
By James D. Cox*

I. INTRODUCTION

We are frequently reminded that the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934 are the foundation of Japan's securities laws. Nevertheless, the regulation of securities markets vastly differs between the U.S. and Japan. It is well documented that the U.S. mandatory disclosure requirements are far more demanding in breadth and detail than those of Japan and other developed countries. Indeed, many believe that the U.S. has produced a regulatory regime that is the envy of other countries.

The U.S. Congress has placed control over disclosure issues in an independent regulatory agency, the Securities and Exchange Commission (SEC), and periodically exerts the agency to aggressively pursue market frauds and regulatory actions to assure the integrity of the U.S. securities markets.1 Congress assures regulatory rigor through the watchdog role served by populist-dominated committees, and by appropriating funds at a higher level than any other country in the world. Express and implied private actions provide further enforcement.2 The private plaintiff is armed with somewhat permissive substantive standards on issues of ma-

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teriality, level of culpability, and causation. More importantly, aggressive private enforcement of the securities laws is subsidized through America's embrace of class action procedures as well as the contingency fee arrangement.

The U.S. self satisfaction with its securities laws is shown in its negotiations with other nations to improve disclosure standards and regulatory enforcement. As capital markets have become more and more international, pressures have mounted to standardize both disclosure rules and market practices to facilitate access to markets and to foster greater efficiency. U.S. policy makers, however, envision this as a game in which the other nations of the world should raise the level of their disclosure rules rather than the U.S. lowering its own disclosure requirements.

Japan is a country that has earned special attention in this regard. Although the Tokyo Stock Exchange is the largest securities exchange in the world in terms of market capitalization, there is wide distrust, both inside and outside of Japan, of its securities markets. For example, one finds reports labeling Japan's financial markets as an "insider trading paradise" with minimal regulatory enforcement. In addition, it is reported that the Japanese Government has paid lip service to full disclosure, yet has "not punished companies for making incorrect or

3. See, e.g., TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) (materiality does not require proof that omitted or misstated fact would have caused reasonable shareholder to change vote); Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (whether speculative information is material is determined by a balance of the probabilities and magnitude).

4. The antifraud rule has the most demanding requirement for fault because scienter must be proven. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). This has been interpreted to include reckless utterances. See, e.g., Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977) (stating that recklessness is "a lesser form of intent [rather] than merely a greater degree of ordinary negligence"). In contrast, issuers have absolute liability for materially misleading registration statements, and their underwriters, directors, and outside experts are liable unless they establish that after a reasonable investigation each had a reasonable basis to believe that the registration statement was free of any material defect. See Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

5. See, e.g., Basic, Inc. v. Levinson, 485 U.S. at 247 (investor may recover without proof that he read or even received the misleading report).

6. The U.S. Government's position has, not surprisingly, been criticized for, among other reasons, losing sight of the fact that markets less regulated than American markets can nevertheless still be perfectly fair. See John Gilardi, CME's Broksky Calls for Changes on NYSE Listings, REUTERS, May 18, 1990, available in LEXIS, Nexis Library, Wires File; Nathaniel C. Nash, Stretching the S.E.C.'s Reach, N.Y. TIMES, July 13, 1986, § 3, at 4. A retreat to America is that it should have greater concern that its laws are too demanding and that modification of its disclosure laws is in order.

misleading statements to shareholders."8 Not surprisingly, the U.S. Government has pressured Japan to reform its securities laws and increase enforcement efforts. Meetings between the two countries' securities agencies rarely pass without a discussion of disclosure reforms. Since the mid-1980s, pressure has intensified, culminating in the signing of the Structural Impediments Initiative Agreement (SII) in June 1990. The SII provides, among other things, that Japan will review its commercial code "to enhance shareholders' rights and increase public disclosure requirements for corporations."9 In the face of such pressure, regulatory change has occurred in Japan10 and discussions continue between the two countries.

This article suggests a framework to assist the governments of Japan and the U.S. in their continuing negotiations over what differences in disclosure and enforcement are acceptable to both countries. It is not the purpose here, nor should it be in negotiations between the two countries, to resolve which nation is correct. Instead, the purpose of this article is to suggest a framework for efficient regulatory competition between the two countries' markets. It will be shown that a good deal of diversity, indeed even laxity, can coexist within mutually agreed upon principles for fair competitive regulation.

II. THE CULTURE OF REGULATION

Japan's approach to disclosure can be viewed as embryonic. Historically, the overall function of financial regulation in Japan was to protect and nurture Japan's financial institutions as they struggled to emerge from the Third World. Although Japan has emerged as a First World Country, it maintains a system of close relationships between the government, more specifically the Ministry of Finance, and the brokerage houses, banks, and insurance and trust companies. Informality and opacity characterize dealings between the regulator and the regulated.


Detailed regulatory requirements are absent, thus those participating in Japan's markets must instead rely upon "a quiet nod or shrug from the Ministry of Finance . . ."\textsuperscript{11} This system, more commonly known as gyoseishido, or "administrative guidance," reflects the overall Japanese philosophy that close ties between the regulated and the regulator are one of the great virtues of the Japanese financial system. Critics view the series of stock scandals as a natural consequence of the philosophy of administrative guidance.\textsuperscript{12}

The Ministry of Finance's close relationships with industry was furthered by the movement of Ministry personnel into important positions in brokerage firms, banks, and insurance and trust companies. These interconnections create a powerful web between business and state and have many advantages. For example, the Ministry of Finance avoided further selling pressure on the Tokyo Exchange during the market break in October 1987 by "asking" banks, insurance companies, and trust companies to restrain their selling activities. More generally, such close relationships permit Japan to formulate and carry out an economic policy for its private sector. At the same time, the administrative guidance does not invite innovation\textsuperscript{13} or undyingly protect investors.\textsuperscript{14} The Ministry of Finance's paramount position with respect to its grip on the financial markets is suggested by the government only symbolically chastising the Ministry of Finance in the wake of the recent scandals. The Diet, instead of husbanding a major restructuring of the Ministry of Finance, has proposed that a semi-independent watchdog agency, the Securities and Financial Examination Committee (SFEC), should be created to oversee financial markets. As proposed, members of SFEC would be appointed by the Ministry of Finance with the consent of the Diet. The Ministry of Finance would then have exclusive power over disciplinary measures for abuses unearthed by an SFEC investigation.\textsuperscript{15}


\textsuperscript{13} For example, the Ministry of Finance's response to off-shore trading in Japanese equity warrants was initially to scuttle such trading by requiring their registration in Japan. The Ministry also blocked Japanese banks from participating in the Globex system which provides for 24 hour-a-day futures trading. Marcus W. Brauchli, As Japan's Economy Gains Clout, Ministry Of Finance Struggles, WALL ST. J., Dec. 20, 1989, at A1, A7.


Some have charged that the SEC also maintains too close a tie to the industry it is charged with watching. While some would argue that the SEC advances the interests of investors, allocational efficiency, and public confidences in capital markets, critics and some close observers of the SEC offer quite a different perspective. Critics who see the agency through the window of political choice theory offer the conclusion that the agency seeks to maximize its utility by responding to the constituency that will offer the greater rewards for agency action or inaction. For example, the Commission's former head economist, Professor Jarrell, explains that the ultimate abolition of fixed-rate commissions on the New York Stock Exchange (NYSE) was a rational agency response to changing political support for its activity. Jarrell observes that with the increasing institutionalization of trading on the NYSE and the concomitant rise of economic, and hence political, influence of financial institutions, the SEC and Congress became increasingly stronger proponents of abolishing fixed commission rates. Moreover, the Exchange's resolve to hold the line weakened with its awareness that the institutions would otherwise circumvent its bar to negotiated commissions, thus depriving it of income from the transaction.

Political choice theory thus offers a less than flattering explanation of agency behavior, suggesting that governmental agencies charged with advancing the public interest do so by seeking to maximize their own level of political support. Decisions are not based on the public good; rather, tough regulatory issues are resolved according to the special interest groups from which the agency derives support. Thus, the benefits of an agency's actions, whether through regulation, deregulation, or subsidies, can, according to the political choice literature, be predicted by an

18. Japan also has fixed brokerage commissions. It was believed that the huge revenues generated by monopolistic-like rates created the perception on the part of large investors that the brokerage firms had an obligation to compensate their large customers for the losses suffered in the declining market. Quentin Hardy, Japan's Finance Ministry Seeks Reform For Sake of Image More Than Change, WALL ST. J., Nov. 11, 1991, at A10.
19. See Harry S. Gerla, Swimming Against the Deregulatory Tide: Maintaining Fixed Prices in Public Offerings of Securities Through the NASD Antidiscouragement Rules, 36 VAND. L. REV. 9, 14-16 (1983)(arguing practices that occur today to circumvent fixed price offerings occurred earlier when trading was subject to fixed commission rates).
ex ante knowledge of the relative support the agency draws from the interest groups competing for its regulatory favors.

Commentators have also invoked political choice theory to explain the Commission’s inaction. For example, Professors Macey and Haddock state that the failure of the Commission to fulfill Congress’ 1975 command that the Commission “use its authority . . . to facilitate the establishment of a national market system for securities. . .” can be attributed to the SEC’s desire to protect entrenched institutions.22 The centerpiece of Macey’s and Haddock’s analysis is the Commission’s reluctance to invalidate the off-board trading restrictions that presently exist at all of the securities exchanges. These restrictions prevent exchange members from trading exchange-listed securities on other exchanges and therefore create several anti-competitive effects. The most notable effect being that the restrictions foreclose non-exchange members from trading in exchange-listed securities unless tribute is paid to the exchange member who handles the trade. In addition to the wealth transfer between non-exchange and exchange members, Professors Macey and Haddock lament that the restrictions discourage more competitive executions that could result if trading occurred at points other than where the particular security is listed.23

In view of the serious anti-competitive effects posed by the off-exchange trading restriction, one wonders why the Commission has not managed this provision more aggressively. Professors Macey and Haddock attribute the Commission’s continued willingness to protect the exchanges to the greater political power wielded by the exchange. They observe that the support for a national market system arises solely from a cohort of brokerage houses that do not staff specialists on the various exchanges.24 The influence of these brokerage houses, however, is overwhelmed by that of the far greater number of brokerage firms who are exchange members and therefore derive rents through the status quo as trading in all exchange listed securities must flow through them. Some of these members also serve as specialists on the exchange. Unlike the situation that propelled the SEC to abolish fixed-rate commissions, the institutions were ambivalent to the off-board trading restrictions.25 Hence, unless there is a very large outcry from that most noncohesive group, the

23. Id. at 334.
24. Id. at 340.
25. Id. at 339-40.
small investor, the political wind that moves the Commission on this regulatory sea will be created by those with the least interest in regulatory change.

Political choice theory provides a useful context within which to examine some of the SEC's decisions on regulatory issues, such as fixed-commissions and off-board trading limitations. However, political choice theory does not explain a wider range of securities regulations issues where the SEC is roundly criticized by industry participants for being too solicitous of investor interests and too aggressive in mandating disclosure. For example, regarding international securities regulations, the SEC is charged with being too zealous an advocate of disclosure and too reticent a deregulator of U.S. capital markets. It should be noted that these complaints are raised by industry forces, the very group the political choice theorists suggest have captured the SEC's agenda. The SEC's commitment to demanding disclosure standards and aggressive pursuit of market frauds sets it apart from the Ministry of Finance. It is noteworthy that this course is predicted by political choice models.

The historical roots of U.S. Securities laws, not the crass political support the agency garners through its decisions, provides the full answer to what sets the culture of U.S. securities regulation apart from that of other countries. The U.S. commitment to securities regulation began in response to the Great Depression. The Exchange Act's focus on market abuses was greatly affected by the revelations of the Senate Banking and Currency Committee. Ferdinand D. Pecora, counsel for the Committee, led the nation through a litany of abuses believed to lie at the heart of the market's overheating during the heady 1920s. The "Pecora hearings" riveted attention on a host of market offenses that preceded the crash and emphasized the regulatory laxity that existed under state blue sky laws. It can be said that the Pecora hearings produced not simply the securities laws, but a culture that by and large continues forward today. Congress has contributed to this culture through its own preoccupations with fraud and zealous pursuit of regulation. For example, the expression of populist concerns such as those set forth in the preamble to the Exchange Act is frequently repeated in new legislation expanding the SEC's authority.

The question then arises - what has this history produced? Professor Langevoort offers a useful description and explanation of several re-

sultant foibles of the SEC, namely its penchant for secretiveness, its reticence to articulate clear predictable standards, and its use of rhetorical conventions. Most frequently these practices occur in the context of extending regulation or providing narrow exemptions to existing rules. Professor Langevoort explains these practices as part of the natural tendency of all agency staffs to respond to internal, as opposed to external, rewards and stimuli. 28 Preoccupations with protecting turf, self preservation, and certainty are steady fare for those whose major interplay is the agency with whom they are employed. Although Langevoort's explanation is not inconsistent with political choice theory, he emphasizes the importance to the agency's staff of the rewards it derives from internal sources in carrying out the agency's task, while political choice theory emphasizes external rewards.

The differing disclosure and other securities regulation demands imposed by the U.S. and Japan are explained by their two clashing regulatory cultures. To be sure, just as one can detect movement in Japan toward more disclosure and regulation, one can also witness a continuing emphasis on deregulation in the U.S. However, the change is not rapid, and perhaps it cannot even be viewed as deliberate. Rather each step is taken with a great deal of hesitation and sometimes reluctance. While internationalization of securities markets and corporate offerings is very much upon us, we may seriously question whether such events have overtaken each country's securities regulators. In light of the internationalization that has already occurred in securities markets, it is time for the U.S. and Japan to reassess their overall regulatory philosophy as well as the specific demands of their securities laws. The persistent question is whether one nation's laws should replicate that of another.

III. REGULATORY DIVERSITY AND THE PATH TO A COMPETITIVE EQUILIBRIUM

It is debatable whether, even in a perfect world, harmonization of securities regulation is a desirable goal. The standard arguments favoring diversity are that it fosters experimentation and innovation. Approaches that prove to be efficient regulatory devices can lead the way for


other nations. Understanding efficiency begins with the recognition that differing regulatory approaches embody differing costs and benefits for both the investors and those regulated. The trade-offs between the investors and the regulated is not a zero sum game. Gains bestowed on one group quite likely diverge from the costs they visit on others. Some regulatory approaches may, for example, impose greater overall costs on issuers than the total collective benefits they confer on investors by shielding the investors from fraudulent or improvident investment proposals. Similarly, while not requiring the disclosure of certain types of information leads to the issuer’s saving in disclosure costs, those savings may be dwarfed by the investors’ expenditures to obtain the information. Thus, as there are differing regulatory approaches among the nations, one can expect to see a good deal of difference in the quality of each nation’s regulation. Such divergence paves the way for others to follow, so that the level of regulation for all nations generally rises.

Regulatory competition is the natural product of diversity in regulation and has the potential to discourage harmful regulatory laxity as well as extreme regulatory rigor. In a sense, different nation’s regulators provide a market force that stands ready to discipline the regulator who is tempted to embrace too little or too much regulation. Countries with lax regulation will be seen as a modern day Barbary Coast to which some investors will be unwilling to launch their investment. As transactions flow around the lax regulatory shores of that state, pressure will build for the country to bring its regulations closer to the mainstream of industrialized countries. Similarly, the country whose regulatory zeal knows no limits can expect its protections to be avoided by those who envision that the costs of compliance outstrip their benefits. This too can be expected to dampen some of the regulatory zeal that otherwise will lead to disaffection.

Contemporary commentators who express comfort with regulatory diversity follow too simple a path. Their analysis is incomplete in failing to identify areas where regulatory uniformity and rigor are necessary to assure the competitive regulatory equilibrium believed to foster productive experimentation, innovation, and competition. Before chanting that diversity is beautiful, it needs to be recognized that diversity can be both a blessing and a curse, depending upon the particular regulatory issue. Modern financial theory provides a convenient model by which to examine why this is so, and also assists in defining the types of disclosure issues for which diversity of regulation among nations is inappropriate.

Presently, U.S. securities laws assure that finely-tuned distinctions among companies competing for investor attention are disclosed while
Japanese firms are not required to make such disclosures. Such differences do not necessarily mean one country’s disclosure requirements are either unworthy or socially wasteful. It is socially optimal to expend resources to reduce market abuses, at least to the point where the value of an extra unit of enforcement equals the value of the fraud deterred. Investors considering investing in two different markets will not be neutral to the otherwise equal risks and returns posed by the two competing investments if it is widely recognized that the incidence of fraud, manipulation, and other abuses are significantly lower in one market than another. Ex ante, the investor will discount the price of the security in each market by the combined value of the average likelihood and magnitude of the fraud posed by all securities traded on that exchange. Hence, the securities on the market which enjoy an overall lower likelihood of abusive practices will ex ante trade at prices slightly higher than those of less regulated markets.

Because investors can easily engage in transborder investment, U.S. investors can consider investing abroad in foreign issuers who compete with U.S. based issuers on a different disclosure footing. Under the traditional dominance principle of selecting investments, investors who opt for a foreign issuer over a U.S. issuer do so because of a larger return if the investment is of the same or a lesser risk classification. Similarly, issuers are not bound to raise capital in their home state and will go abroad where the overall cost of capital, including all transaction costs such as those imposed by the applicable securities laws, are lowest.

Where the level of disclosure is different between two markets, as between the NYSE and the Tokyo Stock Exchange, the securities traded

30. There is abundant evidence that arbitrage activity exists across international markets causing the pricing of securities to reflect the effects of governmental policies. See e.g., Mustafa N. Gulektsin et al., Capital Controls and International Capital Market Segmentation: The Evidence from the Japanese and American Stock Markets, 44 J. of Fin. 849 (1989).

31. The problems with this model, however, become more complex when securities are traded on more than one international exchange due to linkages among the exchanges. The linkage of exchanges poses troubling jurisdictional disputes, particularly if there is not agreement on the necessity or degree of surveillance, oversight, and transcription of conduct. Moreover, linkages can facilitate arbitrage trading for individual linked stocks and therefore cannot be expected to override the impact of greater risks of a foreign market’s looser regulation of its markets. On the subject of linkages of international exchanges, see generally, Charles C. Cox & Douglas C. Michael, The Market for Markets: Development of International Securities and Commodities Trading, 36 CATH. U. L. REV. 833 (1987).

32. One reason most American firms do not embrace a listing on a foreign exchange is that the costs of securing a foreign listing are not trivial and the concomitant benefits are frequently difficult to measure. See generally Robert F. Grondine, Access To Capital Markets: Do Costs Outweigh Benefits For Foreign Listers On TSE, E. ASIAN EXECUTIVE REP., Feb. 15, 1989, at 9, available in LEXIS, Nexis Library, Easian File.
on the Tokyo Stock Exchange will on average be seen as riskier than their counterparts listed on the NYSE. From this perspective, we can reasonably hypothesize that, if the additional disclosure requirements for U.S. listed securities were in true equilibrium such that the marginal cost of the additional disclosure does not exceed the marginal benefits of that disclosure, investors and issuers would be neutral in their choice between conducting their transaction in New York or Tokyo. That is, issuers may logically prefer offering their shares in the U.S. even though this entails greater disclosure-related costs because the securities can be sold at a higher price. An issuer who chooses to avoid the more demanding U.S. disclosure requirements by limiting its offer to foreign markets must expect to receive a lower amount for its securities. Under such an equilibrium state, the additional risk of transactions in the less demanding disclosure state results in a greater discount ex ante of the security's price; the amount of that discount being the total of all the various losses investors endure—which losses could have been avoided by the additional disclosure—averaged across all the securities in that market. As a result, investors, if a true equilibrium disclosure condition existed across all nations, would demand higher returns to invest in the lower disclosure state than in the higher disclosure state. Consequently, issuers who raise capital in a lower disclosure state must be prepared to receive less for their security, or engage in substantial costs to signal that their security is less risky than the average security within that market.

We may then ask where Japan and the U.S. are placed on this regulatory continuum. Although the data in this area is incomplete, what is available points toward the conclusion that U.S. regulation is more demanding than what one would expect to find in a competitive equilibrium. In 1989, sixty-seven U.S. corporations listed their shares on the Tokyo Stock Exchange. However, only eight Japanese corporations listed their shares on the NYSE, and none were listed on the American Stock Exchange or NASDAQ. Additionally, there are sixteen Japanese ADRs traded on NASDAQ. A greater willingness of Japanese firms to seek listing in markets with less demanding disclosure requirements is suggested by the fact that ninety-three Japanese firms are listed on the London Stock Exchange, a sum nearly twelve times greater than are listed on the New York Stock Exchange. This disproportionate relationship is consistent with the view that Japanese companies do not find

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that the benefits of listing their shares in the U.S. provide sufficient reward for the additional disclosure duties and their allied costs. In contrast, foreign investors trade in U.S. markets more than U.S. investors trade in foreign markets. Government statistics reveal that in 1989 foreign purchases and sales in U.S. securities markets totaled $416 billion whereas purchases by U.S. residents in foreign markets was $230 billion.35 The disproportionate interest in foreign residents' purchases in the U.S. is consistent with the thesis that efforts to assure the overall fairness of U.S. securities markets makes those markets more attractive havens for investment activity.

At the same time there is a growing willingness by U.S. companies to list their shares on the Tokyo Stock Exchange, Japanese issuers are reluctant to list their shares in the U.S. This data does not tell us, however, whether there are appropriate tradeoffs between additional regulatory costs and the firms' costs of capital. For example, the small number of Japanese firms that list their shares on U.S. markets may believe that lower capital costs that we expect issuers to experience as a result of more demanding disclosure requirements is not sufficient to compensate for the costs of that regulation.

Data such as this is something of a box score on how countries are administering their securities laws. As seen earlier, such comparisons can be expected to stimulate or at least nurture competition among regulating states. The benefits of such competition were examined previously. The danger is that competition results in a "race to the bottom." But, there are some natural forces that should discourage such a decline of investor protection. As will be demonstrated in the next section, these disciplining forces can work only if regulators commit to foster an environment for fair competition.

IVA. COMPETITIVE MARKETS AND MANAGERIAL OPPORTUNISM

The suggestion that regulators should nurture competition among international exchanges raises the spectra of our recent and ongoing experiences with such competition among national exchanges and NASDAQ concerning the issue of dual class common stock. The NYSE was under pressure to permit listing of common shares for public shareholders when the issuer had a second class of common stock with enhanced or "super" voting rights outstanding. The NYSE historically has barred

"dual class common,"36 whereas the NASDAQ places no limitation on multiple classes of voting common stock. The American Stock Exchange stations itself between these two markets, permitting listing of multiple classes of common stock if that class is permitted to elect at least twenty-five percent of the board of directors.37 The hierarchy among the exchanges over this issue has been convincingly explained38 by the NYSE listed company managers' stronger commitment to acting more efficiently in serving their stockholders' interests. The strength of that commitment would be eroded if managers could easily embrace dual classes of stock, thereby avoiding the threat of displacement through a change in control. In return for companies bonding themselves to the higher governance standards of the NYSE, the companies enjoy a lower cost of capital, greater liquidity for the individual company's shares, and a range of pecuniary and nonpecuniary gains derived from the enhanced reputation of being listed on the NYSE. However, the combination of a pervasive threat of takeovers in the 1980s and the emergence of NASDAQ as a highly liquid and efficient market caused managers to reevaluate the costs and benefits of being listed on the NYSE. Simply put, given the choice between slightly lower capital costs and job security, a steady check weighed more heavily in management's mind. The NYSE pleaded for Congress or the SEC to prevent managers from acting opportunistically vis-à-vis their public shareholders.39

The message one derives from the dual class voting scenario is that competition among the exchanges is far more likely to result in a "race to the bottom" where the exchanges are able to develop a clientele along purely managerial interests rather than corporate interests.40 The eff-

36. NYSE, Listed Company Manual, Rule 313.000 (A), (C).
39. The SEC's response was to promulgate Rule 19c-4 which required the various exchanges and the NASDAQ to include among their listing requirements standards barring issuers who have taken action that would have the effect of "nullifying, restricting or disparately reducing the per share voting rights of common stock of such issuer registered under section 12 [of the Exchange Act]." Voting Rights Listing Standards, Exchange Act Rel. No. 25891 (July 7 & 13, 1988), 17 C.F.R. § 240.19c-4 (1991). The rule was, however, invalidated in The Business Roundtable v. S.E.C., 903 F.2d 406 (D.C. Cir. 1990).
40. Professor Fischel takes issue with the race to the bottom thesis, arguing that shareholders and investors, who enjoy an infinite number of investment opportunities, will not trust their money with managers who seek havens where shareholders and investors can be exploited. Daniel R. Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock, 54 U. Chi. L. Rev. 119, 127-32 (1987). Professor Fischel's argument is vulnerable on the ground that shareholders are presented a distorted choice on such questions. See Lucian A. Bebchuck, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on
cient differences among the NYSE, AMEX, and NASDAQ were not disrupted by the presence or absence of a specialist system, by the question of whether pricing was more fragmented in the dispersed NASDAQ market versus the two leading domestic exchanges, or by the rapidity with which orders are executed. Rather, the disruption resulted from the NASDAQ, and to a lesser extent the AMEX, allowing purely managerial, as opposed to corporate, interests to be served by listing their shares there. This has allowed for the possibility that the varying costs of capital due to the relative efficiency and fairness of the competing markets may play a diminished role in each company’s listing decision.

It is important that the Commission and the regulators, although differing on how to regulate their respective markets, commit that the content of their securities laws will not permit purely private decisions to overwhelm a company’s capital decisions. The goal is to promote inter-market/inter-nation competition on matters that benefit, but do not harm, the issuer’s interest. The individual firm’s decision of where to list the company’s shares for trading and where to undertake a public offering should be one guided by the regulatory impact on the company and not the manager’s utility function. The content of each nation’s disclosure rules should not permit managerial choices to transfer wealth from the issuer to the manager. To so permit introduces an undesirable effect not only on the content of regulation, but also on competitive regulation among nations.41

Of paramount importance in formulating a position regarding international agreements on the content of securities laws is what can best be described as the abuse of managerial opportunism. Managerial opportunism is an expression identifying a wide range of possible concerns that may influence an issuer’s choice among markets. However, not all issuer’s concerns are instances of managerial opportunism. For example, an issuer may avoid listing its security in the U.S. believing that the additional disclosure regarding its future operations compromises its product marketing. Thus, its capital market will likely be one that carries a higher discount rate because of its weaker disclosure laws. Because such a decision is grounded on the issuer’s interest, it falls outside the manage-

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rial opportunism rubric. Such a difference in disclosure laws is evidence of healthy regulatory competition and should not be a reason for the U.S. to call for similar disclosure requirements in Japan. In contrast, management's decision not to offer the issuer's security in the U.S. because there would be a need to disclose the extent of earlier self-dealing contracts with the issuer would be a decision guided by managerial opportunism. The difference being that in this example the desire to avoid disclosure produces no corresponding benefit to the issuer. In determining whether managerial opportunism underlies an issuer's decision, the focus is upon whether the disclosure item is likely to be one that furthers the private interests of the manager over the interests of the issuer. These considerations are important because only those considerations that bear on the costs and benefits to the issuer play a legitimate role in the exchange between relative costs of capital and competitive regulatory regimes. Countries that tolerate managerial opportunism effectively cheat in this competition because they garner rents via weak regulation, and do so at the expense of both investor protection and fair competition to their sister nations.

It should be understood that no company's manager is likely to make an initial selection of the country where they will go public, or even list their securities for trading, purely on concerns of managerial opportunism. Rather, practice indicates that strong commercial interest and good financial sense support going public and obtaining an initial listing in a country where the issuer has substantial operations. Moreover, there are strong organizational pressures for minimal internal controls so that weak national or exchange directives for internal controls can be expected to be overcome by internal organizational pressures. The concern posed by international regulatory competition is not nearly so much the initial public offerings or a firm's primary listing, but rather the later financing decisions by firms with sufficient international presence to make it financially practical to consider offering its securities in other countries. It is at this level that concern for managerial opportunism runs a serious risk of deflecting the natural inter-market equilibrium that otherwise would exist. The next section examines how market offenses and accounting standards lend themselves to managerial opportunism.

V. MANAGERIAL OPPORTUNISM AND INTERNATIONAL DISCLOSURE STANDARDS

A. Market Offenses

Once leaving the environs of the Hyde Park area of Chicago, one is greeted by uniform condemnation of insider trading. This may be due to the fact that insider trading is the quintessential illustration of the type of behavior that involves managerial opportunism. Uniform proscription of such opportunism is necessary to assure fair competitive choices among international markets.

In overview, the regulation of insider trading is justified by legitimate concerns of the perverse incentives management personnel and their close advisers would have if there were a laissez faire attitude toward insider trading. For example, managers may be seriously tempted to delay the release of material non-public information until they have had a chance to gain personally by trading. Additionally, because significant inside information is not systematically acquired, at least not of the type that assures abnormal changes in the price of the issuer’s securities, the temptation may exist to distort corporate announcements so to facilitate the insider’s private trading agenda. Such distortions may include introducing a certain degree of opacity into corporate announcements, thereby creating uncertainty in the pricing of the company's securities and thus affording insiders the advantage of timing their purchases and sales to coincide with known peaks and valleys in the security’s trading. Insiders may ultimately be tempted to control real economic events within the firm for the purpose of causing intertemporal price variations. Insiders could embrace risky opportunities, creating greater fluctuations in the stock’s price and thereby affording insiders an advantage over outside investors in deciding whether the security is under or over priced. Fears such as these justify removing the incentive for insiders to so manipulate corporate announcements and activities and are consistent with the regulation of insider trading throughout developed markets.

The question is raised whether the quest for eroding managerial opportunism demands not only the proscription of insider trading, but also its active prosecution. On this point, the checkered history of former

Article 188 of the Japanese Security Exchange Law\footnote{Securities and Exchange Law art. 188 (Jap.).} is relevant. This provision is comparable to that of section 16(a)\footnote{15 U.S.C. § 78p(a).} of the Securities Exchange Act in that it required corporate officers, directors, and owners of more than ten percent of the company's securities to report their holdings and trading in the company's securities. In 1953, the Japanese provision was repealed, thereby eviscerating the operation of Article 189 which required corporate insiders to disgorge any gains realized by the sale of the company's securities made within six months of their purchase.\footnote{The American parallel to this is § 16(b) of the Exchange Act, 15 U.S.C. § 78p(b).} Interestingly enough, as part of the legislative reform that brought new proscriptions to insider trading in Japan, the Diet in 1988 reinstated the reporting requirement for corporate officers and ten percent shareholders.\footnote{Securities and Exchange Law art. 190 (Jap.). Commentators, however, question whether this change is more than cosmetic and precisely what real effects this change will have on the likelihood that the Japanese Government will enforce article 190. See Mark J. Happe, Note, Inside the Japanese Stock Market: An Assessment, 5 Am. U. Int'l L. & Pol'y 87, 113 (1989).} The message of this experience is that grappling with managerial opportunism, such as the potential for insider trading, requires a commitment beyond mere proscription of the conduct. Effective mechanisms for enforcement of the legislative proscription are also required. Thus, serious concern continues regarding whether Japan, or for that matter other countries with developed markets, will expend the level of resources necessary to enforce those proscriptions universally believed to be necessary to assure fair competition among capital markets. Absent sufficient enforcement commitments, there continues to be the ever present threat that managerial opportunism will erode the base for effective competition among markets.

The history of reporting insider trading activity in Japan raises the larger question of what to include within the category of managerial opportunism. The disclosure command of Article 188 touched on an element of self-interest in that it indirectly sought information that senior corporate personnel abused their position by trading on confidential corporate information. A more direct form of self-interest appears in the wide range of items required to be disclosed in subpart 400 of Regulation S-K where matters pertaining to the background and transactions of the firm's promoters, managers, and dominant stockholders must be disclosed.\footnote{Regulation S-K seeks a variety of information on relationships and transactions that may pose a conflict to senior management's stewardship. Subpart 400 of Regulation S-K seeks} Information such as this should be a common feature of disclo-
sure standards as nondisclosure allows for managerial opportunism.\textsuperscript{49} One may well detect, however, that managerial opportunism could well attach itself to any disclosure item, where to otherwise report a transaction honestly would render a negative impression of the firm and its managers. For example, most cases involving falsified financial reports can be explained as managers wishing to avoid disclosing the truth because their continued stewardship would be jeopardized or they would suffer some other adverse consequence if full disclosure were made. This is very much the case, but this example raises a far different question than disclosure guidelines.

Management’s desire to place a different face on the issuer’s performance and financial position is not so much a question of what information needs to be disclosed as it is a question of the individual country’s commitment to prosecute fraudulent financial reporting. Certainly no country can legitimately argue its economy or investors are benefitted by fraudulent financial reporting or for that matter insider trading.\textsuperscript{50} On these two fronts there is strong international consensus. However, resources must be committed to give effect to each nation’s commitment. This is an area where most developed countries, including Japan, lag, although the prospect of the new SFEC holds a good deal of promise. Subtle questions such as the degree of disclosure of self-dealing transactions and other transactions that portend managerial opportunism require more deliberate investigation. Such questions cannot easily be brushed aside because they involve matters of a type that can reward the manager at the expense of his firm.

\textsuperscript{49} Among the information for which disclosure is being guided by concerns that underlie the SII are related-party transactions. The Americans have insisted that Japanese accounting rules should disclose significant transactions between a reporting company and its affiliated companies, major shareholders, and certain other related parties such as large shareholders and directors. Among the transactions to be reported are sales transactions, loans, and transfers of certain lines of business. See \textit{Lawrence W. Bates, Japan’s New Disclosure Rules and Keiretsu Relationships}, E. Asian Executive Rep., June 15, 1991, at 7, \textit{available in} LEXIS, Nexis Library, Easian File.

\textsuperscript{50} Such concerns prompted the recent adoption of the “5\% percent rule” in Japan whereby those who own more than five percent of an issuer’s stock must disclose their ownership. It has been reported that the rule has reduced the incidence of market manipulation that arose by speculators initiating rumors to lure small investors into bidding up the price of a firm’s stock with the speculators dumping their own holdings at a substantial gain. Hidetaka Tomomatsu, 5\% Disclosure Rule Stymies Stock Speculators: Shadow Deals Laid Bare to Public Light, JAP. Econ. J., Dec. 19, 1990, at 1, \textit{available in} LEXIS, Nexis Library, JET File.
B. Accounting Standards

Just as there is a need for nations to coordinate their regulatory directives and enforcement efforts to remove managerial opportunism as a basis for listing or offering securities in any particular market, there is also a need for minimum accounting standards across the world’s developed markets. Certain disclosure principles must be uniformly adhered to if countries are to focus managerial preferences among competing markets and regulatory regimes on the relative cost of capital in each market. For example, consider the simple illustration of two countries whose disclosure commands are identical except that Country A predeterminates the accountant’s unqualified opinion on adequate internal controls whereas no such requirement exists in Country B. Managers may well prefer Country B because they can avoid duplication of personnel as Country B does not predetermine the accountant’s yearly clean opinion on a discrete division of responsibilities in the receipt and distribution of cash or other property. Managers who wish to appropriate funds to themselves may also prefer Country B over Country A. To be sure, Country B companies will incur greater capital raising costs, but these costs are borne by the firm and not by the manager who may well profit personally by the lower level of accountability and asset protection that accompanies strict internal control standards. Thus, and not surprisingly, it would appear internal control requirements for audit certificates are a worthy candidate for harmonization.

1. Income Smoothing and “Window Dressing”

An opportunistic use of accounting standards by managers can occur in a number of ways that are not fraudulent. However, the managers’ common quest for security and reputation can also plant the seeds for managerial opportunism. Managers have strong incentives to avoid disclosing abrupt and significant changes in revenues, costs, and earnings, especially if changes in these items are below those of prior years. Such incentives have led to the well-documented propensity for income smoothing among managers. Income smoothing involves managerial

51. At least at the stage of securing listing of a security, particularly on the Tokyo Stock Exchange, there is substantial review of the issuer’s overall quality which is far more scrutinizing than the listing process in America. This is sometimes argued to remove the need for demanding disclosure standards. See James E. Schrager & Julian Gresser, *U.S., Japan Stock Markets: Divergent Goals*, JAP. ECON. J., Feb. 10, 1990, at 9, available in LEXIS, Nexis Library, JEL File.


behavior on a variety of fronts with the objective of minimizing intertemporal changes in revenues, costs, and earnings. Simply stated, the valleys in trend lines are filled in and the peaks in those trend lines are clipped. This occurs not solely by the timing of economic activities within firms, but also by deft use of accounting principles. Even in the U.S., such principles permit a range of decisions that alter the manner and timing of reporting items.

Interestingly, while empirical data supports the belief that managers of U.S. corporations engage in income smoothing, there is also abundant evidence that income smoothing does not fool the market.\textsuperscript{54} United States capital markets are not misled by income smoothing techniques, because for nearly two decades prevailing accounting principles have mandated that when a material accounting change occurs, there must be disclosure of enough information to permit investors to determine what the reported results would have been had the change in estimate or principle not been made.\textsuperscript{55} Indeed, this is a prevalent feature of U.S. disclosure laws. Where more than one reporting choice is available, companies are permitted to exercise a choice, so long as enough collateral disclosure is made to enable financial statement users to determine reported income or financial position under a different method. This feature is not so much a protection against fraud as it is a means of assuring comparability among reporting companies.

A frequently expressed concern with respect to reporting by Japanese companies is their use of “reserves.” Reserves are common in Japanese companies and exist for such diverse purposes as retirement and severance benefits as well to absorb extraordinary items.\textsuperscript{56} The reserves are highly discretionary items, additions and withdrawals require a minimum of disclosure thus enabling managers to smooth reported income from year to year. Further discretion is afforded managers of Japanese companies with respect to foreign currency translations. Multinational Japanese corporations typically have branches, divisions, and subsidiaries throughout the world so that reporting questions arise regarding the translation of off-shore transactions into the yen. In the U.S. there is a


\textsuperscript{55} See \textit{APB ACCOUNTING PRINCIPLES}, Opinion No. 22 (Am. Inst. of Certified Pub. Accountants 1972).

highly stylized approach to this, however, there is a good deal of laxity within Japanese accounting standards. For example, Japanese corporations are not bound to use the currency of the country where the transaction occurred and Japanese corporations apply different transaction rates for subsidiaries and branches. This gives rise to great temptations to affect overall results not only by the exchange rate selected but also by defer characterization of the off-shore entity as a branch or subsidiary. Finally, Japan has much greater freedom than the U.S. to characterize transactions as extraordinary. This permits an additional convenient means to smooth reported income from year to year by merely moving a large item to the extraordinary category.

Quite a different potential for manipulating reported results arises in the area of consolidated accounting. For many years, the U.S. has had fairly rigid guidelines regarding when a parent corporation must issue consolidated financial statements. U.S. reporting requirements require consolidation when a corporation directly or indirectly owns fifty percent or more of another company. The so-called equity method of including another corporation's position and performance is required when twenty to fifty percent ownership exists. In contrast, Japan does not require consolidation if the subsidiary's assets, sales, and income are ten percent or less than those of the consolidated enterprise. This has on occasion allowed the practice of "window dressing," whereby profits and losses are hidden in the accounts of subsidiaries. In this regard, consider the following analysis of the issue of consolidated versus unconsolidated reporting.

Is there always a big difference between consolidated and unconsolidated earnings in Japan? The answer is, no, generally speaking. A survey comparing parent-only and consolidated earnings for the latest terms available indicates that out of more than 2,000 listed companies, the consolidated earnings of over 400 were more than 1.1 times bigger than parent-only figures, and that the consolidated earnings of 50 were

58. YAMASHITA, supra note 56, at 247.
59. Even though not required, some Japanese companies have voluntarily disclosed such information, finding that the positive reaction of investors is a benefit sufficient to at least incur the extra costs of such consolidated reporting. Groups Releasing Consolidated Results: Disclosure No Longer Conined Only to Parent, JAP. ECON. J., June 23, 1990, at 36, available in LEXIS, Nexis Library, JEJ File; Tomio Shida, MOF Adopts Lax Rule on Disclosure, JAP. ECON. J., Jan. 19, 1991, at 1, available in LEXIS, Nexis Library, JEJ File (while some release consolidated information, most issuers are relieved that the Ministry of Finance backed away from mandating such disclosure).
60. Yamashita, supra note 56, at 247.
more than two times as large. ... The Nihon Keizai Shimbun forecast the 1987 ... business performance of 802 manufacturers and non-manufacturers listed on the Tokyo, Osaka, and Nagoya stock exchanges. Consolidated net income is expected to grow an average 10.9% and parent-only net income 7.1%, meaning that consolidated net income will be about 1.2 times larger than parent-only net income.

Since unconsolidated or parent-only estimates become available before consolidated ones, investors are most accustomed to them, and, generally, there are not many differences between the two sets of figures. Securities houses compete in being the first to provide investors with accurate unconsolidated estimates. These estimates are published in newspapers and they are convenient for investors to grasp a general trend for the year ahead.61

One cannot have as sanguine a view of the above as its author. Some twenty percent of the sampled firms had consolidated earnings at least ten percent greater than those reported for the parent.62 Moreover, we should consider the incentives such weak disclosure demands provide for analysts to garner inside information for their clients about an individual firm's likely consolidated performance. Finally, analysts' predictions, while filling a gap, are historically less reliable than those provided by the firm itself.63

2. Depth of Reporting

The disclosure laws in most countries, including Japan, lack the detail and depth of U.S. disclosure requirements. This difference is illustrated by the report that in June 1989, Akai Electric Company, an audio equipment manufacturer, issued a one-page release announcing revisions to its earnings forecast for the year. The brief release announced that the company expected to post a pretax recurring loss of 2.79 billion. Virtually no information was disclosed that would enable investors to assess whether the unexpected drop in earnings was due to sustained competition or strategic miscalculations by management. Additionally, investors were unable to assess how long the adverse conditions were likely to continue.64 As illustrated, Japan's disclosure requirements, in contrast to

61. Id. at 248-49. The survey referred to is identified by the author as Kaisha Shikkho (Company Quarterly), Toyo Keizai Shinposha, first quarter 1988.
62. Parents are under no obligation to report their affiliates' earnings if they either own less than 50% of the affiliate or the affiliate's earnings or assets are no more than 10% of the firm's assets, sales, and income. Id. at 247-48.
64. TSE's Handling of Disclosure Leaves Insiders, Public in Dark, JAP. ECON. J., Nov. 4,
those in the U.S., impose no obligation on an issuer to report whether the conditions contributing to the loss are likely to continue and what general effects they will have. In contrast, the Management Discussion and Analysis portion of Regulation S-K demands that in such a situation the company disclose known conditions and trends that are reasonably likely to have a material effect on earnings, assets, or liabilities. Thus, one can find in this illustration support for a criticism of not just Japanese disclosure laws, but those of most countries—that they lack the detail and depth of the U.S. disclosure requirements.

A final illustration involves the reporting requirements for segments of a business. U.S. companies are required to disclose certain financial information for any product or group of products that account for at least ten percent of an enterprise’s total profits, including the revenues, profits or losses, and assets used for that product or group of products. Issuers generally have opposed segmental reporting because they believe disclosures based on specific product lines can rob the firm of potential competitive advantages. Nevertheless, the information is mandated by the U.S. disclosure rules because of its demonstrative usefulness to investors. In contrast, line of business reporting is not mandated by Japan’s disclosure laws.

Both the treatment of extraordinary items and segmental reporting point out the classic conflict between those who prepare financial statements and those who use them. To the users of financial statements, more disclosure is always better. However, there is the fear that absent mandatory disclosure rules there will be an over expenditure of societal resources by financial statement users who will needlessly duplicate each other’s efforts. The call for mandatory disclosure on this basis is further enforced by the belief that the security’s issuer is likely to have the lowest cost to produce the information and that the information so produced will be more accurate. Additionally, there is always the concern that

1989, at 32, available in LEXIS, Nexis Library, JEJ File. The report also disclosed that the company’s president selectively explained the factors contributing to the unexpected loss to the company’s banks. Id.
68. Yamasita, supra note 56, at 245. In practice, most Japanese companies that disclose segment information disclose sales revenues for certain industry groups.
absent mandatory disclosure there will be delays in disclosure by managers who will seek personal gains by capitalizing on their advance knowledge of the company's progress and performance.

The reporting company's concerns must also be recognized. Adding depth and detail to financial disclosures entails tangible costs, especially when the precise prescription of that depth and detail is embodied in technical government directives. Furthermore, it is readily apparent that disclosure of some information may pose serious regulatory and competitive problems for companies doing business internationally. For example, segmental information may raise new questions regarding "dumping" violations or the consistency between the allocation of tax liabilities among various host nations and the results being reported on financial statements. Moreover, disclosure issues cannot always be dictated solely by the needs of financial statement users because, as seen above, so long as the information is a free good to users it will always be over-consumed.

3. Consensus on When To Agree and To Disagree

Overall, Japan provides weak financial reporting rules for changes in accounting principles and estimates, the reporting of extraordinary items, reserve accounting, consolidated reporting of affiliated companies, and segmental reporting. Further, the weaknesses in consolidated reporting permit a good deal of room for managerial opportunism. The broad discretion Japanese managers enjoy under prevailing accounting standards similarly impairs the listing and offering decisions, and thereby poses serious questions to those concerned with fostering regulatory diversity and competition in securities markets. Finally, Japan and most other countries' disclosure requirements are not nearly as stylized or penetrating as those that exist in the U.S. Each such disclosure weakness can be seen as presenting a fertile area for the type of managerial opportunism that can defeat a competitive regulatory hierarchy that was earlier recommended as a valuable norm for countries to base their individual regulatory preferences upon. At first blush, this may appear to demand regulatory uniformity because it can be argued that any country that retreats from the norm invites the embrace of managerial opportunism.

However, this need not be the case. Consider the difference between the disclosure issue posed in the "Akai" illustration and the hidden

69. For example, a decade ago it was roughly estimated that the costs of America's disclosure system for publicly traded firms were no less than $1 billion. Susan M. Philips & J. Richard Zecher, The SEC And The Public Interest 51 (1981).
reserves or the "window dressing" possibilities that exist with Japan's lax accounting standards for consolidated financial reporting. The former problems go to the completeness with which an externally caused event occurs. Similarly, the disclosure issues posed by segmental reporting goes to how much detail is to be disclosed in connection with announcing the results of operations. In contrast, the problem posed by reserves and "window dressing" through artful consolidated accounting techniques are not problems that bear on reporting of transactions carried out at arms length; rather, these are activities that arise through the fiat of managers. As such, they pose far greater concerns than completeness. They raise concerns for manipulation of overall results.

Thus, it would appear that in the realm of disclosure standards all countries should embrace those accounting standards that remove the opportunity for the financial performance and position of the firm to be manipulated. For example, reserve and consolidated accounting are areas where common standards are necessary to remove the flexibility managers otherwise enjoy to engage in "window dressing." Such an understanding does not require prohibiting reserves or mandated uniformity in consolidated financial statement standards and practices. Individual differences in these areas pose no serious problems to international markets provided management's exercise of discretion in such areas is accompanied by sufficient disclosure. The appropriate international response to reserve accounting and other instances which permit managerial discretion to interdict the accounting reports is not to prohibit such activities but to require transparency by collateral disclosure of the effects of management's accounting choice. The collateral disclosure should be enough to permit financial statement users to extrapolate from the disclosed information what financial results would have been had management not so exercised its discretion. Such a regulatory response not only assures comparability across all issuers, domestic and foreign, but also rids disclosure choices from the sharpest form of managerial opportunism. In other areas, individual differences among countries is not dysfunctional. On these types of issues, countries with lax disclosure requirements will find their markets characterized by lower disclosure costs but higher costs of capital. In this respect, regulatory competition establishes a useful hierarchy of markets so that issuers may choose the disclosure regime that best fits their needs. In addition, individual countries may pursue their own distinct disclosure philosophy.