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Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure

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SECURITIES REGULATION AS LOBSTER TRAP: A CREDIBLE COMMITMENT THEORY OF MANDATORY DISCLOSURE

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What functions does the existing mandatory disclosure system serve? In this Article, I argue that the existing SEC system can be understood as providing issuers with a mechanism for making a credible commitment to high quality, comprehensive disclosure for an indefinite period into the future. This credible commitment device is particularly useful to new domestic issuers and to foreign issuers seeking to tap the U.S. capital markets. This credible commitment justification explains the striking but little discussed practical and formal asymmetry between the ease of entry into the SEC system and the difficulty of exit from it. I then consider the implications of this credible commitment view for the various proposals on securities disclosure in a global capital market, and the tradeoffs between the potential benefits of increasing competition among suppliers of disclosure regulation and the potential loss of the ability of any system to offer credible commitment.

INTRODUCTION

A miracle of birth occurs when a company goes public. Because it happens all the time, one can take for granted the legal and institutional infrastructure that facilitates the transformation of a closely held enterprise—in which ownership and management overlap and in which participants have continuous access to information—into a firm in which ownership and control are

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substantially separated, in which shares are traded in public capital markets, and in which the supply of information is far more constricted and episodic. The miracle is even greater when it is cross-border. How is it that a closely held, high-tech start up with its operations in an industrial park outside Tel Aviv, Israel, and with customers and marketing facilities scattered around the world, can tap the U.S. capital markets?[1]

In this Article, I examine the connection between going public, cross-border securities transactions, and the U.S. mandatory disclosure regime. I argue that an important but largely unappreciated function of the U.S. mandatory disclosure regime is the extent to which it permits issuers to make a credible commitment to a level and *permanence* of disclosure. This ability to credibly commit facilitates contracting between closely held issuers and the dispersed investors they wish to attract, thereby reducing the cost of capital.[2]

This understanding of the U.S. disclosure regime has important implications. First, it emphasizes a function of, and justification for, the existing system which has largely been ignored, and that is particularly useful in understanding the role mandatory disclosure plays in the transformation of closely held firms into public companies. Second, it provides an explanation for a striking feature of that regime, namely, that it is easy to enter but very hard to exit. Third, it casts light on the question of who should regulate cross border securities transactions, and reveals difficulties in both Merritt Fox's "economic center of gravity" anti-regulatory choice principle and identifies unacknowledged costs of the various pro-regulatory competition proposals that have been floated recently.[3]

[1] I take Israeli high-tech firms as an example because they have pioneered the use of international equity markets, so much so that it has become relatively routine. For a description and analysis, see Edward B. Rock, *Greenhorns, Yankees and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Markets*, 2 THEORETICAL INQUIRIES IN LAW 711 (2001). But the phenomenon is spreading and can be expected to accelerate. For European developments, see *Europe's Great Experiment*, ECONOMIST, June 13-19, 1998, at 67.

[2] Making commitments credible is also one of the most important functions of corporate law. The central feature of corporate law, namely, the corporate legal form itself, can be understood as a device that allows investors to credibly commit to locking themselves in to a long-term relationship, with restricted exit. This function is particularly clear in the case of close corporations and in the comparison between close corporations and partnerships. *See* Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999). The analysis here is thus in the same spirit as Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381 (1990).

[3] The literature on mandatory disclosure is enormous. Important contributions

In Part I, I focus on the rules governing entrance into and exit from the U.S. mandatory disclosure system. These features, which are intimately linked to the extent to which the system can serve as a credible commitment device for issuers, have not received nearly as much attention as other elements of the system.

In Part II, I outline the ways in which a mandatory disclosure regulation can serve as a credible commitment device, both with respect to initial public offerings as well as with respect to firms entering other capital markets for the first time. I then explain how the entry and exit features of the U.S. disclosure system can best be understood as facilitating credible commitment.

In Part III, I draw out the implications of this credible commitment view for the various proposals on securities disclosure in a globalizing market, and on the tradeoffs between the potential benefits of increasing competition among suppliers of disclosure regulation and the potential loss of the ability of any system to offer credible commitment. I close with a brief conclusion.

I. ENTRY INTO AND EXIT FROM THE U.S. DISCLOSURE SYSTEM

In the voluminous literature on the U.S. mandatory disclosure system, a great deal of attention has been focused on the content

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include: FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 276-314 (1991); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995); and Paul G. Mahoney, *Mandatory Disclosure As a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

Elements of an approach similar to mine can be found in Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989), and Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 151-52 (1987). *See also* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

In two recent papers, Oren Fürst has argued that the U.S. investor protection system allows profitable foreign firms to credibly convey private information. *See* Oren Fürst, *A Theoretical Analysis of the Investor Protection Regulations Argument for Global Listings of Stocks*, International Center for Finance Working Paper Series, (Sept. 10, 1998), *available at* http://icf.som.yale.edu/html/finance_center.shtml; Oren Fürst, *Investment in EMU Countries Using the Expected Residual Income Valuation: The Value Premium Is Higher and More Stable Than You Thought*, International Center for Finance Working Paper Series, (Aug. 31, 1998), *available at* http://icf.som.yale.edu/html/finance_center.shtml. For another signaling analysis of the listing decision, see C. Sherman Cheung & Jason Lee, *Disclosure Environment and Listing on Foreign Stock Exchanges*, 19 J. BANKING & FIN. 347 (1995). My analysis differs in a number of respects, including in my focus on the asymmetry between entry and exit, and the similarity between the benefits gained from mandatory disclosure for foreign issuers and IPOs.

of mandatory disclosure (i.e., what must be disclosed) and on its mandatoriness. Sometimes lost in this discussion is the fact that the system is voluntary at least in the sense that firms opt into it by choosing to go public or, in the case of foreign firms, to register their securities in the United States or to list them on a national exchange.[4] Lost also in the discussion is the striking asymmetry between the ease with which a firm may enter the system and the difficulty of exiting it. As we will see, this asymmetry, more than anything else, flags the system as a precommitment device.

A. *A Short Primer on Entry into the SEC-System*

Getting in to the SEC-system is easy. Disclosure requirements on securities transactions are divided between the Securities Act of 1933 ("the 1933 Act"),[5] which regulates issuance of securities, and the Securities Exchange Act of 1934 ("the 1934 Act"),[6] which imposes continuing and periodic reporting requirements in connection with the subsequent trading of securities.

An issuer can enter the SEC-system through a public offering of securities covered by the 1933 Act. If an issuance of a security does not fall within an exemption, then the issuer must comply with the SEC's disclosure requirements.

Once, however, securities have been issued, the 1933 Act fades in importance, and the 1934 Act comes to the fore. The crucial concept in the 1934 Act which triggers periodic disclosure obligations is "registration" under section 12.[7] Under section 13, "every issuer of a security registered pursuant to section 12 of this Act shall file with the Commission" such information as the Commission shall require for the "proper protection of investors and to insure fair dealing in the security."[8]

The registration requirement of section 12 can be triggered in a variety of ways. First, a security may not be traded on a national

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[4] The dimensions of choice are reasonably large: foreign firms can choose whether or not to enter U.S. markets; domestic and foreign firms can choose between private financing, sophisticated investors (pursuant to Rule 144A, Private Resales of Securities to Institutions, 17 C.F.R. § 230.144A (2001)), and public financing. That said, it is obviously true that one dimension of choice is constrained: you cannot access U.S. public capital markets without complying with the SEC disclosure requirements.

[5] 15 U.S.C. §§ 77a-77z-3 (1994).

[6] *Id.* §§ 78a-78mm.

[7] Securities Exchange Act of 1934 § 12(a), 15 U.S.C. § 78l.

[8] 15 U.S.C. § 78m.

securities exchange unless it is registered.[9] Second, any issuer with a nexus to interstate commerce and which has more than 500 shareholders and assets of more than $10 million must register, whether or not it is traded on a national exchange.[10] Third, any issuer which has registered securities under the 1933 Act is subject to the 1934 Act's section 13 continuing disclosure requirements.[11]

Finally, issuers who are not required to register under section 12 may elect to do so voluntarily. Voluntary registration makes sense in several contexts. First, shares must be registered in order to be included in the National Association of Securities Dealers Automated Quotation System ("NASDAQ").[12] Second, registering shares under section 12 facilitates resale of restricted securities by holders, although it is not strictly required.[13]

The registration procedure under section 12(g) is straightforward, even if assembling the information is not.[14] For new registrants, Form 10 applies and requires comprehensive disclosure.[15] For securities of issuers who are already subject to reporting obligations under sections 13 or 15(d),[16] the shorter Form 8-A permits information to be incorporated by reference.[17]

For foreign issuers, entry is slightly different, but every bit as easy.[18] For closely held firms, one can enter through two channels. One method is to form a wholly owned U.S. subsidiary to hold the operating assets. If one then takes the subsidiary public, everything will be exactly as before, as the subsidiary is a U.S. corporation.[19] After the public offering, the corporation is, say, a

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[9] *See* Securities Exchange Act of 1934 § 12(a), 15 U.S.C. § 78l(a); *see also* NYSE COMPANY MANUAL B-5 (Apr. 15, 1965) (stating that securities must be registered under the 1934 Act).

[10] *See* section 12(g) and Rule 12g-1; *see also* 15 U.S.C. § 78l(g) (requiring registration by every issuer with more than 500 shareholders and assets of more than $1 million to register); Exemption from section 12(g), 17 C.F.R. § 240.12g-1 (2001) (exempting issuers with assets of less than $10 million from § 78l(g)).

[11] 1934 Act section 15(d). *See* 15 U.S.C. § 78o(d); Requirement of Annual Reports, 17 C.F.R. § 240.15d-1.

[12] NASD Manual, Rule 4310 (CCH), at 5275 (July 2001).

[13] 1933 Act, Rule 144(c). *See* Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters, 17 C.F.R. § 230.144 (giving public information requirements for resale of restricted securities).

[14] *See* 17 C.F.R. § 12b-1 to -36.

[15] *See* Form 10 and Form 10-SB, General Form for Registration of Securities Pursuant to section 12(b) or (g) of the Securities Exchange Act of 1934, 17 C.F.R. § 249.10.

[16] *See* 15 U.S.C. §§ 78m, 78o(d).

[17] *See* Form 8-A, for Registration of Certain Classes of Securities Pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934, 17 C.F.R. § 249.208a.

[18] For a discussion of the difficulties, and the attitudes of foreign issuers, see James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 3 STAN. J.L. BUS. & FIN. 51 (1997).

[19] For an example, see Orbit/FR, Inc., Form S-1 Amend. No. 2, Registration No. 333-25015 (June 15, 1997), *available at* http://www.sec.gov/Archives/edgar/data/1037115/

Delaware corporation, with shareholders, customers and operations all scattered around the world, a not uncommon situation.

Alternatively, a foreign firm can simply register its securities pursuant to the 1933 Act prior to a public offering.[20] If a foreign private issuer[21] registers securities under the 1933 Act, then, as with domestic issuers, it becomes subject to the 1934 Act's periodic disclosure obligations by virtue of section 15(d).

For issuers which are already publicly traded, entry into the U.S. disclosure regime can be accomplished through a number of channels. First, listing securities or American Depositary Receipts ("ADRs")[22] on a national exchange is deemed by the SEC to constitute a voluntary entry into the United States and results in the registration requirement and accompanying disclosure

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[20] The prohibition in section 5 of the 1933 Act on the offer or sale of unregistered securities applies equally to foreign issuers. 15 U.S.C. § 77e. Section 6 likewise anticipates the registration of securities of foreign issuers. *Id.* § 77f. Neither sections 3 nor 4 provides any categorical exemption for the sale of foreign issues. *Id.* §§ 77c-d. The SEC considers all foreign companies which have either securities listed on a U.S. exchange (including ADRs) or which have made a public offering of securities under the 1933 Act, as having voluntarily entered the U.S. market. *See* Securities Act Release No. 33-6360, 24 SEC DOCKET 3, 4 (Nov. 20, 1981).

[21] 1933 Act Rule 405 defines "foreign private issuer" to include all foreign issuers, except foreign governments, and excludes issuers of which more than 50 percent of the shares are held directly or indirectly by residents of the U.S. and either the majority of the executive officers or directors are U.S. citizens or residents or more than 50 percent of the assets are located in the United States or the business is principally administered in the United States. Definition of Terms, 17 C.F.R. § 230.405 (2001).

[22] American Depositary Receipts "are negotiable certificates issued by a United States bank or trust company . . . [which] represent an ownership interest in a foreign private issuer's securities deposited, usually outside the United States, with a financial institution as depositary." Mark A. Saunders, *American Depository Receipts: An Introduction to U.S. Capital Markets for Foreign Companies*, 17 FORDHAM INT'L L.J. 48, 49 (1993); *see also* Regis E. Moxley, *The ADR: An Instrument of International Finance and a Tool of Arbitrage*, 8 VILL. L. REV. 19, 22-23 (1962). The principal advantages of investing in a foreign issue through an ADR rather than directly are that the depositary "facilitates (i) the payment of dividends to security holders, (ii) the transfer of ownership of deposited securities, and (iii) communications between the foreign private issuer and security holders." *See* Saunders, *supra*, at 52. In addition, ADRs avoid foreign inheritance taxes and probate in foreign courts. *See* 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 814-15 n.72 (3d ed. 1999) (quoting SEC, Office of Int'l Corp. Fin., Memorandum on American Depository Receipts (ADRs) 1-2 (Sept. 1983)).

Depositaries are typically sponsored by foreign issuers who establish the depositary with a U.S. bank, and pay the expenses. The advantages of a sponsored depositary over an unsponsored depositary are several: (i) it gives the issuer greater control over the activities of the depositary and allows the issuer to require the depositary to provide notice to holders and to distribute annual reports; (ii) a sponsored depositary is a requirement for listing ADRs on the New York and American Stock Exchanges, and preferred although not required by NASDAQ; (iii) because no fees are deducted by the depositary from dividends, ADRs are made more attractive to investors. *See* Saunders, *supra*, at 56-57.

obligations.[23]

Second, an issuer may voluntarily register in order to be able to use the NASD Automated Quotation System, as discussed above. Indeed, listing a security, including an ADR, on NASDAQ will necessarily trigger the registration obligation.[24]

The disclosure requirements for public offerings by foreign private issuers are similar to those for domestic U.S. issuers with three principal differences. First, while the foreign financial statements must have substantially similar informational content, they need not be prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"), if presented in accordance with the home country generally accepted accounting principles, and significant variations from U.S. GAAP and Regulation S-X are described. Second, compensation of directors and officers need only be disclosed in the aggregate, unless the issuer already discloses such information to its shareholders. Third, information regarding transactions with management is required, but only to the extent the issuer already discloses such information to its shareholders.[25]

The SEC has promulgated several rules in an attempt to prevent unanticipated, unexpected, or involuntary triggering of a registration obligation. The most interesting of these is Rule 12g3-2, which exempts foreign private issuers from 12(g) in two situations.[26] First, issuers are exempt if there are "fewer than 300 holders resident in the United States."[27] Second, under rule 12g-3(b), securities of any foreign private issuer are exempt from 12(g) if the issuer furnishes the Commission with whatever information it discloses in its home country, with explanations of the home disclosure obligations and changes,[28] *so long as* the securities have *not* been registered under section 12 and are not quoted on an

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[23] *See* Securities Act Release No. 6493, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,435, at 86,292 (Oct. 6, 1983); Securities Act Release No. 6433, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,272, at 85,459, 85,460 (Oct. 28, 1982); Securities Act Release No. 33-6360, 24 SEC DOCKET at 4.

For securities listed on a national exchange, registration is effected by the issuer's filing of an application with the exchange, and no separate registration is required. *See* Securities Exchange Act of 1934 § 12(b), 15 U.S.C. § 78l(b) (1994); § 78l(g)(2). ADRs are themselves securities, "separate and apart from the deposited foreign securities they represent." Saunders, *supra* note 22, at 58.

[24] *See* Exemptions for American Depository Receipts and Certain Foreign Securities, 17 C.F.R. § 240.12g3-2(d)(2001).

[25] *See* Saunders, *supra* note 22, at 69-70 (quoting U.S. SECURITIES & EXCHANGE COMM'N, INTERNATIONALIZATION OF THE SECURITIES MARKETS III-67 to -68 (1987)).

[26] 15 U.S.C. § 78l(g) (1994); 17 C.F.R. § 240.12g3-2.

[27] 17 C.F.R. § 240.12g3-2(a).

[28] *See* § 240.12g3-2(b).

"automated inter-dealer quotation system."[29]

In addition, Rule 12g-1 exempts foreign private issuers if "on the last day of its most recent fiscal year the issuer had total assets not exceeding $10 million and . . . such securities were not quoted in an automated inter-dealer quotation system."[30]

Foreign private issuers who list a security on a national securities exchange or NASDAQ are subject to somewhat more lenient periodic disclosure requirements under the 1934 Act than domestic issuers. The principal differences are that foreign private issuers file annual reports on Form 20-F (within six months of the close of the fiscal year), and periodic reports on Form 6-K.[31] As with filings under the 1933 Act, foreign issuers need not comply with U.S. GAAP or Regulation S-X, if the financial statements are presented in accordance with the generally accepted accounting principles of the foreign issuer's domicile, and a reconciliation of the differences in measurement items is provided.[32] Importantly, foreign private issuers need not prepare or file proxy statements, unless they already do so in their domicile jurisdiction.[33]

B. *Exit from the SEC-System*

While opting in to the SEC-system is easy, exit is extremely difficult for firms that become even reasonably widely held. Indeed, it is nearly impossible, short of buying back enough shares to bring the number of shareholders below 300.

Under section 12(g)(4), the registration obligation "shall be terminated ninety days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than three hundred persons."[34]

An alternative but equivalent exit route is provided by section 15(d).[35] As discussed above, 15(d) imposes a duty to disclose

[29] *See* § 240.12g3-2(d). Securities issued before October 5, 1983 were grandfathered in. *Id.*

[30] Exemption from Section 12(g), 17 C.F.R. § 240.12g-1 (2001).

[31] Form 20-F, Registration of Securities of Foreign Private Issuers Pursuant to Section 12(b) or (g) and Annual and Transition Reports Pursuant to Sections 13 and 15(d), 17 C.F.R. § 249.220f (2001); Form 6-K, Report of Foreign Issuer Pursuant to Rules 13a-16 (§ 240.13a-16 of this Chapter) and 15d-6 (§ 240.15d-16 of the Chapter) Under the Securities Exchange Act of 1934, 17 C.F.R. § 249.306 (2001).

[32] *See* § 249.220f.

[33] *See* § 249.306.

[34] 15 U.S.C. § 78l(g) (1994); *see also* Certification of Termination of Registration Under Section 12(g), 17 C.F.R. § 240.12g-4 (2001)

[35] 15 U.S.C. § 78o (1994).

under section 13 on issuers who have issued securities pursuant to a 1933 Act registration statement. For issuers subject to disclosure obligations under 15(d),

> [t]he duty to file under this subsection shall . . . be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons.[36]

Both exemptions are slightly expanded by rules 12g-4 and 12h-3(b) to include any class of securities held of record by "less than 500 persons, where the total assets of the issuer have not exceeded $10 million on the last day of each of the issuer's three most recent fiscal years."[37]

For firms listed on a national exchange, exit is even more difficult. Under section 12(d), there is no unqualified right to delist.[38] Rather, deregistration depends on the rules of the Exchange and then is discretionary with the Commission:

> A security registered with a national securities exchange may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and, upon such terms as the Commission may deem necessary to impose for the protection of investors, upon application by the issuer or the exchange to the Commission.[39]

Under the NYSE's longstanding but now modified Rule 500, for example, securities could be delisted only after two thirds of the shareholders vote in favor and not more than 10 percent vote against.[40] The Commission has, at least at times, imposed additional obligations. Specifically, during a period in which there was a wave of delisting applications, the Commission, in addition to the NYSE requirements, imposed a requirement of a vote of a majority of the shareholders per capita.[41]

Thus, for a typical firm to deregister, it must "go private," either through a cash merger with an unregistered firm, a reverse stock split, a multi-step sale of assets, a self tender or a

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[36] *Id.* § 78o(d).

[37] Suspension of Duty to File Reports Under Section 15(d), 17 C.F.R. § 12h-3(b)(1)(ii); *see also* Certifications of Termination of Registration Under Section 12(g), 17 C.F.R. § 12g-4(a)(2)(ii) (same exemption).

[38] 15 U.S.C. § 78l(d).

[39] *Id.*

[40] *See* 2 NEW YORK STOCK EXCHANGE GUIDE, Rule 500 (CCH) ¶ 2500, at 4234 (July 2001).

[41] *See* LOSS & SELIGMAN, *supra* note 22, at 1885-89 & nn.88-89 (discussing Shawmut Assn., 15 S.E.C. 1028, 1035, 1038 (1944), *aff'd*, 146 F.2d 791 (1st Cir. 1945)).

dissolution.[42] Going private transactions trigger particularly detailed (but not continuing) disclosure obligations under section 13(e).[43]

With respect to foreign issuers, the situation is similar. Securities of a foreign private issuer are eligible for suspension if the securities are held of record by "(i) [l]ess than 300 persons resident in the United States or (ii) [l]ess than 500 persons resident in the United States where the total assets of the issuer have not exceeded $10 million on the last day of each of the issuer's three most recent fiscal years."[44]

II. The SEC Disclosure System as a Credible Commitment Device

A. *The Basic Story*

Consider a firm that is privately held and is interested in raising capital from outsiders. In order to convince outside investors to invest in the firm at a price that makes it worthwhile for insiders to sell, several interrelated problems must be solved. A potential investor will worry, first, about how to value the investment and whether the investment is worthwhile at the offering price. Second, investors will worry about their vulnerability during the life of the investment, an investment in a firm which, at least initially, will have a controlling shareholder or group of shareholders. Finally, a potential investor will worry about an exit strategy: how will it realize profits on the investments?[45] It is in the joint interests of the potential investors and the firms to reassure investors on each of these concerns.

In this context, potential investors will worry, *inter alia*, about the quantity, quality, and permanence of the information flow. With respect to quantity, they will worry whether the information

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[42] *See* 1A MARTIN LIPTON & ERICA STEINBERGER, TAKEOVERS & FREEZEOUTS, §§ 9.01-.08 (19th prtg. 2001).

[43] *See* 15 U.S.C. § 78m(e); *see also* Going Private Transactions by Certain Issuers or Their Affiliates, 17 C.F.R. § 240.13e-3 (2001); Schedule 13E-3, Transaction Statement Under Section 13(e) of the Securities Exchange Act of 1934 and Rule 13e-3 (§ 240.13e-3) Thereunder, 17 C.F.R. § 240.13e-100 (2001).

[44] Suspension of Duty to File Reports Under Section 15(d), 17 C.F.R. § 240.12h-3(b)(2) (2001).

[45] These concerns are interrelated because the investors' concerns about vulnerability during the investment and exit will be reflected in the price ex ante. Although interrelated, it is useful to separate these concerns in order to see how issuers and investors can increase their joint surplus by providing credible assurance.

is sufficiently complete to determine what the investment is worth, in a format that makes it easily comparable over time and between companies, and whether others receive enough for a secondary market to develop, which, in turn, provides investors with a valuable exit option.

With respect to quality, they will worry about whether the information they receive is credible. The quality of the information will be important for valuing the investment opportunity, and for the development of a secondary market.

With respect to permanence, the potential investors will worry about the future: will they, and the market, continue to receive enough information on a continuous or periodic basis to monitor the firms, to protect their investment, and to update their appraisal during the life of their investment? Will they receive enough information to know whether to sell or to buy in the secondary market? Will the market receive enough information for a liquid secondary market with small bid ask spreads to develop which will value the shares accurately?[46]

How can a new issuer convince potential investors that it will disclose high quality, comprehensive information indefinitely? This is not a trivial contracting problem. First, the contracting parties must be able to specify the content of a commitment that runs indefinitely, in a way that permits modification of the disclosure obligations as circumstances change. Crafting structures that permit modifications while preventing opportunistic changes bedevils the design, interpretation, and enforcement of long term "relational contracts."[47]

Second, the parties must establish a credible and accurate enforcement mechanism. In this context, this requires providing both a forum in which the obligation will reliably be enforced, and, moreover, an adjudicator who can understand the nature of the obligations and distinguish between performance and breach.

Reputation alone may help but is unlikely to be sufficient. A new issuer typically has not developed any reputational capital to use as a bond. Moreover, when, as in IPOs, there is typically a

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[46] These same concerns apply to the issuance of new financial products. As more and more income streams are securitized, issuers face the same need to make credible commitments to amount, quality, and permanence of disclosure, in order for investors to value the security and for efficient secondary markets to emerge.

[47] *See, e.g.*, Northern Indiana Pub. Serv. Co. v. Carbon County Coal Co., 799 F.2d 265 (7th Cir. 1986); Aluminum Co. of Am. v. Essex Group, Inc., 499 F. Supp. 53 (W.D. Pa. 1980). *See generally* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992).

controlling shareholder or shareholder group after the offering and for an indefinite time, the reputational bond, such as it is, may be swamped by potential gains from opportunistic behavior.

Although it is now generally accepted (at least among academics) that a central function performed by underwriters is to rent their reputational capital to issuers,[48] as a form of guarantee of the accuracy and completeness of the information in the prospectus, this will only help at the IPO stage, and perhaps episodically thereafter. The underwriters' role is largely that of a midwife: once the company is public, the underwriters' involvement will be limited, occurring if and when the firm returns to the market to sell additional securities. Why should investors believe an issuer's promises that, after the dust of the IPO settles, and the underwriter has disappeared, it will continue to provide high quality information indefinitely?

B. *The SEC-Disclosure System as a Solution*

The existing SEC disclosure system can be understood as a mechanism for solving these contracting problems. First, as has been recognized, it serves a standardization function, both with regard to form and quantity of disclosure, thereby aiding in the comprehension and comparison of different investment options. Thus, Regulation S-X provides accounting conventions to be used in all forms filed under the 1933 and 1934 Acts.[49] Likewise, Regulation S-K is a central repository of rules governing disclosure under the 1933 and 1934 Acts.[50]

Second, it provides a mechanism for the adjustment of reporting obligations over time. The SEC continually tinkers with the content of the issuers' reporting obligations.

Third, it provides a credible and specialized enforcement mechanism, which warrants both the comprehensiveness and quality of the information disclosed. Here, the public and private enforcement machinery of the securities laws and the combination of criminal and civil liability makes securities disclosures far more credible than purely contractual representations.[51] Although

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[48] *See, e.g.*, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

[49] *See* 17 C.F.R. §§ 210.1-01 to 210.12-29 (2001).

[50] *See id.* §§ 229.10 to 229.1016.

[51] *See* EASTERBROOK & FISCHEL, *supra* note 3, at 283; Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461 (1981); Marcel Kahan, *Games, Lies, and Securities Fraud*, 67 N.Y.U. L. REV. 750 (1992).

common law fraud plays a similar role generally, the elaborate public and private enforcement mechanism of the securities laws adds an additional layer of protection.

Finally, the limitations on exit, backed by the public and private enforcement mechanisms, make the commitment to *indefinite* disclosure credible.

The SEC system can play a similar role with respect to foreign issuers when they enter the U.S. capital markets. For a foreign issuer seeking to attract U.S. investors, the problems are analogous to those faced by a firm going public, with added difficulties of language, culture and enforceability. A U.S. investor considering investment in a foreign stock will worry about receiving enough information of high enough quality indefinitely in order to value the investment, to protect itself while invested, and to facilitate the development of a secondary market. The theoretical puzzle here is why investors should be more willing to purchase shares of a foreign issuer on the New York Stock Exchange or the NASDAQ, than abroad?[52] Why should it help an Israeli company to raise capital to be listed on a U.S. exchange rather than the Tel Aviv exchange? After all, the company is the same either way.

Transaction costs, while part of the answer, cannot be the complete answer. For large institutional investors, the cost of executing trades on foreign exchanges cannot be that large. Given the existence of market professionals and institutional investors, one would think that if the securities were attractive then the barriers of language and distance would be easily overcome. After all, the very same companies are able to sell their products internationally despite similar barriers. Why do they not seem to be able to sell their securities with equal ease?

The gatekeeping function served by underwriters with respect to domestic IPOs clearly provides part of the answer but, for the same reasons discussed above, cannot be a full explanation. The existing U.S. mandatory disclosure system provides another significant piece of the puzzle. By opting in to the U.S. disclosure system, a system that demands a high level of disclosure, with severe sanctions for incomplete or inaccurate disclosure, combined with the difficulty of opting out once the decision has been made to opt in, foreign issuers, like domestic closely held firms, are able to make a credible commitment to provide high quality disclosure into the indefinite future.[53]

[52] *See* Katherine Smith & George Sofianos, *The Impact of an NYSE Listing on the Global Trading of Non-US Stocks* (NYSE Working Paper No. 97-02, June 1997), *available at* http://www.nyse.com/pdfs/sp97-02.pdf.

[53] Which is not to say that problems of language and enforcement may not still make

Interestingly, because of the differences between full 1934 Act disclosure and the more limited disclosure required of foreign private issuers, foreign private firms (unlike U.S. firms), can choose between two disclosure packages: full (by taking the U.S. subsidiary public); or "disclosure-lite" (by going public as a foreign private issuer).

It is also worth noting that issuers, when they opt in to the SEC-system, commit to substantially more than the periodic and annual disclosure requirements of sections 12 and 13. In particular, they may commit to the proxy regulation under section 14(a), the tender offer regulations under sections 13(d) and 14(e), and the insider trading limitations under sections 10(b) and 16. While the disclosure aspects of these sections can be understood as part of the disclosure package, there are also significant substantive elements. This complicates the analysis in several ways. First, it points out that the commitment is to a package of provisions from which issuers cannot pick and choose. Second, because of this bundling, coming up with a global judgment about whether the package is optimal, or whether, from the perspective of the issuer, opting in is worthwhile, is probably impossible.

C. *The Nature of the Commitment*

What, then, is the nature of the commitment that an issuer makes when it opts into the U.S. mandatory disclosure system? The exit rules outlined above mean that going public results in a commitment to shareholders to make extensive disclosure indefinitely, that is, so long as they are around, unless the number of shareholders drops below 300. The content of the disclosure is credible because false statements are subject to significant sanctions. The commitment to continue to disclose is backed by the same set of sanctions, including injunctions and fines.[54] Finally, the commitment is to a disclosure system that can be updated by the SEC, as needs change, and not to a frozen set of requirements.

The 300 shareholder threshold for deregistration is an interesting feature. First, it is essentially exclusive: a vote to exit the disclosure system, even by a supermajority of shareholders, will not be effective. Second, the 300 shareholder threshold makes the issuer's commitment conditional: we will continue to make the SEC mandated disclosures so long as things work out in marketing

foreign issuers less attractive than domestic issuers. *See, e.g.*, Jeff Brown, *Beware of Many Risks in Buying Foreign Stock*, PHILA. INQUIRER, Dec. 14, 1997, at D1.

[54] *See* 15 U.S.C. §§ 78u, 78u-3, 78ff (1994).

shares (defined as >300 shareholders). This means that if the public offering turns out to be successful, the issuer is committed. If, however, the offering flops, either because the company cannot interest investors in its shares or because it fails down the line, then, in extremis, the firm can retreat from the expense of the disclosure commitment. Here, the fact that the 300 shareholder exit provision does not apply in the calendar year in which the issuer has issued securities pursuant to a registration statement can be understood both as setting a minimum get-acquainted period, and as setting an unwaivable minimum duration of disclosure.

The 300 shareholder threshold also eliminates holdout problems in any future going private transaction. If a firm with 10,000 shareholders decides to go private, no single shareholder or group of shareholders can force it to remain public.

But this threshold, while eliminating holdouts, raises the possibility of a shareholder stampede. Because shareholders of a delisted and deregistered firm typically find themselves trapped in an enterprise with a controlling shareholder and little information, the likelihood of delisting can act as a threat inducing shareholders to tender in a going private transaction.[55]

There are a couple of responses to this. First, stampedes are not always bad.[56] If the buy back offer is sufficiently attractive so that shareholders reasonably expect that nearly all of the other shareholders will accept, the pressure to tender may not be suboptimal, but may, indeed, be necessary to allow the bidder to capture the returns on its investment in gathering information and taking control.

Second, the standard solution to the pressure to tender—a shareholder vote—has problems of its own.[57] In firms in which there is a controlling shareholder or group of shareholders, as is typical in IPOs, a shareholder vote provides no protection against opportunistic behavior. Indeed, quite the opposite. More generally, in cases where the company succeeds in attracting investors (e.g., 10,000 shareholders), the vote will be easier to satisfy than the 300 shareholder threshold, and is subject to all the problems of agenda setting and bundling that we've seen in connection with charter amendments.[58] On the other hand, in

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[55] *See* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 267-69 (2d Cir. 1984).

[56] *See* Sanford J. Grossman & Oliver D. Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. 323 (1980).

[57] On a class-wide vote as a solution to pressure to tender, see Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985).

[58] For discussions of these problems in the context of dual class recapitalizations, see Lucian Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable*

cases in which the company has failed to attract a following (say, only 600 shareholders), the vote may be harder to satisfy than the 300 shareholder threshold.

D. *But Why Is Disclosure Mandatory?*

In the preceding subparts, I argued that the existing mandatory disclosure system can be understood as facilitating credible commitment by issuers. But need the system be a mandatory system in order to serve that function?

Traditionally, two justifications have been given for mandatory securities disclosure. First, mandatory disclosure is said to be necessary to protect investors and the integrity of the capital markets. A second justification maintains that mandatory disclosure is necessary to solve market failures in the collection and dissemination of information.[59] Because information has some of the properties of a public good, issuers will disclose too little in the absence of standardized mandatory disclosure obligations on all firms. In addition, because securities analysts may not be able to capture the full benefits of information they collect, they will invest too little in collecting information. A mandatory disclosure regime can be understood as subsidizing these activities in order to approach an optimal level. Finally, it may be that a mandatory disclosure regime, by placing the duty of disclosure on the firm, will prevent wasteful duplication of information which would otherwise result from the individual pursuit of trading gains. In other words, in the absence of mandatory disclosure, it may be that both two little and two much information is collected and disclosed.

Neither of these justifications—both of which are controversial—explains why credible commitment requires a system of mandatory disclosure. To clarify the issue, one must distinguish between two senses of "mandatory." In the first sense, "mandatory" can be understood to mean "enforced": once one enters a given system, enforcement is such that one must comply with the requirements of that system, including exit requirements. Alternatively, a system can be said to be mandatory if all who fit a particular set of criteria must comply with a set of disclosure

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Constraints on Charter Amendments, 102 HARV. L. REV. 1820 (1989); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988).

[59] *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

requirements. The current system is mandatory in both senses: the SEC's array of enforcement resources leads to a relatively high level of enforcement; and any issuer who issues shares to the U.S. investing public, or lists its shares on a U.S. exchange, must comply with the SEC's periodic disclosure requirements, whether it would otherwise choose to do so or not.

The argument in this part is that a system that is mandatory in the first sense, namely, an enforced system, plays an important role in facilitating credible commitment. Under the existing system, an issuer triggers this system, and makes a commitment to investors, by going public in the United States.

But that leaves open the further question, raised explicitly by the portable reciprocity proposals, as to whether credible commitment requires that the system be mandatory in the second sense: whether all issuers, including those who do not seek to take advantage of the credible commitment features of the system, must likewise be required to comply. The connection between the SEC's domestic regulatory monopoly and the credibility of issuers' commitments is a critical and difficult question to which I turn below, in Part III.

III. IMPLICATIONS FOR INTERNATIONAL REGULATION AND THE "WHO SHOULD REGULATE?" DEBATE

In recent years, there has been a vigorous debate over the questions of who should regulate securities disclosure and the extent to which issuers should be able to choose their disclosure regimes.[60] The positions range from Merritt Fox's physical presence test[61] to various versions of interjurisdictional competition and reciprocity.

As I will discuss below, the recognition that an important function performed by the existing U.S. disclosure regime is to assist issuers (both domestic and foreign) in making credible

[60] Prominent U.S. contributions to this debate include: Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855 (1997) [hereinafter Choi & Guzman, *National Laws, International Money*]; Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 CAL. L. REV. 903 (1998) [hereinafter Choi & Guzman, *Portable Reciprocity*]; Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997); and Roberta Romano, *supra* note 3. *See also* Edmund W. Kitch, *Competition Between Securities Markets: Good or Bad?*, *in* THE FUTURE FOR THE GLOBAL SECURITIES MARKETS: LEGAL AND REGULATORY ASPECTS 233 (Fidelis Oditah ed., 1996).

[61] *See* Fox, *supra* note 60.

commitments to disclose indefinitely reveals difficulties in each type of proposal, when compared to the status quo. As we've seen above, in order for a disclosure regulation to serve as a device that aids issuers in making a credible commitment to complete and continuous disclosure into the future, it must have a characteristic "lobster trap" structure: easy to enter voluntarily; hard to exit.

A. *Regulation by Domiciliary Jurisdiction*

Merritt Fox argues for regulation by the country in which the firm's "physical presence" or "economic center of gravity" is located.[62] In Fox's analysis, because the primary costs and benefits of disclosure are felt in the place in which the operations of the firm are located, one should grant regulatory authority to that country.[63] Critical to Fox's argument is the assertion that the primary effect of disclosure regulation is in improving the efficiency of the choice of investments at the firm level. As such, Fox rejects the orthodox "investor protection" justifications.[64]

Fox's proposal focuses on minimum standards of disclosure, and does not directly address attempts by foreign issuers to opt-in to higher U.S. standards.[65] But, to the extent that Fox argues that the jurisdiction in which the firm's economic center of gravity is located has *optimal* incentives to set disclosure standards, he seems implicitly hostile to issuer attempts to opt out of what the home jurisdiction concludes is the optimal package.[66]

For Fox, the question is whether managers can be expected to exploit for personal gain the freedom to adopt a higher level of disclosure, or only the freedom to adopt a lower level.[67] If there is an asymmetry, then Fox can argue for minimum standards, set by the jurisdiction in which the firm's economic center of gravity is located, while permitting firms to adopt higher disclosure standards by opting in to stricter systems.[68] Although disclosure regulations can be used strategically,[69] it is, indeed, difficult to

[62] *See id.* at 2506.
[63] *See id.*
[64] *See, e.g.*, *id.* at 2509.
[65] *See id.* at 2551.
[66] *See id.* at 2582.
[67] *See id.* at 2545-46.
[68] In subsequent discussions, Merritt Fox makes clear that his approach is not intended to prevent foreign issuers from voluntarily opting in to the higher U.S. disclosure standards, but, rather, to create a floor. *See* Merritt Fox, *The Securities Globalization Disclosure Debate*, 78 WASH. U. L.Q. 567, 576-77 (2000).
[69] *See, e.g.*, Kahan, *supra* note 51.

concoct a scenario in which managers will have significant personal incentives to assume disclosure obligations that benefit the managers at the expense of shareholders.

So long as a physical presence-based system only established minimum standards, it would not affect the ability of a foreign firm to opt in to the U.S. disclosure regime in order to credibly commit to comply indefinitely with the high level of disclosure demanded under U.S. securities regulation.

By contrast, a physical presence-based system that had *exclusive* jurisdiction over an issuer would severely undermine a foreign firm's ability to raise capital in the United States. Consider the Israeli high-tech start up. Under such a system, neither of the current mechanisms for opting in to the U.S. capital markets would suffice to trigger U.S. disclosure regulation. An Israeli chartered corporation such as Teva Pharmaceuticals could not commit itself to U.S. disclosure standards through a listing of its ADRs on the New York Stock Exchange because, under an exclusive jurisdiction approach, Teva would still be categorized as an Israeli firm and subject only to the Israeli disclosure regulation.

Similarly, an Israeli firm such as Mercury that, under the present system, commits itself to the U.S. disclosure regime by incorporating in Delaware and then going public, would no longer be able to accomplish this. In a physical presence system, so long as Mercury's economic center of gravity remained in Israel, the transactions that result in Mercury being or becoming a "Delaware corporation" would make no difference to the allocation of regulatory authority. Finally, both the minimum and exclusive jurisdiction analyses are indeterminate for international firms with no easily identifiable economic center of gravity, and, for such firms, easily manipulable.

In short, the Israeli firm, wishing to tap U.S. capital markets, and willing to commit to abide by U.S. standards, could be stuck with Israeli standards. Experience has taught that, even though the direct costs for a U.S. investor to buy shares of an Israeli company in Israel are not particularly high, firms that want to attract U.S. investors do much better coming to the United States and committing to U.S. disclosure requirements.[70]

The lesson here is that one cannot neglect the extent to which

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[70] *See* Rock, *supra* note 1; *see also* Mark Dennis, *Israeli ADRs: High-Tech Trade*, FIN. TIMES (London), Feb. 1, 1996, at 36; Link Magazine, *Israel: The New York Showcase, in* ISRAEL: A NEW ECONOMY TAKES SHAPE 19, *Special Sponsored Section* to INSTITUTIONAL INVESTOR, July 1993; Neal Sandler, *Born in Israel, Issued on Wall Street*, BUS. WK. (Int'l Ed.), Aug. 5, 1996, at 49; Neal Sandler, *. . . Or Go Forth to the U.S. and Prosper*, BUS. WK. (Int'l Ed.), Feb. 26, 1996, at 41.

mandatory disclosure regulation helps issuers and investors contract for capital. As we've seen above, the problem of contracting for a given level, quality, and permanence of disclosure is not trivial and one should not ignore the extent to which the current system succeeds. Investment capital is available all over the world, yet it is the U.S. capital markets, under the SEC disclosure system, that are without peer in the public financing of new enterprises, high tech and otherwise, domestic and foreign.

B. *Interjurisdictional Competition, Portable Reciprocity, and Efficient Regulatory Scale*

In contrast to Fox's "economic center of gravity" approach,[71] Romano, Mahoney, and Choi and Guzman all argue for some version of interjurisdictional choice and competition.[72] Under Romano's proposal, any firm could choose any disclosure regime, either state or federal, domestic or foreign, and, as long as the choice was clearly disclosed, could sell securities in any country.[73] On Romano's proposal, firms could change jurisdictions by a majority shareholder vote, unless some other provision were provided in the charter.[74] To avoid interstate conflict of laws, Romano argues for an analogue of the corporate "internal affairs" doctrine.[75] Similarly, Choi and Guzman argue for complete "portable reciprocity," with the choice being among countries (rather than states), with similar freedom to move in and out.[76] Mahoney argues for devolution of regulatory authority to stock exchanges, with free issuer choice among exchanges.[77]

Their justification is straightforward, and is largely derivative from the "race to the top/race to the bottom" debate in corporate law. Investors, or at least the investors who determine market prices, are presumed to be able to choose among disclosure regimes just as they can choose among companies making complex products like computer assisted design workstations, with the suitability of the disclosure regime for a given company similarly reflected in the market price. Such complete competition among

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71 *See* Fox, *supra* note 60.

72 *See* Choi & Guzman, *National Laws, International Money, supra* note 60; Choi & Guzman, *Portable Reciprocity, supra* note 60; Mahoney, *supra* note 60; Romano, *supra* note 3.

73 *See* Romano, *supra* note 3.

74 *See id.* at 2415-18.

75 *See id.* at 2402-12.

76 *See* Choi & Guzman, *Portable Reciprocity, supra* note 60.

77 *See* Mahoney, *supra* note 60.

jurisdictions, they argue, will lead to the optimal amount of diversity among disclosure regimes, and optimal disclosure terms, with a migration of firms to the most appropriate disclosure regime. What unites all these differing proposals is the notion that interjurisdictional competition will maximize investor and firm choice.

When one asks whether these proposals would undermine the status quo's easy and routine facilitation of credible commitments, one comes to the question I raised earlier, namely, the connection, if any, between the SEC's (domestic) monopoly over disclosure regulation and the credibility of issuer commitments. As we will see, the question ultimately goes to the minimum efficient scale for the provision of disclosure regulation and whether that scale is low enough to permit more than one provider. The danger is that regulatory competition may lead to fragmentation and thereby undermine the ability of any regulatory system to offer issuers the opportunity to commit credibly to maintain a given level of disclosure indefinitely.

As we've seen above, the critical features that make an issuer commitment credible are the quality and quantity of information and the difficulty of exit.[78] None of the commentators has devoted much attention to the exit terms. While Romano and Choi and Guzman, for example, would permit ease of entry—into the United States or any other disclosure regime—they seem to depart from the current system by also proposing easy exit, through, for example, approval by a simple majority of the shareholders.[79]

Would opting-in to such a system by itself create a credible commitment to indefinite high quality disclosure in such a world? The answer seems to be negative. A simple majority shareholder vote requirement for relisting will not be sufficient for two reasons. First, in firms with a majority shareholder or shareholder group, usually the case for several years after an IPO, a majority vote requirement is meaningless. Second, even if the firm does not have a controlling or majority shareholder, there are a variety of means by which managers can manipulate shareholder voting.[80]

Reputation alone will also be insufficient, for the reasons described above.[81] While a firm which opts in and then out of the U.S. system will likely damage its reputation, that potential cost will not provide as credible a commitment ex ante as the current system, especially for new firms with little reputational capital, and

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78 *See supra* Part II.A.

79 *See* Choi & Guzman, *Portable Reciprocity*, *supra* note 60; Romano, *supra* note 3.

80 *See* Gordon, *supra* note 58, at 42-55; *supra* notes 58-59 and accompanying text.

81 *See supra* pp. 685-86.

controlling shareholders.

Moreover, even for firms without controlling shareholders, the reputational bond is problematic if listing decisions are made by managers while the reputational cost is borne by shareholders. In such circumstances, opting-in to the mandatory disclosure regime can be understood as a means by which shareholders bind their managers to maintain a given level of disclosure indefinitely, against a managerial tendency not to disclose bad information. Because shareholders are likely to bear the cost, ex ante, of managerial manipulation of disclosure, shareholders will benefit by protecting a commitment to disclose from such manipulation.

C. *A Simple Contractual Solution?*

But these arguments may not be very persuasive: what stands in the way of an issuer making a credible commitment to present and future investors by, for example, adopting the *existing* SEC deregistration standard by contract, either directly with the shareholders or indirectly by a contract with a regulation provider, or by opting in to a package with limitations on exit?

Consider, first, a contractual provision between the firm and its shareholders. The problem here is a reprise of the more general problems with a purely contractual solution described above: a contractual enforcement system is less robust than the mixed public and private, civil and criminal system we currently have, and untried issuers (often with controlling shareholders) have little reputational capital to use as a bond.[82] The point is not that contractual solutions are theoretically impossible, only that there seem to be significant practical difficulties, which, in aggregate, make a private contractual commitment less credible than the existing commitment.

But, to the extent that a private contractual solution does not carry enough punch, why won't the competitive providers of regulation in a system of portable reciprocity step in to offer credible commitment? This is the most interesting possibility and the difficulties accompanying it pose deep and intriguing issues about the nature of such a market for regulation.

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[82] I do not want to overstate the problem. An argument that the current system provides routine credible commitment does not require a showing that no contractual mechanism is possible.

1. In a Competitive Market for Regulation, Will a Regulation Provider Provide Credible Commitment?

Focus now on the individual regulatory jurisdictions or regulation providers. Could individual jurisdictions market themselves as credible commitment jurisdictions by making entrance easy and exit difficult, or, alternatively, by offering a menu of regulatory choices including one with easy entrance and restrictive exit? To the extent that mandatory disclosure serves a credible commitment function, does anything stand in the way of a specific jurisdiction offering the status quo structure, either as a mandatory term or as an option that issuers could choose?

For this to work, the commitments would have to be enforced. It is here that we confront an important tension implicit in the attempts to increase regulatory competition. A principal variable among "regulation providers" is the credibility of a regulator's commitment to enforce its own regulation. If issuers and investors cannot be assured, ex ante, that the regulator will enforce the regulation ex post, then commitment to the regulatory framework will not be credible. For this to obtain, the regulator must have the ability to identify breaches of its rules, incentive to punish those breaches, and sanctions that are sufficiently large to deter, all of which could be problematic in a world of portable reciprocity. Put simply, devolution of regulatory authority, when combined with competition among regulators, may, by fragmenting suppliers of regulation, deprive issuers of the ability to commit credibly to a level and permanence of disclosure.

Compare the SEC and the NYSE as regulators. Although the NYSE may be as or more sophisticated than the Commission in identifying breaches, it has a substantially smaller arsenal of sanctions.[83] While the SEC has at its disposal both civil fines and criminal sanctions, including imprisonment, the biggest stick that the Exchange has is the threat of delisting. Even if the NYSE listing agreement included an enforceable liquidated damages clause, it would still pale next to the prospect of a Federal court injunction or imprisonment. This is a particular problem for new issuers who have little reputational capital to put on the line. Moreover, to the extent that the rule the Exchange is seeking to enforce is a rule *limiting* delisting, the threat to delist is no sanction at all.

Similarly, the existing dual system of private plus SEC

[83] *See* Marcel Kahan, *Some Problems with Stock Exchange Based Securities Regulation*, 83 VA. L. REV. 1509, 1516-17 (1997).

enforcement of an obligation to disclose is likely to be more effective than pure private enforcement by a court of the relevant jurisdiction (in the case of a contractual or charter commitment by an issuer).

2. One Share, One Vote

But these points of comparison between public and private regulators, and among public regulators, are less interesting than a perhaps less obvious difficulty, namely, the differences in the *incentives* of regulators to enforce their own regulations.[84] The New York Stock Exchange's reaction to departures from its long standing rule of one share one vote provides a real world example of the differences that competition makes.

The NYSE had historically prohibited dual class common stock.[85] By contrast, the NASD placed no limits, while the American Exchange permitted firms to issue multiple classes but would only list those classes that had the right to elect at least 25 percent of the directors.[86]

In 1982, after General Motors ("GM"), a NYSE company, issued restricted voting shares as part of its acquisition of EDS, the Exchange faced the dilemma of either delisting GM or modifying its policy.[87] The NYSE balked at delisting such a prominent listed company and, after forming a committee, ultimately proposed a significant dilution in its rule.[88] By the time the committee issued its recommendation in 1987, numerous other listed companies had adopted or proposed dual class recapitalizations.[89] When the NYSE, AMEX and the NASD failed to agree upon a uniform rule, the SEC stepped in by issuing Rule 19c-4, which prohibited most dual class capital structures.[90]

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[84] For an important discussion of NYSE incentives to enforce its own rules, see A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999). For an interesting discussion of the history and future of listing requirements, and the effects of demutualization and competition, see Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325 (2001).

[85] For a full discussion and background, see Gordon, *supra* note 58, at 1-8.

[86] *See id.* at 5.

[87] *See* Robert L. Simison, *GM Purchase of EDS May Spur Exchange to Alter its Rules or Delist Auto Maker*, WALL ST. J., July 11, 1984, at 2.

[88] *See* Gordon, *supra* note 58, at 71-72.

[89] *See* Manning Gilbert Warren III, *One Share, One Vote: A Perception of Legitimacy*, 14 J. CORP. L. 89, 93 n.36 (1988).

[90] Governing Certain Listing or Authorization Determinations by National Securities Exchanges, 17 C.F.R. § 240.19c-4 (2001); Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed. Reg. 26,376 (July 12, 1988) (codified at 17 C.F.R. pt.

Note the peculiar bind in which the NYSE found itself when General Motors challenged its longstanding rule. The Exchange's threat to delist GM was hardly credible for two reasons: first, GM was sufficiently prominent that the Exchange apparently worried that losing it, and the other firms which subsequently adopted dual class capital structures, would jeopardize the Exchange's standing as the leading national exchange; and second, delisting would impose little harm on companies because of the near substitutes offered by the American Exchange and NASDAQ.

Note, also, who ultimately tried to enforce the NYSE's rule: the Commission. In deciding whether to enforce a one-share, one-vote rule, the Commission faced a fundamentally different choice than the Exchange did. All of the factors that insulate the Commission from pressure to adopt rules that issuers prefer, the bedrock of the argument to replace the Commission with more responsive suppliers of regulation, likewise make it more likely that the Commission will enforce its own rules.

The one-share, one-vote controversy—whatever one thinks about the merits of the rule—provides a cautionary lesson in the tension between competition among suppliers of rules and the ability of any one supplier to commit credibly to enforce its rules.[91] The problem facing the NYSE was that the harm it might incur by delisting a GM which breached Exchange rules was greater than the harm GM would bear and also apparently greater than any benefits the Exchange thought it might receive.

Here we see a difference that exchange size makes: the larger the number of listed companies, the less harm is caused to the exchange by losing a few. That is, the threat of exit posed by the exit of one of 1000 exchange listed companies will be much less than the threat of exit posed by one of 100. We also see the link between exchange market power and credibility of the commitment to enforce: the fewer alternatives available to listed companies, the less likely they are to accept the sanction of delisting.

If firms can exit, and if there is an optimal scale for regulation, then unrestricted exit may be similar to a bank run. Once a critical number of firms exit, others will also even if they believe that their

240). Although the D.C. Circuit ultimately held the rule to be an invalid exercise of SEC rule making power, Bus. Roundtable v. SEC, 90 F.2d 406 (D.C. Cir. 1990), the exchanges, which had already adopted the rule, have retained it. *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 748-51 (2d ed. 1995).

[91] For a detailed and insightful discussion of the one share one vote rule as a precommitment device and the Exchange's inability to make good on its commitment, see Gordon, *supra* note 58.

current regulatory regime is best, if only more firms used it.[92]

3. NYSE Rule 500

More recently, a similar dynamic can be seen in the controversy over the now modified NYSE delisting rule, Rule 500.[93] Under the old version of Rule 500, a member firm could delist if and only if the decision was approved by a vote of two-thirds of the shareholders with no more than 10 percent objecting.[94] By contrast, the decision to list can be made by the board of directors.[95] In other words, entrance and exit into the NYSE, like the SEC mandatory disclosure system, had traditionally had the characteristic lobster trap structure that marks it as a credible commitment device: easy to enter; hard to exit. Neither of the NYSE's principal competitors, the AMEX and NASDAQ, had or has such a stringent rule.[96]

As competition between the NYSE and the AMEX and NASDAQ has intensified, this feature came under attack by the competing exchanges, by the SEC and by the NYSE's own companies. The NASD has long argued that Rule 500 was anticompetitive, and should be rescinded.[97]

In its Market 2000 Report, the SEC agreed, finding no justification for the existing rule, and recommended "a standard that relies on a determination by the board of directors.[98] For example, the new standard could require approval by the board of directors and a majority of the independent directors, or it could

[92] Thus, there can be a run on a bank even if it is healthy and is known to be healthy, if depositors believe others will run.

[93] 2 NEW YORK STOCK EXCHANGE, Rule 500 (CCH) ¶ 2500, at 4234 (July 2001). For a discussion of the original rule and a discussion and approval of the revised rule, see Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Relating to Voluntary Delistings by Listed Companies, 64 Fed. Reg. 40,633 (July 27, 1999) [hereinafter Voluntary Delistings Rule].

[94] *See* Voluntary Delistings Rule, *supra* note 93.

[95] *See* 2 NEW YORK STOCK EXCHANGE GUIDE, Rule 311 (CCH) ¶ 2311, at 3044 (Nov. 1994).

[96] AMEX's analogous rule, Rule 18, requires board approval and a statement of reasons, after which AMEX notifies the issuer whether the reasons warrant delisting and whether the issuer must inform its shareholders at least 15 days in advance of the Exchange Act 12(d) filing. 2 American Stock Exchange Guide, Rule 18 (CCH) ¶ 9238, at 2424 (Dec. 2000). NASD's rules for NASDAQ/NMS simply require written notice from the issuer. NASD Manual, Rule 4480(b) (CCH), at 5571 (Dec. 2000).

[97] For a summary of the opposition to Rule 500, see U.S. SECURITIES & EXCHANGE COMM'N DIV. OF MARKET REGULATION, *Study VI: Regulatory Structure and Costs, in* MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS VI-1, VI-11 to -12 (1994), *available at* 1994 SEC LEXIS 137, at *39-*44.

[98] *Id.* VI-12.

require a review of the delisting decision by the board's audit committee."[99]

Pressure likewise was brought to bear by listed companies. NYSE Chairman Richard Grasso has been quoted as saying "Do you think I liked spending 45 minutes explaining the rule every time I met with company executives?"[100]

The NYSE ultimately submitted a proposed rule change for SEC approval to amend Rule 500 to permit an issuer to delist after obtaining approval of (1) the board of directors and (2) the audit committee, and providing shareholders with at least 20 and no more than 60 business days notice, and written notice to no fewer than 35 of the largest record holders.[101] Again, one sees competitive pressure undermining the ex post enforcement of rules which, ex ante, form the basis of a credible commitment.[102]

The concern with devolving the responsibility for setting disclosure requirement to exchanges, to states, or to anyone else, is that an issuer, dissatisfied with having to disclose comprehensive, high quality information, would threaten to switch to a different exchange or jurisdiction with laxer disclosure requirements unless the first regulator relaxed its own requirements. With fragmentation, the ability of the exchanges to refuse such a request from a large issuer will decline, for better (this is the mechanism that is thought to optimize the content and disclosure requirements) *and* for worse.

4. Interstate Charter Competition

Does interstate competition for corporate charters have a better record than the NYSE of withstanding pressures ex post not to enforce commitments made ex ante? This is a hard question to answer largely because, perhaps as a result of a competitive market for corporate charters, one simply does not find the same asymmetry in entrance and exit that one finds in the mandatory disclosure system or NYSE listing requirements. Entry into Delaware law is as easy as exit from it. As a technical matter, the easiest way to "reincorporate" into Delaware is to form a Delaware corporation, and then to merge the non-Delaware corporation with the Delaware corporation with the Delaware

[99] *Id.*

[100] Jon Birger, *Rule Change Sparks Exchange of Fire: NYSE, NASDAQ Intensify Listings Battle*, CRAIN'S N.Y. BUS., Nov. 24-30, 1997, at 1.

[101] *See* Voluntary Delistings Rule, *supra* note 93, at 40,633.

[102] In this regard, see Pritchard, *supra* note 84, at 992.

corporation as the surviving entity. Reincorporation out of Delaware works the same way: one forms a non-Delaware corporation into which the Delaware corporation is merged, leaving the non-Delaware corporation as the surviving entity.[103] In both cases, Delaware imposes precisely the same requirements: a board resolution recommending the merger; followed by approval by a majority of the outstanding shares entitled to vote.[104] Indeed, strikingly, the story told about the interstate competition for corporate charters is a story solely about *states* making credible commitments to *issuers*, not the reverse.[105]

It is striking that in the best known example of interjurisdictional competition for regulation, the interstate competition for corporate charters, we do not find the characteristic lobster trap structure that marks a credible commitment device. This highlights an important feature of the current system of regulation. By combining a "monopoly" disclosure regulator for publicly traded companies, with competition for terms governing the internal affairs of corporations, we have a system that permits regulatory competition along one dimension while permitting issuers to make credible commitments along a second but complementary dimension. None of the portable reciprocity proposals would preserve this because they would induce competition across all dimensions.

D. *Imperfections in Regulatory Competition*

One might respond to this analysis as follows: "If Rock's right about the importance of credible commitment and the difficulty that competitive regulation providers might have in providing it, then there should be a governmental Office of Credible Commitment whose responsibility it is to enforce commitments, thereby rendering them credible." I agree. There should be such an office, and, indeed, there is: it is called the SEC. On my analysis, given that firms have the option of remaining privately held and thereby outside the reach of the mandatory disclosure system, the act of going public can roughly be understood, at least

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[103] In other words, "reincorporation" is a misnomer.

[104] *See* DEL. CODE ANN. tit. 8, § 252 (1991 & Supp. 2000) (incorporating the requirements of § 251 which governs mergers of Delaware companies). Under section 252, whatever requirements are imposed by the non-Delaware state must likewise be satisfied. *See* § 252(c).

[105] *See* Romano, *supra* note 3, at 2391.

in part, as the act of triggering the Office of Credible Commitments' jurisdiction.

My point, here, is really an industrial organization point. The core issue is the minimum scale at which a provider of regulation can credibly commit to enforcing its own regulations. For a regulation provider to be able to provide the credible commitment function described earlier, it must itself be able to commit, credibly, to enforcing its own regulations, including its regulations on exit.

For now, and because of history, the SEC not only has a monopoly on U.S. criminal sanctions, but also is the only regulator with a history of enforcing high disclosure requirements. While, as Paul Mahoney has argued elsewhere, the NYSE, in the past, may have been an effective enforcer of disclosure regulation (especially when it had a monopoly over trading major securities),[106] it does not currently have such a reputation.

In addition, regulatory systems may exhibit significant network externalities. There seems to be a value for a firm to be regulated by the same regulator who regulates others because it makes their disclosures more easily comparable, because the flow of cases makes the rules more definite and predictable, and because the cost of developing expertise can be spread over more companies, making advice cheaper.

If this is right, then even if the reformers' proposals were adopted and the SEC's regulatory monopoly were broken, nothing would change, at least for a long time. If credible commitment is a significant part of the story, and no one can rival the SEC's package of disclosure, regulation, and enforcement, then the firms one cares about (i.e., the legitimate firms rather than con artists) will stick with it. It may be that the mandatory nature of the SEC system is largely otiose.[107]

CONCLUSION

We have a system of securities regulation that is, in many

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[106] *See* Mahoney, *supra* note 60, at 1469.

[107] Two developments support this view. First, firms which issue securities to institutional investors under Rule 144A of the 1933 Act (and which are therefore exempt from the 1933 Act disclosure requirements) provide disclosure that is essentially identical to that required for public offerings. *See* Private Resale of Securities to Institutions, 17 C.F.R. § 230.144A (2001). Second, securities lawyers are genuinely surprised and amazed that anyone would suggest changing the current system which they view as working pretty well, and appalled at the prospect of increasing the multiplicity of regulations beyond what they view as the suboptimal diversity of state blue sky laws.

respects, the envy of the world. When the SEC promulgates new rules, securities commissions from around the world examine and often adopt them with but minor modifications. The system that has allowed high tech start-ups to grow into gigantic firms provokes jealousy and imitation from across the globe. Given this success in highly competitive international capital and product markets, it is worth figuring out how it is that the U.S. system manages a core function of a capital market, namely, raising capital, so effectively. In this Article, I argue that a critical feature of that success is the extent to which the U.S. disclosure system permits issuers to make credible commitments to full, high quality disclosure into the indefinite future, a commitment that is necessary to the marketing of securities and the development of the critical secondary markets. Although contractual solutions are theoretically possible, it is hard to think of, much less find, real world examples of plausible contractual solutions that come close to providing as good a solution to the credible commitment problem as is routinely provided by the existing mandatory disclosure regime, with regard to content, credibility, and enforceability.