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## National Laws, International Money: Regulation in a Global Capital Market

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## National Laws, International Money: Regulation in a Global Capital Market

### Cover Page Footnote

Choi is an Assistant Professor, University of Chicago Law School. Guzman is a Law Clerk to the Honorable Juan Torruella, Chief Judge of the United States Court of Appeals for the First Circuit. J.D., Harvard Law School, and Ph.D., Harvard Economics Department.

## ARTICLES

# NATIONAL LAWS, INTERNATIONAL MONEY: REGULATION IN A GLOBAL CAPITAL MARKET

Stephen J. Choi\* and Andrew T. Guzman\*\*

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## INTRODUCTION

THE current framework for securities regulation in the United States emerged from the Great Depression of the 1930s. In response to the financial excesses of the 1920s and the perceived presence of rampant fraud and manipulation in the capital markets, Congress passed the Securities Act of 1933<sup>1</sup> (the "Securities Act") and the Securities Exchange Act of 1934<sup>2</sup> (the "Exchange Act") in rapid succession.<sup>3</sup> Together, the two Acts form the core of the modern-day American securities regulation regime.<sup>4</sup> Since the Great Depression, this regime has grown and flourished under the guidance of the Securities and Exchange Commission ("SEC"). Likewise, in several other countries, similar regimes—some modeled explicitly on the American system—have taken root.<sup>5</sup> For several decades after the 1930s, these regimes essentially operated independently of one another. Although both companies and investors crossed national boundaries to raise or invest capital in some limited circumstances, the majority of financial activity took place within national borders. The advent of cheap and widespread communication mechanisms among countries, as well as the development of more reliable clearance and settlement systems to conduct international transactions, radically transformed world capital markets and has led to the integration of individual country markets.<sup>6</sup> Today issuers regularly cross international boundaries to raise capital across multiple countries.<sup>7</sup> Similarly, investors may place their funds in a multitude of investment opportunities around the globe.

The globalization of the world's securities markets has brought the promise of more efficient markets and greater diversification of unsystematic risks, to the benefit of both issuers and investors. Internation-

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1. 15 U.S.C. §§ 77a-77bbbb (1994).

2. 15 U.S.C. §§ 78a-78ll (1994).

3. See Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 Ohio St. L.J. 329, 329 (1988).

4. Other Acts which also form part of the United States securities regime include: the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Investor Protection Act of 1970. See Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 35-46 (3d ed. 1995) (describing these Acts).

5. For example, the Japanese securities regime, at least in its framework, is patterned after the United States's system. See James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 Hastings Int'l & Comp. L. Rev. 149, 149 (1993).

6. The world-wide movement towards market-based regimes as well as the growth of international currency markets accelerated the trend towards globalization. See, e.g., Andrew X. Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA Pac. Basin L.J. 62, 63 (1993) (describing the formation of China's securities markets).

7. Through American Depository Receipts, for example, hundreds of foreign companies have gained access to the liquidity and capital of United States stock exchanges over the past decade. See Joseph Velli, *American Depository Receipts: An Overview*, 17 Fordham Int'l L.J. S38, S46-50 (1994).

alization, however, has also multiplied the challenges facing the regulators of capital markets. In particular, globalization has increased the burden on an individual country's regulators seeking to maintain adequate disclosure, antifraud, and anti-manipulation rules both within their own borders and abroad.<sup>8</sup> For example, corporate insiders who want to cash in on their informational advantage relative to investors may seek to profit through trades in countries where insider trading laws are nonexistent or rarely enforced. To the extent that regulators seek to prevent insiders from profiting from their informational advantage but are unable to monitor or regulate trades taking place in foreign jurisdictions, the effect of insider trading prohibitions is undermined.<sup>9</sup> Furthermore, countries may compete with one another to reduce the level of antifraud or mandatory disclosure liability in order to attract issuers.<sup>10</sup>

This Article develops a framework to analyze the impact of globalization on country-specific securities regimes and to discuss possible avenues to protect investors and maintain capital market integrity on a global scale. This framework is then used to demonstrate that, under certain simplified circumstances, the internationalization of capital markets may lead to either a race-to-the-top or a race-to-the-bottom in the quality of individual national securities regimes, depending on how firms, investors, and managers behave. In this sense, the dynamics of international regulatory competition resemble those of state regulatory races-to-the-top and races-to-the-bottom in the United States. There are, however, two important differences.<sup>11</sup> First, unlike the case of state competition, international competition takes place without any oversight from a governing body able to regulate for the entire market. While individual states may appeal to the federal government to step in where a race-to-the-bottom is evident, individual countries have no similar centralized authority to turn to. Although international treaties may serve as an alternative means to engender cooperation among countries, such treaties are both time

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8. Countries may seek to regulate transactions that take place abroad if those transactions have an effect within that country. Under Regulation S, for example, the United States may seek to impose the registration requirements of section 5 on foreign issuers selling securities to foreign nationals where selling efforts take place in the United States. See Securities Act Rule 903(b), 17 C.F.R. § 230.903(b) (1996).

9. See Jeffrey Taylor, *SEC Seeks Buyers of Duracell Options with Inside Knowledge of Gillette Deal*, Wall St. J., Sept. 17, 1996, at A2 (reporting that Swiss and Bahaman financial institutions refused to identify possible insider traders to the SEC).

10. See James D. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition*, 55 Law & Contemp. Probs. 157, 175 (Autumn 1992).

11. For a discussion of state regulatory competition, see Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435, 1444-46 (1992); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251, 254-62 (1977).

consuming to negotiate and difficult to enforce. Second, the degree of difference among issuers, investors, and regulatory goals is greater in the context of inter-country competition than state competition.

This Article argues that in a richer model of securities regulation—one that accounts for differences among issuers, investors, and countries—the internationalization of securities markets provides an unambiguously positive impact on the efficiency of securities markets. This is so because the presence of heterogeneous issuers and investors allows countries to compete to attract segments of the securities market rather than seeking to appeal to the entire market. This, in turn, implies that certain countries will adopt regulations that cater to particular types of securities, and that investors will be able to identify the risk and quality of an issue at least in part by the country where the issue takes place. For example, some countries may employ particularly stringent securities disclosure and antifraud regimes, attracting more truthful issuers. Investors, in turn, will price each issue based on its associated country. Because differences are more pronounced between individual countries than between two states within the same country, this richer model applies more to international regulatory competition than to domestic races.

Given the more realistic context of a heterogeneous securities market, this Article proceeds to consider a range of possible regulatory strategies that could be adopted to deal with international capital markets, including the dominant approaches taken in the United States. It offers a series of recommendations, calling for a return to a more territorial jurisdictional limit on American securities laws and for the support of international capital mobility. This Article also argues for a recognition of the principle that Americans who go abroad to invest in foreign securities markets should be considered to have accepted the risks and returns that exist in those markets. In addition, this Article suggests that the rise in importance of institutional investors and market-driven, third-party gatekeepers provides additional assurances that a territorial regime is optimal from both a global point of view and from the point of view of American investors and firms.

The Article proceeds as follows. Part I provides a framework to analyze the impact of globalization on national securities regimes and then analyzes the implications of the framework for global securities markets. Part II discusses the responses to globalization that currently exist and are used in the United States, including an assessment of the advantages and disadvantages of each. It also offers recommendations regarding how national laws should respond to the challenge posed by international investment. Further discussion of how national regimes can encourage the development of welfare increasing outcomes is included in part III, which also defends the recommendations of this Article against the charge that capital markets are not sophisticated enough to benefit from these proposals.

## I. FRAMEWORK OF ANALYSIS

Over the past fifteen years, world capital markets have undergone rapid and dramatic change. Driven by the rise in information technology and relative political and economic stability across several different nations, capital markets—from Hong Kong, Singapore and Taiwan to the United States, Switzerland, and Great Britain—have become largely interconnected. Traders on the London Stock Exchange, for example, monitor bid-ask prices on the New York Stock Exchange and other markets when determining their own market clearing prices. Today, companies regularly go abroad either to seek new financing or to develop a liquid market for their existing securities. By 1993, almost 1000 foreign companies had listed securities in the form of American Depository Receipts within the United States.<sup>12</sup> Investors, similarly, often place their funds abroad either directly through the purchase of foreign securities in foreign markets or indirectly through a domestic institutional investor intermediary specializing in overseas investments.

Despite the widespread and well-recognized growth in international securities activity, the academic community is only beginning to analyze this phenomenon. In order to further the understanding of the impact of the growing integration of capital markets on securities regulatory regimes, this part develops a simple theoretical foundation with which to analyze the pressures facing individual countries and their regulatory regimes. The framework will be used to examine the impact internationalization has on regulation and policy decisions. Although the framework makes some important assumptions that will be relaxed later in the Article, an understanding of this simplified model of international securities markets will be helpful to follow the more realistic discussions later in the Article.

A. *The Conceptual Framework*

First consider the major parties to a securities offering transaction: investors, issuers, and the countries within which the transaction takes place. Investors seek to maximize the return on their investment, adjusted for the amount of systematic risk involved.<sup>13</sup> The key problem plaguing capital markets is one of asymmetric information between issuers and investors. In a world without any regulatory protections, investors bear the risk that the securities they purchase may be worth less than the securities' represented value. The buyer—who has the greatest incentive to evaluate correctly the value of the security—often possesses only limited information regarding the firm issuing the

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12. See Velli, *supra* note 7, at S46.

13. See Thomas E. Copeland & J. Fred Weston, *Financial Theory and Corporate Policy* 193-217 (2d ed. 1983) (deriving and discussing the capital asset pricing model of securities pricing).

securities. Insiders and the firm itself are more likely to have accurate information about the state of the firm and the fair value of the securities. Insiders and the issuer, however, have only a limited incentive to disclose this information and, indeed, often have an incentive to release misleading information in order to raise the price of the securities artificially. Issuers, for example, may use this advantage to issue overvalued securities for the benefit of their current shareholders. Rational investors, of course, realize the incentive of insiders and issuers to engage in such practices and discount the value of securities accordingly. This result may actually cause some issuers to release corporate information voluntarily.<sup>14</sup> For several reasons, however, issuers may nevertheless fail to release all information truthfully. For example, managers interested in insider trading may delay the release of information or even actively misstate the true value of their company's securities.<sup>15</sup>

Keeping in mind the asymmetry of information between investors and issuers, consider the pool of all firms that represent to the public that the value of their issue is equal to a certain amount. Investors, using publicly available information, may be able to distinguish the quality of issues only between gross subsets of these firms. Within any one particular subset investors may lack the ability to separate relatively high- and low-value companies. Without any form of mandatory disclosure or an antifraud regime, investors seeking to maximize their return will price all firms within any one subset the same, leading high-value firms to subsidize low-value firms.<sup>16</sup> More stringent securities regulations which work to reduce the asymmetric information problem would reduce the size of these subsets as investors become better informed. This will decrease the amount higher-value firms subsidize lower-value firms, leading to a more efficient allocation of capital.

Issuers, in turn, seek to maximize the proceeds from any particular offering of securities. At any given issue price, issuers will prefer less regulation. Greater regulation in the form of more stringent antifraud or mandatory disclosure rules may result in higher costs associated with putting forth an offering or may increase the likelihood of frivo-

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14. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 675 (1984). But see John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 717, 722-23 (1984) (arguing for the necessity of a mandatory disclosure system).

15. Additionally, because information is a public good, corporations acting privately may under-provide this information. See Coffee, *supra* note 14, at 722.

16. For example, consider the situation where a high-value firm is worth \$20 per share but a low-value firm is worth only \$10 per share. Where investors are unable to distinguish between the two types of firms, investors will pay \$15 per share for the shares of each firm. This, in turn, may lead high-value firms to either seek out means of credibly distinguishing themselves from low-value firms or to simply exit the market.



lous suits resulting from the offering.<sup>17</sup> Of course, stricter regulation may increase the willingness of investors to pay more for any particular issue, and issuers as a group may desire higher regulation as a result. Holding the issue price constant, however, increased regulation will discourage some issuers from entering the market and will, therefore, reduce the supply of new issues.

Finally, key to the framework is the notion that individual countries will compete to maintain or expand their respective financial centers. Singapore, for example, gains as both foreign issuers and investors seek to float and trade securities within Singapore's borders. Increased volume provides domestic residents with greater liquidity and domestic companies with reduced transaction costs in raising capital. Furthermore, increased volume provides a country with greater tax revenue and gives domestic regulators more responsibility and prestige. The country may also enjoy spillover benefits to the economy as a whole in the form of increased job formation as issuers choose to establish factories and operations where they raise capital; greater international trade spurred through greater stability and liquidity in the financial sector may also result. Although countries may certainly pursue other objectives, many will either pursue volume as their primary goal or else find that volume maximization is a necessary precursor to whatever other goal they choose to pursue. For example, a country may seek to use its securities market as a means to raise revenue—perhaps by imposing a tax on every transaction. The country must also, however, take into account the impact of such a policy on overall volume; excessive taxation will reduce revenue through its negative impact on volume. Similarly, countries interested in investor protection will also benefit from increased securities volume: more volume leads to greater economies of scale for regulatory authorities as well as more attention from sophisticated investors and international financial intermediaries. These, in turn, lead to greater efficiency in the market to the benefit of all investors. As this Article also discusses, the ability of countries to pursue objectives other than securities volume maximization becomes limited as capital mobility increases.

A simple representation of an individual country's securities market is provided in Figure 1. The  $x$ -axis in Figure 1 corresponds to the volume ( $q$ ) of securities transactions within the country. The  $y$ -axis, conversely, represents  $1-r$  where  $r$  is the discount rate relative to the represented "value" of the securities. The represented value is defined here as the issuer's own publicly stated expected present value of future payments to investors. Investors discount this stated value, taking into account the risk of business failure and the risk of fraud.

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17. Cf. James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. Pa. L. Rev. 903 (1996) (providing evidence on the presence of frivolous securities fraud class action suits).

Where the economy has a high incidence of fraud, investors will discount the represented value at a greater rate. For example, an issuer may state that investors will receive \$100 cash payment next year for purchasing their security this year; where investors take as their discount rate  $r = 0.1$ , then investors will pay only \$90 for the security today. To focus on the effects of fraud, the remainder of the Article assumes that the discount  $r$  takes into account only the risk of fraud. In other words, the time value of money is taken to be zero and it is assumed that there are no other systematic risks.

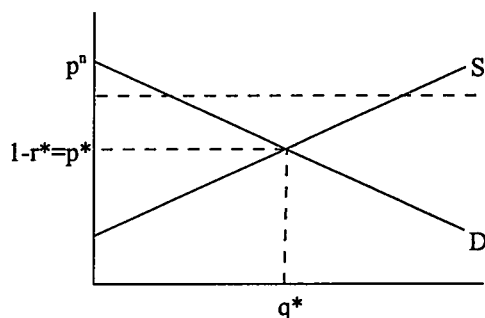


FIGURE 1

Within the framework of Figure 1, there are two separate dynamic considerations. First, the supply of securities in the market depends negatively on the discount rate. For example, a range of issuers with investment projects of different value may exist. Some issuers may have relatively low-return projects; others may have relatively high return projects. The greater the discount rate, the lower the amount of proceeds that any one issuer may obtain from an offering. Therefore, at high discount rates, only those issuers with relatively high-return projects will seek to issue securities. Only these issuers are able to realize enough return from their investment projects to justify obtaining capital with such a high discount factor. Conversely, as the discount rate drops, more issuers are able to obtain capital to fund their investment projects profitably. This relationship is represented by the supply curve,  $S$ , in Figure 1. To the extent additional regulations placed on issuers raise their costs, to achieve the same level of return issuers must receive a correspondingly lower discount rate. More regulations therefore shift the supply curve upward. In other words, all other things being equal, additional regulations cause fewer firms to supply securities at any given discount rate.

Second, the volume of securities investors will demand depends on the discount rate. Investors always face the choice of consuming their funds or investing them for greater future consumption. To the extent

that a range of different preferences exist among investors with respect to future consumption, the amount of investment funds available will vary with the discount rate. As the discount rate decreases, fewer investors will choose to participate in the capital market. Conversely, higher discount rates—corresponding to a higher rate of return for investors—will result in a greater demand by investors for investment projects.<sup>18</sup> The dynamics of investor demand are represented by the demand curve,  $D$ , in Figure 1. Investors will adjust for the possibility of fraud by demanding a higher discount rate. All other things being equal, therefore, the greater the probability of fraud, the lower the securities demand at any given discount rate. To the extent more stringent regulations reduce the risk of fraud, therefore, the demand curve will shift upwards.

Equilibrium occurs in the domestic framework where the securities supply and demand lines meet. In other words, equilibrium is achieved when the market supply of securities issues equals the market demand for such issues. Where supply does not equal demand, market forces will cause the discount rate to adjust until the two become equal. For example, where the supply of securities is greater than the demand for securities, securities issuers will be induced to increase the discount rate for their securities, raising  $r$  until the market clears and all issuers are able to find investors willing to purchase their securities at the market clearing discount factor—at point  $(1-r^*, q^*)$  in Figure 1. The sensitivity of investment demand and securities supply—in other words, the demand and supply elasticity—will determine the amount  $r$  must adjust before the market clears. Where the supply of securities is completely elastic at  $r^*$ —for example, because capital is mobile and issuers are able to obtain  $r^*$  in other countries—then the market will always clear at  $r^*$ .

Given this framework, the “first best” or social optimum occurs when investment projects are financed if and only if they have a positive net expected value. Because transfers between investors and issuers result in no net social loss or gain, social welfare depends solely on the number and quality of investment projects undertaken. Note that an increase in the number of securities offering transactions is not necessarily indicative of increased social welfare; some of the additional volume, for example, could represent negative expected value projects issued fraudulently to the public. The first best, therefore, corresponds to the volume of transactions which would occur in the absence of asymmetric information and fraud. If all parties to a transaction were fully informed, demand would be perfectly elastic at

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18. The curves representing the demand ( $D$ ) and supply ( $S$ ) of securities will also depend on a variety of other factors that are not explicitly represented in the figure. When these factors (i.e., the overall economic climate) change, the curves will shift accordingly.

$1-r=1$ .<sup>19</sup> Therefore, within this framework, the theoretical first best occurs at the point  $(1, q^f)$ , which corresponds to a discount rate of zero and the corresponding volume, denoted  $q^f$ . Point  $(1, q^f)$  is displayed below in Figure 2.

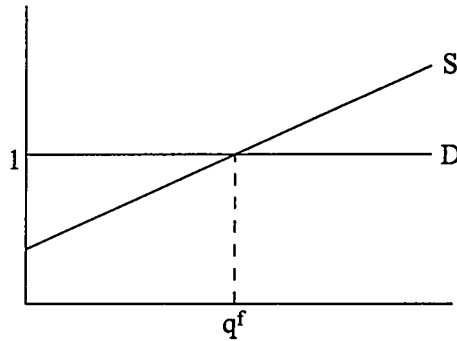


FIGURE 2

In a world of asymmetric information, however, the first best is unobtainable. Given a particular set of demand and supply curves driven by both domestic factors and international capital mobility, however, regulators may affect the positioning of the securities supply and demand lines within the framework in an effort to achieve the “regulatory ideal.” We define the regulatory ideal as the level of regulation that issuers and investors within any one country would choose if they could contract freely and without cost.<sup>20</sup> We denote the regulatory ideal as point  $(1-r^i, q^i)$ . Note that this level of regulation is “ideal” only in the sense that it is preferred by parties within a country. This regulatory ideal, although desirable from the perspective of an individual country—may not represent a good outcome in terms of global welfare, as will be discussed in section B.2.

Regulations that diminish the risk of fraud borne by investors by more than the corresponding increase in cost to issuers represent a net gain to the parties to the transaction. An increase in regulatory controls, for instance, will cause the supply line to shift upward because it will impose an additional cost of compliance on issuers, implying that at any given discount rate issuers will offer fewer securities. Also, tightened regulations will shift the demand curve upward because more regulation will reduce the amount of asymmetric information,

19. In the context of full information, issuers would gain nothing by representing their issues in a misleading fashion, because the investors already know the true value of the issue.

20. We label this level the “regulatory ideal” because it is the preferred regulatory situation from the point of view of all three parties to the transaction: the firm, the investor, and the government.

leading investors to demand more securities at a given discount rate. Where parties experience a net gain, as Figure 3 shows, the shift in the demand curve will be larger in magnitude than the corresponding shift in the supply curve, leading to an increase in the volume of securities sold—to the point  $(1-r^2, q^2)$  in Figure 3.

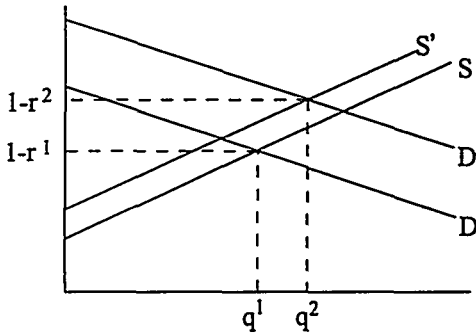


FIGURE 3

Conversely, if an increase in regulations diminishes the risk of fraud by less than the increased compliance cost to the issuer, the supply curve will shift more than the demand curve and the volume of transactions will decrease. Therefore, to the extent issuers and investors make capital decisions based on their own best interests, the joint welfare of issuers and investors is optimized where regulations maximize the volume of transactions. The regulatory ideal,  $(1-r^i, q^i)$ , as a result, is the point that maximizes the joint welfare of issuers and investors and maximizes an individual country's securities volume. As discussed in section B.2, where principal-agent problems lead issuers and investors to make capital decisions not in their respective best interests, however, countries seeking to maximize their securities volume may adopt an individual country regulatory ideal that does not maximize global welfare.

B. *Implications of the Framework*

Despite the simplicity of the framework presented in the previous section, it allows us to analyze a range of questions that pertain to both domestic and international securities markets. In this section, we consider how internationalization affects the behavior of policymakers and the normative implications of these effects in terms of global welfare.

## 1. Mobility & Internationalization

We start with a simple question: How does the internationalization of capital markets affect domestic policy decisions when all countries share similar priorities and goals? In other words, we abstract initially from the many substantive differences among nations and consider only the impact internationalization has on the policy decisions of countries in a world made up of identical parties. As this section demonstrates, internationalization itself, even if countries are not substantively different, can nevertheless affect the policy decisions of those countries. The assumption that countries are identical is then relaxed, and the more complex question of internationalization among heterogeneous countries is examined.

Consider a closed country where neither investors nor issuers have the opportunity to shift their activities abroad. Because even in a closed economy, both potential investors and potential issuers have alternatives to the securities market, they will react to changes in the discount level of securities (by moving along the demand and supply curves, respectively) or in the regulatory regime (through a shift in the curves). Because the market is purely domestic, however, individuals can only avoid domestic regulations by investing their funds in a non-securities vehicle or through consumption. In a strictly domestic environment, therefore, the country has considerable flexibility in its choice of regulatory system. There is no other available securities market, so both issuers and investors must accept the chosen system. Although some choices may be more efficient than others, the lack of alternatives ensures that both the supply of and demand for securities will be relatively insensitive to the choice of regulatory regime,<sup>21</sup> implying that regulatory choices will have only a modest effect on the volume of transactions.<sup>22</sup> Individual countries, therefore, can choose to pursue various domestic goals through their regulatory regimes, even if these goals undermine the efficiency of the securities market.<sup>23</sup>

Now, imagine that the country opens its securities market to interact with the market in another, identical country. In order to make

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21. This is relative to the open economy case.

22. This assumes that the domestic non-securities alternatives are neither too numerous nor attractive.

23. For example, in the domestic context, after a securities regulatory regime is instituted, whether the regime actually achieves the socially optimal level of regulation depends on the makeup of the regulatory agency and the regulated bodies. Bureaucrats within an agency, for example, may have an incentive to expand their power and influence through the promulgation of numerous and complex rules requiring constant agency monitoring. See Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 *Cardozo L. Rev.* 909, 913-16 (1994). Bureaucrats may also seek to enhance their job prospects by catering to the interests of issuers or investment professionals. Agencies, finally, may make mistakes in their regulatory designs which take time and experience to uncover and correct. To the extent this occurs, individual countries may impose levels of regulation that are too high.

the analysis as simple as possible, we will assume that capital movement between the two countries is costless. Prior to the opening of the markets, both countries, by assumption, face identical demand and supply curves, have adopted identical securities regulation and are, in all other relevant respects, identical.<sup>24</sup>

An initial observation is that the opening of the markets will not generate any cross-border activity. After the markets are opened, cross-border transactions are permitted, but because the demand and supply conditions are identical in the two countries, there is no incentive for any party actually to undertake an international investment or offering. The fact that the two countries are identical implies that the discount rate and the regulatory regime are the same in both countries, and there is nothing to be gained by going abroad.

Despite the lack of transnational activity, however, the opening of the capital markets will affect the decisions of policymakers. When the markets are opened, the new, integrated market features twice the demand and twice the supply of each of the individual closed markets. Any policy change in one country has the potential to initiate transnational activity through a shift in investments across countries.<sup>25</sup> Suppose, for example, that one country were to increase its disclosure requirements. This would both increase costs for issuers and reduce the asymmetry of information, shifting both the demand and supply curves upward, as discussed in the framework above.<sup>26</sup> The important point for the present discussion is that the impact of the policy change on the volume of transactions will be greater when markets are integrated than when they remain closed.

To see why this is so, assume for the moment that the domestic market starts at its regulatory ideal point  $(1-r^i, q^i)$ . Now consider an increase in regulatory disclosure requirements that moves the market away from the regulatory ideal. If the market is closed, some issuers will simply choose to eschew the securities market altogether as this is the only way for parties to avoid the new regulations in a closed market. Specifically, issuers will choose not to participate in the securities market when they possess an alternative that offers a higher return than the new securities regime. Conversely, issuers for whom the securities market still represents the best investment option will continue to participate in the market.

Now consider the exact same increase in regulatory requirements if the market is integrated with a foreign capital market. Because we have moved from the regulatory ideal to some other regime, we know

24. By assuming that the two countries are identical, we are able to abstract away the effect that different regimes can have on one another and isolate the impact of internationalization.

25. In other words, the demand and supply curves of each country become more sensitive to changes in the discount level. Both curves are more elastic.

26. See *supra* part I.A.

that participants in the market prefer the old regime to the new one. We also know that the old regime is still available; specifically, it can be found in the foreign country. Because we have assumed that transnational movement is costless, all investors and issuers will choose the foreign regime—that is, they will choose to carry out their transactions in the foreign country—rather than the new domestic one.

The opening of the market, therefore, makes both the demand curve and the supply curve flatter—i.e., more elastic. Ultimately, if markets are perfectly integrated, both the demand and supply of securities are infinitely sensitive to changes in the discount level. No policy change can be made without reducing the volume of transactions to zero in one of the two countries. If the change represents a shift away from the regulatory ideal, all transactions will move to the other country. On the other hand, if the change shifts the regulations closer to the regulatory ideal, it will induce all foreign transactions to move to the domestic market. Because internationalization makes the impact of policy changes greater than they would be in a closed economy, it also increases the pressure on countries to adopt the regulatory ideal level of regulation. The internationalization of capital markets implies that failure to adopt the regulatory ideal will lead to a greater loss in securities volume.

Furthermore, the more countries from which investors can choose, the more likely it is that a policy change will drive a particular local transaction abroad or attract a foreign one. As greater numbers of countries are added, more potential transacting parties exist in foreign markets that may be attracted to a particular country following a change toward the regulatory ideal. Consider, for example, the two-country case in which country 1 places no restrictions on the mobility of its investors and issuers but country 2 remains closed. Although investors and issuers from country 1 are mobile, they are unable to shift their investment activities to any alternative, and country 1, therefore, acts as a completely immobile regime. Next, imagine that both countries 1 and 2 allow mobility. In this case, the regulatory decisions of country 1 will impact the decisions of country 2 as discussed above. To the extent different countries may change their regulatory regimes at different speeds, possess different incentives with respect to the maximization of trading volume within the country's borders, or learn from one another's regulatory efforts, the benefit to one country of providing issuer and investor mobility, rises as other countries provide for capital mobility.

This analysis is important to policymakers because the conclusion that policy changes evoke a greater market response in more integrated economies is equivalent to concluding that policymakers have less flexibility in choosing policy. More integrated economies will make it much more costly for a policymaker to adopt a regime that deviates from the regulatory ideal. A change in regulation that is



viewed as undesirable by issuers and/or investors might lead to only a small reduction in the amount of activity on a domestic securities market. The same change when markets are international, however, may lead to a large drop in activity. For example, parties may simply choose to conduct their business abroad. This suggests that countries will race to adopt the regulatory ideal and that policymakers will have less flexibility to adopt other regimes to achieve goals other than the maximization of the volume within their borders.<sup>27</sup>

To the extent increased internationalization results in increased mobility, the pressure on countries to adopt or at least to move toward the regulatory ideal is therefore increased. The next section considers whether the regulatory ideal is likely to foster globally optimal policies.

## 2. Race-to-the-Top and Race-to-the-Bottom

The discussion of the regulatory framework in part I.A identified what was referred to as the regulatory ideal level of regulation. This regulatory ideal refers to the preferred regulatory regime from the point of view of an individual country. This section examines the broader question of whether this country-specific regulatory ideal is likely to be efficient from a global perspective.<sup>28</sup>

Within the framework provided in part I.A, under conditions allowing fully mobile investors and issuers, countries acting in their own self-interest will adopt a common set of regulatory standards.<sup>29</sup> The common set of standards comes about through competition among countries to offer the most hospitable environment to securities transactions. To the extent that individual countries seek to maximize the volume of transactions, they will set the level of regulation to satisfy both investors and companies; otherwise, the parties may choose to flee to another country.

The first question to be addressed is whether these standards are desirable from an international perspective. Two polar possibilities exist. Countries may compete with one another in order to establish the most efficient regulatory regime, leading to a race-to-the-top. Alternatively, they may engage in a harmful form of competition, result-

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27. See Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism and Functionalism: A Comparison with Reference to Securities Regulation*, 4 *Transnat'l L. & Contemp. Probs.* 69, 82-85 (1994) (discussing reasons why countries may differ in their securities regulatory goals).

28. Debate exists over the optimal level of regulation in a purely domestic situation. See, e.g., Coffee, *supra* note 14, at 722-23; Easterbrook & Fischel, *supra* note 14, at 672-73. In order to focus on the international issues, we will abstract from the domestic issues and assume that there is some agreement as to what constitutes the efficient level of regulation at the global level. We will then ask if that is the amount of regulation that is likely to occur.

29. Part I.C. discusses whether all countries will move to a common regulatory regime or whether they will adopt different regimes.

ing in inefficient regimes and leading to a race-to-the-bottom. On the domestic front, there is debate regarding whether the United States corporate law system promotes a race-to-the-top or a race-to-the-bottom.<sup>30</sup> In the international context, the issues are similar, so only a brief presentation of the main arguments is provided. The section then argues, however, that the dichotomy between a race-to-the-top and a race-to-the-bottom is too simplistic in the international arena, and more realistic assumptions lead to the conclusion that a desirable diversity of regimes may result.

a. *Race-to-the-Top*

The argument that regulatory competition will lead to a race-to-the-top is straightforward. A securities transaction is ultimately a contract between the buyer and seller of a security. It is well established that, in the absence of transaction costs, buyers and sellers will select the most efficient terms for a contract.<sup>31</sup> Similarly, if the parties to a securities transaction can choose among regimes, they will seek the most efficient jurisdiction—the one that offers the level of regulation that maximizes the total value of the transaction, including compliance costs. Jurisdictions that demand too much regulation will be avoided because the cost of compliance is not worth the additional information made available; jurisdictions that have too little regulation will be avoided because the risk-bearing cost borne by the buyer exceeds the savings enjoyed by the seller. Countries competing to attract securities transactions, therefore, will strive toward the most efficient regulatory regime, leading to a race-to-the-top.

The race-to-the-top argument can be illustrated by using the framework established in part I.A. Assume that a particular country begins at the regulatory ideal point  $(1-r^i, q^i)$  which maximizes the welfare of investors and issuers as a group. Assume further that managers seek to maximize the value of their firms.<sup>32</sup> Now suppose that the country considers imposing a different regulatory regime. Because we are moving away from the regulatory ideal—implying that the cost to issuers as a result of the regulatory change is greater than the corresponding gain to investors—the supply curve will shift more than the demand curve, as reflected by the curves  $S'$  and  $D'$  in Figure 4. The resulting equilibrium features a lower volume of sales and a higher discount level, given by  $(1-r', q')$  in Figure 4.

Now consider a reduction in the level of regulations. Because we are reducing the regulations below the ideal level, the cost of such a

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30. In the context of state corporate law, several commentators have debated whether a race-to-the-bottom or a race-to-the-top exists. *See generally* Bebchuk, *supra* note 11, at 1444-46 (noting shortcomings of both theories).

31. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989) (discussing the contractual basis of corporations).

32. This assumption will be relaxed in part I.B.2.b.

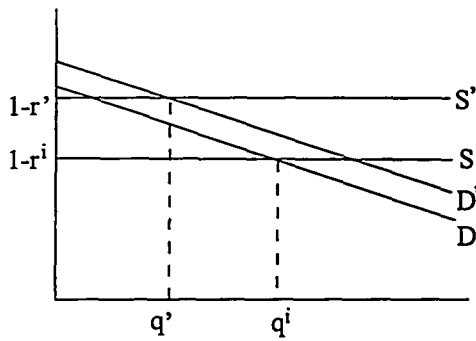


FIGURE 4

change to the investor is greater than the benefits to the issuer. Therefore, the demand curve will shift downward by a larger amount than the supply curve, as shown in Figure 5. The result is an equilibrium at  $(1-r', q')$  in Figure 5 where both the discount level and sales volume are reduced.

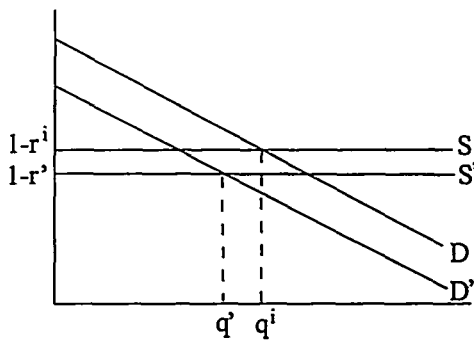


FIGURE 5

In this case, therefore, countries acting individually, and seeking to maximize the volume of securities transactions within their borders, will move toward the regulatory ideal. Furthermore, shareholders of issuers and investors would contract for this level of regulation if they could do so at no cost. Implicitly, therefore, it is the most efficient possible regime from a global perspective. It will come closest to achieving the global optimum of funding projects only if they have a positive net present value.

Moreover, the pressure on countries to race-to-the-top depends on the slope—or sensitivity—of the supply and demand curves. The more sensitive investors are to changes in price—i.e., the flatter the demand curve—the greater the drop in securities volume countries

will experience as they move away from the ideal regulatory regime.<sup>33</sup> Similarly, a flatter supply curve, implying that the supply is more sensitive to changes in the discount factor, will result in countries experiencing larger gains in securities volume as they move toward the ideal regime. In the extreme, where supply and demand are completely elastic, countries will face the greatest pressure to engage in a race-to-the-top. Because greater global capital mobility of issuers or investors necessarily increases the sensitivity of any one country's securities supply or demand curves, such mobility therefore raises the pressure on individual countries to race-to-the-top.

b. *Race-to-the-Bottom*

A race-to-the-top, however, is not the only possible outcome. Races-to-the-bottom may be driven by mobile issuers, mobile investors, or both.

Mobile issuers may provoke a race-to-the-bottom because, although the firm issues the securities, the firm's managers actually choose where the issue will take place.<sup>34</sup> Managers, therefore, may engage in opportunistic behavior to increase their own welfare at the expense of the issuer. For example, although disclosing more information may increase the value of the company to shareholders, managers may prefer not to disclose this information in order to enhance their ability to engage in conduct such as insider trading. Similarly, managers may desire to withhold or manipulate information to boost their compensation or dampen the impact of negative performance on their job prospects.<sup>35</sup> As a result, managers may prefer to issue securities in countries where the securities regime allows them to engage in such opportunistic behavior. Although this behavior reduces net offering proceeds, managers may gain enough to outweigh the indirect loss they suffer from the decline in proceeds.<sup>36</sup>

Because managers choose where to issue securities, a country that wishes to maximize volume will do so by offering the set of regulations that would be negotiated by investors and *managers*. In other words, in a world in which managers' interests diverge from the interests of shareholders, the regulatory ideal will maximize the total value captured by investors and managers rather than investors and shareholders.

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33. See *supra* part I.B.1.

34. See, e.g., Cox, *supra* note 10, at 164-73 (describing how managerial opportunism may result in countries rushing to reduce their insider trading laws and dilute the breadth and depth of their disclosure regulations in order to attract such managers).

35. See *id.*; Coffee, *supra* note 14, at 738-43.

36. The race-to-the-bottom is constrained by the limits to managerial opportunism. These include: (i) corporate law, (ii) corporate structure and compensation schemes, and (iii) inertia, i.e., there is pressure to issue in the market one is already in. This may explain why corporations are not as mobile in some countries. Nevertheless, at the margin, we expect opportunism to play a role.

The pressure on countries to race-to-the-bottom in the face of managerial opportunism depends on the price sensitivity of both supply and demand. The more mobile investors and issuers are, the greater the pressure to race-to-the-bottom, at least where all firms engage in managerial opportunism.<sup>37</sup> Suppose that all countries are identical and that each is at some point other than the regulatory ideal. A country considering deviating towards the regulatory ideal in order to attract issuers driven by managerial incentives will gain more volume if demand and supply are very price-sensitive. If demand is sensitive, a small deviation toward or away from the regulatory ideal would lead to a large change in the number of investors willing to participate in the market for securities at any given discount factor. Similarly, price sensitive supply implies that a small deviation from the regulatory ideal will cause the supply of securities in the national market to change dramatically. This result implies that an increase in the mobility of investors or issuers—i.e., an increase in sensitivity—will make the gains from moving towards the regulatory ideal much greater for an individual country. If the regulatory ideal is undesirable from a global perspective due to the private interests of managers, the race-to-the-bottom is exacerbated by increases in capital mobility.<sup>38</sup>

Where investors are mobile, another possible reason exists for a race-to-the-bottom. To the extent investors invest money through financial intermediaries, a principal-agent problem may exist between the investors and their fund managers. Fund managers, for example, may prefer countries with relatively lax disclosure and insider trading laws that enable the fund managers to profit from trades for their own personal accounts using information gathered for the benefit of the fund's investors. As with the race-to-the-bottom in the case of mobile issuers, some countries may seek to tailor their securities laws to attract such fund managers. Suppose all countries again start with the globally optimal regime. To the extent that a country can increase its trading volume by tailoring its regime to attract opportunistic fund managers, all countries may engage in such a race.

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37. Note that this observation is not, by itself, sufficient reason to discourage capital mobility. Benefits of capital mobility extend far beyond the area of securities regulation and include the efficient pricing of investment opportunities, increased liquidity in foreign exchange markets, and increased opportunities for foreign direct investment. The related benefits include technology sharing, more efficient production, and gains from trade.

38. Of course, a race-to-the-bottom may not occur to the extent the original shareholders of the company realize the incentive of managers to act opportunistically and either impose controls on such managers or else seek managers with non-opportunistic reputations. See, e.g., Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. Chi. L. Rev. 119, 127-32 (1987). Because investors are unable to determine whether managers' selections of another jurisdiction are due to opportunism or another advantage of the jurisdiction—i.e., lower issuing costs—investors may not be able to control such opportunism *ex ante*.

As with mobile issuers, the magnitude of the investor-led race-to-the-bottom depends on the price-sensitivity of supply. More mobile issuers exacerbate the race-to-the-bottom where all investors and countries are homogeneous. Intuitively, a greater supply of issuers magnifies the gain to any one country from attracting more investors through regulations catering to the opportunistic desires of fund managers.

c. *Race-to-the-Regulatory Ideal*

Both of the above "races" are driven by a single national motivation. In each case, national regulatory authorities want to adopt regulations that will maximize the volume of transactions within their jurisdiction. To do so, the national authorities gravitate toward the regulatory ideal in an effort to attract the decision makers in a transaction. In a race-to-the-top case, the shareholders and investors are the decision makers, and the regulatory ideal is optimal to them, implying that it is the most efficient regime. On the other hand, in a race-to-the-bottom situation, managers of issuers and managers of financial intermediaries are the decision makers. Because the interests of these managers generally will not correspond to the interest of shareholders and investors, efforts by the policymakers to appeal to the interests of managers will not be welfare maximizing from a global perspective. Although countries will adopt regulations to maximize their own welfare by maximizing the volume of transactions in their jurisdiction, the overall effect is a race-to-the-bottom.

In both cases, however, it is useful to notice that countries "race" to the regulatory ideal in an effort to attract the decision makers in a transaction. Furthermore, global capital mobility increases the "speed" of the race by increasing pressure on governments to adopt the regulatory ideal. Only by knowing how the decision makers for managers and institutional funds behave, however, can we know if the race is to the top or the bottom.

C. *Heterogeneous Parties and Countries*

The analysis thus far has assumed that issuers, investors, and countries are identical in their preferences. Without more, the analysis in the international context follows that of the domestic state regulation race-to-the-top and race-to-the-bottom literature.<sup>39</sup> The assumptions behind the race-to-the-top and race-to-the-bottom paradigms, however, are too simplistic for the international context. This section expands the analysis to include differences among issuers and investors as well as variations among countries and the domestic size of their securities markets. In particular, this section discusses the possibility that differences among heterogeneous parties will lead to diversity

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39. See *supra* note 30.

among national regulatory regimes. Not only is it possible that a spectrum of securities regimes would develop, but such an outcome would be welfare improving. Finally, this section discusses several factors that determine the likelihood of this desirable outcome.

We relax the assumption of homogeneity among issuers and investors in an effort to make the framework more realistic. Differences may exist among issuers, investors, and national securities markets for many reasons. Issuers, for instance, differ in the cost they bear to comply with a particular securities regime. For most companies, increased mandatory disclosure entails greater legal fees and investigative due diligence costs. Other companies, however, bear not only these costs but also the added burden of having to reveal proprietary or confidential information that may affect their competitiveness. Companies that contemplate launching a new product, for example, may not want to disclose such information before the launch. Where managers drive the issuer's decisions, differences among managers and their preference to engage in opportunistic behavior may also exist. Not all managers may direct their companies to issue securities in countries with relatively lax insider-trading and disclosure laws. If the firm is issuing securities that it believes will be favorably received by the market, and if the manager is not seeking opportunities for self-dealing, the firm may prefer a regime with tough disclosure requirements in order to achieve the most favorable pricing—i.e., the lowest possible discount factor.

Furthermore, in some countries, other sources of law, apart from securities regulation, may regulate managerial opportunism. State corporate law in the United States provides several limits on opportunism. The duty of loyalty, for example, requires managers to act in good faith on behalf of firms;<sup>40</sup> pursuant to the business judgment rule, courts may, at least to a limited extent, scrutinize actions taken by managers to ensure fidelity to the interests of current shareholders.<sup>41</sup> In addition, through contracting, some shareholders may devise compensation mechanisms that decrease the incentive of managers to engage in insider trading and limits the ability of managers to trade in the issuer's securities. Finally, even where managers may want to issue securities abroad opportunistically, the desire to maintain a domestic base of shareholders and other business reasons may limit their ability to do so.

Similarly, investors may be able to put in place mechanisms to reduce the incentives of fund managers to engage in opportunistic behavior. Some fund managers may be compensated based solely on the performance of their investment portfolios. Others may be more or

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40. See Robert C. Clark, *Corporate Law* 141-50 (1986) (describing the corporate duty of loyalty).

41. See *id.* at 123-25.

less restricted in their ability to trade for their own account.<sup>42</sup> Differences may also exist in the incentive and ability of investors to assess the value of securities. Larger, more sophisticated investors may enjoy greater economies of scale in researching securities and have correspondingly greater expertise. Small, individual investors, conversely may lack such resources and depend more on formal legal regulations and protections in assessing securities.

Finally, countries themselves may differ in the "natural" domestic size of the capital markets. Some rather large economies may start with a relatively large number of domestic firms. All other things being equal, such firms may desire to raise capital domestically due to several natural advantages of their home country. First, building a domestic shareholder base may be cheaper to the extent domestic shareholders know more about the company and therefore are willing to discount the represented value by less. Second, greater numbers of domestic shareholders may also increase the political clout of the firm in domestic politics. Third, more domestic shareholders may raise awareness of the company among potential domestic customers of the company. Finally, raising capital domestically may entail fewer unknowns and uncertainties for the domestic company. Of course, to the extent an appreciable cost difference driven by differences in regulatory regimes exists, domestic companies may seek to raise capital abroad. Nevertheless, each country enjoys some amount of natural advantage with respect to its own issuers and investors; where regulatory regimes are similar, firms will gravitate toward their natural, domestic market.

Given these differences among issuers, investors, and countries, countries may not all pursue the same regulatory regime. Rather than racing to the top or bottom, countries may adopt a diverse range of regulatory regimes, leading to what is referred to as a "separating equilibrium." The following section first discusses possible equilibria in instances where issuers and countries vary in their composition, and then discusses the outcome where investors and countries vary in their composition. Although the assumption that all issues are identical is relaxed, it is important to keep in mind that the framework developed in part I.A continues to apply to each "type" of security, making it possible to analyze each type of security in exactly the way that we analyzed securities as a whole in parts I.A and B.

### 1. Heterogeneous Issuers and Countries

Suppose that there are two types of securities issues. For "type A" securities, a relatively high level of disclosure is the ideal level ("high

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42. For example, fund managers in certain countries may be constrained by industry-driven limits on their ability to conduct their own trades. See Sara Calian, *Fund Industry to Unveil Rules on Personal Trades*, Wall St. J., May 9, 1994, at C1, C11 (discussing possible proposals being considered in the United States).



disclosure"). This is so because the relevant firms possess few secrets that they need to protect from competitors and can meet the high disclosure standards at low cost. Furthermore, the disclosed information is valuable to investors and will lead to positive inferences regarding the value of the securities.<sup>43</sup> For "type B" securities, on the other hand, the ideal level of disclosure is much lower ("low disclosure"). This may be because it is costly for firms to comply, they have secrets that will be revealed if they must satisfy a "high disclosure" regime, or the information that would be disclosed is either not critical to investors or will be regarded as negative information by investors.<sup>44</sup>

Consider the optimal strategy for an isolated country (country 1) facing this environment that wants to set its regulatory regime. Assume for the moment that country 1 is closed. This country will choose the regime that maximizes the value of transactions within its jurisdiction. Depending on the relative proportion of type A or type B securities, the regime will be relatively more favorable to one of the two types of firms.<sup>45</sup>

Suppose that given the two types of securities, regulations are set at the level that maximizes volume within country 1 (i.e., the regulatory ideal). Normally, regulations set at a lower level would result in the supply curve as a whole shifting down less than the demand curve shifts, reducing the overall securities volume. Note, however, that for the type B sub-segment of the market, the supply curve may actually shift downward by an amount greater than the demand curve shifts down. The type B subset bears disproportionately high costs from mandatory disclosure and, therefore, will experience a greater downward shift in its supply curve than the type A subset as disclosure regulations are relaxed. In other words, a lower level of regulation will be inefficient for type A securities and for the overall market, but it will increase the efficiency of type B transactions, leading to an increase in the number of such transactions.

Now consider international capital mobility. Assume that countries differ both in the size of their domestic markets and in the composition of firms within their jurisdiction. Suppose that country 1 has a large domestic securities supply with relatively more type A issues while country 2 is small with relatively more type B issues. Country 2 may seek to expand its securities volume by tailoring its regime towards type B issues. Although country 2 may lose some type A issues,

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43. It may also be the case that the management has few opportunities to engage in opportunism—implying that the additional constraint of high disclosure is not costly.

44. In addition, high disclosure would be costly to managers who would lose certain opportunities to extract value from the firm.

45. Of course, an individual country may attempt to devise a separate regime for each type of security. Such efforts will not succeed, however, to the extent that a wide range of different types exist or no easy means exist for regulators to distinguish between the types.

the greater volume of type B issues from country 1 may completely outweigh this effect.

Country 1 then has a choice of how to respond to country 2's opportunistic grab for securities volume. Country 1 may resign itself to losing type B issues and tailor its regime even more toward type A issues, leading to a different regime in each of the countries. We refer to this outcome as a "separating equilibrium." Type A and type B issues will shift their offerings to the countries offering them the most favorable regulations. In a world of perfect capital mobility, country 1 would be host to all type A transactions while all type B transactions would take place within country 2. In such a world, investors would be able to identify the high and low disclosure regimes and, therefore, be able to distinguish type A and type B issues based on the country in which they choose to issue their securities, ensuring that investors will discount the value of these securities appropriately.

With mobility, some countries may tailor their regimes specifically to attract those issuers that experience a relatively high cost from a stringent disclosure regime. Similarly, some countries may seek to tailor their regimes toward managers that wish to engage in opportunistic behavior. Investors will assume that companies that voluntarily select a low disclosure regime either bear a high cost from disclosure or else intend to overstate their represented value. Similarly, if the transaction is to take place in a country with stringent regulations, investors will recognize that the seller submitted to a great deal of disclosure, suggesting that there is less cause to worry about the firm's represented value.

Because investors will be able to distinguish type A issues from type B issues, the existence of two separate and identifiable regimes under which securities can be issued may increase the efficiency of the market, even when compared to the outcome of a race-to-the-top. Therefore, securities may be priced more accurately and at lower cost. Once the fact that all issuers are not identical is recognized, it is easy to see that there is no single "most efficient" regime for all issuers. A mechanism that forces issuers to identify the quality of their issue would be more efficient than any regime. A separating equilibrium does exactly this because countries attempt to capture segments of the global securities market. Within each national market, therefore, there is a smaller range of issuers which allows investors to assess the quality of a given issue more accurately.

From a global point of view, this analysis suggests that diversity in national regimes may be better than any single regime. The benefit of diversity is not simply that "it fosters experimentation and innovation using differing regulatory approaches. . . . [so that] approaches that prove to be efficient regulatory devices can lead the way for other

nations to follow."<sup>46</sup> Nor is it merely that it leads to regulatory competition that can moderate national laws that are either too strong or too weak.<sup>47</sup> Rather, diversity may serve an important role by signaling to investors the quality of an issue, therefore making each individual transaction more efficient.<sup>48</sup>

In the extreme, if there are a large number of different countries, and potential issues are not merely "type A" issues and "type B" issues, but rather are located along a spectrum of possible types, a separating equilibrium could arise with numerous regimes. As the number of regimes grows, the accuracy with which the issuers self-identify the quality of their issue when they choose a market for that issue also grows. With a large enough number of regimes, it may be the case that the main function of disclosure would be to induce the issuer to select the "correct" regime and, thereby, to demonstrate the quality of the issue. The actual disclosure would offer the investor relatively little information that would not be conveyed by the choice of regime.<sup>49</sup>

Unfortunately, a separating equilibrium is not the only possible result. Instead of a separating equilibrium, groups of countries may

46. See Cox, *supra* note 10, at 158.

47. See *id.* at 158-59.

48. Of course, too great a range of regimes may result in added costs of compliance for companies seeking to issue securities in multiple jurisdictions. See, e.g., Trachtman, *supra* note 27, at 79 (advocating reduction of barriers to international issues). Particularly where two different countries' regimes are radically different, such added costs may pose a significant barrier to capital formation. Smaller countries may in fact respond to this pressure by adjusting their own regime to match that of a larger neighbor. Canada, for example, in recent years has moved its own regime much closer to that of the United States. See Cally Jordan, *Regulation of Canadian Capital Markets in the 1990s: The United States in the Driver's Seat*, 4 Pac. Rim L. & Pol'y J. 577, 590-95 (1995) (discussing how the adoption of the Multi-Jurisdictional Disclosure System between the United States and Canada has resulted in a shift in Canada's securities regime toward that of the United States). Nevertheless, the benefit still exists from the competitive pressure that some amount of diversity entails. The increased compliance cost that may result from diversity simply means that some middle level of diversity is desirable and will result in world equilibrium.

49. One caveat is in order. If several countries have similarly stringent regimes but differ in the details of those regimes, a firm may be able to choose to issue its shares in the country that is least likely to require disclosure of the particular information the issuer would prefer to keep hidden. An important problem with any system of diverse regulations or diverse intermediaries is that it allows the *issuer* to decide where to issue. This would not present a problem if regulation were simply a matter of "more" or "less" disclosure, but it is not. Because two regimes may have very similar disclosure requirements when taken in the aggregate, but may differ in significant details, management may benefit from forum shopping. For example, if country 1 has relatively tough insider trading rules but relatively lax rules regarding disclosure of, say, potential future liability, while country 2, which features an overall system of securities regulation that is very similar to country 1's, has relatively lax insider trading rules but tough liability disclosure rules, we would expect issuers to take advantage of these differences. Issuers would choose—on the margin—to issue in the country that requires less disclosure in the areas in which they are "weak." Insiders who are dealing in the firm's stock will issue in country 2 while firms that anticipate the future liability claims against them will issue in country 1.

gravitate toward a single, common regime, a result referred to as a pooling equilibrium. In the case where country 2 tailors its regime to capture the type B issuers, country 1 may adjust its regime towards accommodating type B issuers in an attempt to maintain its volume, leading to a pooling equilibrium where each country has the same regime. In a world without any "natural" advantage to the domestic country, however, this pooling equilibrium is unstable. To see this, suppose that country 2 shifts its regime towards fewer regulations, in favor of type B issuers. Unless country 1 shifts its regime to match country 2's regime, however, type B issuers will flock to country 2 absent some natural tendency to remain in their domestic country. Similarly, to the extent that country 1 does shift its regime in favor of type B issuers and away from that desired by type A issuers, country 2 may reverse its strategy and attempt to win away type A issuers, again leading to a separating equilibrium.

Where countries do possess a natural advantage in retaining domestic issuers, even where issuers are permitted to move their activities abroad, a pooling equilibrium may be both possible and stable. A country's natural advantage essentially increases the cost to an issuer of issuing securities abroad. At the extreme, where international mobility is banned outright, this cost is infinite. Where mobility is allowed, but other factors favor issuing securities domestically, this cost is positive and may vary in magnitude.<sup>50</sup> A large natural advantage allows a country with a large domestic securities market to react to the regulatory strategies of other countries by tailoring its own regime more towards targeted subsegments without losing the remainder of the market. Assume for example, once again, that two countries exist: countries 1 and 2. Country 1 has a large domestic market comprised of two types of issuers, A and B. Suppose further that country 1's market has ninety percent type A and ten percent type B issuers. Now consider the case where country 2 attempts to tailor its regime specifically for type B issuers. Even with this tailored regime, some type B issuers may still choose to remain with country 1 due to country 1's natural advantage. Furthermore, country 1 may react by shifting its own regime more towards type B issuers; to the extent its natural advantage cost is high enough, country 1 may thereby retain its type B issuers without losing any type A issuers to competing countries.

Unlike the separating equilibrium that provides investors with more information about the nature of different securities issuers, thereby raising global welfare, pooling equilibria may reduce global welfare.

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50. For example, domestic investors may have more information on domestic issuers and therefore discount offerings by less. Domestic issuers may also be more familiar with their home country securities laws and clearance and settlement system. Greater numbers of domestic shareholders may also increase the market overall for the issuer's products.

Where different subsegments of issuers and investors exist, for example, competing countries may target those groups which are least served by their domestic country's regime. Compared to the case of homogeneous parties, therefore, international competition that creates a pooling equilibrium may result in countries selecting regimes aimed more toward fringe groups than otherwise. Although better perhaps than the purely domestic case where individual countries adopt regimes radically different from the global ideal, the international pooling equilibrium nevertheless fails to maximize global welfare. The danger posed by a pooling equilibrium is limited, however, by the fact that it requires some natural cost advantage in the domestic regime. Such a cost advantage is, of course, a barrier to capital mobility.

In summary, the presence of a pooling or separating equilibrium depends on three factors. First, the greater the mobility of issuers, the greater the possibility that other countries may seek to capture the business of particular subsets of the issuers, breaking down the pooling equilibrium. Greater numbers of international market alternatives also increases the probability of a separating equilibrium. For example, in the case of a pooling equilibrium involving two countries, a third international market may choose to tailor its regime to satisfy the low-cost-of-disclosure issuers, forcing the initial home country to choose either to remain with the low-cost or high-cost issuers or risk losing both sets of firms.

Second, the greater the natural advantage a country has with respect to its domestic issuers, the greater the likelihood is that the country will be able to maintain some intermediate, non-tailored regime and still retain its securities volume. Returning to the example discussed above, to the extent both type A and type B issues in country 1 are issued domestically due to the importance of maintaining domestic shareholders and due to the uncertainties inherent in investing under a foreign regime, country 1 may be able to successfully adjust its regime incrementally toward type B issues and ward off the tailored regime within country 2.

Finally, the greater the number of alternative securities markets, the higher the probability is that a separating equilibrium will result. In particular, as the number of established securities markets with well-known regimes, reliable transfer and payment systems, and other legal infrastructure increases, the natural advantage countries may enjoy will decrease and thus the probability of a race-to-the-top separating equilibrium is enhanced. Lower natural barriers to mobility, in turn, will result in more competition among countries to tailor their regimes to specific types of issuers, further promoting the likelihood of a separating equilibrium outcome.

## 2. Heterogeneous Investors and Countries

The analysis for heterogeneous investors mirrors that for heterogeneous issuers. Where investors differ in their preferences for particular securities regimes—for example, where some fraction of issuers are driven by fund managers seeking to engage in opportunistic behavior—two types of equilibria may result. First, a separating equilibrium may occur in which different countries tailor their regimes to particular types of investors. Individual investors may then use the signal from the fund manager's selection of a country to infer information on the fund manager's incentives and preferences for opportunistic behavior. Second, a pooling equilibrium may result where larger countries use their natural advantage to retain all types of investors within their borders.

Whether a pooling or separating equilibrium results depends, in turn, on the mobility of investors. The more mobile investors are, the more countries with large numbers of non-opportunistic fund managers lose as they mimic the regime in opportunistic-tailored countries. Investor mobility, therefore, raises the likelihood of a separating equilibrium. Similarly, the greater the number of international alternative markets, the greater the likelihood is that some markets will choose to tailor themselves for the non-opportunistic fund managers, resulting again in a separating equilibrium. Finally, the lower the natural advantage particular countries have in retaining domestic fund managers, the greater the possibility is that a separating equilibrium results.

## 3. Implications for Domestic Securities Regulation

The framework developed in this Article, based on a range of heterogeneous issuers, investors, and countries applies also to the domestic context. In theory, investors benefit from any situation where multiple regimes—for example, the individual states within the United States—compete for a heterogeneous set of investors and issuers. Through this competition, neither a race-to-the-top nor a race-to-the-bottom will necessarily occur. Rather, to the extent that no individual state has too great a natural advantage with respect to its own issuers and investors, a separating equilibrium will arise where particular states tailor themselves toward particular types of issuers and investors. Investors may then look to the state with which a particular issuer decides to associate in order to determine the relative risk of fraud and the merits of the offering.

Despite the theoretical similarity between international regulatory competition and competition between different intra-country regimes, most countries typically have only one national securities regime. Two reasons explain this pattern. First, within any one country, the range of different issuers and investors may not be as great as across different countries. Where other sources of law within one country ade-

quately control for managerial opportunism, for example, the range of different issuer incentives within the country may be minimal. Similarly, the differences among investors within one country may be less than the range across different countries. As a result, a pooling equilibrium between different intra-country regimes is more likely. Because issuers and investors are relatively similar, no one state will be able to gain enough of a market share to make catering to a particular segment worthwhile. Where the pooling equilibrium results in a less than optimal securities regime and most investors and issuers desire a similar level of regulation, a national securities regime may be justified.

Second, even where individual intra-country regimes are free to compete, the market may not value the potential diversity from such competition. To the extent that it is costly for each state in the United States to organize and establish its own separate regulatory regime, states will do so only where enough issuers or investors choose to issue securities under the state's regime. Where issuers and investors are relatively similar, then the state will obtain only those issuers and investors for which it has a natural advantage—for example, issuers and investors located within the particular state. Given the ease of communication and transacting business within one country, however, most intra-country regimes will not even enjoy this natural advantage. Therefore, even where a range of issuers and investors exist, to the extent that other states have already provided for these issuers' and investors' preferences, a new regime will not attract enough volume to justify its expense. As a result, a natural limit exists on the amount of diversity that may occur within one country. In many countries, the presence of a single securities regime may result.

Across several countries, this natural limit also implies that several but not an infinite number of different types of regimes may arise. We do not argue that diversity in regimes is a good in and of itself. Rather, we argue that the global securities market should be free to determine for itself—through a market-based competitive process between regimes—the amount of diversity in regimes. The market will then balance the benefit to issuers and investors from multiple regimes against the cost to different countries of maintaining a completely different level of regulation. Moreover, as the next part discusses, even if arguments do exist that some coordination between regimes may be theoretically worthwhile, the practical difficulties in international cooperation make regulatory competition a better alternative to devising a global regulatory system.

## II. RESPONSES TO INTERNATIONAL REGULATORY PROBLEMS

Where individual countries engage in a race-to-the-top in their securities regimes or, more realistically, generate a separating equilibrium, there is only a limited role for international cooperative efforts

at regulation. Short of information sharing and other enforcement-related cooperation there is no need to establish a cooperative regime. Even in the absence of a negotiated agreement, countries fashioning separate regimes will act to maximize the welfare of issuers and investors on a global scale.<sup>51</sup> As the analysis in part I demonstrates, however, in the case of managers acting opportunistically in the simple race-to-the-bottom model or in the heterogeneous scenario's pooling equilibria, individual country regulations may not advance global welfare. This part discusses several possible responses to the race-to-the-bottom problem and harmful pooling equilibria. First, the extraterritorial application of national laws—in particular, the approach taken by the United States antifraud rules—is examined. Up to this point this Article has implicitly assumed that any regulation adopted by a country would serve to regulate all transactions within the territory of that country. Under this rule of territoriality, the issuer and investor may avoid the jurisdiction of any country simply by moving their transaction abroad. Territoriality, however, is not the only possible method of determining which countries' laws apply to a given transaction. In this part consideration will be given to how different jurisdictional standards affect the rules implemented by national governments and, thereby affect the mobility of issuers and investors. This part then considers the effectiveness of cooperative agreements and efforts to create supranational regulatory bodies aimed at combating races-to-the-bottom and pooling equilibria in the international regulatory context.

#### A. *The Reach of the Antifraud Rules*

The Exchange Act restricts the reach of section 10(b) and Rule 10b-5 only through its requirement that interstate commerce be used.<sup>52</sup> The exact extent of this reach, however, is not specified in the Act. Section 10(b) of the Exchange Act makes it unlawful to employ “any manipulative or deceptive device or contrivance,” “by the use of any means or instrumentality of interstate commerce or of the mails” in “the purchase or sale, of any security.”<sup>53</sup> Section 3(a)(17) of the Exchange Act, in turn, defines interstate commerce as “trade, commerce, transportation, or communication among the several States, or be-

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51. Joel P. Trachtman, among others, argues that some international cooperation is necessary to enforce even one country's securities laws. See Trachtman, *supra* note 27, at 70-71. As we argue in part II.B, *infra*, however, certain forms of cooperation may be harmful.

52. See 17 C.F.R. § 240.10b-5 (1996). In 1948, the Commission adopted Rule 10b-5, which provides an enforcement mechanism for section 10(b).

The reach of the Securities Act antifraud rules, including section 11 and 12(a)(2), are governed under Regulation S. See Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Laws*, 17 Nw. J. Int'l L. & Bus. 207, 214-16 (1996).

53. 15 U.S.C. § 78j (1994).



tween any foreign country and any State, or between any State and any place or ship outside thereof,"<sup>54</sup> section 30(b) of the Exchange Act, furthermore, exempts from the Exchange Act's provisions "any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe."<sup>55</sup> The SEC, however, has not clarified the reach of Rule 10b-5 outside the United States. Instead, the task of determining the reach of section 10(b) has been left to courts, which have grappled with the issue of extraterritoriality on a case-by-case basis.

Today, therefore, the question remains unanswered: To what extent can American laws govern activity that takes place outside its borders? Courts have applied two primary tests to answer this question: the conduct test and the effects test. Each test is described below.<sup>56</sup>

### 1. The Conduct Test (Territoriality)

*American Banana Co. v. United Fruit Co.*<sup>57</sup> is the most important American case to adopt the principle of territoriality. In that case, an American plaintiff filed an antitrust action against an American defendant, alleging that violations of the antitrust laws of the United States had taken place in Costa Rica.<sup>58</sup> Justice Holmes, writing for the Court, concluded that "the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done."<sup>59</sup> This basis for jurisdiction, based on the location of the parties' conduct, has become known as the conduct test.

Under the conduct test, jurisdiction is conferred based on the location of relevant events. In the case of a securities transaction, therefore, jurisdiction can be avoided by moving the transaction to another location. The territoriality standard is the simplest of the possible jurisdictional rules because it divides the world neatly into separate legal regimes. Every country legislates with respect to its own geographic territory.

The reach of the conduct test is, of course, dependent upon what actions are considered to constitute "conduct" for jurisdictional purposes. In a securities transaction, for example, many actions may lead up to the ultimate transaction. Telephone calls may cross jurisdictional boundaries, attorneys may conduct cross-border investigations,

54. See 15 U.S.C. § 78c(a)(17) (1994).

55. 15 U.S.C. § 78dd(b) (1994).

56. Additionally, the Restatement Third of Foreign Relations Law of the United States provides guidance on extraterritoriality. See Restatement (Third) of Foreign Relations Law of the United States (1987); see also Gary B. Born, *A Reappraisal of the Extraterritorial Reach of U.S. Law*, 24 *Law & Pol'y Int'l Bus.* 1, 37-39 (1992) (analyzing the Third Restatement).

57. 213 U.S. 347 (1909).

58. *Id.* at 354-55.

59. *Id.* at 356.

and funds may flow internationally. A workable conduct test, therefore, must specify the amount and type of conduct that is necessary in order to trigger jurisdiction. United States Circuit Courts are split on how to answer this question. The Court of Appeals for the Second Circuit established a very restrictive requirement in *Bersch v. Drexel Firestone, Inc.*,<sup>60</sup> in which it was held that the antifraud provisions of the securities laws:

- (1) Apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country; and
- (2) Apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but
- (3) Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.<sup>61</sup>

In other words, jurisdiction is not conferred by "merely preparatory" acts if it is foreigners that are injured abroad, but may be sufficient when Americans are injured.<sup>62</sup> The *Bersch* test was eventually adopted by the Court of Appeals for the D.C. Circuit in *Zoelsch v. Arthur Anderson & Co.*<sup>63</sup>

In contrast, other Circuits, including the Third, Eighth, and Ninth, have adopted a broader standard for the assertion of jurisdiction.<sup>64</sup> These Circuits have held that jurisdiction is conferred upon the United States whenever conduct occurred in the United States that furthered a fraudulent scheme and was significant with respect to its accomplishment.<sup>65</sup> Under this broader form of the conduct test, therefore, even preparatory acts such as making initial phone calls and

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60. 519 F.2d 974 (2d Cir. 1975).

61. *Id.* at 993.

62. *Id.* at 992; see also *IIT v. Cornfeld*, 619 F.2d 909, 920-21 (2d Cir. 1980) (clarifying the distinction between acts that are merely preparatory and those that directly cause injury).

63. 824 F.2d 27, 33 (D.C. Cir. 1987) (stating that "we adopt what we understand to be the Second Circuit's test"). The D.C. Circuit interprets the Second Circuit test to mean that "jurisdiction will lie in American courts where the domestic conduct comprises all the elements of a defendant's conduct necessary to establish a violation of section 10(b) and Rule 10b-5." See *id.* at 31.

64. See *Continental Grain (Australia) Pty., Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 421 (8th Cir. 1979) (finding that "where defendants' conduct in the United States was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment . . . the district court has subject matter jurisdiction"); *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977) (requiring that "at least some activity designed to further a fraudulent scheme occurs within this country"). The Ninth Circuit adopted the *Continental Grain* test in *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 425 (9th Cir. 1983). For a more detailed discussion of the conduct test in the context of securities regulation, see Kelley Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 Ala. L. Rev. 927, 934-35 (1994).

65. *Kasser*, 548 F.2d at 111-12.

soliciting potential foreign investors in the United States may confer jurisdiction.

Problems exist, however, with the implementation of either form of conduct test. Where significant conduct occurs in more than one jurisdiction, conflict may exist between the jurisdictions applying a conduct-based rule of territoriality. Two countries, for example, may have enough activity within their borders to trigger conduct-based jurisdiction under the *Zoelsch* rule. This is particularly true for transactions involving securities, an essentially intangible product. Offers and sales of securities may occur simultaneously across the borders of two countries. A seller located in the United States, for example, may telephone buyers located in Sweden to complete a sales transaction. Furthermore, the conduct test offers little guidance for determining what acts are central to the transaction and what are merely preparatory.

## 2. The Effects Test (Extraterritoriality)

Although territoriality is the simplest basis of jurisdiction, many countries, the United States among them, do not use a pure version of territoriality to limit the reach of their securities laws. In fact, jurisdiction is often asserted aggressively.<sup>66</sup> Within the United States, the seminal case dealing with antifraud securities regulation is *Schoenbaum v. Firstbrook*.<sup>67</sup> In *Schoenbaum*, the plaintiff was an American shareholder of Banff Oil Ltd., a Canadian corporation. The plaintiff claimed that Banff Oil's controlling shareholders had arranged to have the corporation sell them its own shares at less than market value. This action, argued the plaintiff, constituted a violation of section 10(b) of the Exchange Act.<sup>68</sup> Although the entirety of the transaction at issue took place within Canada, the Court of Appeals for the Second Circuit held that:

[T]he district court has subject matter jurisdiction over violations of the Securities Exchange Act although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors.<sup>69</sup>

In defense of its holding, the *Schoenbaum* court stated that the sale of undervalued stock in Canada would unduly depress stock listed on the

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66. See John C. Maguire, *Regulatory Conflicts: International Tender and Exchange Offers in the 1990s*, 19 Pepp. L. Rev. 939, 949 (1992); *Offshore Offers and Sales*, 53 Fed. Reg. 22,661, 22,662 (1988) (codified at 17 C.F.R. § 230).

67. 405 F.2d 200 (2d Cir.), *aff'd in part rev'd in part*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

68. *Id.* at 204. Specifically, the plaintiff alleged that the insiders had purchased the shares based on information not yet disclosed to the public. *Id.*

69. *Id.* at 208.

American Exchange, thereby generating enough of an effect on the United States market to justify United States jurisdiction.<sup>70</sup>

*Schoenbaum*, therefore, applied jurisdiction not based on any conduct which occurred within the United States but based, at least in part, on the effect of the transaction on the United States capital market. Note, however, that although *Schoenbaum* is cited as an example of the effects test, the court did not go so far as to conclude that an effect on American investors, without more, is a sufficient basis for jurisdiction. Instead, the court suggested that a listing on a United States exchange is an important element in generating the effect on the United States capital markets required to justify jurisdiction. Nevertheless, the principle of *Schoenbaum's* effects test has been followed in several other cases.<sup>71</sup>

With respect to the framework that this Article has laid out, the adoption of the effects test as a means of establishing extraterritorial jurisdiction of a country's laws has the effect of reducing the mobility of investors.<sup>72</sup> Regardless of the location of the transaction, the effects test will bring that transaction under the jurisdiction of the country in which investors live.

Countries may attempt to justify such extraterritorial application of their domestic laws as one response to the race-to-the-bottom. Country 1, for example, may react to pressures from country 2 to reduce its regulatory regime in favor of opportunistic managers in one of two ways. It may itself engage in a race-to-the-bottom, adjusting its own regulatory regime to retain the opportunistic managers. Alternatively, country 1 may choose to extend the application of its laws to

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70. See *id.* at 208-09.

71. See, e.g., *SEC v. Unifund SAL*, 910 F.2d 1028, 1033 (2d Cir. 1990) (stating that trading "on the basis of inside information, options of a United States corporation listed exclusively on a United States stock exchange . . . created the near certainty that United States shareholders . . . would be adversely affected"); *Des Brisay v. Goldfield Corp.*, 549 F.2d 133, 136 (9th Cir. 1977) ("[T]he transaction in question . . . involved the improper use of securities . . . registered and listed on a national exchange and adversely affected not only the plaintiffs but also the American market . . .").

72. Note also that the cost of applying one's laws extraterritorially varies from country to country. In particular, countries with smaller domestic securities markets will experience a greater cost when applying their laws extraterritorially through a broad effects test than larger countries. To see why this is so, suppose that all countries except country 1 allow the sale of securities to their citizens without compliance with their own securities laws, so long as the transaction takes place in a foreign country's market. Country 1, on the other hand, allows the sale of securities to its citizens only if its securities laws are satisfied, regardless of where the transaction takes place. If country 1 is a small country, the issuer is likely to prefer the small loss of liquidity that comes from simply not selling to citizens of country 1 to the costs of satisfying the regulatory regime in country 1. On the other hand, if country 1 represents a large capital market, refusing to sell to its citizens may reduce the market that is available to the issuer and make it more difficult to sell the issue. It may be cheaper to comply with the regulations in country 1 than to lose citizens of country 1 as potential investors. Countries with larger domestic securities markets, therefore, will have greater success in extending their jurisdiction abroad.

cover those domestic issuers and managers that seek to engage in opportunistic behavior abroad, eliminating the gain to these parties from shifting their financing efforts overseas.

A large country like the United States, for example, is able to reduce the pressure of the race-to-the-bottom because its capital market is important and because it has tremendous international influence. The effects tests ensures that American law will be applied extraterritorially in many circumstances, significantly reducing the mobility of American investors in at least two ways. First, extraterritoriality prevents the investors from escaping the dictates of American law. Even if the American securities regime is suboptimal, investors cannot go abroad to take advantage of more favorable regimes because if the effects are felt here, the investor is subject to United States jurisdiction. Second, American investors who wish to invest abroad, despite the fact that American regulations continue to apply to them, may be denied the opportunity to buy securities. Issuers who prefer not to comply with United States law must refuse to sell to American residents. By applying its laws extraterritorially, the United States reduces the mobility of its investors which can reduce the pressure to conform American law to the regulatory ideal as discussed in part II.B. As capital mobility lessens, countries move closer to the purely domestic situation, with all its accompanying problems. For example, without the pressure of international capital competition, individual countries may cater to the interests of the bureaucrats charged with overseeing the regulation of securities. Likewise, a suboptimal regime may result from mistake or inertia, and without external pressures for change it will remain suboptimal.

Most importantly for our present purposes, extraterritorial application of national laws discourages a desirable separating equilibrium. If the laws of, for example, the United States, apply to many transactions by American firms and to many sales to American investors, it is not possible for a country to attract a portion of those issues by adopting a regime that differs from the American one. Indeed, there is an incentive to do exactly the opposite and adopt a regime that matches the American one as closely as possible because this will reduce the additional costs of compliance that firms face if they issue in that country. A country could adopt strict disclosure requirements which would set it apart from the American system, but because the American laws are among the most demanding in the world, most likely, the segment of issuers and investors that would be attracted by an even more demanding regime is minimal. Rather than encourage a separating equilibrium, therefore, extraterritorialism encourages a convergence in securities laws which, in turn, may provoke a race-to-the-bottom.

A regime of territoriality, therefore, may better advance global welfare. Greater territoriality combined with mobility of investors and

issuers increases the likelihood of a beneficial separating equilibrium. As discussed below, the degree of mobility that issuers and investors are granted is of key importance in determining the optimal extraterritorial reach of a country's laws. A world comprised of strict territorial regimes with clear and relatively inexpensive means for parties to opt-out of the domestic regime will provide the greatest pressure on countries to generate a separating equilibrium of different securities regimes, to the benefit of all investors.

### B. *Cooperative Agreements*

Cooperative international agreements offer an alternate possible mechanism for encouraging an efficient global regulatory regime. The United States, for example, through the 1980s and into the 1990s, has pursued an active effort to obtain agreements from several different countries to impose an insider trading regime similar to the one in place in the United States. As a result of this pressure, several countries, including Japan and Switzerland, have instituted similar regimes.<sup>73</sup> The limited success of the American efforts, however, reveals several problems with cooperative agreements as a solution to the potential race-to-the-bottom and pooling equilibria problems.

First, international accords on substantive regulatory issues are often vulnerable to pressure from political interest groups. Once an international regulatory agreement is in place, the actual operation of the agreement becomes open to political maneuvering and rent-seeking. Managers seeking to gain from insider trading may shift to countries where insider trading laws—although present due to an agreement with the United States—may not be enforced vigorously.<sup>74</sup> Countries seeking to attract such managers may, in turn, have an incentive to favor underenforcement. Particularly as time passes from the initial passage of such an agreement, less attention will focus on the substantive issues behind the accord, making it easier to frustrate the agreement through reduced enforcement or through regulatory adjustments to the agreement. Moreover, where agreements are im-

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73. Canada and the United States also entered into a bilateral agreement in 1991, the Multijurisdictional Disclosure System, with respect to offering information disclosure requirements. Under the Multijurisdictional Disclosure System, Canadian issuers may issue securities in the United States while complying with Canadian registration and disclosure requirements so long as the issuer's financial statements conform to the United States's generally accepted accounting principles. Note, however, that even under the Multijurisdictional Disclosure System, Canadian issuers in the United States are still subject to United States antifraud laws. See SEC Release No. 33-6902, 56 Fed. Reg. 30,036 (1991) (codified at 17 C.F.R. §§ 200, 201, 210, 229, 230, 239, 240, 249, 260, 269).

74. Evidence exists, for example, that neither Japan nor Switzerland actively enforce their United States-styled insider trading laws. See *Tokyo Exchange Puts Out Insider-Trading Warning*, Wall St. J., June 18, 1987, at 45 ("While insider trading in a broad sense is illegal under Japanese law, regulations and enforcement mechanisms lag behind those of other countries.").

posed primarily for the benefit of other countries, or where such agreements create large positive externalities for parties outside the country, specific countries may have an incentive to shirk their enforcement responsibilities.

Second, to the extent substantive agreements impose rules not honed from competitive pressures but rather imposed by expert bureaucrats, such rules may suffer from the same problems as regulatory regimes in isolated countries. In particular, the rules may be tailored to benefit bureaucrats charged with regulating securities or may not maximize the welfare of all parties. To the extent SEC bureaucrats benefit from maximizing the size and importance of their own agency, for example, SEC-negotiated agreements may be too complex or may overregulate. Some commentators, in fact, argue that the SEC pushed strongly for United States-styled insider trading laws in foreign jurisdictions to increase the SEC's own stature and responsibility.<sup>75</sup> Bureaucrats may also seek to maximize the benefit to certain regulated groups. As suggested by public choice theorist's capture theory, agency bureaucrats may cause international agreements to favor the interests of the politically-connected few over the diffuse majority of interested parties.

The problems just discussed are, admittedly, also present in a domestic securities regime. Other problems exist, however, that are unique to efforts at international cooperation. For example, international cooperative agreements are often difficult and time consuming to obtain. Each substantive agreement must be negotiated separately. Furthermore, the greater the number of substantive points at issue, the greater the possibility that countries may differ in their approaches and preferences. Countries often negotiate over several different points covering multiple substantive areas simultaneously. As a result, countries may horse trade and deviate from the optimal position on any one particular securities regulatory issue in order to secure an overall agreement. This, in turn, will both prolong negotiations and possibly frustrate a cooperative solution. During the time such international accords are in flux, uncertainty may chill investor activity as well as increase the incidence of the very activity the accord seeks to regulate or prohibit. Insiders, for example, may have increased their trades prior to the adoption of anti-insider trading provisions in Japan and Switzerland to maximize their return in these countries.

In addition, countries may use international agreements to shield themselves from pressures to race-to-the-top or to move toward a separating equilibrium, allowing groups of countries to pursue more op-

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75. See James A. Kehoe, *Exporting Insider Trading Laws: The Enforcement of U.S. Insider Trading Laws Internationally*, 9 *Emory Int'l L. Rev.* 345, 358 (1995) ("Clearly the SEC has every incentive to expand its influence and ideology globally. By extending the U.S. insider trading laws globally, the SEC increases its own international prestige and responsibility, especially in the area of enforcement.").

portunistic goals. For example, a coalition of states may be able to agree on a set of substantive regulations that shield them from pressures to diversify the level of securities regulation. If those countries represent large enough capital markets, they may be able to adopt extraterritorial jurisdictional rules, thereby forcing transactions to take place within their borders even if those transactions might be carried out more efficiently elsewhere or if the global regulatory regime would be better served by a separating equilibrium. Paradoxically, therefore, a cooperative regime may, in certain cases, be worse than if no coordination occurred whatsoever.

Finally, the amount of attention and energy devoted to fashioning the ideal international cooperative agreement draws resources from seeking out other solutions. For some regulators, the search for a beneficial international cooperative agreement becomes itself the goal rather than simply one means to further investor protection or capital formation. During the decade the SEC spent cultivating insider trading laws throughout the world, for example, securities administrators could have focused instead on different means of strengthening the international capital markets as discussed below.

Thus, although a possible solution to the lack of international cooperation, cooperative substantive agreements may not represent the most promising avenue for future activity.<sup>76</sup> As will be discussed in part III, this Article contends that each individual country's regulators should therefore focus on changing the framework of that country's regime—which may involve cooperation with respect to information sharing, encouraging capital mobility, and the like. Regulators should also promote the development of private, non-governmental mechanisms designed to reduce the asymmetric information problem.

### C. *A Centralized, Supra-National Organization*

Recently, commentators have proposed one additional alternative—to delegate the securities regulatory authority of individual countries to regulate securities to one global regulatory body.<sup>77</sup> An extension of the concept of multinational substantive agreements, a supra-national organization would be able to monitor world markets and adjust its regulations accordingly. This organization would create requirements that issues must meet, and implement corresponding penalties for violating the requirements. The organization would also

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76. *But see* Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation*, 12 *Nw. J. Int'l L. & Bus.* 241 (1991) (arguing for greater international securities regulatory cooperation).

77. *See, e.g.,* Manning Gilbert Warren III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 *Harv. Int'l L.J.* 185, 187 (1990) (arguing that a supranational organization may "promote regulatory harmony through the coordination, development, and implementation of common standards").



be charged with enforcing the rules, presumably through domestic laws. Domestic laws could also piggy-back on the regulations; for example, a law could state that compliance with the international requirements is sufficient to comply with the domestic laws for issues within its country.<sup>78</sup>

Such an organization would be able, at least in principle, to weigh the costs and benefits of various regimes and adopt the optimal global regime. Although there is little question that a well-organized and well-managed supranational organization would offer an efficient securities regulation regime,<sup>79</sup> there are many practical hurdles that make this option unrealistic, at least for the foreseeable future. First, such an organization would require the consent and cooperation of national governments, as well as the surrender of significant control to the international organization. To date, efforts to undertake large scale international cooperation on substantive issues of securities regulation have moved slowly, suggesting that countries are simply not prepared to yield control over their securities regulation policies. Second, such a system would lack the benefit of competition in determining the ideal regulatory regime. In addition, the political battles over control of the organization would be between nations—entities not accustomed to deferring to other states or organizations. An international regime would also be unable to harness the informational advantages of having diversity among regulatory systems from which issuers would select a regime. Finally, much like national securities regimes, the supra-national organization would be vulnerable to capture or bureaucratic opportunism.

Whatever one's views on the desirability of a supranational organization, it is unrealistic to expect such an organization to be created in the near future. As such, it is not a reasonable solution to today's problems of international securities regulation.

#### D. *Summary and Recommendation*

Based on the analysis presented above, it is possible to make several recommendations regarding the regulation of international secur-

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78. Some examples of organizations that may eventually act as supranational securities regulatory bodies include the World Trade Organization, the International Organization of Securities Commissions, and the European Community. The Council of the European Community, for example, has sought to further the free-flow of capital within the European Community and to harmonize disclosure standards for companies to list securities on European Community Exchanges. See Trachtman, *supra* note 27, at 96 & nn.83-84. The Council of the European Community has also issued a directive on minimum standards for insider trading laws within the European Community. See Warren, *supra* note 77, at 219-21.

79. Similarly, national securities regulations were optimal when capital flow was primarily domestic. In the United States, for example, state law was found to be inadequate in the 1930s, and national regulations were adopted in their place. The move from national laws to international laws is analogous to the American move from state laws to national laws.

ities markets. In order to encourage a separating equilibrium that allows the market to take advantage of the information revealed by an issuer's choice of regime, national laws must allow capital to flow freely across national borders.

Despite the challenges associated with fashioning a territorialist rule, a strict territorialist rule makes it easy for parties to move their transactions from one jurisdiction to another. For this reason, a territorialist rule supports high mobility of both issuers and investors; as a result, both the supply and demand curves in our framework are flatter than they are under alternative jurisdictional rules. Due to this increased mobility, global forces will exert greater pressure on national governments, making a race-to-the-ideal level of regulation more likely. Under certain assumptions, as described in part I.B, greater mobility may cause a race-to-the-bottom. Under more realistic conditions, however, where issuers and investors vary in their incentives and countries are able to appeal to segments of the overall securities market, increased mobility will tend to result in a desirable separating equilibrium. To the extent that strict territorialist rules raise this mobility, global welfare will also increase.

It is, of course, reasonable for countries to seek to protect the integrity and efficiency of their own capital markets. Countries should be free to adopt national rules that they feel are most advantageous to them—and indeed, it is precisely this freedom that generates diversity among regimes. Countries should also, however, refrain from adopting regulations that infringe on the rights of other countries to govern their own markets. As long as investors are aware of the regime under which they are investing, there is nothing to be gained, and much to be lost by insisting that the laws of their own country apply to them.<sup>80</sup>

The role of extraterritoriality, therefore, should be limited to situations where activities abroad will truly impact national markets. For example, if insiders purchase shares in a firm for their own account at a price below the fair market value, they are reducing the value of all the firm's shares, wherever held. For this reason, a foreign regulatory authority may wish to exercise jurisdiction over the transactions. On the other hand, an issue that takes place in one jurisdiction and that turns out to have been made fraudulently does not harm existing holders of the firm's securities located in other jurisdictions, and therefore, foreign regulators should not seek jurisdiction.<sup>81</sup>

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80. For a detailed discussion of why extraterritoriality does not succeed in protecting national markets or investors, see Choi & Guzman, *supra* note 52, at 219-30.

81. *See id.* (discussing the role for extraterritorial jurisdiction in detail). Even in situations that include the joint listing of securities there is rarely a justification for extraterritorial application of a country's laws. Almost all legitimate regulatory concerns can be addressed with less intrusive regulation. *See id.*

In order to maximize the efficiency of the global securities market, the territorialist rule should increase the ability of investors and issuers to select their own regimes. Furthermore, the rule should allow countries that institute regimes that attract both issuers and investors to reap the benefits through increased securities volume. To do this, the test must tie itself directly to the benefits of increased securities volume. Countries benefit from greater volume through increased fees, increased job creation, and greater domestic liquidity. Therefore, transactions that increase such fees, provide more jobs, and increase liquidity within a country, should be considered within the territory of that country. For transactions that occur on exchanges or are otherwise executed through some exchange system located within one country, determining the territory is straightforward. Therefore, we propose a clear and simple rule: all transactions that occur through an exchange or organized market should be considered within the exclusive jurisdictional reach of the country within which the exchange or organized market operates. For example, transactions that occur within the London Stock Exchange, regardless of the nationality of the participants, should be considered to take place in Great Britain and should be subject only to British law. This bright-line test provides capital market participants with predictable application of regulatory rules, thereby encouraging capital mobility. For the residual number of transactions that take place off-exchange, a more factor driven connection test may be necessary. This test may take into account the nationality of the parties and the location of their communications and payments.<sup>82</sup> This residual ambiguity would not greatly affect the mobility of either investors or issuers. The parties could simply choose to enter into exchange or market system based transactions in order to place themselves clearly under the rules of one territorial jurisdiction.<sup>83</sup>

### III. REGULATORY ALTERNATIVES

Given the problems with cooperative international agreements and extraterritorial jurisdiction as responses to the challenge of international securities regulation, this part now turns to the question of what can and should be done to encourage an efficient international regulatory framework for securities markets. This part outlines two possible alternatives to encourage optimal global regulation: (1) adjustments to the international regulatory climate within which individual countries operate; and (2) the support of alternative private mechanisms designed to protect investors and encourage capital formation.

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82. This test would inevitably involve significant questions of comity.

83. See Choi & Guzman, *supra* note 52, at 228-38.

### A. *Changing the Regulatory Climate*

Part I.B outlined many of the factors that affect whether countries will engage in a race-to-the-top, a race-to-the-bottom, or will find themselves in a separating equilibrium. Governments may act either individually or cooperatively to impact these factors.

In the simple model of homogeneous issuers and countries, part I.B of this Article demonstrates that the mobility of both investors and issuers is crucial in determining the pressure that regulators face to adjust their regimes in the face of international regulatory competition, leading to either a race-to-the-top or a race-to-the-bottom. In any one country, the greater the international mobility of investors and issuers, the more incentive the country will have to impose and maintain a regulatory regime designed to maximize the welfare of investors and firms (race-to-the-top) or their managers (race-to-the-bottom).

Although mobility may exacerbate the race-to-the-bottom where all parties are identical, to the extent that some range of investors, issuers, and countries exist, mobility increases the pressure towards a separating equilibrium among different countries' regimes. Where full investor and issuer mobility is achieved, a country can attract transactions by adopting regulations that appeal to a particular type of issuer and the investors interested in that type of issue. In fact, if there is sufficient mobility, a country that attempts to please all types of issues will attract none of them as each type seeks out more specialized regimes. Efforts aimed at expanding the mobility of issuers and investors across country borders, therefore, may result in the generation of desirable securities regimes, even in the non-cooperative context, by promoting a separating equilibrium.

Countries acting individually or in concert may raise the mobility of investors and issuers in at least three different ways.<sup>84</sup> First, countries may seek domestic changes and international cooperative agreements to reduce direct barriers to the international flow of capital. Although investors seeking to place funds in the United States capital markets may generally do so without restriction, this is not true for many other countries. Foreign investors seeking to invest in South Korea's capital markets, for example, may do so only after approval from South Korea's Ministry of Finance.<sup>85</sup> Foreign investors are also limited in the

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84. It appears that countries are already trying to encourage international mobility in capital markets. "[D]e-regulation is emerging as the approach of choice among national securities regulators, although it is a de-regulation focused not on domestic standards but rather on impediments to cross-border transactions that national regulators have been pursuing with studied persistence." Samuel Wolff, *Recent Developments in International Securities Regulations*, 23 *Denv. J. Int'l L. & Pol'y* 347, 351 (1995).

85. See S. Jane Rose, *The New Wave of International Funds*, 582 *P.L.I. Corp.* 123, 127 (1987).

percentage of shares they may hold in any one Korean company.<sup>86</sup> Even the United States could do more to improve capital mobility. Although investors are able to place their funds outside the United States, oftentimes—according to the strictures contained in Regulation S of the Securities Act—United States securities laws will follow such placements.<sup>87</sup> For example, a Japanese company selling securities solely in Japan and operating only in Japan may nevertheless come under the reach of United States securities laws to the extent some of its investors are United States residents.<sup>88</sup> Similarly, the antifraud rules that have emerged from the Exchange Act are applied to conduct around the world. Either unilaterally or through agreements with other countries, the United States could increase the mobility of its investors by curtailing the reach of its own securities laws. At the very least, the United States and other countries could act to reduce the cost for issuers and investors to opt out of the United States regime and select another country's regime to govern their transaction.<sup>89</sup>

International cooperative agreements focusing solely on investor mobility, moreover, have several advantages over international substantive agreements. Unlike substantive agreements, that must determine the precise type and quantity of disclosure as well as the nature of antifraud rules to apply across several different borders, international mobility agreements need only focus on ensuring that issuers and investors are able to enter and exit countries without difficulty. As a result, unlike a more substantive international agreement, mobility agreements lead to fewer mistakes and are easier to negotiate. Furthermore, once in place, mobility agreements present less danger of subsequent rent-seeking. Substantive agreements are subject to the risk that with changing political tides the agreement might come under attack or renegotiation. In addition, to the extent an international regulatory oversight body is created under a substantive agreement, political pressure will arise for the oversight body to expand its functions or serve the interests of specific interest groups. An agreement providing only for the international mobility of issuers and investors, on the other hand, provides no further room for parties to rent-seek. Rent-seekers have fewer dimensions to argue for changes that might benefit one country over others.

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86. *See id.*

87. *See Choi & Guzman, supra* note 52, at 215-16.

88. Regulation S provides a safe-harbor only for transactions not made with persons in the United States. *See* Securities Act Rule 903(b), 902(i).

89. The justification for the international application of American laws is rarely stated clearly, but is normally considered to focus on protection of American investors and American markets. For a discussion of why extraterritorial application as currently practiced achieves neither of these goals, and why a regime with only very limited exceptions to territoriality could achieve them, see *Choi & Guzman, supra* note 52, at 219-30.

Even in countries where investors have the legal ability to shift investments abroad, countries may wish to enter into bilateral reciprocity agreements with other countries. Reciprocity agreements typically provide that foreign issuers may list their stock on both domestic exchanges as well as raise capital within the domestic market so long as they comply with their home country securities laws. Importantly, such a reciprocity agreement should leave it up to the individual company whether to be governed by the host country's or its own country's laws. Former SEC Chairman Richard C. Bremen, in particular, has criticized such agreements. He has argued that reciprocity places domestic companies at a potential competitive disadvantage relative to foreign issuers seeking capital and that such agreements will cause investor confusion and reduce the ability of investors to compare different issues.<sup>90</sup> Investors, however, already face a large choice of investments across different foreign markets, each with widely differing securities regulatory regimes. Providing foreign companies and their accompanying foreign regulatory regimes with easier access to the United States simply reduces the transaction cost for domestic investors to actually purchase foreign securities. United States investors already may invest directly in German companies within the German capital market system, for example. Taxes and an unfamiliarity with the German capital markets may hinder this mobility; however, reciprocity simply reduces this transaction cost and thereby increases investor mobility. Furthermore, to the extent United States regulations are superior and therefore result in investors willing to pay a higher price for issues, foreign companies will voluntarily elect to comply with United States securities laws.

Second, even where issuers and investors have the ability to opt for different securities regimes, countries may aid mobility through agreements to make this choice clear, credible, and firm. Regulation S, for example, allows United States investors to opt out of the United States regime somewhat if their offshore transactions do not consist of any "directed selling efforts" in the United States and complies with other requirements.<sup>91</sup> What constitutes directed selling efforts, however, relies on whether activities that might "condition" the United States market have taken place.<sup>92</sup> Because the term "condition" is somewhat vague, investors lack the ability to opt out of the United

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90. See Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 *Fordham Int'l L.J.* S77, S89 (1994).

[I]f the SEC were to adopt a system of home country exemptions, then U.S. investors would be confronted even today with financial statements prepared under at least forty different sets of accounting principles. That approach actually has been tried in the past, and the results are chronicled in the Bible in the story of the Tower of Babel.

*Id.*

91. See Securities Act Rule 903(b).

92. See Securities Act Rule 902(b)(1).

States regime with confidence. International agreements, both harmonizing the choice of law issues facing parties to a securities transaction and allowing such parties to commit to a particular regime's laws *ex ante*, will encourage more transactions and increase capital market mobility. In addition, it is important to recognize that choice of law agreements, much like international agreements dealing with capital mobility, face less delay and political opportunism pressure than substantive international agreements.

Third, agreements that encourage the sharing of information and the effective enforcement of securities laws should be encouraged.<sup>93</sup> Diversity in securities regimes is desirable because investors can identify the regimes of the country in which shares are being issued and can adjust the discount factor accordingly. It is, however, important that the securities regulations of every country can be enforced effectively against parties that operate internationally. Agreements that facilitate evidence gathering and the service of process, for example, should be encouraged. Such agreements involve the least amount of cooperation between countries, and as a result, are most easily obtained.<sup>94</sup> Furthermore, because enforcement agreements do not involve any substantive change in countries' securities regimes, these agreements are less vulnerable to political capture.<sup>95</sup>

Fourth, even where investors are free to invest abroad and reciprocity agreements reduce the cost of doing so, mobility may be constrained by "natural advantage" factors not directly related to the securities regulatory regime. For example, even in a world of complete mobility, investors may choose to stay in the United States despite a strong dislike for the United States securities regime because no other country offers the same liquidity or size of capital markets. Similarly, the presence of an efficient stock execution, transfer, and settlement system as well as a strong contract, bankruptcy, and com-

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93. Indeed, agreements dealing with securities enforcement and information sharing are the most prevalent of cooperative agreements among countries today. See Trachtman, *supra* note 27, at 75.

94. See, e.g., *id.* at 85-86 (stating enforcement assistance "provides the least troublesome . . . intrusions on domestic sovereignty").

95. An example of such enforcement agreements are the series of bilateral memoranda of understandings that the SEC has negotiated with various foreign governments. While not formal treaties, the memoranda of understandings serve as mutual expressions of intent that different country regulators will assist one another with both information and enforcement cooperation. See *id.* at 86-87. In particular, memoranda of understandings have been used in the area of insider trading enforcement. See Kehoe, *supra* note 75, at 359-62.

Other agreements may also be desirable in order to achieve various objectives that are not the primary goals of the securities regime. For example, if company X has investors all in country 1 but has some minor activities in country 2 that cause substantial tort harms, the assets in country 2 may be insufficient to pay damages—and therefore X may have great incentives *ex ante* to engage in hazardous activities in foreign countries. This problem would be a case in which an international tort agreement may be useful.

mercial legal system will also affect the mobility decision of investors. Of course, competing jurisdictions will have an incentive to create the necessary infrastructure to attract investors. Nevertheless, efforts should be undertaken to encourage a separating equilibrium through international cooperation aimed at developing legal infrastructures that will increase the willingness of investors and issuers to become mobile.

### B. *Private Mechanisms*

As a substitute for substantive international regulatory cooperation, individual countries may seek to enhance the operation of private devices designed to provide investors with information on securities issues. The main justification for capital market regulation is the information gap between issuers, insiders, and investors. If no asymmetry of information exists—or alternatively, no issuer lies about its own value—then all investors could determine the true value of each company and pay accordingly. In a well-functioning, efficient market, the price would incorporate this information, protecting even unsophisticated investors. The greatest danger, therefore, lies where information is not public or where no well-functioning market exists for the issuer's securities. With respect to international capital markets, the additional danger exists that investors will be insufficiently informed about the legal regime under which they are investing. In these situations, government regulation provides one means of combating the asymmetric information problem. Through disclosure, at least theoretically, private information becomes public, lessening the asymmetric information problem. Through antifraud rules, issuers, again theoretically, are given incentives not to take advantage of investors where an asymmetric information problem does exist. To the extent government regulation is ineffective or impossible to implement on a global scale, however, at least two private mechanisms exist to fill the breach. These involve: (1) certification or reputational intermediaries, and (2) investor empowerment.

#### 1. Certification Intermediaries

Where an asymmetric information problem exists between two market participants—for example, between the issuer and investor—parties recognizing the asymmetry will adjust market prices accordingly. For example, take the case of two companies, X and Y, where X is worth \$100 per share and Y is worth \$50 per share. In this case, investors unable to distinguish between X and Y will price both companies at \$75.<sup>96</sup> Higher-value companies, as a result, subsidize lower-value companies; not surprisingly, higher-value companies have an incentive

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<sup>96</sup>. Note that this assumes that the number of shares of both companies X and Y traded in the market are equivalent.



to distinguish themselves. To the extent higher-value companies are unable to do so, however, they incur a higher cost of capital and may opt to leave the capital market. Furthermore, *ex ante*, companies contemplating whether to make investments in quality may choose not to do so. In other words, companies understanding the problem of asymmetric information will select investments to remain lower-value rather than higher-value companies. Therefore, society as a whole loses as companies forego beneficial investment projects.

The asymmetric information problem is further exacerbated in the international context. Where countries race-to-the-bottom, legal mechanisms designed to allow higher-value companies to distinguish themselves credibly from lower-value companies may weaken. For example, when countries race to dilute their antifraud protections, companies no longer may rely on legal sanctions to bind themselves to truthful disclosures. As a result, investors will view statements from even higher-value companies with skepticism. Similarly, as mandatory disclosure rules weaken, higher value companies may find that investors are less able to compare their value against that of other companies.<sup>97</sup> Particularly where high-value companies lack mobility, they will not be able to switch to a jurisdiction with stringent antifraud or disclosure rules to signal their value to investors.

Certification intermediaries, or gatekeepers, provide lawmakers with an alternative device to protect investors and to identify higher-value companies globally.<sup>98</sup> Certifiers in the global securities context include the major securities and investment firms, such as Goldman Sachs & Co., Morgan Stanley Inc., and CS First Boston, as well as internationally recognized auditing firms, including Deloitte Touche, Arthur Anderson, and Coopers & Lybrand. Certifiers act to reduce the asymmetric information problem between investors and issuers. Through an association with a certifier, higher-value firms are able to signal credibly their value to investors. Investors will consider such a signal to be credible so long as: (1) the certifiers actually possess the necessary expertise to distinguish among different value issues, and (2) the certifiers possess adequate incentives to execute faithfully their certification duties. To the extent that both of these conditions are

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97. Of course, Easterbrook and Fischel argue that higher-value companies will voluntarily disclose information. See Easterbrook & Fischel, *supra* note 14, at 672-75. Without a standardized mechanism to disclose this information, however, investors may not be able to interpret correctly the value of the company. Furthermore, where antifraud regimes are lax, higher-value companies will still face a credibility problem in conveying their true value.

98. For a general discussion of the role of certification intermediaries, see Stephen Choi, *Market Lessons for Gatekeepers*, (working paper on file with authors); see also Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. Law Econ. & Org. 53 (1986) (describing how legal liability may be used to encourage third-party intermediaries to certify the value of another's products).

met, certifiers offer the following advantages over public regulatory mechanisms.

First, certifiers and the signal they provide cross international borders with greater ease than regulatory devices. Without an international agreement, individual countries may employ different securities regulatory regimes. In contrast, Goldman Sachs, for example, is present in dozens of different countries. Goldman Sachs's capital base is spread across these different countries and its professionals are relatively mobile between the countries. Furthermore, Goldman Sachs's reputation with investors spans these different countries. The ability of certifiers to operate across country borders leads to several advantages. Certifiers may develop standardized procedures to evaluate companies and standardized means of transmitting this information to investors, thereby reducing costs. Furthermore, investors may rely on certifiers to provide a known quality of certification. Even where investors contemplate investing in companies from foreign countries where the investors have relatively little experience, the investors may rely on the reputation of the associated international certifier.<sup>99</sup>

Second, unlike government agencies that may lack experience or expertise in regulating securities, international certifiers bring with them great expertise in evaluating investments. Because certifiers are paid in part for their ability to screen out bad investment prospects, they have strong financial incentives to develop their expertise. Even well-intentioned regulators lack the same amount of economic incentive to invest in information technology and financial screening capabilities. Furthermore, because the certifier represents one firm across several different borders, the transmission of its expertise across different country-branch offices is also easier for the international certifier. The international certifier, as a result, may enjoy economics of scope and scale over an individual country regulator. The presence of international certifiers in several countries also provides the certifier an informational advantage to judge the value of multinational corporations. Such presence provides the international certifier with detailed information on each country's securities regulatory regime as well as local knowledge of the operations of multinational corporations.

Finally, unlike government agencies, international certifiers have a greater incentive to execute their certification role faithfully. As with domestic certifiers, international certifiers are paid in part by issuers based on the certifier's ability to deliver investors willing to pay for the issuers' securities at a high price. Investors in turn will pay this price based on the reputation of the certifier to screen for misleading and low-value issuers. The greater the certifier's future potential re-

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99. Of course, where no international certifier is associated with the foreign company, investors lack this certification information.

turn from this function, the more incentive the certifier has to remain faithful. As a result, international certifiers, with capital spread across several different countries, frequently take on larger issues than domestic securities firms. Greater capital investment and increased presence in several different countries encourages international certifiers to remain faithful in their function. This is particularly important because international certifiers certify issuers where investors typically have much less information than domestic issuers.

Left without any international regulation, therefore, private certification agents provide investors in foreign companies with some measure of protection from fraud and reduce the basic asymmetric information problem between themselves and foreign issuers. Furthermore, this protection is relatively independent of country-specific boundaries or regulations.

## 2. Institutional Investors

The private market may also respond to the problem of asymmetric information through the aggregation of resources designed to reduce this asymmetry. Even where investors lack the direct access to issuers that certifiers enjoy, often—with enough resources—other information is available to approximate the true value of an issue. Take for example Netscape, Inc. Information on the general volume of computer sales, the growth rate of the internet, and the nature of Microsoft's competing web browser all could have been gathered and synthesized to assess Netscape's potential. The greatest barrier for most investors to engage in such activity, however, is the cost. Most investors have too little at stake to make such an investigation worthwhile; furthermore, most investors lack the expertise to synthesize this information.

In the domestic context, mutual funds represent one response to the problem of asymmetric information. Investors in a mutual fund essentially purchase not only the right to the underlying securities of the fund but also the expertise of the fund manager in selecting these securities. The rise in the importance of mutual funds and other institutional investors has two implications for domestic securities markets. First, small investors not a part of such funds may experience even more of an asymmetric information problem in the context of new issues. Second, in secondary market trading, securities prices should reflect the information obtained through the efforts of fund managers and, therefore, be more efficient.

Internationally, the growth in importance of institutional investors may also lessen the problem of asymmetric information and thereby reduce the need for international regulatory cooperation. Unlike small investors, institutional investors possess the resources and incentives to conduct detailed investigations of the companies in which they invest across international boundaries. Indeed, as companies become

more multinational, only investors with the capability of gathering information from several different countries will be able to accurately gauge a company's true worth. Furthermore, to the extent that learning about the securities regulatory regime of different countries is costly, institutional investors again possess an advantage over small investors. The large securities volume institutional investors transact makes investigating the securities regulatory regime of several different countries cost-effective. Therefore, institutional investors are more likely than smaller investors to discount securities accurately from countries with relatively lax securities regimes.

As with the domestic expansion of institutional investors, global expansion has two impacts on small investors. First, small investors will suffer an even greater asymmetric information problem vis-a-vis institutional investors. This is particularly true with respect to foreign country investment where small investors typically lack knowledge both on the business operations of the issuer and the local regulatory regime. Because institutional investors will be more successful in trying to purchase securities from higher-value companies, small investors suffer a winner's curse, purchasing disproportionately large quantities of lower-value companies.<sup>100</sup> Second, in secondary markets, the presence of institutional investors will increase the efficiency of such markets ultimately protecting small investors.

Institutional investors, therefore, provide a private mechanism to further goals similar to those pursued by proponents of international securities regulation. Furthermore, individual countries may play a role in either hindering or supporting such institutional investors. Countries, for example, may support the presence of institutional investors in a number of different ways. First, countries may actively subsidize the growth of such investors. In the United States, for example, one of the largest sources of growth for institutional investors has been through the expansion of company-sponsored 401(k) plans.<sup>101</sup> Employee contributions out of their income into a 401(k) plan are not taxed until eventually withdrawn; furthermore, investment income within the 401(k) plan is not taxed until withdrawn from the plan. Employees therefore enjoy the double benefit of deferred taxation and tax-free investment build-up throughout the life of the 401(k) plan.

Second, countries should consider removing restrictions on the investment activities of institutional investors.<sup>102</sup> In the United States,

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100. See, e.g., Kevin Rock, *Why New Issues Are Underpriced*, 15 J. Fin. Econ. 187 (1986) (providing a model of initial public offering discounting based on an asymmetry of information between sophisticated and unsophisticated investors).

101. See I.R.C. § 401(k) (1997).

102. See generally Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. Pa. L. Rev. 1469 (1991) (describing the effects of regulation on the mutual fund industry).

for example, both the Investment Company Act of 1940<sup>103</sup> and the Internal Revenue Code ("IRC") place restrictions on the ability of mutual funds to invest. In particular, both the Investment Company Act and the Internal Revenue Code penalize non-diversified funds.<sup>104</sup> The IRC, for example, only allows funds that meet its diversified criteria to pass through taxes to individual investors. Non-diversified funds must pay another layer of tax in between the tax at the corporate issuer's level and individual income tax at the investor level—resulting in triple taxation for such funds.<sup>105</sup> The diversification requirement forces funds to avoid holding greater than ten percent of the voting stock of any one company, even if the company would represent only a marginal portion of the fund's total size. This, in turn, reduces the incentive for funds to investigate companies for undervalued "deals." Again, such a rule has the greatest impact on international investments in smaller markets where greater asymmetries of information exist. Because funds may, at most, purchase only ten percent of an undervalued company's stock, funds *ex ante* will have less of an incentive to conduct detailed financial research of such undervalued companies.<sup>106</sup>

Third, countries may wish to eliminate any subsidies they provide for small investors to purchase stocks individually. The United States, for example, makes it a priority to ensure smaller investors have the ability to compete with higher volume investors in obtaining quote information and to place orders. The NASDAQ short order execution system is an example of this.<sup>107</sup> Such subsidies, however, cause more investors to eschew funds and to invest individually, leading to a greater need for regulatory protection of such investors. Particularly where such investors would otherwise join a fund rather than invest individually, governments should consider removing this distortion and deterrence to the growth of funds.

Finally, countries may seek to remove any impediments from funds investing overseas. To the extent investing overseas results in large transaction costs (i.e., taxes from the foreign country), countries may seek to reduce such costs through reciprocal agreements with other countries or through the use of depository receipts in their own trad-

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103. 15 U.S.C. §§ 80a-1 to 80a-64 (1994).

104. See Roe, *supra* note 102, at 1474-80 (detailing the prohibitions and penalties within the Investment Company Act and the Internal Revenue Code against nondiversified funds).

105. See *id.*

106. Indian regulators currently are considering reforms to encourage the growth of their mutual fund industry. Among other areas, the reforms may target Indian regulations governing the ability of funds to concentrate investments in one industry or one company. See Sumit Sharma, *India Mulls Steps to Polish Image of Mutual Funds*, *Asian Wall St. J.*, June 27, 1996, at 1.

107. See Richard G. Ketchum & Beth E. Weimer, *Market 2000 and the NASDAQ Stock Market*, 19 J. Corp. L. 559, 577-78 (1994) (describing recent NASD changes to the NASDAQ short order execution system to curb misuse of the system).

ing markets. Countries may also allow indexes of other countries' stocks or derivative instruments based on other countries' stocks to trade domestically to allow institutional investors either to sell short some stock or hedge their positions in foreign countries easily. This is particularly important if other countries do not allow short selling or derivative transactions within their borders. For example, consider an institutional investor that wishes to take a position that a particular foreign equity security will rise by ten dollars per share but no more than twenty dollars per share. If the foreign country where the security trades does not allow derivative transactions, the institutional investor will be unable to take its desired position. To the extent the institutional investor's own domestic country allows such derivative transactions, however, the investor may then purchase the foreign equity abroad and sell a call option domestically on the security with an exercise price of twenty dollars more than the current price of the security to achieve its desired risk-return profile.<sup>108</sup>

### CONCLUSION

As world markets have expanded in scope, the importance of international pressures on domestic securities regulatory regimes has grown. With more reliable and speedier communication devices, both issuers and investors now find it relatively simple to participate in securities transactions in foreign jurisdictions. Furthermore, the growing stability and familiarity of a number of different markets—from Hong Kong to Switzerland—as well as the growth in trustworthy payment and transfer systems has encouraged many domestic parties to conduct their investment activities abroad. This global expansion has provided securities market participants with greater liquidity and more diversification of risk, to the net social gain of all.

Countries, nevertheless, continue to control securities transactions that take place under their specific jurisdiction. Although the world markets may have globalized, the legal and political regimes upon which the world markets rest are highly country-specific. Analysis of securities markets under an assumption of homogeneous participants

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108. See Note, *Investor Liability: Financial Innovations in the Regulatory State and the Coming Revolution in Corporate Law*, 107 Harv. L. Rev. 1941 (1994) (discussing the use of financial derivative securities in international transactions).

Despite the advantages of institutional investors in promoting an optimal global regulatory regime, governments, nevertheless, should remain wary of too much concentration of investment power within the hands of a few institutional investors. Principal-agent problems may exist between the fund trustees and the investors into the fund. Trustees, for example, may short sell stocks within their funds and then dump the stocks in an attempt to reduce the stock price at a gain for themselves. Furthermore, funds themselves may become privy to insider information and engage in insider trading. Finally, although large concentrations of stock ownership may ameliorate corporate governance problems between management and ownership, extensive fund ownership may actually lead to more collusion between companies with cross-linking ownership patterns.

leads to the conclusion that countries may face either a race-to-the-top or race-to-the-bottom in designing their respective securities regulatory regimes. Where a range of investors, issuers, and countries exist, however, greater capital mobility in general increases the likelihood that a separating equilibrium of diverse sets of regulatory regimes will arise and that global welfare will be increased as a result.

In adopting its own national regulatory regime, the United States has chosen to apply its laws extraterritorially. The antifraud rules discussed in this Article are one example of this approach. This Article has attempted to demonstrate that more effective reform may be possible by modifying the conditions under which countries compete for securities transactional volume. Several complimentary strategies have been identified. First and foremost, countries should encourage, rather than discourage international capital mobility. The greater the mobility of capital, the more advantageous countries will find it to establish regimes that appeal to a certain "type" of security, and therefore, the greater the impetus will be towards a diverse set of regimes.

Second, this Article supports efforts to find cooperative approaches to the regulation of international securities but points out that it is important to pursue beneficial forms of cooperation and avoid harmful ones. Agreements that focus on information sharing, enforcement issues, and capital mobility should be encouraged—these all lead to a more efficient functioning of capital markets and regulatory regimes. Attempts to achieve a common substantive law with respect to securities, however, is counterproductive and should be discouraged. A convergence in the securities laws of many countries undermines the natural incentive to establish a range of regulatory systems.

Third, the extraterritorial reach of the securities laws should be severely curtailed. By adopting a territorial approach, with an exception for cases in which behavior abroad truly impacts the domestic market, countries will clarify the choice of law question, reduce the frequency and cost of overlapping jurisdictions, and increase the mobility of capital by allowing investors and issuers to choose their regime without fear that their domestic regime will follow them. Such capital mobility, in turn, increases the likelihood of a beneficial separating equilibrium among regulatory regimes.

Finally, the growth of private mechanisms that help investors judge the value of securities offers a low cost and efficient way to encourage capital mobility and reduce informational asymmetries. In particular, both certification intermediaries and the rise of mutual fund financial investment intermediaries provide promise of greater market-based means for investors to reduce the information asymmetry inherent in securities transactions.

If the international securities market is to function more efficiently, it must be governed in an efficient and sensible manner. Regulating international activity with national laws is one of the great challenges

of modern international law. This Article has attempted to demonstrate that it is possible to regulate international securities markets despite the fact that we lack the ability to legislate internationally. By encouraging capital mobility and by allowing the market to harness the information that is revealed by an issuer's choice of regime, the challenge of national legislation can lead to an efficient result even though we lack the luxury of a truly international securities regulatory regime.