trade related information, but also company news and other information to be disclosed on the market. The co-operation on information was the most important element of Euroquote in the early 90's.<sup>79</sup>

Likewise a common trading system may be regarded as one of the key elements of co-operation between stock exchanges as it gives the traders only one 'entrance' to the market, and only one system to deal with. The first European common trading system with respect to stocks listed on different exchanges was in fact SEAQ-International, which became very successful in the late 80's, see above Section 3.

Both with respect to common information systems and common trading systems the overall expectation is that the total cost involved in running the systems and trading may be less. Operational cost for the participating exchanges and access cost for intermediaries may be reduced, and finally transaction costs for the end investors may be reduced.<sup>80</sup>

A common information system gives investors and financial intermediaries the opportunity to obtain price- and trade relevant information from one source, instead of having to gather them from a number of systems run by different exchanges or from a commercial vendor that have gathered the information from different systems. To achieve the full effect of a common information system, it must be required that information is given in the same form, and with respect to content is based on the same disclosure requirements. This applies both to the trade related information and to information from companies to be disclosed on the market. Therefore, a harmonization of disclosure requirements is needed. This relates both to prospectuses and other information from the listed companies, to ownership transparency (major shareholdings), and disclosure with respect to takeover bids.

A substantial part of the harmonization process with respect to disclosure requirements concerns details of the regulation and requires quick and easy adjustment to international trends and standards. Like the trade related information the stock exchanges may bear the primary responsibility of ensuring such harmonization, including deciding what standard should apply, cf. Section 4, discussing whether a regulatory competition between markets may result in a race to the bottom or a race to the top.

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<sup>79</sup> Cf. *Lee* (1998) pp. 61.

<sup>80</sup> Cf. *Steil* TemaNord 1999:576 p. 26 with respect to Norex, but at the same time pointing out that similar effect could be achieved by other kind of cross-border alliances.

This does not necessarily mean that the legislators do not play a part in the harmonization process. Firstly, the legislators may ensure that fundamental differences in securities laws of the countries involved do not serve as a barrier for harmonization. This may require changes in existing laws or adding new provisions to the law. The regulation on takeover bids in the Nordic countries may be an example of such fundamental differences that changes in the law is required. Secondly, there may be some elements essential to investor protection and market integrity that must be laid down in the law.

#### **5.4.2. Cross-border listings**

As mentioned above in Section 3 one of first initiatives to encourage an integration of the securities markets in Europe was the introduction of the principle of mutual recognition of prospectuses. Cross-border listing should be easier and less costly. Further, with respect to accounts and auditing a company with stocks listed on more than one stock exchange was only to present audited accounts in compliance with the company's national law and follow the national accounting practice. Information given on one stock exchange was to be given simultaneously at the other stock exchanges. With Eurolist the attempt was more systematically to allow the largest companies to be officially and simultaneously listed and thus traded on all EU stock exchanges. It was argued that this would be advantageous to issuers as gaining a 'European' status.<sup>81</sup>

Despite these initiatives and the fact that some multiple listing have been seen, cross-border listing never became a predominant factor in the internationalisation of securities markets in Europa. Many reasons can be pointed out. Firstly, the cost and practical problems of being listed at more than one exchange may discourage issuers from multiple listing, especially when such listing does not significantly increase the capital raised. Seen from the investors' point of view the attractiveness of a company and its stocks may not depend on where it is listed, but on the fact that it is listed *and* there is a liquid market for trade.

Further, even though some of the problems with respect to facing regulation of more than one exchange are eliminated through the principle of mutual recognition, some instances of regulatory collision remain. This is due to the fact that the countries in Europe, including the Baltic Sea Countries use different criteria in relation to the connecting factor of their securities laws. Some securities laws or elements hereof are triggered by the fact that a company is listed on a stock exchange in that particular country no matter where the company is incorporated. Other laws are based on the fact that the company is both incorporated and listed in the same country. Different connecting factors are especially found in the regulation of takeover bids. It means that a bidder for the stocks of a cross-border listed company may fulfil two sets of regulation, or that no regulation applies at all.<sup>82</sup>

#### **5.4.3. Clearing and settlement**

Clearing involves the determination of what each party to a security transaction owes and is entitled to receive. Settlement is the process of actual exchange of securities and payment between the parties of the transaction. Usually Central Securities Depositories (CSDs) are handling the securities-related aspects, and the payment-related activities are handled by the banking/payment system.

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<sup>81</sup> Cf. *Lee* (1998) p. 71.

<sup>82</sup> For further discussion, see *Jul Clausen and Engsig Sørensen* (1999) pp. 211.

Clearing and settlement have over the last years become a more and more important element of the securities regulation. The total costs of a security transaction also include clearing and settlement cost. Competition between national CSDs and international organizations like Euroclear and Cedel has increased, and is expected to increase with introduction of the Euro.<sup>83</sup> As noted in Section 4 above, some of the securities markets reforms of the 90's responded to the increased competition with respect to clearing and settlement by introducing regulation on clearing and settlement into the law. The purpose hereof was twofold; the national CSDs should be given the opportunity to be more competitive, and international standards in relation to netting, short term lending, and pledging became part of the regulation.<sup>84</sup> Most recently and of importance, the EU has enacted the so-called finality directive<sup>85</sup> establishing a common regulation with respect to certain legal aspect (primarily with respect to pledging and insolvency) of clearing and settlement, see further above in Section 3.

However, with respect to co-operation between stock exchanges clearing and settlement has played a less predominant role. For the time being different models for the relationship between national stock exchanges and national CSD exist. In recent years there has been a general trend in Europe towards incorporating the CSD into the national exchanges, which has been the case in Frankfurt, Paris, Amsterdam, Brussels, and Helsinki. On the other hand most other Baltic Sea Countries have CSDs separated from the exchanges. It is debatable and yet not clear which model may suit the market best or whether other models may develop in the near future. It has been emphasised that the former model offers advantages in terms of aligning the business strategies of the exchange and the CSD, whereas the latter offers more strategic flexibility to both parties.<sup>86</sup>

In the beginning of 1999 the so called S4 project involving co-operation of the CDSs of Sweden, Denmark, and Norway failed as it was not approved by the boards of the CDSs. For the time being no further negotiations with respect to co-operation seems to go on, but it shall be noted that the Danish CDS has been transformed into a public limited company with the previous users as owners. The same may happen in Norway.<sup>87</sup> The creation of Clearstream, a joint subsidiary of Deutsche Börse and Cedel International may create a new European trend in alliances concerning clearing and settlement.

If further co-operation or alliances between stock exchanges in the Baltic Sea Region with respect to trade in securities is to develop a harmonization and integration of the national clearing and settlement system and organization hereof must also be taken into consideration. A common solution must be found. In this respect it must be pointed out that despite the existing differences regarding clearing and settlement and the organisation hereof, the Scandinavian CDSs and those of Estonia, Latvia, and Lithuania are much more similar to one another in structure and legal foundation than they are to CSDs operating outside the region, and therefore also easier to consolidate.

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<sup>83</sup> Cf. *Steil*, TemaNord 1999:975 pp. 28.

<sup>84</sup> Cf. *Steil* in *Steil* (1994) noting that clearing and settlement is likely to top the international regulatory agenda, and among other cases mentioning the BCCI-case of July 1991.

<sup>85</sup> Cf. directive 98/26, O.J 1998 I 166/45.

<sup>86</sup> Cf. *Steil*, TemaNord 1999:975 p. 29. See also *Licht* (1998) pp. 61.

<sup>87</sup> See *Steil* TemaNord 1999:576 pp. 29 discussing S4 and possible reasons for it failure.

#### 5.4.4. Harmonization of rules

Certain rules seem to limit cross-border trade and cross-border listings.<sup>88</sup> Different rules imply that the national stock exchanges are seen as fragmented as investors cannot assess the individual systems. Especially the companies listed on more than one exchange will face problems with different rules. In that case they may have to comply with different rules, cf. Section 5.4.2. Finally, the different rules may be seen as a hindrance in situations where trade in securities has connection with several legal systems and, therefore, it is not clear which legislation is applicable.<sup>89</sup>

As seen from Section 3, a limited harmonization of the securities regulation has been carried out within the EU. Furthermore, this harmonization has character of a minimum harmonization. Therefore, it cannot be expected that the EU will ensure the necessary harmonization of rules.<sup>90</sup>

Instead of common rules it could be considered if it is sufficient that the stock exchanges acknowledge each others rules and agree on how to solve conflicts where different sets of rules are applicable.<sup>91</sup> However, it is doubtful whether such solutions are sufficient for solving problems seen from the point of the investors as common rules may be seen as essential. Another solution could be that the individual stock exchanges agreed on acknowledgement of certain rules being equal to their own rules. In this way it is left with the listed companies to decide which set of rules they want to apply. This solution has just been suggested by IOSCO in the area of accounting as it in a resolution has recommended 30 IASC standards as suitable for use in cross-border offerings and listings.<sup>92</sup> Even if such a solution may remedy the problems for companies with cross-border listings it will only remove the problems for investors, provided that most companies use the same rules (such as IASC), and the result is hereby equal to harmonization of rules.

In the light of acknowledgement of the need for harmonization of rules, practice shows some examples that co-operation of that character has been established. An example is the Norex co-operation which at present has begun a harmonization of rules including comparing the existing rule with the requirements at London Stock Exchange, cf. Section 5.2. In iX international exchanges co-operation a harmonization of rules has not been anticipated as the activities have been divided so that the different markets are either under UK or German regulatory regime.

If a harmonization of rules is initiated more question may arise. First, which rules must be harmonised, second, which model should be used for harmonization, and finally the character of

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<sup>88</sup> Cf. also Økonomiministeriet (The Danish Ministry of Economic Affairs) (1999) p. 96 and *von Rosen* (1993) p. 26.

<sup>89</sup> Cf. *Licht* (1997) p. 52 mentioning that the problem primarily concerns internationally oriented stock exchanges such as EASDAQ.

<sup>90</sup> Contrary to this, in the United States they have got an extensive convergence of rules achieved by a common regulatory body SEC which issues most rules relevant for the securities markets. On the American development and the possible lessons for EU, see *Scott in Ferrarini* (1998) pp. 283.

<sup>91</sup> Such a solution is advocated by *Steil in Steil* (1994) p. 225.

<sup>92</sup> Cf. IOSCO Resolution Concerning the Use of IASC Standards for the purpose of Facilitating Multinational Securities offerings and Cross-border listings, May 2000.

the common regulation (legislation contra self-regulation). These questions demand further considerations and will not be dealt with further.

#### 5.4.5. Co-operation on supervision

The supervisory framework for financial markets includes both a supervision of banks, one for insurance companies, and one for the securities markets. The organisation of this supervision is different from country to country but in the following the focus will only be on the function of supervision of the securities market. The purpose of this supervision is to ensure the investors a fair, honest, and orderly market. To achieve this there must be a market supervision (issuers, trade etc.) and a prudential supervision of financial intermediaries.

Traditionally, supervision has been handled by the individual countries. However, this task has lately been increasingly more difficult due to the increased cross-border trade in securities and due to the dissemination of alternative trading systems.<sup>93</sup> The fact that ISD determines the principle on home state control involves an increased demand to ensure an effective and reliable supervision function in all states and demands that there is co-operation between supervisory authorities with respect to the investment firms which trade on the markets in different countries.<sup>94</sup>

This development means that there is a demand for strengthening the co-operation between the national supervisory authorities. So far, this co-operation has been concentrated on bilateral co-operation agreements; the so-called Memoranda of Understanding which facilitate the exchange of information between supervisory authorities.<sup>95</sup> This form of co-operation is hardly sufficient effective to handle the present needs for co-operation and there are several developments which point towards increased co-operation. IOSCO has in many reports and resolutions recommended further co-operation between supervisory authorities.<sup>96</sup> In the EU the Commission in its Action Plan from 1999 argued for further co-operation in this field.<sup>97</sup>

Looking at stock exchanges which already cooperate in some areas there may be a special demand for co-operation regarding the supervision of securities markets. For example if common trading systems exist it must be a prerequisite that a responsible supervision on all participating markets is available. If there is no responsible supervision, especially foreign investors may loose confidence to that market.<sup>98</sup> In the case where the markets are tied together by one trading system the investors might loose confidence to that system. Furthermore, if co-operation includes a common regulation a common enforcement hereof requires that there is common supervision or at least a close co-operation between involved supervisory authorities.

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<sup>93</sup> Cf. the report from the Technical Committee of IOSCO, Supervisory framework for markets, May 1999, p. 12.

<sup>94</sup> Cf. *Biancheri* in *Ferrarini* (1998) pp. 363.

<sup>95</sup> On these agreements, see *Bergsträsser* in *Ferrarini* (1998) pp. 376.

<sup>96</sup> For a review of the different initiatives from IOSCO, see *Althaus* (1999).

<sup>97</sup> See COM (99) 232 pp. 11-12.

<sup>98</sup> Cf. *von Rosen* (1993) p. 27.



In the alliances which are already established or announced to be established there seems to be very little focus on the co-operation between the supervisory authorities. In the Nordic countries there seems to be a tradition for co-operation between the supervisory authorities. Co-operation between the authorities in Estonia, Latvia, and Lithuania exist, too.<sup>99</sup> However, co-operation between the supervisory authorities seems not be an integrated part of the Norex-co-operation. In connection with the merging of the three stock exchanges which forms the EuroNext the question of supervision seems unsolved. It had been pointed out that such extended co-operation will be difficult to maintain three separate national supervision authorities as a supra-national watchdog is needed.<sup>100</sup> In iX international exchanges the problem seems to be solved as the different markets, and hence the supervision hereof has been divided between UK and German regulatory regime.

Summarised it must be concluded that co-operation between the supervisory authorities may be necessary due to the international development in trading in securities.

Furthermore, stock exchanges which cooperate in other fields may have a special reason for entering into such co-operation. If cooperating stock exchanges externally want to create a reliable market they must have a common standard of supervision. If the stock exchanges externally want to be seen as one place of trading it might be necessary with an even more integrated supervision, maybe a common supervision. As supervision often is regulated by law extensive co-operation will require that the legislators must contribute to find a solution.

#### **5.4.6. Second-tier markets**

The market for small and medium sized growth companies has turned out to be difficult to develop in Europe. Compared with the American market, where especially Nasdaq has had tremendous success, the corresponding market in European is limited. The explanation is not clear as the potential number of growth companies and investors seems to be present.<sup>101</sup>

In order to develop this market many attempts have been made. Especially the traditional stock exchanges have established second-tier markets of this nature. Attempts have been made in the Nordic countries without a real success. The establishing of Neuer Market which Deutsche Börse opened in 1997 was far more successful. Neuer Market was one of several new second-tier markets which was established in that period. Nouveau Marche was the first which was established by the Paris Bourse in February 1996. A new company was established, ie. Euro NM which should function as a European-wide network of growth company markets like Nouveau Marche. The intention was that this company should take care of different tasks including marketing of the new markets, taking care of a harmonization of rules, and try to further common trading systems.<sup>102</sup>

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<sup>99</sup> Cf. TemaNord 1999: 576 p 99.

<sup>100</sup> Cf. International Market Insight Reports, New York May 3, 2000.

<sup>101</sup> For an analysis of the problem, see the Commission in COM (95) 498 and *Röell in Ferrarini* (1998) pp. 220.

<sup>102</sup> See further *Licht* (1997) pp. 52.

However, it turned out that the new stock exchanges had a limited success. Neuer Market in Germany was the most successful and just in February 2000 had 20 IPO's.<sup>103</sup> The merger with London and the creation of iX international exchanges will bring together London's techMARK and Neuer Market as the basis for a new high-growth market with a market share of around 80 per cent of traded volume in Europe. Further, iX plans to develop a pan-European blue-chip and high-tech market. The prospect of these markets will be even better if the co-operation between iX and Nasdaq is carried out.

Finally, it should be mentioned that functional pan-European second-tier markets exist. In 1996 EASDAQ was set up primarily by the European Association of Securities Dealers (EASD) but with support from the European Commission.<sup>104</sup> EASDAQ functions as an exchange for growth companies which can be either IPO's or companies already listed on other exchanges wanting an additional listing. Especially within the last few years EASDAQ has had less success and its position is threatened by the latest mergers, especially the merger between Frankfurt and London.

As seen from the above mentioned Germany has a unique position in relation to the other Baltic Sea Countries, which have not been able to develop a second-tier market. As the other Baltic Sea Countries have many growth companies there seems at least theoretically to be a basis for the establishment of such markets. Especially with growth companies it will often be essential with local knowledge and this speaks in favour for establishing one or more markets in the Baltic Sea Region.<sup>105</sup> Co-operation in this field may have many forms. It could either be co-operation on the establishment of many national second-tier markets set up by the existing exchanges which like the Euro NM can cooperate on different levels. The fact that the second-tier markets are set up by the main markets themselves may, however, give the second-tiers market the unattractive status as a market for companies failing to meet the criteria for listing on the main market.<sup>106</sup> Another possibility is to create a new common second-tier market. The stock exchanges in the small Baltic Sea Countries may in the future develop (de facto) to become second-tier markets as the large blue chip companies may move to other large stock exchanges.

No matter which model is used one must consider what rules should be in force for listing on the second-tier markets. The trend seems to be listing and disclosure requirements that are up to main market standards.<sup>107</sup> Furthermore, it must be considered whether it is possible to adjust the regulation to that of the listed companies. For example the fact that there are many high tech companies may give grounds for a special regulation,<sup>108</sup> and thereby further a specialization of the second-tier market. Another question which must be considered is a regulation of cross-listing as in many cases this will be an attractive solution for growth companies.

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<sup>103</sup> Cf. *Peterson*, article in *The Investment Dealer's Digest*, 6 March 2000.

<sup>104</sup> See further *Licht* (1997) pp. 48-52.

<sup>105</sup> Cf. also *Steil* in *TemaNord* 1999:576, p. 24.

<sup>106</sup> Cf. *Röell* in *Ferrarini* (1998) p. 220.

<sup>107</sup> Cf. *Röell* in *Ferrarini* (1998) p. 221.

<sup>108</sup> See the bulletin regarding investor protection in the New economy released by IOSCO technical Committee, May 2000.

It is not possible to point out certain solutions regarding co-operation on second-tier markets. It must be taken into account that in Europe there have only been few (successful) examples of co-operation in this field and the question is whether there is room for more than one second-tier market in Europe. If that is the case the German Neuer Market is in a unique position.

#### **5.4.7. “Mergers” between stock exchanges**

The co-operation on the establishing of EuroNext and iX is sometimes considered mergers. To a certain extent it can be seen as an extended co-operation but the word merger covers in this case different kinds of co-operation as different elements are covered by the co-operation. For example clearing and settlement fall within EuroNext but not in iX. Furthermore, a rule harmonization is an element of iX, but it seems not to be covered by EuroNext.

The just mentioned alliances and Norex are based on the assumption that the participating national stock exchanges will continue to exist. However, the question is whether the market development will result in fewer or maybe only a couple of exchanges in Europe. In that case most of the stock exchanges in the Baltic Sea Countries cannot expect to “survive”. So far there is no evidence for such a development but there are already some national exchanges which are under pressure due to lack of trade. However, no stock exchange has yet closed down. Many other arguments could be mentioned for a need for local stock exchanges.<sup>109</sup>

In connection with establishment of the extended co-operation which are known as mergers some legal complications may arise. As mentioned in Section 5.3 the term merger conceals some different legal constructions. But it is common for them that a change of ownership of the stock exchanges may sooner or later occur. Implementation of the necessary adjustments of the ownership structure is in itself very difficult, but apart from that it is often complicated by nationalistic and political interest which will obstruct the change. A “merger” may be seen as one stock exchange taking over another stock exchange. Likewise it may be feared how many activities will still remain at the national stock exchanges. Such worries have been expressed in the daily press in connection with the establishing of iX and EuroNext. One result may be legal constructions where the cooperating parties are granted extensive veto rights and complicated agreements on distribution of payments and receipts.<sup>110</sup> Such political and legal complications may seriously hamper any co-operation or alliances within the securities markets.

### **5.5. Preliminary conclusion**

It is pointed out in the previous section that a possible stock exchange co-operation within the Baltic Sea Region may most likely only include Sweden, Norway, Denmark, Finland, Estonia, Latvia and Lithuania, and maybe Iceland from outside the region.

If any co-operation is going to be a successful platform for the Baltic Sea Region certain prerequisites must be fulfilled. However, on the other hand even if such prerequisites are fulfilled there is no “guarantee” for a success of the market in the region.

First of all it is of great importance to note and accept that the future development of the securities markets in the Baltic Sea Region to a large extent is depending on the development in

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<sup>109</sup> Cf. *Steil* (1996) p. 60 and *Onando* in *Ferrarini* (1998) p. 230.

<sup>110</sup> As an illustrative case study see the discussion of GLOBEX co-operation in *Lee* (1998) pp. 77-87.

other parts of Europe and globally. The driving forces in the process will be the participants in the market including investors, issuers, professional intermediaries, and the stock exchanges. Investors and intermediaries *must* find it attractive to invest in the Baltic Sea Region and to make such investments by trading at the stock exchanges. Issuers *must* find it attractive to raise capital through listing of stocks and other kind of securities, and the stock exchanges in the Baltic Sea Region *must* be deemed attractive and reliable in comparison with other exchanges.

The legislators will play a role in this development, too, as they may create the legal environment to facilitate the development of a Baltic Sea Market. The privatization of the stock exchanges is an example hereof as it gives the stock exchanges room for a commercial approach. But more reforms of the regulation of securities markets may be necessary as prerequisites for the development of further co-operation between stock exchanges in the region. In this respect at least the following must be emphasized:

1. As pointed out any co-operation means that the participating stock exchanges will have to use the same trading system including having common rules on transparency in trade. But there is a need for developing common rules and regulation in other respects. This is especially the case with respect to prospectus and disclosure requirements including accounting standards and transparency in ownership. These issues are key elements to investor protection and are of great importance for international oriented investors and professionals that should be given the opportunity to evaluate listed companies in the region based on the same kind and amount of information. Common rules may lower the cost of analysing Baltic Sea Region and the companies listed there. Further, there is a need for common or at least to some extent common regulation on take over bids, insider dealing, and market manipulation. Another question is: What is the substance of the regulation?
2. With respect to the regulatory power and competence a combination of statutory based regulation and a more flexible self-regulatory system must be recommended. Basic principles and fundamental requirements are suggested to follow direct from the law. Detailed regulation with the need for flexibility due to rapid changes in the market may be set up by some kind of self regulatory organization including stock exchanges. Common standards and adjustments to a possible international standard may be achieved by coordination between the national regulators or by the creation of a regional self regulatory body. But it has to be emphasised that irrespectively of the regulatory structure efficient enforcement of all kind of rules must exist. Likewise efficient supervision of the markets and its participants must exist.
3. On the contents of the regulation it must be noted that at least all the requirements in the EU directives must be fulfilled. But it must be noted that some of this regulation is outdated and today a regulatory competition exist within the securities market. There is no doubt that the standards required at major internationally oriented markets are higher than what follows from the directives and from the existing regulation in some of the Baltic Sea Countries. Due to the international competition and pressure we predict that the regulatory standard to be applied in a Baltic Sea Region will be a race to the top and not a race to the bottom.
4. As just mentioned a key element of securities regulation is efficient supervision of the market and enforcement of all kind of regulation. If co-operation within the Baltic Sea

Region is going to be carried out, a more extensive co-operation between the supervisory authorities in the participating countries is needed. But a prerequisite for effective supervision at a regional level is that the involved countries have an efficient and well functioning supervision of their own domestic market.

5. Finally, we would like to emphasise without going into details that an alliance also may deal with other issues, including a discussion on how to establish a clearing and settlement system that facilitate and support a common trading system and market created through an alliance between stock exchanges.

Even though different types and structures of co-operation exist or may be expected to develop in the coming years, today, Norex may be seen as the only realistic type of co-operation that in the short run may be suitable for the development of a common market in the Baltic Sea Region or parts hereof. This conclusion is further supported by the fact that most stock exchanges in the region already is part of Norex or have signed a letter of intent be part hereof.

## 6. Is internationalization a threat or a blessing?

### 6.1. Introduction

When discussing capital markets it is important to distinguish between two different issues. One can discuss:

1. Capital markets as such
2. Stock exchanges

What is a capital market? A capital market is best defined by its functions. Capital markets have two main functions:<sup>111</sup>

- To reconcile agents with a financial deficit and agents with a financial surplus, that is to transfer funds between savers and users.
- To facilitate the rearrangement of financial assets and liabilities (which among other things involves a redistribution of risk).

For legislators the task is to ensure macroeconomic efficiency. Rules and institutions should ensure that capital is allocated efficiently. There are many important questions here. Among these should be mentioned:

- How to ensure that capital is allocated to those companies who can use it most efficiently.
- How to ensure that the market for corporate control functions in such a manner that stock owners can replace inefficient managers.
- How to ensure that tax rules do not create locking-in effect that keeps stocks from being traded and capital from being paid out from companies when other companies can use it more efficiently.

In this section we will argue that the international development clearly is moving in a direction that leads to larger efficiency in individual countries, seen from a macroeconomic point of view. The international development is not a challenge. On the contrary: it is a gift.

What is a stock exchange? “Essentially a stock exchange is a market where specialized intermediaries buy and sell securities under a common set of rules and regulations through a closed system dedicated to that purpose.”<sup>112</sup>

According to this definition a country might have several, one or no stock exchanges. A stock exchange is basically a business (not all stock exchanges are limited companies, but the trend is definitely in that direction). Individual stock exchanges face major challenges in the coming years. A stock exchange has two main functions:

- It regulates listed companies, prospectuses, the flow of information etc.
- It is a trading place.

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<sup>111</sup> According to *Rose* (1992).

<sup>112</sup> Cf. *Michie* (1992) p. 662

National stock exchanges face clear threats in these years. The challenges – or threats – mainly come in the second area, the trading place.<sup>113</sup> The coming years will bring alliances, joint ventures and mergers that can “steal” trade from other exchanges. Furthermore new competitors are entering the scene. Trade does not necessarily take place on a stock exchange. During the last years so-called “alternative trading systems” have appeared. Participants (normally institutions and traders) can trade electronically. The distinction between stock exchanges and “alternative trading systems” is a fine one.

The point is that alternative trading systems very easily might end up conquering a large part of all trade in stocks. Instinet and Tradepoint are examples of alternative trading systems.

However it is important to note that these threats to “old” national stock exchanges are not necessarily a threat to national economies as such. The question is complicated but it is probably fair to argue that the threats to local stock exchanges are a gift to the economies as such. The local stock exchanges are threatened because better alternatives for trading are emerging.

## **6.2. Stock exchanges and political interest**

Many national exchanges came to existence at the initiative of the government. Some of them were started several hundred years ago. At that time information problems, natural monopoly problems and capital problems made it natural for governments to take the initiative in this and many other areas. However it might be relevant to mention how the expression “Laissez Faire” came into being. Colbert, Finance Minister under Louis XIV and the effective father of mercantilism, called together a group of businessmen and asked what the government could do to promote trade and industry. One of the businessmen then allegedly answered: *Laissez faire. Laissons nous faire.*” (Don’t do anything. Let us do it”). In many areas that is an even better advice nowadays than it was originally.

Today, governments and legislators still have a tendency to take special interest in the financial sector in general and in the stock exchange in particular.

Stock exchanges are “hot” in the political debate. Policy-makers have a tendency to take many initiatives in this area and are less willing to leave this area to the market forces than many other areas of the same or greater importance. The Nordic Council of Ministers (Nordisk Ministerråd) has investigated the need of increased co-operation between the Nordic stock exchanges and the stock exchanges in Estonia, Latvia, and Lithuania. As late as 1998 a report with the title “Prerequisites for Increasing Nordic and Nordic-Baltic Stock Exchange Co-operation” was written on the initiative of the Nordic Council of Ministers. The Nordic countries consist of Denmark, Norway, Sweden, Finland and Iceland. The Baltic countries consist of Estonia, Latvia and Lithuania. The report was published in 1999.<sup>114</sup> Theoretically four reasons exist for making a new report:

1. Nordisk Ministerråd (1999) was not good enough.

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<sup>113</sup> Theoretically some companies may delist from one stock exchange in favour of another, but that is not very likely, given the small costs of being listed on a given stock exchange and the inconvenience it may have to move.

<sup>114</sup> Cf. TemaNord 1999:976.

2. Nordisk Ministerråd (1999) covered another geographical area than the Baltic Sea Region, as it was limited to the Nordic countries and the Baltic countries, while this report also covers Poland, Germany and Russia.
3. Nordisk Ministerråd (1999) focuses on others areas than our report are supposed to cover, i.e. differences in commission.
4. Things have changed within the last year due to the very fast development in the stock exchange area.

In general we find that the authors of Nordisk Ministerråd (1999) did a very competent job and by and large we subscribe to most of the conclusions in the report as far as they go. The geographical area is different and this we have already commented on earlier in this report. The commissions are in some ways different but not that much. There is no doubt however that the evolution is very fast in this area and this fact may make it necessary to review the sector very often. In May 2000 the three Baltic stock exchanges in Tallinn, Riga and Vilnius signed a letter of intent to join the Norex Alliance just as Oslo did in November 1999 and Reykjavik did in March 2000.

A natural question to ask is how important national stock exchanges are from a macroeconomic point of view. Stock exchanges are businesses. But seen purely as businesses they are rather small, no matter whether we measure size by employment or by profit. Neither the public, the press, nor the legislators would show the same interest in other businesses of the same size. The answer given for the interest is that stock exchanges have a very large influence on the rest of the business community. The main interest lies with the companies using the stock exchange as a source of new equity, but apart from that there is also interest in the income local banks and brokers derive from trading stocks. In other words, the hypothesis is that there are significant positive "external economies" to the individual country dependent on the efficiency of the local stock exchange, and therefore, politicians should take a special interest in stock exchanges.

It is difficult to judge exactly how large these external economies are. But there is reason to believe that they are exaggerated and getting smaller every year. One reason is that competition creates alternatives to the traditional monopolistic national stock exchange. The public should be most interested in the local stock exchange when it was a monopoly and when the government had large power as to regulation. As a matter of fact the situation has been quite different. As to regulation, the situation is that the power of the individual government to regulate has been going steadily down. EU and the market forces combined have done that governments and stock exchanges have very limited degrees of freedom with regard to regulation, compared to the situation 20 years ago. As to the monopoly question, the interest in national stock exchanges has grown in connection with increasing outside competition. The big problem for stock exchanges is that companies and investors might want to go elsewhere and not use the local stock exchange any more. Of course that is a problem for an individual stock exchange as a business but for companies and investors who have used the stock exchange it is not a problem; it is a solution. Historically, European companies have had limited possibilities of finding alternative markets where their stocks could be traded and where they could raise new equity. But internationalisation and new electronic trading systems have diminished the importance of local stock exchanges. New alternatives have risen.

#### **An analogy to the stock exchange industry: The telephone industry**

Until in the 90's many national telephone firms had a local monopoly. If agents in the economy wanted to have a telephone they had to buy the services at the national telephone firm. The



national telephone firm's objective was in some sense to benefit society. However, in the 90's many national telephone companies were privatised. During that period there was at debate whether this service should be owned by the public sector or the private sector and the potential threat of foreigners taking over the national telephone firms. They were incorporated and as public companies their stocks were traded at the (national) stock exchanges. The objective of listed companies is not to benefit society but to create shareholder value. After the privatisation of the telephone firms there has been a number of cross-border acquisitions and mergers within the telephone industry – not per se to benefit society but to benefit stockholders. As a concrete example: Today the company Ameritech has a dominant shareholding in TeleDanmark, which has several large holdings in other national tele companies. Today most people in Denmark do not have special preferences for being customers at TeleDanmark and few people think of whether TeleDanmark, Telia and so forth are Danish or not. In stead they focus on value for money: Where are they able to get the services at the lowest costs. This story tells us:

1. It is not necessarily a problem that a former national monopoly is taken over by a foreign corporation. If foreigners are better at this type of business, and agents in the economy gets the services at lower costs, what is the problem?
2. The objective of public firms is to benefit shareholders, not society. That means that after a former national monopoly has incorporated, the objective is to take care of shareholders interests.

Therefore the possibility exists that legislators take too large an interest in the subject of stock exchanges as such. Of course this is a truth with modifications. Especially in countries in transition one might argue that these countries have not yet reached a stage where the alternatives are satisfying and that legislators should take an interest in creating the necessary regulation for the stock exchange to work. But the general tendency is that the efficiency of the individual stock exchange has less and less importance for the country in question due to increasing international competition. In later years the “danger” of domestic stocks primarily being traded elsewhere has been debated. For instance Sweden had a period where much of the trade in large Swedish companies took place in England where the so-called SEAQ-International conquered a large market share of trade in non-UK stocks. The Swedish stock exchange has since won most of this trade back. But the point is that Swedish firms (or more precisely their stock owners) did not necessarily feel it as a problem that the trade took place in London.

A popular saying is that the financial infrastructure is becoming ever more important for a country. The summary of the report ”Prerequisites for increasing Nordic and Nordic-Baltic Securities Co-operation” starts with the following sentence:

”In connection with this decision the Ministers noted: that the significance of the financial sector and the relevant financial infrastructure for the economic development of a country has increased.”

This quotation, though speaking of the financial sector in general, of course is referring specifically to the stock exchange. And one might with more right say exactly the opposite: the significance of the financial sector and the relevant financial infrastructure for the economic development has decreased.

If we look at the most dynamic sectors (fast growing sectors as e.g. sectors combined with the internet sector, biotechnology and research) we see a tendency for financing from sources outside

the country in which the company is placed to play an increasing role. One should note that no data exist to prove this hypothesis which is based on our impressions of the development but we feel reasonably sure that the tendency is as we have said.

### **6.3. Internationalisation and small and medium-sized companies**

One of the functions of capital markets is to lead investments to the sectors where the return on capital is highest. In connection with the development of the capital markets (including stock exchanges) there is reason especially to discuss small and medium-sized companies. Now “small and medium-sized companies” is a very imprecise expression. The definition depends very much on the speaker and the connotation. Companies that people from Denmark, Iceland or Lithuania might find rather large, will be considered as “small-cap” by Germans. However, we will not make a precise definition.

Empirical observations indicate that small firms have higher cost of capital than large companies. The classical source is Ibbotson who finds that over a long period stocks in small American firms have given higher returns than stocks in large firms. For the period 1926-96 small companies had an average yearly return 5 percentage points above that of large companies.<sup>115</sup>

Furthermore a widespread theory is that two factors, internationalisation and institutionalisation, will lead to even higher relative cost of capital costs for small and medium-sized companies. For instance FESE writes:

”Paradoxically, the institutionalism of the market leads to a problem of financing small and medium size enterprises. This happens because institutions tend to invest in larger companies, leaving smaller companies dependent on other sources of financing which often prove to be more costly.”<sup>116</sup>

There is little doubt as to the long run tendency for institutions – mostly pension funds – to increase their relative share of the value of all stocks. Both due to fear of the ability to raise taxes and to a general tendency of aging populations in the Western countries, governments want future pensions to be funded. In countries with a tradition for funded pensions the combined assets of pensions funds are about 100% of GDP. In the coming years most European countries will move in the same direction.

Also there is reason to believe that pension funds, when they invest outside their country of origin, have a tendency to invest in large companies. Therefore, one cannot rule out that small and medium-sized companies have had their stock price depressed in the later years due to the tendency of pension funds (and other investors) to invest internationally.

Because of the factors mentioned above several governments have tried to take initiatives to help small and medium-sized companies. Among these initiatives are support for stock exchanges for so-called “small-cap-companies” (companies with a relative low market value or “capitalisation”). However, little reason exists for such initiatives.

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<sup>115</sup> Ibbotson Associates: Stocks, Bonds, Bills and Inflation 1997 Yearbook. Chicago.

<sup>116</sup> Federation of European Stock Exchanges: Overview. 1999.

It is difficult to imagine that markets will not react on price changes and that it can be a long term equilibrium that stocks in small-cap-companies gives a very high return compared to stocks in larger companies. A possible equilibrium might be that pension funds (directly or indirectly) invest in small and medium sized companies locally and in large companies globally. They would have an information advantage in investing in small and medium sized companies locally, and furthermore, they would have a possibility of corporate governance that would not exist in the global market. One might also expect personal investors with little wish of trading to invest in small and medium sized companies. These investors do not have the same wish for market liquidity as large investors. Especially they do not care whether the market is “deep”, that is if one can sell large amounts of stocks without depressing price as they do only hold small portfolios.

As a matter of fact, economists do not know that much about the “small firm effect”. Historical numbers might be misleading as a guide to the future and the small firm effect might be due to other factors, for instance differences in risk.

But what is more, even if the internationalisation and the institutionalisation should lead to increased cost of capital for small and medium sized firms, little reason exists for public initiatives. If investors demand a higher expected return from investing in stocks with little liquidity then this is an equilibrium. A common misunderstanding is that the low liquidity in stocks in these companies is due to a market failure at the stock exchange. On the contrary: the technological revolution has made and will continue to make it easier and simpler for all buyers and sellers of stocks to come in contact with one another. Low liquidity for stocks in small companies is not due to market failure at the stock exchange. Liquidity is low mainly because the market capitalisation of the companies is low.

As shown in Section 3 and appendix 1 5% of the companies on the individual stock exchanges stands for 50-80% of the total market value of all companies on the stock exchange. It is no wonder that stocks in companies with market values below maybe 200 million USD are not very liquid. No reason exists why shareholders should trade their stocks very often. In small companies the inevitable conclusion is that the market for their stocks will be thin. And seen from the point of view of society that is quite healthy. Why should market makers and stock analysts use a lot of time analysing a company when the interest for actual trade is limited? No public initiative can change this and it would be harmful to try to do it.

Furthermore, there is reason to believe that the problem is exaggerated. The market will find alternative ways to trade stocks in these companies. Markets may be organised with trade only on some days for small companies to obtain liquidity (the first Monday in the month). After all that is the original method of making a market work. An alternative is to create holding companies owning shares in several small companies, thus making stocks in the holding company liquid.

#### **6.4. Alternative scenarios for the European trading industry**

What are the future prospects or possible choices of the existing stock exchanges?

- The existing stock exchanges can continue as they are. Some of them would probably de facto loose the large cap stocks to other trading systems. They would still be regulators

and take care of information, but as to trade only small and medium-sized companies with little interest for foreigners would be traded on these stock exchanges.

- The existing stock exchanges can cooperate or merge with other exchanges.
- Finally, of course a possibility exists that many of the national exchanges as trading places may become obsolete because of new electronic trading systems offered on a regional or global basis.

A decrease in the number of national stock exchanges must be expected in Europe. However, it is very hard to predict both number of dominant stock exchanges in say 5 or 10 years time and which exchanges will be in alliance with which. History has told us that many experts have been taken by surprise by the evolution until now.

One scenario is that we will see a major co-operation/merger boom and that this process will end up with say e.g. 3 major stock exchanges in Europe. This evolution is comparable with the historical shift from many local exchanges within one country to one national exchange (often located in the capital) as we have witnessed in many countries.

Another scenario is that the existing stock exchanges are too slow to react to investors needs. New pure electronic exchanges take over by setting up a platform offering trading, clearing and settlement for the world largest X companies or a region's largest Y companies e.g. Jiway. In this scenario the new exchanges or alternative trading systems do not form alliances or merge with existing stock exchanges. They just (try to) take over the trade. They will succeed if they are able to offer higher liquidity implying the same or lower costs and/or spreads. Different corporations could continue to be listed at the local exchange. This scenario is comparable with the evolution of the offshore markets as competitors to the individual domestic capital markets in the 60's and onwards where offshore markets developed because they were subject to fewer restrictions and/or incurred lower transaction costs and/or could handle larger amounts than domestic markets.<sup>117</sup>

A third scenario is that at least some stock exchanges are too slow to react. The large cap firms might then either have dual listing or be delisted at the existing exchange and be listed at another exchange.

In the long run Norex does not seem large enough to survive in its current form. If the current members continue their alliance it must form a co-operation or merge with other stock exchanges. However, legislators should not interfere with this but leave it to the stock exchanges.

#### **6.4.1. Can national stock exchanges survive as specialised exchanges?**

One reason for having specialised exchanges is that there are special problems involved in the valuation of the stocks e.g. dot.coms. One could think of a potential specialised exchange for small cap companies where there might be economies of scale in information gathering if the companies were to follow certain rules regarding accounting etc. We have witnessed both types of specialised exchanges but it is hard to see how e.g. a Finnish stock exchange could survive as a special exchange (apart from small and medium cap Finnish corporations but that is hardly what most people understand by specialised exchanges). Both Finland and Sweden are well represented within the telecom industry, but is not likely that these stock exchanges could survive as special telecom exchanges. The main argument for setting up a specialised exchange is that this exchange has found its niche where it has some special knowledge or comparative advantage

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<sup>117</sup> Cf. Rose (1992).

compared to other (national) exchanges. This means that the exchange is able to reap economic gains and that potential corporations from other countries would wish to be listed on this exchange. We have not been able to see within which of the existing areas some of the current stock exchanges in the Baltic Sea Region have a comparative advantage resulting in a specialised exchange.

### **6.5. Divorces and stock exchanges**

If we look at the EU there has been a slow but consistent development in the number of members. No country (except for Greenland) has left the EU but several countries have joined. There has been little doubt as to what countries were prospective members. In the agreements there has never been a contract determining what should happen in the event that a country wanted to leave. The EU has been a "Catholic Marriage". It is important to notice that stock exchange co-operation until now have had the character of being "Protestant marriages" or engagements. Marriages are being agreed upon and shortly after the partners may leave each other because a better partner has appeared or the partners have found that their characters are not mutually compatible. There is no reason to expect complete fidelity nor is there any reason to wish for it. Estonia, Latvia, and Lithuania might wish at a later time to be "wed" to the German stock exchange. Finland might join the Norex even if for the time being it has signalled that it wants to cooperate with Germany.

It makes good sense to make "marriage contracts" which specifies who is to pay what if a partner leaves the others. But there is no reason to try to bind partners together in an eternal union. A world of difference exists in this area and in the area of EU.

That is another reason why legislators should interfere as little as possible in these questions. The political process is rather slow and a consensus once obtained can be very difficult to change even if good arguments exist to change earlier decisions.

### **6.6. Regulation and macroeconomic efficiency**

Legislators and other policy makers have a major influence on the efficiency of the capital market. Here we shall only discuss one question:

Does national tax rules ensure optimal capital allocation?

Efficiency demands among other things that:

- Companies pay stock owners the money they cannot invest profitably.
- Stock owners sell stocks if they have a higher value for other investors than they have for themselves.

In both areas tax rules can be a hindrance for optimal allocation.

In many countries tax rules "punish" dividends. They are taxed by a higher tax rate than unrealised capital gains on stocks.

It is interesting to see that companies do not pay out high dividends. The average dividend ratio (dividend in per cent of the market value of the company) is today only about 2% and this percentage has been falling for many years. Tax is not the only reason for this, but nonetheless the numbers give food for thought.

In some countries capital gains are taxed when realised. This makes trading expensive as trade will lead to a tax payment that could be postponed. In many countries this “hidden transaction costs” dwarfs the transaction costs on the stock exchange.

Tax is still one of the areas where legislators have some control. As mentioned earlier, in the area of regulation the degree of freedom has become rather limited due to external pressure.

## **6.7. Preliminary conclusions**

In this section we have argued for the following conclusions, seen from an economist’s point of view:

- It is important to distinguish between integration of capital markets and integration of stock exchanges. Capital markets are already to a large extent integrated whereas we have only seen the beginning of stock exchange integration.
- Legislators take too large an interest in stock exchanges, given the macroeconomic influence of the efficiency of stock exchanges in the individual country.
- The importance of the efficiency of local European stock exchanges has probably been falling for several years and that tendency is going to continue. The reasons are that alternative providers of equity have emerged and alternative trading possibilities have been announced and that the efficiency of national stock exchanges has grown fast.
- The effect of internationalisation on small cap companies is very uneven. For traditional (old economy) small cap companies with low growth opportunities the problems might possibly become larger as large institutional investors increasingly prefer large cap companies. On the other hand small cap companies with high growth opportunities (new economy) have rather easy access to equity capital and relevant alternatives to going public exist. The reason is of course that they are no longer limited to a local capital market that may have limited ability to judge the quality of these companies. International venture capital and cross-border investing by existing companies are increasing in influence.
- No obvious optimal stock exchange regions exist nor are there any reason to have firm expectations as to how many stock exchanges will exist in the future or what regions they will encompass.
- The Baltic Sea Region may in no way be described as an optimal or even logical region as far as stock exchanges are concerned. The stock exchanges in the Baltic Sea Region are quite different.
- One should avoid “Catholic marriages” between stock exchanges because the future optimal structure is very unclear. Co-operations will change and stock exchanges will form new alliances and break old ones. This makes political interference rather undesirable because it will put a value on co-operation with old partners in other areas.
- The existing Norex agreement seems very natural, given the situation today. Depending on the development new partners might join the alliance. But no special reason exist for the next partners to be the other Baltic Sea Countries.

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