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## The Securities Globalization Disclosure Debate

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# THE SECURITIES GLOBALIZATION DISCLOSURE DEBATE

MERRITT B. FOX\*

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A global market is developing for the shares of an increasing portion of the world's 41,000 publicly-traded issuers.<sup>1</sup> This trend has given rise to an active debate concerning what United States policy should be toward regulation of their disclosure practices.<sup>2</sup> This Article is a comment on this

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1. INTERNATIONAL FINANCE CORPORATION, EMERGING STOCK MARKETS, FACTBOOK 1998, at 23 (1998).

2. See, e.g., William J. Baumol & Burton G. Malkiel, *Redundant Regulation of Foreign Security Trading and U.S. Competitiveness*, in MODERNIZING U.S. SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES 35-51 (Kenneth Lehn & Robert Kamphuis, eds. 1996); Richard Cameron Blake, *Advising Clients on Using the Internet to Make Offers of Securities in Offshore Offerings*, 55 BUS. LAW. 177 (1999); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999); James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200 (1999) [hereinafter *Regulatory Duopoly*]; James A.

debate through the eyes of an active participant.<sup>3</sup>

A review of the debate reveals five basic approaches to the question of proper U.S. policy.<sup>4</sup>

*-Issuer Nationality.* The United States should retain its existing mandatory disclosure regime and impose this regime on each issuer that has the United States as its economic center of gravity. Under this approach, the location of transactions in the issuer's shares and the residency of the persons engaging in these transactions are irrelevant.

*-Transaction Location.* The United States should retain its existing mandatory disclosure regime, but should impose this regime on all issuers where a significant number of transactions in their shares are effected in the United States. Under this approach, the nationality of the issuer and the residence of the investors transacting in its shares are irrelevant.

*-Investor Residency.* The United States should retain its existing mandatory disclosure regime, but should impose this regime on all issuers where a significant number of investors transacting in its shares are U.S. residents. The nationality of the issuer and the location of transactions in its

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Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 NW. J. INT'L L. & BUS. 119 (1996); Franklin R. Edwards, *Listing Foreign Securities on U.S. Exchanges*, 5 J. APPLIED CORP. FIN. 28 (1993); Oren Furst, *A Theoretical Analysis of the Investor Protection Regulations Argument for Global Listing of Stocks*, unpublished paper on file with the author (1998); Uri Geiger, *The Case for the Harmonization of Securities Disclosure Rules in the Global Market*, 1997 COLUM. BUS. L. REV. 241 (1997); Roberta S. Karmel, *Changing Concepts of Extraterritoriality*, N.Y. L.J. Jan. 30, 1998 at 1, 3; Edward F. Greene et al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 BUS. LAW. 413 (1995); J. William Hicks, *Protection of Individual Investors Under U.S. Securities Laws: The Impact of International Regulatory Competition*, 1 GLOBAL LEGAL STUD. J. 431 (1994); Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227 (1998) [hereinafter *International Diversity*]; Amir N. Licht, *Games Commissions Play: 2x2 Games of International Securities Regulation*, 24 YALE INT'L L. 61 (1999) [hereinafter *Games*]; Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1 (1999); Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, unpublished paper on file with the author (1999); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); Marc I. Steinberg & Lee E. Michaels, *Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity*, 20 MICH. J. INT'L L. 207 (1999); Joel P. Trachtman, *Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation*, unpublished paper on file with the author (1999).

3. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997) [hereinafter *Disclosure in a Globalizing Market*]; Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696 (1998) [hereinafter *Political Economy*]; Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) [hereinafter *Retaining Mandatory Disclosure*].

4. While many participants in the debate take positions that weave together two or more of these approaches, the categorization set below forms a useful way to describe their positions and examine their underlying premises.

shares are irrelevant with this approach.

*-International Uniformity.* The United States should work with other countries to develop a globally uniform disclosure regime. One way to accomplish this would be through each country adopting substantively identical rules (“harmonization”) that would then be applied by national governments in accordance with any of the three principles of jurisdictional reach outlined above. Another way would be to establish an international agency that would develop and apply its own regime, which would replace the existing nationally based regimes.

*-Issuer Choice.* The United States regime should no longer be mandatory. Under this approach, any issuer, U.S. or foreign, can avoid the U.S. regime if it chooses instead to subject itself to the regime of one of the fifty states or of any other country.

I have taken the position in prior writings that, with certain limited exceptions, the United States should adhere exclusively to the first approach, that of issuer nationality.<sup>5</sup> Thus, as a general matter, the United States should apply its regime to all U.S. issuers and no others, even if their shares are publicly offered in the U.S. or listed on a U.S. exchange and even if a significant number of investors transacting abroad in their shares are U.S. residents. Commentators who disagree with this position adhere, at least in part, to one or more of the other four approaches. Current U.S. practice consists of a mix of the first three approaches.<sup>6</sup> In Part I of this Article, I briefly review why I advocate the issuer nationality approach. In Part II, I evaluate the positions of other commentators who share my assumption that the nationally based mandatory system of disclosure should, or as a realistic matter will, be continued but disagree with issuer nationality as the way to determine the reach of each country’s regime. In Part III, I evaluate the position of commentators who disagree with issuer nationality because they believe the whole system of nationally based mandatory disclosure should be abandoned, either in favor of international uniformity or in favor of issuer choice. I conclude in Part IV with a discussion of what I believe are the open issues.

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5. See *supra* note 3. For other adherents of this approach, see Greene et al., *supra* note 2; Baumol & Malkiel, *supra* note 2.

6. See Fox, *Political Economy*, *supra* note 3, at 705-17.

## I. THE REASONS FOR CHOOSING AN ISSUER NATIONALITY APPROACH

### A. *Choosing a Policy on the Basis of a Regulatory Incidence Analysis*

Put aside for the moment consideration of the international uniformity and issuer choice approaches and assume for a moment that the United States will retain its existing mandatory disclosure regime. We must therefore develop out of the three remaining approaches—issuer nationality, transaction location and investor residency—a principle of jurisdictional reach for deciding to which issuers the U.S. regime should be applied. In my view, the appropriate way to develop such a principle of jurisdictional reach is to undertake a regulatory incidence analysis. We need to identify which of the world's issuers are the ones for which the United States is the country where the benefits of good regulation of their disclosure, and the costs of bad regulation of their disclosure, are concentrated.

A principle that involves applying the U.S. regime to the issuers so identified and to no others is most likely to satisfy the twin U.S. goals of maximizing U.S. economic welfare and minimizing conflict with other countries. It is also the principle most likely to maximize global economic welfare.

As will be developed below, these issuers turn out to be the issuers whose economic center of gravity as a firm is the United States, *i.e.*, issuers for which the United States is the location of their headquarters and their greatest concentration of physical capital and employees and is where their entrepreneurs at the time of founding resided.<sup>7</sup> Throughout this paper, a firm having these characteristics is what I refer to as a “U.S. national”; a firm's country of incorporation is not the primary factor in the definition.

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7. Most of the world's issuers, even ones labeled “multinational,” still have a distinct nationality of this sort in some country (particularly if the EC is for these purposes treated as a single country). In 1990, profits from foreign operations of U.S. corporations amounted to only about one-sixth of all corporate profits. See 72 SURV. CURRENT BUS. No. 12 at 14 NIPA Table 6.16C (1992). In 1989, overseas assets of even U.S. corporations designated as “multinational” were only about one-fifth of their total assets. See J. Lowe & R. Mataloni, Jr., *U.S. Direct Investment Abroad: 1989 Benchmark Survey Results*, 71 SURV. CURRENT BUS. No. 10 at 29 (1991) (data from Table 1). I will briefly consider exceptions to this generalization—truly multinational companies such as Daimler-Chrysler and BP Amoco—in Part IV *infra*.

*B. Why the Issuer Nationality Approach Best Identifies where the Benefits and Costs of Disclosure Regulation are Concentrated*

*1. The Benefits and Costs of Disclosure*

Additional issuer disclosure produces social benefits by improving how proposed new investment projects in the real economy are selected for implementation and the way existing projects are operated.<sup>8</sup> Additional disclosure produces these social benefits directly when an issuer contemplates implementing a new project by means of a new stock offering. Because of the disclosure-induced increase in the accuracy of the price at which the shares will be sold, the firm's cost of capital is brought more in line with the social cost of investing society's scarce savings in the contemplated project and so these savings are more efficiently allocated.<sup>9</sup>

Additional disclosure produces these social benefits through a second route as well, which is unrelated to whether the issuer is offering new shares, by increasing the effectiveness of several of the devices that limit the extent to which managers of public corporations place their own interests above those of their shareholders. To start, additional disclosure assists in the effective exercise of the shareholder franchise and in shareholder enforcement of management's fiduciary duties.<sup>10</sup> It also increases the threat of hostile takeover when managers engage in non-share-value-maximizing behavior. This is because the additional disclosure both makes a takeover less risky for potential acquirers and reduces the chance that a value-enhancing acquisition will be deterred by the target having an inaccurately high share price.<sup>11</sup> Finally, by reducing the riskiness associated with holding an issuer's

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8. I have discussed this point in more detail elsewhere. See Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at 2544-50. See also Marcel Kahan, *Securities Laws and the Social Cost of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

9. See Fox, *Retaining Issuer Disclosure*, *supra* note 3, at 1358-63.

10. See Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 L. & CONTEMP. PROBS. 113 (1999). In the United States, we are so accustomed to a high level of issuer disclosure that we tend not to appreciate its importance with respect to these devices. A comparison with Russia is revealing. There, the dearth of disclosure renders the fiduciary duties nominally imposed on management almost useless. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996). It also makes relatively meaningless disinterested shareholder approval of transactions in which management is interested. See Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Fiascos*, 75 N.Y.U. L. REV. 1720 (2000).

11. The market for corporate control is a well-recognized device for limiting the agency costs of management where ownership is separated from control, as in the typical publicly held corporation. More information and the resulting increase in price accuracy improves the control market's effectiveness in performing this role. A potential acquirer, in deciding whether it is worth paying what it would need to pay to acquire a target that the acquirer feels is mismanaged, must make an

stock in a less than fully diversified portfolio, additional disclosure increases the use of share price based management compensation, which also helps align the interests of managers and shareholders.<sup>12</sup> Additional disclosure entails social costs as well, however, in terms of both the out-of-pocket expenses that an issuer incurs for such items as lawyers, accountants and printing and the staff time required to produce the needed information.

As a result of these benefits and costs, an issuer's level of disclosure affects the real returns it generates. An issuer has a socially optimal level of disclosure, the level at which the marginal social benefits just equal the marginal social costs. If a country's issuers disclose at their optimal level, this will maximize the disclosure-induced enhancement to returns generated by capital-utilizing enterprises in that country.

## 2. *The Incidence of Benefits and Costs*

In an efficient market, an issuer's share price takes into account the effect of the issuer's particular disclosure regime on its future expected cash flow. At the same time, because globalization makes capital relatively mobile internationally, competitive forces push capital toward receiving a single global expected rate of return (adjusted for risk). Thus, investors in all the world's issuers tend to get the same risk adjusted expected return even though issuer disclosure practices may vary widely from one country to the next. The higher returns that result from a country's issuers disclosing at their optimal level therefore go largely to the suppliers of the issuers' less mobile factors of production, their entrepreneurs, who will get higher prices when they sell shares in the firms they founded, and labor, who are likely to enjoy higher wages in an economy where capital is allocated and used efficiently.

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assessment of what the target would be worth in the acquirer's hands. This assessment is inherently risky and the acquirer's management is likely to be risk averse. Greater disclosure, however, reduces the riskiness of this assessment. Hence, with greater disclosure, a smaller apparent deviation between incumbent management decisionmaking and what would maximize share value is needed to impel a potential acquirer to action.

Also, when share price is inaccurately high, even a potential acquirer that believes for sure that it can run the target better than incumbent management may find the target not worth the price. The increase in share price accuracy that results from greater disclosure reduces the chance that a socially worthwhile takeover will be thwarted in this fashion.

Greater disclosure thus makes the hostile takeover threat more real. Incumbent managers will be less tempted to implement negative net present value projects in order to maintain or enlarge their empires or to operate existing projects in ways that sacrifice profits to satisfy their personal aims. Those that nevertheless do these things are more likely to be replaced. See, MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY 84-91 (1987).

12. See Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at 2548-50.

*Thus, the persons in the world who primarily benefit from higher real returns when a country's issuers disclose at their optimal level are the country's entrepreneurial talent and labor, who are residents of the country, not the investors in these issuers.*<sup>13</sup>

The reader may ask whether this analysis ignores another benefit of mandatory disclosure—investor protection—which will be concentrated where an issuer's investors are concentrated. The answer is no, because investor protection is not a sound justification for mandatory disclosure: disclosure is not necessary to protect investors against either unfair prices or risk. Consider first unfair prices. Under the efficient market hypothesis, securities prices are unbiased whether there is a great deal of information available about an issuer or very little. In other words, share prices will on average equal the actual value of the shares involved whether issuers are required to produce a lot of disclosure or only a little. Thus, greater disclosure is not necessary to protect investors from buying their shares at prices that are, on average, unfair, *i.e.*, greater than their actual values.

Now consider risk. With less information available about an issuer, share price, while still unbiased, is less accurate, *i.e.*, it is more likely to be significantly off one way or the other from the share's actual value. For an investor with a less than fully diversified portfolio, greater share price inaccuracy can make the portfolio more risky. High quality disclosure would, to some extent, protect such an investor by reducing this risk. The investor, however, can protect herself much more effectively and at less social cost by

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13. If a country's issuers represent only a small portion of all equities available to investors in the world, investors would share in none of these gains. The country would be analogous to a single small firm in a perfectly competitive industry. Such a firm's level of production has no effect on price. Following this analogy, what the country produces is investment opportunities—dollars of future expected cash flow—just like the firm produces products. A disclosure improvement's positive effects on managerial motivation and choice of real investment projects will increase the number of dollars of future expected cash flow that the country has to sell. This benefits the entrepreneurs, who are selling the cash flow, and labor, who gain from the overall increase in the country's economic efficiency. See Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at 2561-69. Because the country is like a small firm, however, the increase in the amount supplied is not great enough to lower the price at which a dollar of future expected cash flow is sold. Thus there is no benefit to investors, the "buyers" of these dollars of expected future cash flow.

If a country's issuers represent a substantial portion of all equities available to investors in the world, as is the case with the United States, investors will share in some of these gains. A disclosure improvement's increase in the number of dollars of future expected cash flow that the country has to offer would be great enough to lower the price at which a dollar of future expected cash flow is sold, at least slightly. Thus, investors would gain from the improvement. This is equally true of foreign investors as U.S. investors, however, and foreign investors own almost two-thirds of all the shares of publicly traded issuers in the world. See *id.* at 2525 n.51. And it is equally true of disclosure improvements of U.S. issuers whose shares are primarily sold to, or traded among, only foreign investors as it is of U.S. issuers with primarily U.S. shareholders. For a more detailed discussion of these points, see *id.* at 2552-80 and Fox, *Political Economy*, *supra* note 3, at 732-39.



simply diversifying more.<sup>14</sup>

This reasoning shows that no matter how globalized equity investing becomes, the benefits of good disclosure practices by U.S. issuers will remain concentrated in the United States and the benefits of good disclosure practices by issuers abroad will remain concentrated in their respective home countries.<sup>15</sup> This reasoning also shows that the location of transactions in an issuer's shares is simply irrelevant to where the benefits and costs of the issuer's disclosure practices accrue. A regulatory incidence analysis therefore suggests that the U.S. regime should be applied to all U.S. issuers, wherever their shares are offered or traded, and should not be applied to issuers of any other nationality, even when their shares are offered or traded in significant volume in the United States or purchased abroad by significant numbers of U.S. investors.

It should be understood that an issuer nationality based system of allocating jurisdictional reach among countries makes no assumption about whether regulation is needed at all. It simply allocates to the government of every issuer's home country the decisions concerning whether or not the issuer will be required to disclose and, if it is so required, the extent of that requirement. Having said this, if there is a need for regulation (as I believe

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14. In portfolio theory terms, issuer disclosure reduces firm specific ("unsystematic") risk. Firm specific risk can be completely eliminated by sufficient diversification. See Barbara Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984).

15. To the extent that globalization has not yet proceeded far enough to fully result in a single global risk adjusted expected rate of return on capital, the remaining market segmentation simply reinforces the point that the gains from a country's issuers disclosing at their optimal levels will be concentrated at home. A country whose issuers disclose at the optimal level of disclosure will have capital utilizing enterprises that produce higher returns net of costs of disclosure. If the single rate assumption is correct, the gains from getting the disclosure level right will be primarily enjoyed by the less mobile claimants on these returns, domestic entrepreneurs and labor, not by the suppliers of capital, who, wherever in the world they live, will at best enjoy a slight increase in the overall global expected return on capital. See *supra* note 13. If the assumption is incorrect, the reason would be that each country's investors still have a degree of bias against issuers from other countries. In that event, U.S. investors, for example, might share disproportionately in the gains from moving the U.S. issuer disclosure level toward its optimal level. The bias of foreign investors against U.S. issuers would mean that the increase in the number of expected dollars of future cash flow resulting from the change in required disclosure would be offered to a somewhat restricted market and push their price down more for U.S. investors than for other investors. *Id.* To the extent that a U.S. issuer has U.S. shareholders, the fact that U.S. investors will share disproportionately in the gains from optimal disclosure simply creates an additional U.S. interest in the level of the issuer's disclosure. As for a hypothetical U.S. issuer whose shares are sold to and traded among only foreign investors, entrepreneurs and labor in the United States would, just as if there were a single global expected rate of return on capital, enjoy most of the gains from optimal disclosure. See Fox, *Securities Disclosure in a Globalizing Market*, *supra* note 3, at 2561-69. Thus, the United States' interest in the disclosure behavior of even this second kind of issuer would be as strong as it is shown to be under the assumption in the text.

there is<sup>16</sup>), it obviously arises from the fear that without regulation, issuers will disclose at less than a socially optimal level, not from a belief that they will disclose too much.

### 3. *The Harm from Taking Transaction Location into Account*

It also should be noted that, while the location of transactions in an issuer's shares is irrelevant to where the costs and benefits of the issuer disclosure practices are felt, the mistaken belief that transaction location is relevant actually can harm U.S. interests if the belief leads to transaction location being counted as a factor in deciding whether to apply the U.S. regime to any given issuer. Two types of harm arise. First, assuming that the United States acts in its own rational best interests in its decision to require disclosure and in its choice of required level, the transaction location approach gives the managers of U.S. issuers an opportunity to exercise their preference to disclose less than is socially desirable by making an offering, or promoting trading in its shares, exclusively abroad in a country with less strict requirements.<sup>17</sup> Second, the transaction location approach needlessly reduces the volume of transactions effected in the U.S. by scaring away foreign issuers whose managers would gladly offer their issuers' securities in the United States, or have them trade there, but for the fact that their issuers would be required to disclose more. This hurts the U.S. securities industry and increases the cost and difficulty for U.S. investors to pursue many foreign investment opportunities.<sup>18</sup> The fact that some foreign issuers find it advantageous to impose the stricter U.S. regime on themselves in no way undermines this point since these issuers can voluntarily choose to impose the U.S. regime on themselves anyway.<sup>19</sup>

### 4. *Conclusion*

In sum, the argument for the issuer nationality approach is as follows:

-The United States *does* have strong interest in the disclosure behavior of all U.S. issuers, even those whose shares are sold to, or traded among, foreigners. If U.S. issuers disclose at their socially optimal level, the benefits in terms of the resulting increased real returns will accrue primarily to U.S.

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16. See Fox, *Retaining Mandatory Disclosure*, *supra* note 3.

17. See Fox, *Political Economy*, *supra* note 3, at 745-54 for a more detailed discussion of these points.

18. See Fox, *Political Economy*, *supra* note 3, at 754-57 for a more detailed discussion of these points.

19. See Part I.C.3. *infra*.

entrepreneurs and labor. The investors in these issuers will receive the global risk-adjusted expected rate of return regardless of the disclosure practices of U.S. issuers.

-The United States *does not* have a strong interest in the disclosure behavior of any foreign issuers, even those that are sold to, or traded among, U.S. residents. Whether or not the U.S. regime applies to these issuers, U.S. investors who purchase their shares will receive the global risk adjusted rate of return.

-The location of transactions in an issuer's shares is simply *irrelevant* to whether the U.S. has an interest in an issuer's disclosure behavior. Taking location into account in determining whether to apply the U.S. regime to the issuer actually harms United States interests by providing a means for U.S. issuers to evade U.S. regulation and by scaring away foreign issuers from markets located in the United States.

### C. Qualifications

My suggestion that the United States exclusively utilize the issuer nationality approach to statutory reach is subject to three qualifications.

#### 1. Foreign Issuer IPOs in the United States

The first qualification concerns an initial public offering (IPO) by a non-publicly traded foreign company to U.S. investors. The U.S. new issue regime should be applied to such a transaction because there is no assurance that the price at which such securities would be sold absent this regulation would necessarily reflect the effect on the issuer's expected future cash flow of only being bound by its home country's presumably less rigorous disclosure system.<sup>20</sup> One reason for concern is that the mechanisms needed to generate price efficiency in the market for IPOs are more complicated, and their existence less well established empirically, than the mechanisms that appear to generate price efficiency in secondary markets. A second concern is that some of the relevant empirical literature suggests that even U.S. issuer IPOs in the United States are priced inefficiently high. In contrast, a new share offering to U.S. investors by an established publicly traded foreign issuer does not raise these concerns, because the offering's price will be determined primarily by the prevailing price in the secondary market for the issuer's already outstanding shares.

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20. See Fox, *Political Economy*, *supra* note 3, at 742-43 for a more detailed discussion of the points in the subsection.

### *2. New Issue and Periodic Disclosure by Issuers from Developing Countries and Newly Emerging Economies*

Although there is substantial evidence that many foreign secondary markets display the same kind of efficiency as those in the U.S., the testing of this proposition, especially with respect to markets outside Europe, is certainly not as extensive as with U.S. markets. We cannot be sure that the more immature markets found in developing countries and newly emerging economies have the same level of efficiency as markets in the United States and Europe. Moreover, the mechanisms that appear to generate price efficiency in the United States and Europe are not as firmly in place in such markets. Caution again suggests that at least initially the issuer nationality approach not be extended to issuers whose shares trade primarily in these markets.<sup>21</sup>

### *3. Foreign Issuer Option to Adopt the U.S. System*

Under the issuer nationality approach, foreign issuers are not required to comply with the U.S. disclosure system. It is in no way intended to deprive them of the option to impose this system on themselves if they wish to do so. An issuer's compliance with its own country's disclosure system is intended as a floor, not a ceiling.<sup>22</sup>

## II. TRANSACTION LOCATION AND INVESTOR RESIDENCY BASED CRITIQUES OF THE ISSUER NATIONALITY APPROACH

A number of commentators share my assumption and/or desire that the nationally based mandatory system of disclosure regulation will be maintained—thus rejecting the international uniformity and issuer choice approaches—but disagree with issuer nationality as the correct way to determine jurisdictional reach of each country's regime. Their criticism of the issuer nationality approach arises from a number of concerns, to which I will respond below.

### *A. Comparability*

One concern with the issuer nationality approach voiced by some commentators is that it would result in divergent regulatory standards

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21. *See id.*

22. *See id.* at 756.

applying to different companies participating in the U.S. capital market. Professor James Cox, in endorsing the transaction location approach, has raised this concern most prominently. Specifically, he “question[s] whether within a single market there can arise a reasonable pricing hierarchy among firms according to differences in the regulatory system guiding their disclosures.”<sup>23</sup> He consequently counsels the SEC, at least when it comes to accounting standards, to stay the course and press for disclosure by foreign issuers trading in the U.S. market to be as close to U.S. disclosure as possible.<sup>24</sup>

Professor Cox’s apparent goals in judging what is good disclosure policy appear very close to my own:

Disclosure assumes significance not solely because investors can avoid questionable ventures, but because it facilitates investors in making the comparative judgments necessary for capital markets to fulfill their allocative functions.<sup>25</sup>

He fails, however, to show that having issuers simultaneously trading in U.S. markets that are regulated by different disclosure systems compromises this goal in a fashion that injures either U.S. or global economic welfare.

### *1. Empirical Evidence*

Professor Cox begins his analysis by looking at a study by Eli Amir and others concerning the market reaction when a foreign issuer trading in the United States files its Form 20-F.<sup>26</sup> Because there is typically a delay between when the issuer discloses what it is required to disclose under its home country regime and the filing of the 20-F, market reaction to the 20-F filing has the potential of showing whether the additional disclosures elicited by the U.S. requirements contain information of value to investors.

It is not clear, though, how the results of this study could bear on the question of whether it is undesirable to have issuers trading in the same market regulated, respectively, by two different regimes. Assume that the U.S. disclosure requirements do elicit new information of value to investors;<sup>27</sup> what would that prove? It suggests that a foreign issuer that

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23. Cox, *Regulatory Duopoly*, *supra* note 2, at 1202.

24. *See id.*

25. *Id.* at 1211.

26. *See* Eli Amir, et al., *A Comparison of the Value Relevance of U.S. versus non U.S. GAAP Accounting Measures Using Form 20-F Reconciliations*, 31 J. ACCT. RES. 230 (Supp. 1993).

27. As Professor Cox candidly concedes, the Amir study actually never comes to a conclusion on this question. *See* Amir, *supra* note 26, at 262. *See also infra* note 49 and accompanying text for a

conforms with the U.S. regime would have a more accurate share price. Who gains from this increased price accuracy, however? The regulatory incidence analysis above shows that it is entrepreneurs and labor in the issuer's home country, not U.S. investors in the issuer, that are the primary gainers from the improvement in capital allocation and reduction in the agency costs of management that result from increased price accuracy.<sup>28</sup> Are these gains greater than the costs of the additional disclosure? That is hard to know for sure, but the socially optimal level of disclosure for issuers from most countries is probably lower than that for U.S. issuers.<sup>29</sup> More importantly, it is the issuer's home country government that represents the greatest concentration of persons who bear both the benefits and the costs of the level at which the issuer discloses, and so that government's determination of costs and benefits implicit in its own disclosure requirements should be privileged over the U.S. government's implicit determination.<sup>30</sup>

Professor Cox also reviews empirical literature concerning share price reactions when a foreign issuer decides to list its shares on a U.S. exchange or upgrade its over-the-counter trading status, in each case triggering for the first time the obligation to file a Form 20-F.<sup>31</sup> The studies show that share

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discussion of other literature concerning this question. Nevertheless, it is very difficult to imagine that, as a whole, the more extensive disclosure requirements of the United States do not elicit at least some information helpful for increasing the accuracy of assessments of an issuer's future cash flows.

28. See *supra* Part I.B.

29. See Fox, *Political Economy*, *supra* note 3, at 757-60.

30. Professor Cox, in critiquing my arguments for the issuer-nationality approach, states:

An obvious concern with [the Fox and other approaches] is that the regulating state is not, when a secondary listing is involved, the same state as that where either the investors or the secondary market is located. This permits the regulating state to regulate without having to be politically responsive to all those who are impacted by its regulations.

Cox, *Regulatory Duopoly*, *supra* note 2, at 1252 n.98. In fact, concern with where the impact of disclosure regulation will be is what has driven my entire scholarly effort in the area of disclosure regulation in a world of globalizing securities markets. Professor Cox makes this statement without acknowledging my conclusion that the state where the secondary market and the investor are located is not affected in any important way by the disclosure practices of foreign issuers and without trying to respond in any way to the analysis I use to reach this conclusion. See, Fox, *Political Economy*, *supra* note 3 at 732-739 and Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at 2552-80 (discussing the points of which are summarized in the regulatory incidence analysis in *supra* Part I.B). Professor Cox also states that I argue foreign issuers making "secondary listings will pressure their home state authorities to address any harmful laxness in their regulations." Cox, *Regulatory Duopoly*, *supra* note 2, at 1229 n.98. I make no such argument. Indeed, I share his skepticism issuer managers would find it in their best interests to disclose at the socially optimal level. See Fox, *Political Economy*, *supra* note 3, at 746-54; Fox, *Retaining Mandatory Disclosure*, *supra* note 3, at 1342-68. My real argument is the much less controversial one that, given that the foreign issuer's home government represents the individuals who will enjoy the primary benefits from its issuers disclosing at a socially optimal level, the home government is better positioned than U.S. authorities to determine what that level is. Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at 2580-2608.

31. See Cox, *Regulatory Duopoly*, *supra* note 2, at 1217-23.

price reacts positively to such a decision, but again this really proves nothing concerning the question of whether it is undesirable to have issuers that trade in the same market disclose under two regimes. To start, as Cox admits, the positive price reaction may be due entirely to the increased liquidity that accompanies this decision. Equally important, the sample involves an extraordinarily strong self-selection bias. The manager of an issuer making this decision is doing so despite the personally disagreeable increased disclosure involved. She presumably does so because she expects that the U.S. listing or trading status upgrade will be sufficiently positive for the shareholders so that on balance she will benefit too. It would be very surprising if the market's evaluation of the move would not correlate positively with hers. There are a number of reasons why such a move can be good for shareholders. In addition to liquidity gains, the decision may signal something positive about future cash flows.<sup>32</sup> It may also be that this company's optimal disclosure level is indeed higher than what is required by its home country, but this says nothing about the optimal disclosure levels of compatriot firms that do not choose to list on a U.S. exchange or upgrade their over-the-counter trading status. U.S. investors might wish to buy, or trade in, the shares of these compatriot firms as well.

## 2. *Regulatory Competition*

After his review of this empirical literature, Professor Cox considers the theoretical issues underlying the question of whether having issuers disclosing under two regimes in the same market is undesirable. In the first part of his more theoretical analysis, Cox considers regulatory competition. In doing so, he unfortunately confuses the rationales underlying issuer nationality approach with the rationales underlying issuer choice approach. He states that both approaches depend on a belief that regulatory competition is likely to promote optimal disclosure standards.<sup>33</sup> In reality, while the issuer choice approach depends on this belief, the issuer nationality approach most decidedly does not. Cox then goes on to present a sharp critique of the logic behind the belief in regulatory competition, a critique with which I largely agree. Indeed, I have argued extensively that one of the virtues of the issuer nationality approach is that it frustrates regulatory competition,<sup>34</sup> and Roberta Romano, one of the primary proponents of issuer choice, has criticized the issuer nationality approach specifically because it has this capacity to

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32. See Fürst, *supra* note 2 (on file with author).

33. See Cox, *Regulatory Duopoly*, *supra* note 2, at 1230.

34. See Fox, *Political Economy*, *supra* note 3, at 746-57, 766-97.

frustrate regulatory competition.<sup>35</sup>

### 3. *Market Efficiency and Noise Theory*

In contrast to regulatory competition, the issues of market efficiency and noise theory clearly are relevant to the desirability of both the issuer nationality and issuer choice approaches. Cox claims that we lack adequate evidence of market efficiency with respect to the implications of different issuers operating under different disclosure regimes to undertake safely either proposed reform.<sup>36</sup> Adequacy is in the eyes of the beholder, but the evidence here is more substantial than Professor Cox suggests. The whole structure of the contemporary U.S. disclosure regime—with its short form and shelf registration for established issuers, as well as the other reforms that arose out of the integrated disclosure movement—relies on the assumption of market efficiency, at least with respect to affirmative disclosures made in SEC periodic disclosure filings. The SEC thought the body of theoretical and empirical work in financial economics supporting this assumption sufficiently sound to justify these reforms at the time they were enacted, and few commentators currently are calling for their rollback based on second thoughts about the assumption's validity. The same body of work provides an equally secure base for the assumption that the market will be efficient with respect to the implications of different disclosure regimes. Consider specifically what is at stake here: a laxer regime simply permits an issuer to avoid comment concerning a matter about which a stricter regime would require the issuer to say something. The market should be just as efficient in the unbiased processing of the implications of such absences of comment as it is in processing the affirmative disclosures required under the U.S. regime. Prices will be less accurate under the lax regime, *i.e.*, often further from a share's actual value one way or the other, but they will still be unbiased.<sup>37</sup>

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35. See Romano, *supra* note 2, at 2426-27.

36. See Cox, *Regulatory Duopoly*, *supra* note 2, at 1234.

37. According to the efficient market hypothesis, the price at which an issuer's shares trade will be unbiased whether there is a great deal of information available about the issuer or very little. By "unbiased," I mean that the price, on average, is equal to the share's actual value; *i.e.*, what the future income stream accruing to the holder of the share—its dividends and other distributions—turns out to be, discounted to present value. Speculators—the persons whose actions in the market set prices—assess what this future income stream will be based not only on what information is available about the issuer but also on what is information not available. The empirical literature testing the efficient market hypothesis suggests that the inferences that speculators draw from issuer disclosures are in fact unbiased. Because there is no reason to believe that their inferences from issuer absences of comment are any more likely to be biased than their inferences from issuer disclosures, this literature suggests as well that the inferences they draw from issuer absences of comment are also unbiased. I discuss these points in more detail elsewhere. See Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at



Professor Cox also raises the question of noise theory. Noise theorists believe that share prices are affected by the irrational expectations of naive speculative traders, who act on the basis of fads, fashions, and irrational psychological predispositions.<sup>38</sup> Cox suggests that the findings of the noise theorists “do not support subjecting investors to multiple disclosure standards.”<sup>39</sup> A careful investigation of the implications of noise theory does not suggest that it in fact undermines the case for the issuer nationality approach.<sup>40</sup> As has been analyzed above, the primary impact of any inaccuracy in an issuer’s share price will be on the entrepreneurs and labor in the issuer’s home country. This analysis in no way depends on the inaccuracy being induced by the trading of entirely rational investors who simply have a low level of information rather than by noise trading.

There is thus no reason to take into account in the design of U.S. disclosure policy the possibility that noise may influence the share prices of foreign issuers trading in the U.S. market unless the noise makes the prices unfair to U.S. investors. Since noise is as likely to cause prices to be too low as too high, the proposition that share prices on average equal actual value still holds even if the noise theorists’ description of the world is correct.<sup>41</sup> Thus noise poses no problem even for the most unsophisticated U.S. investor unless she engages in naive speculation by trying to beat the market through following the fads and fashions. The long term investor, the dart thrower, and the index fund investor are no worse off with the noise than they would be without it. The naive speculator will be hurt by relying on the fads and fashions because there will be smart money traders who are ready to take trading positions opposite the naive speculator and wait out the fad. The fact that investors, through this kind of naive speculation, can lose wealth to

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2533-39.

Professor Cox suggests that the validity of the integrated disclosure reforms depends only on the market being informationally efficient, whereas issuer nationality requires securities to be priced in a fundamental value efficient market. See Cox, *Regulatory Duopoly*, *supra* note 2, at 1247. It is unclear, however, what the reasons are for believing there is a difference in the kind of market efficiency required to justify the two reforms. Prices in a market that is informationally efficient but not fundamental value efficient still are unbiased in the sense of being as likely to be below actual value as above. The difference is that, unlike the price in a fundamentally efficient market, price in a market that is only informationally efficient is not necessarily the most accurate assessment of actual value that can be made given available information.

38. See, e.g., Fisher Black, *Noise*, 41 J. FIN. 529 (1986).

39. See Cox, *Regulatory Duopoly*, *supra* note 2, at 1234, 1246-47.

40. The points that follow in the text summarize a more extensive discussion of mine concerning why noise theory does not undermine the argument that the issuer’s home country has the greatest interest in its disclosure level. See Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at 2536-37 n.76, 2555 n.103.

41. See *id.*

others in this fashion does not in my view suggest that noise introduces into the market any kind of structural unfairness.<sup>42</sup> The better public policy response to concerns about the plight of naive speculators is an adequate public education effort against the dangers of such speculation and regulation of brokers and investment advisors who promote it inappropriately.

Moreover, even if one does consider it unfair that naive speculators lose money in this fashion, there is no sound theoretical reason to believe *a priori* that increased disclosure is any more likely to alleviate the unfairness than to exacerbate it. This is because one of the effects of increased disclosure will be to reduce the riskiness for smart money speculators to engage in the trading activities that move wealth to themselves from the naive traders.<sup>43</sup>

#### 4. Risk Reduction for the Undiversified Investor

The final theoretical issue considered by Professor Cox concerns the effect of multiple disclosure regimes on undiversified investors.<sup>44</sup> Admittedly, permitting foreign issuers to trade in U.S. markets, while disclosing under their less rigorous home country regimes, will make easily available to U.S. investors securities with share prices that are less accurate than they would be if these issuers were subject to the U.S. regime. While this will not add to the risk incurred by fully diversified investors, it will add risk to the portfolios of investors in these stocks who are undiversified, which reduces their expected utility. Greater disclosure by foreign issuers under the transaction location approach would benefit these less than fully diversified U.S. investors by reducing the unsystematic risk in their portfolios.

It is unlikely, however, that this gain is worth the costs of the transaction location approach, particularly because the same gain—the reduction of unsystematic risk—can be achieved just as effectively by a program of educational and institutional reform that will encourage U.S. investors to diversify. The costs of the transaction location approach are substantial. If the U.S. policy imposes its regime on all foreign issuers whose shares are offered

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42. *See id.*

43. *See id.*

44. Cox, *Regulatory Duopoly*, *supra* note 2, at 1234-35. Professor Cox also suggests that allowing foreign issuers to trade in the United States while disclosing at the lower level required by their home country regimes will permit more fraudulent offerings to succeed and thereby will switch regulation from playing the *ex ante* prophylactic role that the SEC-reviewed registered public offering process provides to playing the *ex post* deterrence role that litigation provides. *See id.* at 1235-36. Again, however, if it turns out that *ex post* litigation-based regulation is socially inferior, it is entrepreneurs and labor in the home country that will pay the price. Investors will be protected because the higher risk that an investment in a foreign issuer will produce no returns except those derived out of a high-transaction-cost law suit will be discounted in the initial price of foreign-issuer shares.

or traded in the United States, many foreign issuers will seek to avoid the U.S. regime, keeping their shares out of the U.S. market. This hurts U.S. investors, who are better off when shares of additional issuers are made available, even if these additional issuers only disclose at a very low level.<sup>45</sup> The loss in U.S. investor utility from a smaller number of foreign issuers' shares being available may be greater than the gain in such utility from the increased disclosure by foreign issuers that do make their shares available. Thus, U.S. investors can actually be made worse off by applying the U.S. regime to foreign issuers. When U.S. foreign relations and global economic welfare considerations are taken into account, the costs to the United States in applying its regime to foreign issuers is even greater. Imposition of the U.S. regime requires the issuer to disclose more than officials in the issuer's own country have determined is cost effective. At least in the eyes of these foreign officials, this higher level of disclosure required by the United States costs more than it is worth and thus reduces the net returns to capital utilizing productive activities in their own country. This damages the issuer country's entrepreneurs, suppliers of labor and, if the issuer has previously gone public at home, suppliers of capital.

These foreign relations problems will be severely exacerbated by the growing globalization of financial information and the declining difficulty and expense of effecting share transactions abroad. If the United States is serious about protecting undiversified U.S. investors, it will switch from the transaction location approach that Professor Cox is currently advocating to the investor residency approach. If the United States follows Professor Cox's approach, the U.S. regime would be applied to foreign issuers with greater and greater frequency whether or not they actively target U.S. investors in their offerings or actively encourage secondary trading of their shares among U.S. investors. Each additional application is objectionable to the issuer's home country, as its residents suffer the welfare loss from the issuer disclosing more than is socially optimal. This is particularly true because the U.S. regime is imposed to cure the purely domestic U.S. problem of inadequate investor diversification.

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45. Whatever level of disclosure is imposed on the issuer, each additional investment opportunity available to U.S. investors that a share value maximizing firm finds worth selling into a market with unbiased pricing represents an increase in demand for savings. It therefore marginally raises the overall market expected rate of return available to every such investor. Also, each additional investment opportunity has a future return generated by a probability distribution with somewhat different variance-covariance characteristics than any existing opportunity and therefore permits investors to compose portfolios with more favorable tradeoffs between risk and return than otherwise would have been available. For a more formal elaboration of these points, see Fox, *Disclosure in a Globalizing Market*, *supra* note 3, at 2542-44.

### 5. *Network Externalities*

Professor Jack Coffee has made a somewhat different comparability based argument for the transaction location approach:

An initial “network externality” is the advantage of complementarity. As issuers conform to common disclosure, accounting, and listing standards, investors gain the ability to compare securities in a common language and scoring system. Inherently, investors need to compare security A against security B and this task becomes quicker and easier as more issuers converge to [common] . . . disclosure and accounting standards.<sup>46</sup>

Coffee undoubtedly has a point here, after all, providing a common language is one rationale for nationally based mandatory disclosure in the first place.<sup>47</sup> The question is: how important is it to achieve greater commonality than now exists? A major portion of the capitalized value of the world’s publicly traded equities is issued by issuers subject to the regimes of a relatively small number of major capitalist countries.<sup>48</sup> There is evidence, for example, that speculators—the persons whose trading sets prices—are “multilingual” in sufficient number that the share price accuracy of foreign issuers trading in the United States is not significantly enhanced by their provision of U.S. GAAP reconciliation, which is currently required.<sup>49</sup> Coffee suggests that the efforts these speculators undertake to effect their translations is a waste.<sup>50</sup> However, the waste may not be that significant because only a limited number of such speculators are needed to achieve price efficiency. It is likely to pale in comparison to the costs, considered above, of imposing U.S. standards on foreign issuers.<sup>51</sup> Moreover, if the

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46. Coffee, *supra* note 2, at 694.

47. Frank Easterbrook & Daniel Fischel, *Mandatory Disclosure and The Protection of Investors*, 70 VA. L. REV. 669, 685-87 (1984).

48. At year-end 1994, the “G7” countries (the United States, Canada, the United Kingdom, France, Italy, Japan, and Germany) together accounted for 75 percent of the world’s total market capitalization of nearly U.S. \$15.2 trillion. INTERNATIONAL FINANCE CORPORATION, EMERGING STOCK MARKETS FACTBOOK 1995, at 15 (1995).

49. One way to test this proposition is to compare, for foreign issuers listed on a U.S. exchange, the response of their share prices when they originally announce their earnings prepared on the basis of home country conventions, with the response of their share prices when they subsequently announce these earnings reconciled with U.S. GAAP. Gary Meek performed such a test and found that the price response to the first announcement suggests it has considerable information value, while there was not a statistically significant price response to the second announcement. See Gary K. Meek, *U.S. Securities Market Responses to Alternate Earnings Disclosures of Non-U.S. Multinational Corporations*, 58 THE ACCT. REV. 394 (Apr. 1983).

50. Coffee, *supra* note 2, at 694.

51. See *supra* Part II.A.3 notes 36-43 and accompanying text.

network externalities from foreign issuer compliance with U.S. standards are, in fact, as significant as Coffee suggests, the transaction location approach will not be necessary to maintain the benefits of comparable disclosure, at least now that the network externalities involving comparable disclosure are already firmly established in the U.S. market. Foreign issuers will affirmatively want to take advantage of these externalities by joining the group, which, under the issuer nationality approach, they would be free to do.

Coffee goes on to suggest that additional network externalities exist because all issuers that trade in the U.S. market contribute to its “reputational capital” by adhering to strict U.S. disclosure rules.<sup>52</sup> Again, this is not a compelling argument for a well-established market like the one for securities in the United States. The speculative traders who set price distinguish among existing firms in the U.S. market along thousands of different lines including type of industry, character of management, quality of management, potentially threatening new technologies, corporate charter provisions, etc. It is hard to see why they could not distinguish along one more dimension: strictness of applicable disclosure regime.

### *B. Bonding and Private Information Revelation*

Another rationale for the transaction location approach, suggested by both Professors Coffee and Rock, is that it allows foreign issuers to impose on themselves the U.S. disclosure regime. Because such a move is hard to reverse, it permits a foreign issuer to make a bond to the market that the issuer will continue to provide the higher, U.S. level of required information over a long period of time.<sup>53</sup> It is plausible that many foreign issuers listing in the United States were motivated to do so at least in part by a desire to make such a bond, but preserving the opportunity for foreign issuers to engage in such bonding does not require the transaction location approach. Bonding is equally available under the issuer nationality approach as long as these firms have the option, as I recommend, to impose the U.S. regime on themselves.<sup>54</sup>

Professor Oren Fürst shows similar enthusiasm for the United States preserving the transaction location approach because it enables highly profitable foreign firms to convey credibly private information regarding their firms’ future prospects by choosing to list their shares in the United States and thereby impose on themselves the strict U.S. disclosure regime.<sup>55</sup>

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52. See Coffee, *supra* note 2, at 694.

53. See *id.* at 691-92; Rock, *supra* note 2.

54. See *infra* Part I.C.3.

55. Fürst, *supra* note 2, at 1.

Again, the issuer nationality approach offers these highly profitable foreign firms the same opportunity as long as the option exists to impose the U.S. regime on themselves.

### C. Administration and Enforcement

Professor Cox's support of the transaction location approach over the issuer nationality approach is also based on his concern that the issuer nationality approach would create difficult problems of administration and enforcement.<sup>56</sup> Professor Karmel has endorsed the transaction location approach on similar grounds, stating that "it has made for relative certainty in structuring transactions, and it has avoided conflicts and tensions between the SEC and foreign regulators."<sup>57</sup> Cox gives as his example the problems of a U.S. issuer making a public offering in France, which under the issuer nationality approach would be governed by the U.S. disclosure regime. Cox suggests that if the issuer violated the U.S. rules and the United States brought an action, it would "pose terrific political and international issues these authors [the reference includes both myself and authors proposing the issuer choice approach] do not address."<sup>58</sup> Again, it appears that Professor Cox has confused the issuer nationality and issuer choice approaches even though they differ significantly with regard to this matter.<sup>59</sup> As I analyzed in an earlier work, a U.S. enforcement action against such a U.S. issuer would be fully justified under international law pursuant to the "nationality" principle,<sup>60</sup> a universally accepted principle that allows a state to prescribe conduct by its nationals, whether inside or outside the state.<sup>61</sup> I have analyzed

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56. See Cox, *Regulatory Duopoly*, *supra* note 2, at 1239-42.

57. Karmel, *supra* note 2, at 3.

58. Cox, *Regulatory Duopoly*, *supra* note 2, at 1240.

59. Cox's confusion between the issuer-nationality approach and the issuer-choice approach is suggested by his statement, "[g]reater extraterritorial breadth is recognized with respect to powers of a state over *its* citizens abroad, but this is not the relationship we find with the Dutch corporation purporting to invoke U.S. disclosure standards in its French offering." *Id.* at 1252 n.130 (emphasis added). In this statement, Cox appears to agree with my position that there is no international law problem with the United States enforcing its regime against a disclosure violation by a U.S. issuer making an offering in France, which is all that the issuer-nationality approach calls for.

60. See Fox, *Political Economy*, *supra* note 3, at 727. Ironically, it is the transaction location approach that, when applied to secondary trading of foreign issuer shares in the United States, can create problems under international law. These problems arise where neither the issuer nor anyone contractually related to it offered, sold, or promoted the trading of its shares in the United States, yet organized trading in the issuer's shares nevertheless developed in the United States. In that situation, the issuer has undertaken no conduct occurring within the United States. The nationality principle obviously does not work either. And the substantial effects principle is only of debatable help. See *id.* at 724-27.

61. See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §402(2)

the political ramifications of the issuer nationality approach as well,<sup>62</sup> and applying that analysis, it is hard to imagine how such an action by the United States is likely to raise major political problems with France.<sup>63</sup> Is France really going to object if a U.S. issuer making an offering in France discloses more than what French law requires?<sup>64</sup> And if the French wish the U.S. issuer to say something more than the U.S. regime requires, the U.S. adoption of the issuer nationality approach in no way stops them.

Moreover, Professor Cox's choice of example here is odd. His entire article concerns the problems he sees in having domestic issuers disclosing under the U.S. regime and foreign issuers disclosing under their respective home country regimes trading simultaneously in the U.S. market, not the French market. Thus the example more relevant to the concerns of his article would be a French issuer making a public offering in the United States, which under the issuer nationality approach would be governed by the French disclosure regime. Would the United States, which by the very adoption of the issuer nationality approach chose to leave the regulation of such an issuer to its home country authorities, object if French authorities took action? Of course not.

It should also be noted that among the three approaches to statutory reach, the issuer nationality approach provides for the most practical administration of disclosure regulations in a globalizing era. U.S. authorities would be responsible only for issuers located in the United States. These are the issuers that U.S. authorities best understand. They are also the issuers who are

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(1987) [hereinafter RESTATEMENT]. The nationality principle involves "determining jurisdiction by reference to the nationality or national character of the person committing the offense"; *The Harvard Research on International Law: Jurisdiction to Prescribe*, 29 AM. J. INT'L L., Supp. 1, 435, 445 (1935). It is described by commentators as "universally accepted." *Id.* Professor Cox suggests that this does not constitute adequate authority because I do not "consider well recognized limits on a nation's jurisdiction to enforce its prescriptions," Cox, *Regulatory Duopoly*, *supra* note 2, at 1252 n.126, but he ultimately makes nothing of this distinction, citing the same section of the RESTATEMENT as I do and even making reference to the nationality principle as one of "the five bases for claiming jurisdiction under international law." *Id.* at 1241 n.130.

62. See Fox, *Political Economy*, *supra* note 2, at 735-36.

63. Professor Cox is silent about exactly what he thinks the "terrific" political issues might be.

64. The only French group who possibly could be injured by extending U.S. disclosure requirements to U.S. issuers whose shares are offered in the French market are persons who profit from the volume of securities transactions effected in France. With the issuer nationality approach, U.S. issuers will no longer have an incentive to evade U.S. disclosure rules by offering and promoting the trade of their shares abroad. Thus, the proposed switch in approach would diminish the volume of U.S. issuer share transactions located in other countries. This injury is not a legitimate basis for other countries to protest the proposed extension of the U.S. requirements. Between countries, volume is a zero-sum game. It should be won or lost based on the cost and quality of the transactional services available in each country, not on the ability of one country to offer a way to evade regulations of another country aimed at behavior that primarily affects the welfare of residents of the country whose regulations are being evaded.

easiest for U.S. authorities to investigate, because their records and principal employees are likely to be located in the United States, and whose cases would be the easiest to prosecute, because potential witnesses and defendants mostly reside within the jurisdiction.

Also, contrary to Professor Karmel's concerns, the issuer nationality approach would lead to the most, not the least, certainty in structuring transactions, because in the age of the Internet, there is likely to be much more ambiguity as to the place of a transaction than as to the nationality of the issuer.<sup>65</sup>

### III. ABANDONING NATIONALLY BASED MANDATORY DISCLOSURE

The issuer nationality approach has also been subject to more radical critiques, both from the right and from the left. From the right, advocates of the issuer choice approach argue that the United States regime should no longer be mandatory and that any issuer, U.S. or foreign, should be allowed to avoid the U.S. regime if it chooses instead to subject itself to the regime of one of the fifty states or of any other country.<sup>66</sup> From the left, advocates of international uniformity argue that mandatory disclosure should be retained but that all issuers worldwide should be subject to the same regime.<sup>67</sup> I will

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65. See Blake, *supra* note 2; Fox, *Political Economy*, *supra* note 3, at 780-82.

66. Recently, Professors Choi, Guzman & Romano have made fully elaborated proposals for full scale issuer choice. See Choi & Guzman, *supra* note 2; Romano, *supra* note 2. Professor Palmiter has recommended that issuers be able to opt out of the federal mandatory disclosure system, but only for the offering of securities, not for periodic disclosure. Palmiter, *supra* note 2, at 86-101. Professor Palmiter's primary concern does not appear to be transnational securities transactions, however. *See id.* These recent proposals have less-elaborated historical antecedents. See Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Causes and Regulatory Consequences*, in INTERNATIONAL COMPETITIVENESS IN FINANCIAL SERVICES 349 (Marvin H. Kusters & Allan H. Meltzer eds., 1991); Nicholas Demmo, *U.S. Securities Regulation: The Need For Modification to Keep Pace with Globalization*, 17 U. PA. J. INT'L ECON. L. 691, 720 (1996).

67. See, e.g., Geiger, *supra* note 2; Steinberg & Michaels, *supra* note 2, at 261-65 (the world's countries, by self-selection, would be divided into three groups—developed market, semi-developed market and emerging market—and each group would work out uniform disclosure rules for its countries' issuers that would permit sale and trading of their securities anywhere within the group). IOSCO, a worldwide organization of countries that provides a forum for meetings of the securities regulators of member states, initially undertook a straddle in which it urged countries either to adopt uniform rules (international uniformity) or reciprocity (essentially the issuer nationality approach). INTERNATIONAL EQUITY OFFERS, REPORT OF THE TECHNICAL COMMITTEE OF IOSCO (Sept. 1989), *cited in* Steinberg & Michaels, *supra* note 2, at 241. IOSCO, in cooperation with IASC, is seeking to develop a recommended set of international accounting standards and has developed a set of non-financial disclosure standards that could be used in a single uniform disclosure document for cross-border offerings, and thus has tilted toward international uniformity as the preferred result. See IOSCO, INTERNATIONAL EQUITY OFFERS, REPORT OF THE TECHNICAL COMMITTEE (Sept. 1989) (available from www.iosco.org), *discussed in* Michel Hurley, *International Debt and Equity Markets*, 8 EMORY INT'L L. REV. 701, 733 (1994); Steinberg & Michaels, *supra* note 2, at 241, 243-46; Roberta



consider each approach in turn.

### A. *Issuer Choice*

#### 1. *Comparing the Two Approaches as Responses to Globalization*

The current U.S. approach to statutory reach has a significant transaction location component to it.<sup>68</sup> As a result, a foreign issuer wishing to offer its shares in the United States or to have them trade on a U.S. stock exchange or NASDAQ must, under the current U.S. approach to statutory reach, comply with the requirements of the U.S. disclosure regime.<sup>69</sup> Under issuer choice, as proposed by both Professor Romano and by Professors Choi and Guzman, the foreign issuer would be able to choose its own country's regime instead.<sup>70</sup> They each argue that this would improve international capital mobility and reduce costs because foreign issuers no longer would be deterred by the U.S. regime's high disclosure requirements<sup>71</sup> from entering U.S. markets or seeking U.S. investors. These are indeed valuable benefits, but they are equally obtainable under the issuer nationality approach. Thus, the globalization of the market for securities does not form a basis for choosing one approach over the other. The decision must be based on other considerations.

#### 2. *An Issuer Nationality Critique of Issuer Choice*

I recently have written extensively on the question of issuer choice.<sup>72</sup> Thus, I will comment here only briefly why I believe that issuer choice is the inferior way to improve international capital mobility and to eliminate the cost for issuers of complying with more than one regulatory regime. Professor Romano argues that issuer choice would lead to jurisdictions competing to offer issuers regulations that maximize share value.<sup>73</sup> Professors Choi and Guzman argue that it would lead to a diversity of available regimes and permit each issuer to select the one best suited to its particular needs.<sup>74</sup> Neither argument, however, adequately takes into account the fact that issuer choice would result in each issuer selecting a regime

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S. Karmel, *The IOSCO Venice Conference*, N.Y. L.J. Oct. 19, 1989, at 3.

68. See Fox, *Political Economy*, *supra* note 3, at 705-17.

69. See *id.*

70. See Romano, *supra* note 2, at 2361-62; Choi & Guzman, *supra* note 2, at 907.

71. See Romano, *supra* note 2, at 2419-20; Choi & Guzman, *supra* note 2, at 922-23.

72. See Fox, *Retaining Mandatory Disclosure*, *supra* note 3.

73. See Romano, *supra* note 2, at 2362.

74. See Choi & Guzman, *supra* note 2, at 916-17.

requiring it to disclose at less than its socially optimal level. This is because each issuer's private costs of disclosure exceed the social costs of its disclosure, while its private benefits are less than the social benefits.

This divergence between private and social costs and benefits means that the current system of mandatory disclosure should be retained. The issuer nationality approach is the best way to retain it while enhancing international capital mobility and eliminating the costs of issuer compliance with multiple regimes. This is so unless the proponents of issuer choice can show either that the current system causes issuers to deviate even more (just in the opposite direction) from their optimal disclosure levels than would issuer choice, or that issuer choice has some other redeeming feature outweighing its underdisclosure effect. So far they have not done so, and a careful analysis of the empirical evidence and the theoretical considerations bearing on these questions strongly suggests that such a showing is not possible.<sup>75</sup>

### 3. *Issuer Choice Critiques of Issuer Nationality*

Professors Choi and Guzman provide the most comprehensive issuer choice based critique of the issuer nationality approach.<sup>76</sup> They start by suggesting that I champion the issuer nationality approach over the issuer choice approach to avoid the "race to the bottom."<sup>77</sup> I have in fact used this phrase, but primarily in connection with the consequences of globalization on U.S. disclosure standards under a transaction location approach.<sup>78</sup> With regard to issuer choice, however, the phrase does not accurately describe my concern. Assuming for a moment that a diverse set of regimes does in fact remain after a switch to issuer choice including some regimes requiring a high level of disclosure (a possible, though not inevitable, state of affairs after the switch),<sup>79</sup> the exact nature of any given regime and whether it has moved downward does not really matter. What matters is the nature of the

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75. See Fox, *Returning Mandatory Disclosure*, *supra* note 3, at 1342-1410.

76. Choi & Guzman, *supra* note 2, at 948-50.

77. See *id.* at 948.

78. See Fox, *Political Economy*, *supra* note 3, at 766-97.

79. There is also the distinct possibility that issuer choice will lead to a convergence of disclosure regimes with each jurisdiction competing to attract the maximum number of issuers by trying to appeal to the broadest possible segment of the market. This would be accomplished by offering a regime that minimizes the average distance between its requirements and the preferences of each of the world's issuers. U.S. issuers would move from being regulated by a standard designed for the average U.S. issuer to being regulated by one designed for the average issuer worldwide. This would reduce, not enhance, U.S. welfare because the only effective choices then available to U.S. issuers would likely have requirements further from these issuers' socially optimal level of disclosure than is the current U.S. mandatory regime. I discuss these points more fully in Fox, *Returning Mandatory Disclosure*, *supra* note 3, at 1396-1404.

particular regime each issuer chooses. My concern is that, because each issuer's private costs of disclosure exceed the social costs of its disclosure, while its private benefits are less than the social benefits, the resulting market failure will lead each issuer to choose a regime requiring it to disclose less than is socially optimal. Thus, the problem is not so much that *regimes* would march lock-step to the bottom, but that each *issuer* would choose a regime with disclosure requirements a notch or two below what is socially optimal for that particular issuer.

Professors Choi and Guzman also suggest that I ignore the possibility of a "race to the top" resulting from regimes competing to attract investors and issuers with value maximizing managers.<sup>80</sup> And they suggest that I deny an issuer "with a very high quality offering" the opportunity of being governed by a very strict regime.<sup>81</sup> I have two responses. First, I am not sure what a "race to the top" would look like, but I am sure that Professors Choi and Guzman would agree that it would not be a good thing for all regimes to require a high level of disclosure. Second, given the divergence between social and private costs and benefits, issuers are not looking for disclosure regimes requiring more disclosure than is socially optimal for them. Hence, there is certainly no force within the system to push all jurisdictions to higher requirements. My proposal, however, does make room for issuers whose managers would prefer a stricter disclosure regime than is offered by their home jurisdictions. Such issuers have the option to impose on themselves the U.S. regime.<sup>82</sup> Thus, to the extent that issuers display a demand for high-disclosure regimes and that jurisdictions indeed do seek to enlarge the number of issuers utilizing their regimes, jurisdictions' incentives under the issuer nationality approach to provide high disclosure regimes will be at least as great as under the issuer choice approach.

Professors Choi and Guzman's last critique of the issuer nationality approach, a point raised by Professor Romano as well, is that issuer nationality eliminates the incentives that competition provides regulatory authorities to avoid the overly burdensome regulation that these authorities otherwise might prefer.<sup>83</sup> This point may or may not be valid, but it is certainly unproven. In essence, the issuer choice advocates assume a public choice type governmental failure under the issuer nationality approach, while they ignore the market failure that arises under issuer choice. They neither work out the case that public choice factors would in fact lead to too high a

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80. Choi & Guzman, *supra* note 2, at 949.

81. *See id.*

82. *See supra* Part I.C. notes 20-22 and accompanying text.

83. *See* Choi & Guzman, *supra* note 2, at 749-50; Romano, *supra* note 2, at 2362.

level of required disclosure, nor show that if it does, the problem is more serious than the market failure that is the traditional justification of mandatory disclosure in the first place.<sup>84</sup>

### *B. International Uniformity*

Proponents of the international uniformity approach believe that the United States should work with other countries to develop a globally uniform disclosure regime.<sup>85</sup> One way to accomplish this would be through each country adopting substantively identical rules (“harmonization”) that would then be applied by national governments in accordance with any of the three principles of jurisdictional reach outlined above.<sup>86</sup> Another way would be to establish an international agency that would develop and apply its own regime, which would replace the existing nationally based regimes.

#### *1. Comparing the Two Approaches as Responses to Globalization*

In a world in which the market for the shares of an increasing number of issuers is becoming global, uniform disclosure standards would, in comparison to a nationally based system of mandatory disclosure utilizing the transaction location or investor residency approaches, reduce barriers to

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84. I am skeptical of both these points. See Fox, *Retaining Mandatory Disclosure*, *supra* note 3, at 1416-19.

85. See *supra* note 67.

86. The SEC, and some key persons who have been associated with the SEC, have professed interest in disclosure rules being internationally uniform, but want the rules to be as close as possible to the current U.S. rules. See Regulation of International Securities Markets, SEC Release No. 33-6807 (Nov. 14, 1988) (laying out a preference for uniformity in broad terms); James R. Doty, *The Role of the SEC in an Internationalized Marketplace*, 60 *FORDHAM L. REV.* S77, S78, S85, S86 (1992); Simon M. Lorne, *Current Trends in International Securities Regulation*, 28 *CORNELL INT'L L.J.* 453 (1995). Adherents of this position are, in a sense, “trying to have their cake and eat it too.” They really are seeking to achieve the same goals as are served by the investor residency and transaction location approaches: assuring U.S. resident investors wherever they buy, and investors from anywhere who utilize U.S. markets, that the issuers (whether U.S. or foreign) whose stock they buy provide traditional U.S. level disclosure. At the same time, they seek to eliminate the existing barrier—the difference between U.S. and foreign disclosure standards—that keeps most foreign issuers away from U.S. markets, a barrier that deprives the U.S. securities industry of business and limits or makes more expensive for U.S. investors a variety of foreign investment opportunities. The problem with this position is that foreign countries are unlikely to agree to rules that come close to U.S. standard because the optimal disclosure level for their issuers is lower abroad than in the United States. See *infra* notes 88-91; Licht, *Games*, *supra* note 2 (discussing models of the bargaining dynamics and competitive factors that would shape whether there would be convergence of disclosure rules); Fox, *Political Economy*, *supra* note 3, at 757-65 (describing the unlikelihood of international agreement on uniform rules); *id.* at 766-85 and 799-822 (describing the likelihood that absent a switch to the issuer nationality approach, globalization will lead to a lowering of the traditional U.S. level of required disclosure).

capital mobility and provide administrative convenience by saving issuers the need to comply with multiple national regimes.<sup>87</sup> Uniform disclosure standards would not, however, be any more effective at reducing the barriers to capital mobility than a nationally based system using the issuer nationality approach. And a nationally based system using the issuer nationality approach would be significantly more convenient administratively than an international regime, because dealings between the entrepreneurs or managers of the issuers and the officials regulating them would be between persons who share a common culture, language, and understanding of business practices.<sup>88</sup>

## 2. Other Considerations

Thus again, if a choice is to be made between issuer nationality and international uniformity, it must be made on other grounds. Here, each approach has its relative advantages. The key advantage of the issuer nationality approach is that there are likely to be important differences among issuers worldwide in terms of the level of disclosure that will maximize the returns, net of the costs of this disclosure, that their capital-utilizing productive activities generate. These differences in their socially optimal disclosure levels are significantly related to the nationalities of the issuers involved because they arise out of differences in the corporate governance regimes of the different countries. Disclosure is of more value, for example, in a market centered economy than in a bank centered one, and therefore, despite the higher costs of greater disclosure, issuers in a market-centered economy will tend to have a higher socially optimal level of disclosure.<sup>89</sup>

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87. See, e.g., Facilitation of Multinational Securities Offerings, Securities Act Release No. 33-6568, 1985 SEC LEXIS 2074 (February 28, 1985) (suggesting agreement among several countries on a single prospectus format and common disclosure standards as one possible approach to facilitating multinational offerings). See also John M. Fontecchio, *The General Agreement on Trade in Services: Is It the Answer to Creating a Harmonized Global Securities System?*, 20 N.C.J. INT'L LAW & COM. REG. 115, 123 (1994) (suggesting that GATS be considered as a means to pull the governments of the world toward a harmonized global securities market); Manning Gilbert Warren III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L.J. 185, 187 (1990).

88. Professors Fanto and Karmel conducted a survey of foreign issuers that had registered their shares with the SEC. Their results provide an example of this kind of problem. Some of the surveyed issuers complained that the SEC staff was unfamiliar with the business, accounting and legal practices in their countries, thereby generating more lawyer involvement and expense. See James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 32-35, (NYSE WORKING PAPER NO. 97-101, 1997).

89. See Fox, *Political Economy*, *supra* note 3, at 758-60; Licht, *International Diversity*, *supra* note 2, at 237-53. Steinberg and Michaels' suggestion, discussed in note 67 *supra*, of three groups of

Compared to the issuer nationality approach, the two key advantages of international uniformity are comparability and a better capacity to deal with transborder information externalities. We have already discussed why the need for comparability is probably exaggerated.<sup>90</sup> Transborder externalities are potentially a more serious concern. In a world with international trade and multinational corporate operations, some of an issuer's competitors, major suppliers, and major customers may not share the issuer's nationality and so will not be subject to the same disclosure regime as the issuer. This problem biases a national government downward when the national government considers requiring a higher level of disclosure rather than a lower one. The government knows that if it chooses the higher level, each of the nation's issuers will suffer the costs of all of the issuer's competitors, major suppliers, and major customers finding out the additional required information, whether these competitors, suppliers, or customers are domestic or foreign. But each of the nation's issuers will enjoy the benefit of finding out the additional required information only from those of its competitors, major suppliers, and major customers that share its nationality. Thus, there is a transborder externality associated with the national government's decision setting the level of disclosure for its issuers. The government will choose the level that will maximize the welfare of its residents. It will not account for the benefits from additional disclosure that would be enjoyed by its issuers' foreign competitors, major suppliers, and major customers of its issuers. The process by which a uniform international standard would be set, whether by international negotiation or by an international agency, would internalize this transborder externality and thus eliminate the bias.<sup>91</sup>

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countries self-identified in terms of market development each developing its own uniform rules appears to be a compromise between fully accounting for national differences among issuers and having full international uniformity. Steinberg & Michaels, *supra* note 2, at 261-65. It is not clear that the tradeoff that they propose is particularly helpful, however. First, national differences in socially optimal disclosure levels differ for many reasons other than level of market development: the United States, Germany and Japan are illustrative of this point. Second, there is no reason to keep an issuer from the emerging country group that only complies with that group's disclosure rules from trading in the U.S. as long as their principal trading market, wherever it is located, is efficient. *See supra* Parts II.B.2 and II.C. The primary gain from transnational securities transactions for an emerging country issuer is presumably to access capital from developed countries; an offering by such an issuer into another emerging country would be of little value to the issuer.

90. *See supra* Part II.A.

91. I discuss these points in more detail elsewhere. *See*, Fox, *Political Economy*, *supra* note 3, at 747-49, 762-64.

#### IV. CONCLUSION

I have advocated here and in prior writings the superiority of the issuer nationality approach over the four alternatives. I cannot claim that this issuer nationality approach is a perfect response to the problems and opportunities posed by the globalization of the market for securities; it is just a less imperfect response than any of the other four approaches. There are open issues—issues that will become more pressing over time as the real economy begins to resemble more closely the financial economy in its degree of globalization. One is how to deal with truly transnational corporations such as Daimler Chrysler or BP-Amoco. At the moment, such corporations constitute only a small portion of the capitalization of the world's corporations, but their number is obviously growing. It is not clear whether there is a natural limit to this kind of transnational consolidation of firms, and, if so, where that limit is. A second question is what to do about transborder information externalities. These too will increase with the growth of international trade as a proportion of all economic activity, because such growth will result in each of the world's issuers sharing its nationality with a smaller portion of its competitors, major suppliers, and major customers.

Neither of the trends involved in these open issues enhances the arguments of the investor residency, transaction location, or issuer choice approaches. Rather, both point toward an ideal of an international regime, but one that respects differences in the socially optimal disclosure levels of issuers from different countries. This ideal poses two huge challenges. One is how to design such a regime. The other is how to create on the ground an effective, responsive administering agency. The magnitude of these challenges suggests that we will be living with a nationally based system for some time to come and that if issuer nationality is used as the basis for determining statutory reach, this system is preferable to a poorly designed or implemented international regime.