

# Benefits from securities markets and reforms in Norwegian securities legislation

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**This article discusses the ways in which efficient securities markets benefit society, how Norwegian securities market legislation is being modernised to be in line with European standards, and in addition issues related to changes in Norwegian securities market infrastructure. In the first section the social usefulness of securities markets is explained. The most important aspect of this is that smoothly functioning securities markets, together with a well developed financial sector, promote growth throughout the economy. Through the direct transmission of funding from investor to projects, securities markets also contribute to financial stability. The second section deals with amendments to Norwegian securities markets legislation that are under way. Special attention is paid to the European Economic Area and its implications, including the requisite transposition of EU legislation into Norwegian law. The third section discusses the specific tasks performed by the stock exchange and comments on whether the infrastructure organisations of securities markets need to be domestic in order to reap the social benefits of securities markets.**

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## 1. The social functions of securities markets

### *1.1 Seven benefits*

A money economy with access to interest-bearing loans enables the individual to distinguish between income and consumption flows. This encourages capital accumulation, which means that housing projects and investment in production equipment take place at an earlier point in time, thus increasing the stock of real capital in the economy. Investment must be based on predicting the future, and involves elements of risk. Credit is only widely available when the risk factors are managed by a developed credit intermediation system (mainly banks) in which there is sufficient confidence. Very large, high-risk investments are difficult to finance, even for a bank, because the level of risk may be unacceptably high. However, it may be easier to acquire equity capital for such projects if a number of private participants join together, each with limited ownership interests. Furthermore, loans for large projects can be raised if the loan is divided between several lenders (including banks).

Division into interests makes it possible to carry out large projects because the risk and investment are spread between several participants. Equity and lender interests can be standardised as tradable shares and bonds respectively. This reduces the financial costs, since those furnishing the funds require lower compensation because they are able to withdraw the funds when the need

arises. An investor can do this by selling securities in secondary markets, but in order to function smoothly, such markets require adequate information and general trading rules governing execution, priorities, etc.

Through securities markets, the risk associated with a particular project is spread and borne directly by the investors. If financial institutions were to fund the project, a large part of the risk would be concentrated in these institutions, but when securities are issued and the risk is directly borne by the investors, this relieves the financial sector of financial risk. In this way securities promote financial stability.

The specific role of securities markets in the economy is to streamline the issue and sale of

- ownership interests in a company, such as shares
- loans to a company or project, such as bonds

by issuing standardised shares and bonds in the form of securities and by organising and centralising the trading of securities in a single marketplace with fixed rules. Through the securities market an unspecified number of participants can become shareholders or bondholders in an undertaking under standardised conditions. After the securities have been listed on the stock exchange, the organised market, shareholders and bondholders can sell their shares and bonds in a secondary market. Securities may be sold to anyone and without consultation with the company that issued them.

The standardisation of contracts and information requirements governing these transactions enable the investor to choose the degree of risk exposure for a particular project. The investor can also impose a required

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rate of return in relation to risk, and the investment decision can be reassessed by selling securities. This ensures that capital markets channel capital to projects with the highest return. A share in a company entails the right to share in the profits and to exercise a certain degree of control. In efficiently functioning securities markets the price of claims and shares in the company reflects the information available about the company. A company with a high expected return will be able to finance its expansion by raising capital in the market.

Thus far, five benefits to society to be derived from an organised financial system involving securities have been described:

- Credit in the private sector increases the stock of consumer and real capital.
- Project-sharing spreads risk and makes large, high-risk projects possible.
- This relieves the financial sector of financial risk and promotes financial stability.
- Competition to generate a return results in the best projects being financed.
- The standardisation of securities claims reduces the credit intermediation costs.

This also applies wholly or partly to other types of financial claims, and the social benefits of securities are similar in many ways to those of other financial claims. This similarity means that the boundaries for the form selected change; for example there is competition between bonds and syndicated bank loans. Banks can finance lending in the bond market by securitising assets. Securities are traded in regulated markets, but if other capital or credit intermediation at a particular point in time is considered to be more secure, cheaper and more efficient, this will be preferred. The costs of securities trading are partly determined by costs incurred in the payment and settlement system, the stock exchange and the stockbroker system.

An important consequence of the fact that securities markets offer a number of different standardised equity and lender shares for investment is that an investor can have a diversified portfolio of securities in different companies. Since companies face different risks, a diversified portfolio reduces the risk for the investor. The possibility for an investor to diversify also has social benefits, since it means that a larger number of participants will be willing to invest in high-risk projects with high social returns, enabling the project to acquire equity and loan capital. A further benefit is that investors can themselves choose the degree of exposure to risk they are willing to bear. In practice this is done by hedging different types of risk (exchange rate, interest rate, commodity prices, risks to life or objects: non-life or life insurance).

In addition to the five benefits mentioned above, an organised financial system for securities has the following two advantages:

- By providing opportunities for diversifying and reducing risk, securities markets provide safer saving for those with excess capital.
- Smoothly functioning financial markets, including securities markets, promote long-term economic growth.

## *1.2 Factors that contribute to economic growth*

We have argued above that smoothly functioning financial markets have a positive effect on long-term economic growth: they encourage division of labour and specialisation because transaction costs are lower. This reduces information costs and promotes appropriate allocation of resources, since projects are evaluated in connection with the provision of equity and loan capital. This makes it possible for both savers and entrepreneurs to manage the risks, and promotes transparency in the way the company is managed and a certain degree of control over the management. In this way the financial system encourages saving by making it safer, and promotes specialisation, leading to technological advances in the production of goods and services. Since priority is given to projects with a high degree of product development, such a system increases innovation and growth in the economy.

These effects were empirically verified in a survey by Levine (1997). The survey includes studies comparing different countries and examines particular sectors and the liberalisation of the financial sector in particular countries. He found a significant relationship between long-term economic growth and a well developed financial sector. This is supported by other studies controlling for other factors that contribute to economic growth. Thus there is empirical support for using the existence of a well developed financial sector as an indicator that the country will have a high growth rate later. Comparative studies of economics history that do not use econometric methods also support this conclusion.

The survey shows that we do not know precisely which parts of the financial system are decisive for economic growth, or how the growth-promoting factors act in the different phases of the process from an agricultural economy via an industrial economy to a mainly service-producing economy. Levine mentions in particular that there is no theoretical or empirical answer to the question of whether growth-promoting factors vary systematically with the structure of the financial system (i.e. whether the system is bank-dominated, as in Japan or Germany, or market-dominated, as in the UK and the US). Nor is it possible to distinguish between the contribution made by securities markets and that made by the rest of the financial sector. However, on the basis of the various functions in the financial sector, it seems reasonable to assume that modern and efficient financial

institutions and an efficient securities market both promote growth.

Levine (2005) maintains these conclusions even when taking account of the extensive research activity that has taken place since 1997. He adds that no one has examined whether growth can take place when a country imports all financial services or whether national production of these services is needed to achieve the beneficial effects.

## 2. New Norwegian securities markets legislation

The Securities Trading Act and the Stock Exchange Act play a central role in the regulation of financial markets in Norway. Sound legislation in this area promotes efficient and knowledge-based allocation of capital. These acts were passed in 1997 and 2000 respectively and have generally functioned well.

During the last two years the Ministry of Finance has held five consultation rounds on securities trading rules in Norway, and has recently proposed completely new legislation. It may seem strange that such a comprehensive process has been set in motion to amend legislation that functions well, but the reason is, as explained in Box 1, that Norway is obliged to do so through the EEA Agreement. Thus, the work in the EU on improving the functioning of the single market for financial services in the EEA has made it necessary to adopt amendments, especially in the structure of the Norwegian acts.

### 2.1 New EEA legislation

The purpose of the European Commission's Financial Services Action Plan (2000–2005) (FSAP) was to realise more of the growth potential of an integrated and efficient financial market, and FSAP was expected to make a considerable contribution to growth in GNI. The plan pointed out that it was a major problem that it took so long to develop Community law, and that legal acts (directives and regulations) were out of date before they were adopted. The problem is particularly great when developments in the market made details of the rules inappropriate or inapplicable. The provisions of the EU Treaty relating to Community law do not distinguish between the modification of technical details and decisions to adopt new legislation for previously unregulated areas. In order to improve the functioning of the markets a procedure has been developed that will, within the framework of the treaty provisions, allow for a more dynamic legislative process, and ensure that decisions on new framework principles are taken under satisfactory and transparent conditions. The procedure makes it simpler to adapt the technical implementing measures to new developments in the market. This ensures that rules continue to be applicable when new

products or financing techniques are introduced.

The new procedure has four levels. Level 1 is the level at which legal acts (directives and regulations) are adopted by the European Parliament and the Council of Ministers in accordance with the rules set out in the Treaty. At this level the framework principles are decided and the authority to determine the technical implementing measures for the legal acts adopted by the Commission is delegated. Level 2 refers to the implementation measures enacted by the Commission through specific comitology procedures. The observers from the EFTA countries in these committees are able to participate and put forward comments and proposals, but they do not have the right to vote. At Level 3 common supervisory standards are developed and legislative proposals to the Commission are drafted. This work is done in committees in which supervisory authorities (and central banks for banking) participate. Since these committees are advisory they do not vote, and the EFTA countries are full members.

When these procedures were initially agreed, it was understood that legal acts would be developed in transparent processes and in extensive consultation with market participants. The cooperation both at the supervisory level and between finance ministries would contribute to equal and simultaneous implementation of legislation throughout the EEA. Norway's participation in this work and in the intensified cooperation on supervision is useful when detailed Norwegian legislation is being drafted.

Level 4 secures correct implementation of Community law by the Member States. The enforcement is planned to be tighter in the new system. The cooperation between supervisory authorities in the various committees plays an important role in the creation of a common understanding of the rules. However, it is also essential that the Commission and ESA monitor the implementation of legal acts and if necessary take a case to the court to ensure equal implementation.

Four directives have been adopted in this new system of regulation, which have been or are being implemented in national law throughout the EEA. These are:

- the prospectus directive
- the market abuse directive
- the markets in financial instruments directive (MiFID)
- the transparency directive

In the field of securities law, a directive has also recently been adopted in which the Commission is not given the authority to issue implementing provisions:

- the directive on takeover bids

The implementation of these directives in Norwegian law is discussed below.

## Box 1: The European Economic Area Agreement<sup>1</sup>

*The European Economic Area (EEA) Agreement creates a single European market for goods and services. The agreement applies to financial services, which means that the Norwegian financial markets are fully integrated with the European markets. Thus the same rules apply to Norwegians as to all other European market participants abroad, and likewise all European market participants are bound by the same rules relating to their activities in Norway as their Norwegian competitors. The Norwegian authorities are obliged to follow the same rules and supervisory practices as their European counterparts.*

### **Background and general rules**

In 1994 Norway joined most of its EFTA partners into an organised cooperation with the EU to create a European economic area. The idea for this arrangement was a follow-up of the Single European Act of 1986. In 1989 Commission President Jacques Delors proposed a European economic area with more structured arrangements for trading and with common institutions to secure a level playing field. At this time the EFTA countries signing the agreement were Austria, Finland, Iceland, Norway and Sweden. Now that Austria, Finland and Sweden have become members of the EU, and other new members have joined both organisations, a total of 28 countries have signed the EEA Agreement: the 25 members of the EU, and Norway, Iceland and Liechtenstein from EFTA.<sup>2</sup>

The EEA is an internal market governed by common rules, which allow the free movement of goods, services, capital and persons within the area. The four freedoms strengthen trade and other economic relations and to ensure equal conditions the agreement covers competition and state aid. It does not apply to the EU's Common Agricultural Policy or the Common Fisheries Policy, but contains provisions relating to certain aspects of trade in agricultural and fish products. Nor do the EFTA countries participate in the tax cooperation within the EU. However, the three EEA EFTA states do participate in a number of Community programmes and agencies. When EFTA countries participate in such programmes, they have the same right to recruit national experts to the programme as EU

member states. When appropriate, EFTA countries may also send nationally funded experts to work with the European Commission or in relevant EU Institutions.

The national implementation of the common rules throughout the EEA is monitored by the European Commission for the EU states and the EFTA Surveillance Authority (ESA) for the EFTA states. Conflicts between national authorities and ESA may be brought before the EFTA Court in Luxembourg, which is the counterpart of the Court of Justice of the European Communities in the EU.

### **Homogeneity of markets and financial services**

The free movement of services – including financial services – is important for EEA homogeneity. This is achieved by the integration of EC legislation in the relevant fields into the EEA Agreement through a decision by the EEA Joint Committee on a legal act that has been formally adopted by the EU. Basic legal acts relating to financial services are proposed by the European Commission and adopted through co-decision by the European Council and the European Parliament. Legislation labelled implementing measures are enacted by the Commission through comitology procedures. The EEA EFTA states participate in the same way as EU member countries in the preparatory stages of the work in the Commission on new basic legislation. They are also observers in the comitology committees. However, the EEA EFTA countries do not participate from the time the Commission has proposed a legal act until the adoption by the co-decision procedure is completed.

Decisions of the EEA Joint Committee are prepared by various working groups from the EFTA states. WG FIN deals with financial services, and the Norwegian members of the group represent the Ministry of Finance, Norges Bank and the Financial Supervisory Authority of Norway. The preparations consist of making sure the legal act is relevant, identifying any national problems and clarifying whether additional time is needed for national implementation. An important aspect of this work is related to the nature of the EFTA cooperation. The EFTA member states have not transferred any legislative powers to EFTA or the EEA Joint Committee. The decisions therefore clearly state whether the rules must be approved by the relevant national parliament. In Norway and with regard to financial

<sup>1</sup> This box draws on the home pages of the EFTA, cf. <http://secretariat.efta.int/> and on the home pages of the Norwegian Delegation to the EU, cf. <http://www.eu-norway.org/about/eeaforside.htm>.

<sup>2</sup> At present negotiations are taking place on enlarging the EEA to include the two new EU members, Bulgaria and Romania.

services, it is a constitutional requirement that such approval must be obtained when the EU legal act can only be implemented through amendments to a Norwegian act. This affects the date of the entry into force of the Joint Committee decision. In the financial services area, the EEA EFTA countries and the Commission have so far agreed on which legal acts are to be integrated into the EEA Agreement.

To sum up, Norwegian participation in the development of the internal market for financial services involves membership of preparatory working groups under the European Commission. The Norwegian authorities also participate in the work of the committees at the comitology stage. There are no special Commission programmes related to financial services. However, the Norwegian authorities sometimes send nationally funded national experts to work in relevant EU institutions (e.g. the Commission, the ECB). The competent Norwegian authorities participate in the preparatory work of the EFTA working groups prior to the Joint Committee decisions relating to financial services.

### **Market consequences**

The most important question is of course the conse-

quences of the EEA Agreement for developments in the market. It is fair to say that the objectives of the agreement in the field of financial services have so far been fulfilled. The agreement secures the free participation of European players in the Norwegian part of the European market, and Norwegian participation elsewhere in the EEA. There may be problems relating to the rules regulating the EEA market, but the problems relating to the smooth functioning of the market are not related to differences between EFTA and EU states.

A large number of European players participate in the different financial wholesale and retail markets in Norway, and cross-border consolidations have taken place in almost all areas of financial services. These consolidations have been concentrated in the Nordic area, and many Nordic players wish to extend their activities, particularly to the Baltic region. Thus, market integration is likely to increase.

The cooperation between ministries, central banks and supervisors in the area began long before the EEA Agreement, and has developed in accordance with the rules of EC legislation and market needs.

## *2.2 Status of Norwegian implementation*

All the above directives have been incorporated into the EEA Agreement and must therefore be implemented in Norwegian law, and new legislation (acts or regulations) has been or is in the process of being introduced to this end. Some of the key dates and document names for the five directives are given in Box 2. The current status is as follows:

- The market abuse directive has been incorporated into Norwegian law through amendments to the general provisions in Chapter 2 of the Securities Trading Act.
- The prospectus directive has been implemented by replacing the provisions of Chapter 5 of the Securities Trading Act, which relate to prospectus requirements, with new provisions.

- The Ministry of Finance is preparing the implementation of the directive on takeover bids. The consultation round for amendments to Chapter 4 of the Securities Trading Act has been completed.
- The Ministry of Finance is also preparing the implementation of the MiFID and the transparency directive. The consultation round on a new securities trading act and a new act relating to regulated markets, or stock exchange act, has been completed.

Apart from the directive on takeover bids, these directives amend or modify rules that are already part of the EEA Agreement and have already been incorporated into Norwegian law. The directive regulates an area that has not previously been covered by Community law, but the field is already covered by existing provisions in Norwegian law concerning mandatory bids. Thus it can be said that implementing this directive will only require adjustments in Norwegian law.<sup>1</sup>

<sup>1</sup> This directive was controversial, and in order to arrive at a decision the Community rules were made more lenient than those favoured by many countries and the EU Commission. The directive provides for the authority to issue stricter rules. The Norwegian securities markets legislation committee has as explained below proposed stronger protection of minority shareholders.

The directives are part of the EU's efforts to ensure better and more equal conditions of competition in the internal market for financial services and eliminate differences in market conditions resulting from national law. Provisions are often made more precise and in many cases authority is granted to issue supplementary provisions.

In general there is a need to make at least minor adjustments in Norwegian legislation based on the wording of the directives. In many cases a good solution will be to follow the wording of the directive concerned closely and to authorise the ministry to issue detailed regulations. This is a simple way of fulfilling the obligations devolving from the directives while at the same time improving the dynamics of the legal system.

Although some of the amendments are more substantive, they have several common features:

- In many cases the requirements concerning the disclosure of information have become stricter. Issuers have a stricter obligation to provide information to the market and to publish a prospectus. There are stricter requirements for intermediaries and consultants as regards rules for information disclosure in relation to issuers and customers, for example concerning possible conflicts of interest. The rules on reporting suspicious transactions are also being tightened as part of the efforts to combat economic crime.
- Stricter requirements are being imposed on supervision of securities trading and enforcement of the rules, which have become tighter, and the supervisory authority will be able to impose administrative sanctions. The directives also require the supervisory authority to be independent. The Financial Supervisory Authority of Norway, Kredittilsynet, will therefore have the overriding responsibility for prospectus control<sup>2</sup> and will have greater authority, for example with regard to securing of evidence and information about telephone use.

The following are among the new rules:

- Investment consultancy and operation of multilateral trading facilities will be included among the investment services subject to licensing. Securities firms will be subject to stricter requirements concerning the disclosure of information and possible conflicts of interest. It is proposed to repeal the special Norwegian provision stating that the marketing of financial instruments is an investment service

that is subject to licensing. A new special Norwegian provision is proposed, defining limited and general partnerships as financial instruments.

- One of the new provisions for safeguarding non-professional investors is that the existing scheme for individual securities firms is being expanded in the form of a guarantee fund for securities firms. This change is the result of the current dialogue with ESA on how far the previous scheme complied with the provisions of the directive and provided sufficient protection for investors.<sup>3</sup> This is an example of a Level 4 measure influencing Norwegian law.
- The major proposed changes affect the rules concerning mandatory and voluntary bids that protect minority shareholders in the event of a change in control of the company. The government's proposed new rules have not yet been finalised, but the securities markets legislation committee has proposed that the percentage of voting rights in a company requiring a mandatory bid is reduced from the existing requirement of 40 per cent. The majority proposal is a reduction to more than one-third of the voting rights in the company, whereas a minority is suggesting 30 per cent. A majority of the committee has also proposed making it mandatory for the large shareholder to make a new bid upon acquisition of shares representing more than half of the voting rights in the company. A minority wish to introduce the same rule as in the London City Code, whereby a mandatory bid must be offered upon each acquisition above one-third of the voting rights until the shareholder has acquired more than half of the voting rights.<sup>4</sup> The majority are proposing that in the case of mandatory bids the offerer will be able to make it a condition that approval is obtained from the authorities when necessary. In order to prevent the occurrence of poison pills, the room for manoeuvre is limited to the board and management of the target company when a bid is made.

Some of the changes proposed correspond to recent market developments. The following are among the most important reasons for the reforms that are being incorporated into Norwegian legislation:

- The volume of cross-border activity between intermediaries, issuers and investors is growing. It is becoming increasingly common for Norwegian investors to invest abroad and for foreign investors to invest in Norwegian securities. This is often done

<sup>2</sup> According to Norwegian regulations, the Oslo Stock Exchange (OSE) will continue to have the practical responsibility for prospectus control. It has to submit annual reports of its work to Kredittilsynet and notify the authority of all complaints submitted to the OSE Appeals Committee.

<sup>3</sup> In a reasoned opinion of 11 April 2003, the EFTA Surveillance Authority maintained that existing Norwegian law on this point was not fully in conformity with Norway's obligations under the directive. If Norway does not amend its rules pursuant to such a statement, the EFTA Court will be asked to determine whether the rules are in breach of Norway's EEA obligations.

<sup>4</sup> In the public consultation round, Norges Bank gave priority to legal harmony between the Nordic countries and supported a proposal for 30 and 50 per cent for compulsory offers to all shareholders.

## Box 2: EEA basis for reforms in Norwegian legislation on securities markets, securities and issuers

European Parliament and Council directives on:	EC legal acts/ OJ reference	Replaces	EEA decision, time limit for implementation	Norwegian consultation round, time limit for comments	Proposition to the Storting	Recommendation of parliamentary committee	New Norwegian rules as from
Market abuse	2003/6/EC L096, 12.04.2003	89/592/EEC	38/2004 of 23.04.2004, by 23.10.2004	Consultative document KT <sup>1</sup> of 1.03.2004, by 03.05.2004	Proposition to the Odeisting No. 12 (2004-2005)	Recommendation O. No.38 (2004-2005)	01.09.2005
Prospectus	2003/71/EC L345, 31.12.2003	89/298/EEC	73/2004 of 08.06.2004, by 01.07.2005	Work group KT <sup>1</sup> of 01.06.2004, by 13.09.2004	Proposition to the Odeisting No. 69 (2004-2005)	Recommendation O. No.90 (2004-2005)	01.01.2006
Takeover bids	2004/25/EC L142, 30.04.2004	New	70/2005 of 30.04.2005, by 20.05.2006	Official Norwegian Report 2005:17, by 05.12.2005			
Markets in financial instruments (MIFID)	2004/39/EC L145, 30.04.2004	93/22/EEC	65/2005 of 29.04.2005, by 31.01.2007	Official Norwegian Report 2006:3, by 29.05.2006			
Transparency	2004/109/EC L390, 31.12.2004	Much of 2001/34/EC	120/2005 of 30.09.2005, by 20.01.2007	Official Norwegian Report 2006:3, by 29.05.2006			
Guarantee fund for securities firms	97/9/EC L084, 26.03.1997		12/98 of 06.03.1998	Consultative document KT <sup>1</sup> of 20.02.2004, by 03.05.2004	Proposition to the Odeisting No. 12 (2004-2005)	Recommendation O. No.38 (2004-2005)	01.07.2006

<sup>1</sup>Kredittilsynet (KT) is the Norwegian FSA.

through a custodian. In practice, such transactions resulted in a specialised activity in which securities are traded within the custodian institution (usually a major international bank). These activities are now the subject of legislation and market supervision. The legal terms are “multilateral trading facilities” and “systematic internalisation”.

- Commodity derivative activities are becoming increasingly common in a number of countries, and this is largely a cross-border activity. The directive provisions in this area are new in terms of EEA rules. However, as a result of the common Nordic market for electricity and related market for electricity derivatives, most of them have already been incorporated into Norwegian (and Nordic) law.
- Facilitating effective corporate governance is another growing trend. This takes the form of stricter requirements for the disclosure of information and for the right to make use of voting rights in companies across borders. Stricter requirements are being imposed on issuers to provide information, and amendments in accounting legislation are leading to improved harmonisation of the content of reporting. Tighter requirements are also being imposed on intermediaries with regard to the disclosure of information and possible conflicts of interest.

### 2.3 Costs

Adapting to the new rules will involve certain costs for both market participants and supervisory authorities. As discussed above, many of these changes are more concerned with form than with content, which means that in many cases there will be one-off costs for the adaptation of procedures to new requirements. Since a new standard is to be adopted for the whole of the EEA, adjustment could result in cheaper operations for intermediaries and issuers. Investors will be able to recognise more easily the system under which other markets are operating and this could reduce the cost of investing in new markets. The Financial Supervisory Authority of Norway will have new responsibilities and will have to follow up more detailed legislation. On the other hand, it will to a greater extent be able to draw on the experience of other supervisory authorities with respect to interpretation and practices in connection with new changes.

## 3. A national stock exchange?

### 3.1 Introduction

There have recently been a number of restructurings in the trade in securities and in the settlement of securities trades, either in the form of takeovers or through the formation of alliances. Work is under way to reduce the cost of cross-border trading in securities, and legal monopolies are prohibited throughout the EEA. Until now natural monopolies have existed in most countries in the area, but recently a large group of international banks stated their intention to establish an international market to deliver these services at a lower cost.<sup>5</sup> The debate on possible international consolidations is frequently coloured by national considerations. For instance, the French president, Jacques Chirac, is sceptical of a merger between Euronext<sup>6</sup> and the New York Stock Exchange. He would prefer Euronext to cooperate with the German Deutsche Börse.<sup>7</sup>

Similar views are held in Norway. Some observers argue that it would be a loss to Norway if the Oslo Stock Exchange (OSE) were to be taken over by a foreign owner, on the grounds that a foreign takeover would involve the closure of the national marketplace and the transfer of the activity to the buyer's country. However, the closure of the national marketplace is not an inevitable consequence of foreign ownership. In several international consolidations national markets have continued their activity in national companies owned by an international holding company. Thus there are three possibilities: a national market with a national owner, a national market with a foreign owner and no national market. In the last case, Norwegian companies seeking to be listed and investors wishing to invest in listed securities would have to use the services of foreign marketplaces or stock exchanges.

The benefits of organised trading in securities were described in section 1, and some information on the situation regarding the stock exchange in Oslo is given in Box 3. When considering whether the marketplace needs to be national, it is useful to be more precise as regards the functions performed by the marketplace and the associated costs. A foreign offer to take over the exchange will only succeed if it is sufficiently generous for the current owners to be willing to sell. The buyer needs to be confident that the price paid will generate an acceptable return and must manage the company accordingly. Therefore, it is necessary to weigh the services provided against the costs attached to the trading platform, settlement services and the securities firms.

<sup>5</sup> See <http://www.finextra.com/fullstory.asp?id=16156>

<sup>6</sup> Euronext owns the stock exchanges of Amsterdam, Brussels, Lisbon and Paris. The settlement of trade on these exchanges is with Clearnet as central counterparty. The CSD's of the Netherlands, Belgium, France, the UK and Ireland form the Euroclear Group.

<sup>7</sup> See for example Le Figaro of 6 June 2006, [http://www.lefigaro.fr/eco-entreprises/20060606.WWW00000320\\_euronext\\_chirac\\_espere\\_encore\\_une\\_solution\\_franco\\_allemande\\_.html](http://www.lefigaro.fr/eco-entreprises/20060606.WWW00000320_euronext_chirac_espere_encore_une_solution_franco_allemande_.html)



## Box 3: The situation in Norway and the position of the Oslo Stock Exchange

The Oslo Stock Exchange (OSE) is a limited liability company that was established in 2001 through the demutualisation of the previous stock exchange. The name of the holding company is Oslo Børs Holding ASA. At the end of 2005 the largest shareholders were DnB NOR ASA (19.7 per cent); Fidelity Funds Europe (10.0 per cent); Orkla ASA (10.0 per cent) and Norsk Hydro's pension fund (8.9 per cent). Slightly more than half the equity is held by large Norwegian shareholders. Settlements take place (without a central counterparty) in VPS ASA, the Norwegian CSD.

A change of ownership of the OSE or of the rules relating to the ownership must take place before mid-2007. Legally, the largest ownership share of the parent company may not exceed 10 per cent. The banks that merged to form DnB NOR received a dispensation allowing them to hold their shares until mid-2007, and the Ministry of Finance must soon decide whether the dispensation should be extended or whether the rules on ownership share should be changed. An argument in favour of changing the rules, is that the EFTA Surveillance Authority (ESA) has maintained in a reasoned opinion that limiting the maximum ownership share to 10 per cent breaches the rules on the free movement of capital within the EEA. The ESA accepts the Norwegian argument that this limit ensures market integrity and the independence of providers of infrastructure services, but it considers the limit of 10 per cent to be unnecessarily restrictive in relation to the aim.<sup>1</sup> If a foreign takeover were to take place, the most likely scenario – at least according to the press – is the purchase by the Swedish company OMX AB of part or the entire infrastructure for trading in financial instruments in Norway. OMX AB is a holding company that already owns all the markets for securities trading in the Nordic–Baltic region apart from that in Norway. OMX AB also owns the CSDs of Iceland, Estonia and Latvia and 40 per cent

of the CSD of Lithuania.<sup>2</sup> The company also handles the financial settlement of electricity derivatives traded on Nordpool. The largest owner of OMX is Investor AB (10.8 per cent). The Swedish state held 6.8 per cent at end-2005.

The OSE has been cooperating with OMX in the NOREX alliance since 1999. The alliance seeks to develop the Nordic region as a common marketplace for securities, and the cooperation covers the common trading rules. The OSE uses the trading system Saxess, which OMX has developed and owns. In October 2006 about 50 securities firms were members of the OSE, equally distributed between Norwegian and foreign firms. The Norwegian firms were equally distributed between banks and independent brokerage firms.

The market value of the companies listed on the OSE has increased considerably over the last decade, and so has the turnover. The end-1995 market capitalisation was 29.7 per cent of 1995-GDP, and the corresponding figure was 40.5 per cent in 2003 and 73.7 per cent in 2005. Growth has continued and the market value in November 2006 relative to estimated GDP in 2006 is 90.3. The turnover velocity reported by the OSE was 69.3 in 1997, and increased to 97.7 in 2003, 128.9 in 2005 and 153.6 in November 2006.

The OSE's operating income for 2005 was NOK 361 million, and operating expenditures were NOK 174 million. The post-tax profit was NOK 144 million. Increased market activity resulted in growth in operating income of more than 25 per cent in the last reported year, while expenditures increased by 3.5 per cent. With respect to both activity and growth, the Oslo Stock Exchange is dominated by trading in shares. This activity is concentrated on a few large issues. The 10 issues with the largest number of transactions accounted for 36.4 per cent of the trades and 59.6 per cent of trading value in 2005.

<sup>1</sup> See press release 2004-15: <http://www.eftasurv.int/information/pressreleases/2004pr/dbaFile5289.html>

<sup>2</sup> The CSDs of Sweden and Finland together form an international concern, while the CSDs of Denmark and Norway are independent. Among the large owners of all these companies are large national banks. The CSD and the stock exchange of Iceland are both owned by the holding company that was taken over by OMX in the autumn of 2006.

### 3.2 *The role of the exchange as a marketplace*

A stock exchange is an arena where issuers of securities meet with investors, and the meetings take place in primary and secondary markets. The exchange benefits from such activities; it is thus interested in as many meetings as possible taking place, and in issuers and investors returning as frequently as possible. Issuers are needed to supply new projects and investment opportunities, and investors are needed to make new investments and reinvest their funds, since this contributes to efficient capital allocation.

In the primary market issuers present their projects with the assistance of securities firms. Investors assess the investment opportunities, also with assistance from securities firms. The organiser of the marketplace applies quality standards to the issues and determines whether they are suitable for quotation in the marketplace.

In the secondary market investors can reassess their decisions and if necessary move their investments to issues that suit them better. They can also terminate an investment and withdraw their funds. When making their decision, investors can obtain information from companies and analyses by securities firms, newspapers or other sources. Some of this information is freely available and some has to be bought. A high degree of liquidity in the market is a great advantage for the investor because this provides an opportunity to rebalance the portfolio quickly and with only a small market impact on prices. A broad market is also advantageous, since this increases the probability of finding investments with suitable risk profiles. The investor will also consider it important to have rules that ensure that information from issuers is made available to all market participants at the same time, and that insiders are not permitted to use their information advantage. Finally, it is necessary that the market organiser ensures that individuals or groups cannot trade systematically and thereby mislead the market (prohibition of market manipulation).

To facilitate trading the stock exchange offers a trading system with clear rules on execution, priorities, etc. The trading system is made available to investors through securities firms that are members of the exchange. Investors can enter their orders directly into the system, but often they prefer to use a securities firm to look into the trading possibilities. This can be important for large trades, since it ensures that the market price is not changed as a result of knowledge that such a trade (buying or selling) is about to take place.

When the trade has been agreed the information is transmitted to a settlement system where buyer and seller exchange money and securities at the agreed price and time. Settlement systems have netting rules whereby only the net position in securities and money is settled. In the case of trade in several currencies, either the

investor needs to have all the necessary currencies available or the settlement system must have a facility for currency exchange. When the settlement is completed the investor will have securities in the central securities depositories (CSDs) of the involved countries, and liquidity in bank accounts in the various currencies. The settlement completes the trading cycle.

### 3.3 *The costs and effects of a foreign takeover*

The presentation of the functions of the marketplace allows for a discussion of important points and possible changes in costs and functioning in the event of a foreign takeover.

#### **Efficiency of trading activity**

Normally competition serves as a guarantee of social efficiency. Many of the functions performed in or around the marketplace are produced by or with the help of competing securities firms, and would not be affected by a takeover. This applies to services needed by the issuer prior to public offerings, information from issuers to the market, the analysis of securities and investment advice.

There is an element of monopoly in the activity specific to the organiser of the market, or at least there are a very small number of service providers. The marketplace is a meeting point for issuers and investors and between investors, and the usefulness of the marketplace increases with the number of meetings that take place. This is particularly important for liquidity and the breadth of the market. Liquidity increases with the number of participating investors as they will have different liquidity needs and differences in their preferred risk profile. Breadth increases with the number of issuers and the variations in the risk profile they present to the market. An important question for large international investors is the price impact of large trades, but enlarging the investor base should alleviate this problem. Other things being equal, there are benefits to be had from large marketplace organisations. Whether these other things are equal will be discussed below, but if negative effects are excluded, it must be concluded that the consolidation of several marketplaces is advantageous.

Issues related to the trading system, information requirements, distribution of information and surveillance of market activity can also be viewed from this perspective. Information requirements are imposed by the authorities and the marketplace itself. In the EEA the public information requirements are governed by EC legal acts (“*acquis communautaire*”) and are the same throughout the area. A large market with harmonised requirements makes it simpler to interpret EEA requirements and any other requirements imposed by the marketplace. The same effect can be obtained if several

markets cooperate on setting the same requirements. Similarly, the trading system, distribution of information, and surveillance of market activity can all benefit from a large marketplace, but the gains as regards the service provided can also be achieved through cooperation. The question of how to produce these services at a minimum cost – through a merger or cooperation – is a question that the authorities can leave to the market participants to decide.

### **New costs with foreign ownership?**

Transferring an activity to a location outside Norway may result in new costs for Norwegian market participants, and it is important to identify any new costs incurred by a foreign takeover. If, for instance, the work of obtaining approval for new issues is centralised to the principal location of the marketplace, factors such as language barriers and travel expenses may increase the cost of the process leading up to listing. This may result in fewer listings, which means that a smaller share of the productive capital of the society concerned is subjected to the daily quality assessment provided by trade in an organised securities market. This could reduce capital productivity. The probability of this happening is an argument in favour of the social benefits of national ownership. Another argument for national ownership is small companies' fear of drowning in a large stock exchange and not receiving sufficient attention from securities firms. However, this is not likely to be very important since even the largest exchanges have a stream of new issuers coming in. A number of Canadian energy companies have been listed in Oslo in the last few years. The reason could be their fear of drowning in the North American exchanges, but Norwegian securities firms maintain that the high quality of the energy sector analysis in Oslo, which results in "correct" pricing, is the explanation.

The trading that currently takes place on the OSE can be transferred to foreign hands if issuers and investors transfer their activity to a competitor offering better and cheaper services. This would not be a problem for society, and furthermore as the activity in question is network activity the likelihood of such a change is very small. It is more likely that foreign control of the activity will be the result of a takeover. The buyer will have to offer a large enough payment for the enterprise for the current owner to be willing to sell. To obtain a return on the investment, the buyer will have to attract more activity or reduce costs, or a combination of the two.

Many of the advantages of a takeover of the OSE by OMX have already been achieved through the use of the same IT solution for trade, common rules on trading and the same system of market surveillance. There may be gains from centralising and streamlining the large IT systems and networks, and for emergency backup systems for power supply and telecommunications.<sup>8</sup> Centralising market surveillance may provide similar

gains. It seems certain that Norway will participate in the recently established Nordic index in order to increase the level of activity. The effect of a takeover on trading activity is not obvious, and an additional language requirement will increase the cost to issuers. A new owner will try to increase activity through an increase in the number of issuers and investors. Therefore, it does not seem rational for a new owner to introduce reforms that increase the costs related to but outside the trading activity. A similar argument would apply to other buyers, and this could explain why local exchanges have been continued in consolidations in Europe. This also has the advantage that no new legal uncertainty is introduced. Thus, the argument probably also applies to Norway.

### **Settlement efficiency**

The countries of the Nordic–Baltic region do not have the same system for settlement of trades. At present there are national settlement systems using the eight different local currencies. Even after the probable entry of the Baltic republics into the euro area, there will be five currencies in use (the euro in Finland and the Baltics and the various krone currencies in the four Nordic countries). The registry of ownership will still be national. It is therefore likely that different settlement systems will continue to be used. Maximum efficiency in the use of capital can only be attained if a currency received in one country can be invested in another currency on the same day and without the need for a supplementary exchange of currencies. This is not possible today and investors need to have settlement accounts in all relevant currencies. The movement of liquidity has to be organised as a special trade with two cost elements: the exchange fee (including spread) and the costs of tying up liquidity in several currencies.

Banks gain from providing services that facilitate trading in securities in different currencies. The gain increases proportionally with the spread and almost proportionally with the trade. Box 4 shows that the greater the number of netting possibilities, the greater the spread that can be taken from customers without their having to carry out currency trades in their own books.

No further gains in this area can be expected from a change of ownership of the OSE. The Norwegian service provider is VPS, and it is this institution that would need to change its systems if further improvements are to be made. A project, S–4, to create a single securities settlement system for the four markets in Oslo, Copenhagen, Helsinki and Stockholm was considered in 1999, but the project was never realised since the four involved CSDs could not reach agreement on the payment for a feasibility study. The obstacles were the differences in size of the parties and the differences between what each hoped to gain. The relative market sizes have changed dramatically, but there has been no

<sup>8</sup> Euronext reports that large gains can be made in this area through the possible merger with the New York Stock Exchange (<http://www.finextra.com/fullstory.asp?id=16151>). A similar situation would be if OMX were to join a large international alliance so that maintenance and development of one IT platform can be closed down.

## Box 4: Gains to banks from currency trading

Banks can profit from trading in securities in currencies other than their own. An example of this is when a Norwegian bank facilitates equity trading in Stockholm for its customers. On a particular day the bank has two customers making use of the facility. B buys Swedish equity for SEK 1 million, and S sells Swedish equity worth the same amount. The middle rate is 0.90 and the currency margin is  $\pm 0.5$  per cent. The commission for equity trade in Sweden is 0.1 per cent.<sup>1</sup>

In the example the payments will be:

- The bank's commission from B:  
 $1\,000\,000 \cdot 0.9045 \cdot 0.001 = \text{NOK } 904.5$
- The bank's commission from S:  
 $1\,000\,000 \cdot 0.8955 \cdot 0.001 = \text{NOK } 895.5$
- The bank's total commission:  
 $904.5 + 895.5 = \text{NOK } 1\,800$

This seems acceptable to customers, but if all transactions on the day in question are disclosed, they will reveal that the bank makes a larger profit on currency trading than from commissions.

Transactions related to B's purchase of Swedish equity:

- B transfers to the bank, for the equity and as commission:  $\text{NOK } 904\,500 + \text{NOK } 904.5$ .
- The bank transfers to the Swedish broker and the Swedish exchange:  $\text{SEK } 1\,000\,000 + \text{exchange commission}$ .
- The Swedish broker transfers to the bank, which passes it on to customer B: the Swedish equity.

Transactions related to S's sale of Swedish equity:

- S transfers to the bank, which passes on to the Swedish broker: Swedish equity.
- The Swedish broker transfers to the bank:  $\text{SEK } 1\,000\,000$ .
- The bank transfers to the Swedish exchange: exchange commission.
- The bank transfers to S, for the equity net of the commission:  $\text{NOK } 895\,500 - \text{NOK } 895.5$ .

Net result for the three:

- B pays  $\text{NOK } 905\,404.5$  and receives Swedish equity.
- S sells Swedish equity and receives  $\text{NOK } 894\,604.5$ .
- Net for the bank in  $\text{NOK}$ :  $+ 905\,404.5 - 894\,604.5 = \text{NOK } 10\,800$ .
- Net for the bank in  $\text{SEK}$ :  $-1\,000\,000 + 1\,000\,000 - 2 \cdot \text{exchange commission} = -2 \cdot \text{exchange commission}$ .

The exchange commission is very low. At the OSE it is  $\text{NOK } 20$  for a trade of  $\text{NOK } 1$  million. In addition, there is an annual membership fee. The bank's costs in  $\text{SEK}$  will be very small.

As shown above, the bank makes a profit on the activity. In the example the commission is only a fifth of the total; the remainder comes from providing services to customers with different needs. If the bank's customers had been buying shares, the only profit to the bank would have been the commission, since it would have had to buy  $\text{SEK}$  in the market. In the example there is complete netting: the bank does not need to engage in any currency trade, and makes a good profit.

It is the customers who pay for the extra profit to the bank. This can easily be seen when the entire investment is considered. The customer buying equity will at a future date sell the equity and convert the proceeds to  $\text{NOK}$ . He will then have to pay commission and a currency margin. When investing in Norway he will only pay commission on both occasions, but when the investment is in Sweden he pays the margin between buying and selling the currency in addition. In the above example and on the basis of observed margins and commissions, the Norwegian investor pays a fee of 0.2 per cent on a Norwegian investment, while the total fee for the investment in Sweden is 1.2 per cent when the investment is terminated. The consequence is that the required expected return will have to be larger for an investment in Sweden than for one in Norway. This is a rational element in the so-called "home bias" in investment decisions.

A general formula for the bank's daily profit from the activity has two elements:

$$\Pi = v \cdot (\sum S + \sum B) \cdot (m + c - t) - v \cdot |(\sum S - \sum B)| \cdot m$$

<sup>1</sup> The commission and exchange rate margin chosen here are close to the rates given on Norwegian banks' home pages on 31 October 2006.

The profit ( $\Pi$ ) is calculated in NOK. The first element is the income and costs associated with the total activity. Gross activity in NOK is the exchange rate ( $v$ ) multiplied by the gross trading value in SEK ( $\Sigma S + \Sigma B$ ). The activity is multiplied by the sum of the currency margin ( $m$ , measured from the middle rate) and the commission ( $c$ ), less the trading commission to the Swedish exchange ( $t$ ). The second element is the size of the foreign exchange trade the bank will in fact have to engage in. Because the netting is not complete, the cost to the bank is the exchange rate multiplied by the absolute value of the net trade in SEK  $|\Sigma S - \Sigma B|$  and by the currency margin.

There are two reasons why the above formula gives a lower profit than what is actually achievable. One is that a bank with international activity will have other activity in the country in question and will therefore have some local liquidity. This may be enough to avoid the need for an exchange of currency to serve the equity trade customers. The other reason is that the formula applies to a particular day. If the profits from the activity over several days are calculated, the first element (with the earnings) will increase, while the second element, the bank's costs, will normally be reduced (at least relatively) and therefore the actual trade for the bank will be reduced.

relaunching of the idea in the shape of an S-4 or an S-8<sup>9</sup> project. It might be easier to start such a project if one consolidated stock exchange were to request it on behalf of all its customers. However, among those who might not be in favour of the project are the banks. They derive considerable earnings from the present currency trading, and some of them are large owners of exchanges. The banks' earnings (explained in Box 4) would fall if a multicurrency settlement system were established as this would involve smaller volumes of currency trading. The earnings would also fall if currency exchange margins become smaller. There are examples of competition of this kind.<sup>10</sup>

### Supervision issues

Public supervision of the participants in securities markets and of trading activities ensures that securities firms and the exchange have a sound basis, and that the activities comply with the legislative requirements in this area. If a consequence of a change of ownership of the OSE or VPS is that adequate supervision is no longer feasible, this could be used as an argument to stop a foreign takeover. The provisions of the EEA Agreement covering the free movement of capital in the internal market include financial services such as stock exchanges. Considerable efforts are being made to reduce the cost of cross-border trading in securities, and the supervision and regulation of the activity in the markets are being developed at the European level. As explained in section 2, these rules also apply to Norway. The principle is that the home country supervises the institutions involved and the host country the activity in the markets. As about 25 foreign securities firms are active members of the OSE, there is already cooperation on supervision. A foreign takeover of the OSE and a

transfer of some of the functions of the market to another country in the EEA would mean changes in the responsibilities of the national supervisory authorities involved. However, under the EEA Agreement the Norwegian authorities' desire to retain supervisory authority over institutions operating in Norway is not a viable argument for stopping a foreign takeover.

If a project like the S-4 described above were to be carried out, the relevant central banks would have an interest in securing the integrity of their national payment system and ensuring the safety of the settlement system. There are international standards for the safety of settlement systems (cf. the BIS and IOSCO (2001)). A project like the S-4 would also link the payment systems of the countries involved, but this would require cooperation between the central banks. In principle, such cooperation is not new and there is a norm for cooperation on systems for trading in currencies (i.e. CLS). Trades in the Nordic krone currencies are settled through CLS, and the Nordic central banks participate in the cooperation, cf. Andresen and Bakke (2004).

## 4. Summary

All financial systems provide services that are essential for project assessment, division of labour and risk management, but there are considerable differences in the quality of the services provided in the various countries around the world. Improvements in these areas can affect saving and investment decisions and thereby economic growth. Since there are many sources of friction in the markets, and since legislation, rules and policies are substantially revised in different economies over time, an improvement in one of these functions may have very different consequences for resource allocation

<sup>9</sup> S-8 would include Iceland and the three Baltic states.

<sup>10</sup> A Norwegian internet-based securities firm says that it does not benefit from currency activity. Most likely the company makes one daily currency transaction for the net position of its customers and uses the same exchange rate for buyers and sellers of currency that day. The income for the company is only the trading fee.

and prosperity. The effects of the improvement will depend on what other market imperfections there are in the economy concerned.

The importance of keeping the regulatory system abreast of developments in the market, and the need to have a tighter regulatory regime, are two of the reasons why comprehensive reforms are being carried out in European – and Norwegian – legislation relating to securities trading. The aim is to establish a legislative system that is able to keep pace with such developments and that is understood by the industry. This will ensure better and more equal competitive conditions throughout the internal market for financial services.

Among the new measures being introduced are the requirements for better and more comparable information about issuers, which will improve the conditions for capital allocation. The stricter requirements concerning common rules for information and disclosure of information will also improve these conditions. Intensified competition between securities firms will reduce transaction costs and benefit both issuers and savers. Equal practices by supervisory authorities will be important for the achievement of these objectives.

The changes will involve some restructuring costs, but the main advantage is that a new European standard for information etc. about and trading in financial instruments will be established through implementation of the new Community legislation in national law. This will improve the efficiency of the capital market and promote economic growth to the benefit of all the EEA countries, including Norway.

This analysis of whether social efficiency will be impaired if ownership of the marketplace changes to foreign hands did not find systematic deviations between private gains to the owner of the marketplace and to society. To keep the costs to users for using the network low, business will probably be maintained nationally even with a foreign takeover, and a policy for national ownership should not be necessary.

Costs in cross-border securities trading can be reduced. It is probably easier to decide on efficiency measures in the settlement of such trades if there is common ownership of the CSDs or the marketplace. As banks gain from the present system, they cannot be expected to work actively in favour of efficiency measures at this point. Important efficiency gains in this field can probably be achieved without a change of ownership in market infrastructure.

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