REGULATORY DUOPOLY IN U.S. SECURITIES MARKETS

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Due to globalization, the world is a much smaller place today than it was when the U.S. securities laws were enacted. In an era of global trading and offerings of securities disclosure policy for U.S. securities markets is formulated with a healthy respect for the rules, customs, and practices of foreign markets. Thus, for policymakers, regulatory competition is as important a strategy as is harmonization. Theorists have long embraced the view that regulatory competition among markets will result in a regulatory hierarchy that is optimal for investors and the issuers of securities. In this Article, Professor Cox takes the regulatory hierarchy paradigm to the next analytical level. He considers the policy implications of diverse regulatory standards within a single market, focusing much of his analysis on the significant issue presently confronting the SEC: Whether its registrants should be permitted to satisfy the mandatory disclosure requirements by using International Accounting Standards.

INTRODUCTION

Formulating public policy for regulating capital markets is a delicate undertaking. Governments committed to a market economy seek to nurture Adam Smith's invisible hand as it allocates resources efficiently in their economies. Since there is a clear inconsistency between professing obeisance to capitalism and allowing civil servants to dictate what ventures may raise funds in capital markets, developed countries' securities laws are disclosure- rather than merit-based. But disagreements abound among countries as to what is to be disclosed and the detail with which items are to be presented. On the one hand, nations seek to liberate their issuers from burdensome disclosure requirements that may increase the cost of capital and retard economic growth. On the other hand, no self-respecting country wants to become the Barbary Coast of the financial world because of weak financial market regulation. Weak regulation heightens the riskiness of investing with the effect that both high-quality companies and investors will steer their activities away from the shoals of any Barbary Coast and toward markets where they can more reliably and economically chart their courses to raise funds or invest. Disclosure policy is thus not a science but a bundle of social, political and economic choices that nations make.

It is fundamental to the law of nations that each country's respective laws apply only to transactions within its borders. The scope of securities law in any country is, therefore, territorial. Viewed differently, however,

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securities law is hardly territorial at all. Just as John Donne reminds us that no man is an island unto himself, no country formulates the content of its securities laws without a good deal of consideration of the practices of its sister countries. Technology and globalization profoundly increase both the difficulty and the need for each country to continually reevaluate its securities laws. A country seeking to contain its companies and investors by erecting a wall of unreasonable regulatory demands will find a fiber optic tunnel through its ramparts allowing its subjects to escape to more hospitable markets.

The ease with which technology allows companies and investors to match their interests in either home or host markets does not mean the death of the securities laws. Quite to the contrary, globalization and technology collectively nurture an environment of regulatory competition among nations. And though competition necessarily suggests that there is a race, it need not be a race "to the bottom." I have written elsewhere that regulatory competition among countries has and will continue to yield a hierarchy among international capital markets.¹ Investors who perceive *ex ante* that a particular market poses a higher instance of fraud, manipulation, unfairness or general uncertainty regarding the trustworthiness of financial information for securities will discount the price of each security in that market by a greater amount than a comparable security in a market where they believe there is a lower incidence of such abuses or disclosure deficiencies. The challenge, in part, for policy-makers is to decide where they wish their country's securities markets to fall within the capital market regulatory hierarchy.

Whereas earlier applications of the regulatory hierarchy argument considered how investors, issuers, and regulators would respond to the differing levels of risk posed by competing markets, each of which posed its own level of regulatory rigor, this Article examines the policy implications of a market regulator recognizing more than one disclosure standard for companies participating in its country's capital market. I therefore take the regulatory hierarchy model to the next analytical level by inquiring whether *divergent* regulatory standards within a single market can be expected to result in a hierarchy among securities traded within that market. The analysis proceeds in two connected, yet different, contexts. The specific context in which the viability of regulatory disclosure hierarchy is considered is the current debate over whether the U.S. Securities and Exchange Commission should allow foreign registrants the option of satisfying mandatory U.S. disclosure standards either by reconciling their financial statements to U.S. generally accepted accounting principles (GAAP) or preparing their financial statements according to International Accounting Standards (IAS). I also consider the viability of a regulatory disclosure hierarchy in the broader context of whether the

1. See James D. Cox, Rethinking U.S. Securities Regulation in the Shadow of International Regulatory Competition, 55 *Law & Contemp. Prob.* 157, 158-64 (1992).

SEC should accord issuers entering U.S. capital markets the freedom to use the disclosure standards of another regulatory body, such as those of Switzerland or Delaware. In this latter context, I closely examine the relative strengths of the regulatory competition argument championed by some who believe the SEC should no longer enjoy a monopoly over disclosure practices for U.S. capital markets.

This paper therefore addresses whether the policy objective should be to promote convergence or divergence of disclosure standards for U.S. capital markets. I challenge the assumptions relied on by commentators who favor divergent disclosure standards and also question whether within a single market there can arise a reasonable pricing hierarchy among firms according to differences in the regulatory system guiding their disclosures. In the context of the SEC's current consideration of IAS, I counsel that the SEC and investors are best served by staying the course whereby the SEC continues to promote convergence between IAS and U.S. GAAP. Nevertheless, I recognize that convergence is never perfectly achieved, so that the SEC will at some point have to recognize IAS out of political considerations. This paper thus concludes by recommending how it may do so while still preserving a significant role for itself as the proponent of convergence.

Part I examines the organizational structure of the Financial Accounting Standards Board and the International Accounting Standards Committee and questions whether their similar structures could assume importance in the SEC's acceptance of IAS for its registrants. Because the SEC has emphasized the comparability of reporting standards as the key consideration for their acceptability in SEC filings, Part II reviews the empirical evidence bearing on the benefits of requiring foreign issuers to reconcile their financial statements to U.S. GAAP. The purpose of this review is to determine whether U.S. GAAP does in fact produce information useful to investors when investors already have access to non-U.S. GAAP information. If this question is answered negatively, it would appear that the SEC's support for the monopolistic position enjoyed by U.S. GAAP for SEC filings is weakened considerably. Part III reviews the empirical evidence respecting the various benefits foreign issuers obtain upon listing their securities in the U.S. Though these benefits are likely the result of many factors other than the rigor with which the SEC regulates disclosure in U.S. markets, it is important that those factors are equally consistent with the increased transparency in reporting that is facilitated by U.S. GAAP.

Because the SEC has identified comparability of reporting standards as the central criterion for accepting IAS, it is important to consider whether there are significant securities markets in which comparability has not been an SEC objective. This question is addressed in Part IV, which examines evidence bearing on whether the SEC has already seriously compromised comparability in the market that exists for Level I ADRs and the institutional trading market that surrounds Rule 144A.

Part V examines the most fundamental question regarding the decision to accept IAS, namely, whether the decision is properly made by the SEC or by another regulatory body. There is a lively debate over whether the SEC should continue to be the sole regulator of disclosure standards for the U.S. market or whether multiple disclosure regimes (i.e., divergent standards) should prevail. This debate bears on the SEC's possible acceptance of IAS, since such acceptance would introduce an alternative to U.S. GAAP for SEC registrants. If this result is feasible, we might well ask—as have the commentators whose positions are reviewed in Part V—why SEC registrants should be limited to only those reporting standards that have been approved by the SEC. Finally, Part VI offers guidance as to how the SEC can approach its future consideration of IAS in ways that are consistent with the evidence and reasoning advanced in this Article.

I. THE EVOLUTION OF ACCOUNTING STANDARD SETTING ORGANIZATIONS

Accounting standards have an important connection to management's stewardship of the firm. This dimension of accounting is aptly captured in Professor Louis Lowenstein's observation that "you manage what is measured."² An example of this insight is the experience of Daimler Benz following its listing on the NYSE in 1993. Because it was required to reconcile its German-prepared financial statements to U.S. GAAP, Daimler Benz's managers' purposeful uses of liberal German standards were made transparent. The standards were used to conceal in "reserves" earnings in good years, followed by draws upon prior years' reserves in poor years to increase earnings with the result that year-to-year fluctuations in earnings were moderated. In the year of its listing, Daimler reported a profit of \$354 million under its home country accounting standards but upon reconciliation under U.S. GAAP it reported a loss of \$1 billion.³ The significance of the Daimler Benz new obligations under U.S. GAAP is clear: they made management's stewardship transparent. The relative rigor of GAAP standards revealed that the Daimler management's aggressive pursuit of diversification into widely-ranging fields such as aerospace, software and consumer appliances had yielded only high costs and low revenues. Following listing on the NYSE, Daimler Benz has changed its top management team, divested itself of under-performing product lines, and become a highly profitable company even under U.S. GAAP.⁴

As can be seen, accounting standards have impacts quite distinct from the commonplace financial analysis of current and prospective in-

2. See Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 *Colum. L. Rev.* 1335 (1996).

3. For a detailed analysis of the numerous accounting items giving rise to this change in reporting Daimler Benz's net income, see Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Registrants*, 29 *Int'l Law.* 875, 881-86 (1995).

4. See Holman W. Jenkins, Jr., *Before Chrysler, Daimler Was a Soap Opera*, *Wall St. J.*, June 10, 1998, at A19.

vestors. Accordingly, managers are hardly neutral observers in the development, application, or choice of accounting standards that report on their stewardship of the firm. Indeed, there is a rich history of opportunistic and artful use of accounting standards by managers to advance their interests at the expense of investors. Consequently, the process of standard setting for financial reporting in the U.S. has frequently placed members of the accounting profession on a collision course with their clients.

A. Standard Setting in the U.S.

Through most of this century, world capital markets have been segmented, so that the regulatory demands of each country were not influenced in any significant degree by the regulations imposed by other countries. Not much was made of the fact that the regulatory demands varied from country to country because capital raising occurred exclusively at home, pursuant only to domestic disclosure requirements. In this environment, the U.S. regulatory culture excelled above that of other countries. The United States was so successful partly because its regulators and political institutions remained deeply influenced by the belief that lax disclosure requirements exacerbated the financial collapse of the Great Depression. More importantly, because the U.S. had emerged from World War II with a financial and industrial base unrivaled in the world, it could embrace regulatory choice without considering the consequences for the global competition of U.S. firms. There simply was no need in the U.S. to rationalize securities laws with an eye towards sister markets—U.S. markets had no peers.

Indeed, financial markets at the end of World War II were deeply segmented due to numerous barriers such as taxation and restrictions on foreign ownership, capital mobility and foreign exchange transactions.⁵ The U.S. securities laws continued to be immune to the effects of international regulatory developments until the 1970s, when market reforms and liberalization began in developed countries.⁶ Since then, deregulation of capital market laws has been a steady trend worldwide. The trend has had special significance in the evolving content of U.S. securities laws as investors have pursued market diversification to reduce portfolio risk and

5. See, e.g., Ronald I. McKinnon, *Money and Capital in Economic Development* (1973); Edward Shaw, *Financial Deepening In Economic Development* (1973).

6. See Joel Seligman, *The Transformation of Wall Street* 607–10 (rev. ed. 1995). Illustrative of the importance of international events on the content of the U.S. securities laws is the creation within the SEC of Office of International Corporate Finance in 1973. See Securities Act Release No. 5355 (Jan. 11, 1973). See also Carl T. Bodolus, *The Internationalization of the Securities Markets*, 29 *Bus. Law.* 107 (1974). For excellent summaries of the transformation of financial markets during this period and the important competitive pressures felt by U.S. markets from London, see Peter Dicken, *Global Shift: Transforming the World Economy* 399–403 (3d ed. 1998); Roy C. Smith, *The Global Bankers* 8–40 (1989).

issuers have increasingly considered accessing foreign financial markets to reduce the cost of capital.⁷

Though the Securities and Exchange Commission has been the supreme regulatory authority in the United States since its creation in 1934, throughout its life the Commission has depended upon the private sector to establish both accounting and auditing standards. In the formulation of financial disclosure requirements in the U.S., it is striking that the central claim of public criticism, until relatively recently, has consistently been that private sector standard setters were too poorly organized to promulgate *rigorous* accounting standards. That is, the concern has not been that the accounting profession has excessively regulated disclosure, but rather that professional standards, conventions and protocols were too general to be considered principles that could be applied uniformly across public companies.⁸

7. See generally SEC, Request for Comments on Issues Concerning Internationalization of the World Securities Markets, Exchange Act Rel. No. 21958, Fed. Sec. L. Rep. (CCH) ¶ 83,759 (April 18, 1985).

8. The most important professional U.S. accounting organization, the American Institute of Certified Public Accountants (AICPA), in 1938 created within itself the Committee on Accounting Procedures for the purpose of promulgating accounting principles. Prior to the Committee's creation, principles were not established or recognized in any systematic fashion—they arose out of practice and informal acceptance by members of the profession. Over the next 20 years the Committee issued 51 Accounting Research Bulletins (ARBs). Because the Committee's power was limited to merely recommending good accounting practices, however, its influence over standardization of accounting principles and conventions was minimal. Accountants, in rendering their audit opinions, could opine that their client's statements were in conformity with GAAP, even if the procedures used were inconsistent with those recognized in an applicable ARB, provided the reporting method used had some acceptance in practice. Thus, GAAP under the ARBs depended more on the acceptance by accountants and their clients of the recommended methods than on the force of the standard setter itself. See James D. Cox, *Financial Information, Accounting and the Law* 6–18 (1980); Paul B.W. Miller & Rodney J. Redding, *The FASB: The People, the Process and the Politics* 18–27 (1986).

Over time, dissatisfaction with the Committee grew because it failed to conduct research or detailed analyses in support of its bulletins; recommendations were instead reflections of its members' views of desirable reporting methods. This dissatisfaction ultimately gave rise to the AICPA creating in 1959 the Accounting Principles Board (APB) to replace the Committee. The APB's members were selected from large accounting firms, but with token representation from business, government and even the academy. Addressing the Committee's perceived weaknesses, the APB was empowered with a budget sufficient to retain a modest full-time staff, who researched and prepared research reports in connection with leading academics or practitioners as background for standards promulgated by the APB. See Robert T. Sprouse & Detlev F. Vagts, *The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal*, 30 *Law & Contemp. Prob.* 706, 706–11 (1965). During its existence, the APB issued 31 opinions and 4 statements. The influence of the APB was enhanced in 1964 when it finally resolved that financial statements prepared using methods embraced by the APB were in accordance with GAAP. Other reporting methods, however, satisfied GAAP, provided they had "substantial authoritative support." AICPA, *Establishing Financial Accounting Standards, Report of the Study of Accounting Principles* (1972). Such support

Since 1972, the primary accounting standard setter in the U.S. has been the Financial Accounting Standards Board. The FASB's formal organization is essentially that recommended in the Wheat Report: its decisions are rendered by its seven members who are required to sever all ties with their former employers, and no more than 4 of its members can be from public accounting. The FASB enjoys extensive research and technical support from a large permanent staff that is frequently augmented by leading academics who oversee its research studies.⁹ Financial support for the FASB is derived from a separate entity,¹⁰ the Financial Accounting Foundation, which raises funds from all sectors of the financial community. The FAF's trustees also fill vacancies that arise on the FASB's board.

Thus, the FASB reflects the objective—one that has evolved over time—of a professional accounting standard body insulated from the pressures of the accountants' clients. The FAF provides this insulating quality as well as the muscle to provide funding for a professional staff and procedures for standard setting that are unrivaled in any other country. Importantly, the FASB's independence is further steeled by the watchful eye of the SEC.

existed when the method employed consisted, for example, of "practices commonly found in business," "requirements and views of stock exchanges," "the views of commercial and investment bankers," "regulatory commissions' uniform systems of accounts and accounting rules," "the regulations and accounting opinions of the Securities and Exchange Commission," and finally, "affirmative opinions of practicing and academic . . . accountants." *Id.* Today, accountants may use a method that departs from that adopted by either the FASB or the AICPA only upon demonstrating such departure is justified by unusual circumstances. See AICPA Code of Professional Conduct Rule 203, 2 AICPA Professional Standards (CCH) et seq. 91.02 (1977).

Throughout its life, the APB encountered unrelenting criticism. Complaints included that it produced too little work, that it failed to concern itself with the broad objective of financial statements and the underlying principles for their preparation, and that its positions reflected the desires of the accountants' clients. Concern was also expressed that the APB's procedures and organization did not insure participation in its processes by nonaccountants or elicit the views of the users of financial statements—the groups most frequently found absent at the APB's high table were security analysts and financial executives whose views, the APB's critics argued, were as relevant as those of the independent accountants.

The APB's end was hastened by a committee chaired by former SEC Commissioner Francis M. Wheat. See SEC, *Disclosure to Investors: A Reappraisal of Federal Administration Policies Under the '33 and '34 Acts* (1969). The "Wheat Report" detailed the above criticisms of the APB and called for a more independently structured accounting standard setter. In response to this recommendation, the APB was disbanded and the Financial Accounting Standards Board (FASB) was created in July, 1973.

9. For a more detailed description of the FASB's procedures, see FASB, *The IASC-US Comparison Project: A Report on the Similarities and Differences Between IASC Standards and U.S. GAAP 39-63* (1996) [hereinafter *FASB Comparison Project*]; Armstrong, *The Work and Workings of the Financial Accounting Standards Board*, 29 *Bus. Law.* 145 (Supp. 1974).

10. Five FAF trustees can be from public accounting; at least three must be from the finance-corporate sector, such as financial analysts, business executives, or bankers; and the ninth trustee is an educator.

B. *The International Accounting Standards Committee*

It is ironic that the dawn of the FASB coincided with the first evidence of globalization. That is, at the same time that greater rigor for U.S. accounting standards was being called for, U.S. capital markets and companies were facing increasing competition. By 1973, it had become a viable option for U.S. companies to raise funds in London's financial markets, and American companies had lost significant portions of their product markets to more efficient foreign competitors.¹¹ Further evidence that 1973 was a watershed year was the creation of the International Accounting Standards Committee (IASC). Its mission, from its inception, has been the promotion of uniformity in international financial reporting.¹²

IASC's original membership of accounting bodies from 10 countries¹³ has now expanded to representatives from nearly 90 countries.¹⁴ The IASC Board is dominated by representatives of accounting organizations who serve up to 5 years, part-time, and without pay.¹⁵ Similar to earlier U.S. experience, complaints have arisen that the diverse and part-time character of the IASC Board and the tightness of its resources limit its effectiveness. Important financial assistance for the work of the IASC occurs through its International Advisory Council, which also monitors and reviews the activities, plans and performance of the IASC, albeit without the power to either participate in or amend its decisions.¹⁶ The most striking aspect of the IASC is how its evolution has paralleled the U.S. experience in accounting standard setting. Just as the U.S. accounting standard setters evolved from little more than a fraternal organization to become an authoritative entity with a professionalized staff, so too has the

11. We thus find that in the last 25 years of the century an important focus of SEC efforts has been discrete, but significant, accommodations to foreign issuers seeking to access U.S. capital markets. Though such accommodations make U.S. capital markets more attractive to foreign issuers, they do little to address the competitive concerns of domestic companies. See, e.g., Edward F. Greene et al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 *Bus. Law.* 413, 429-34 (1995).

12. An additional focus of the IASC when originally created was establishing standards for use in developing countries which lacked any authoritative accounting standard setting body. See SEC, *Report on Promoting Global Preeminence of American Securities Markets* 7 (Oct. 1997) <<http://www.sec.gov/news/studies/acctgsp.htm>> [hereinafter SEC Report].

13. See David Mercado, *Evolving Accounting Standards in International Markets*, 961 *P.L.I./Corp.* 343 (1996).

14. See *The Standard Setters*, *Fin. Times*, Oct. 10, 1996, at 12.

15. See FASB Comparison Project, *supra* note 9, at 66. In fact, the seat is held by the accounting organization, not its representative. See David S. Ruder, *Reconciling U.S. Disclosure Policy With International Accounting and Disclosure Standards*, 17 *Nw. J. Int'l L. & Bus.* 1, 14 n.41 (1996). The board members are joined by non-voting observers who include representatives from the FASB, European Community and IOSCO. See FASB Comparison Project, *supra* note 9, at 43.

16. See FASB Comparison Project, *supra* note 9, at 50-51. The IAC is made up of 10 members from the business community and accounting profession. See *id.* at 66.

IASB. For example, because IAS are intended to reach transactions in multiple business environments for which there will be important differences, IAS tend to be more broadly drafted and less technical than their U.S. counterparts.¹⁷ The breadth of the standards also invites circumvention or varying approaches among countries purporting to operate pursuant to the same standard. Such variance is reminiscent of the U.S. experience prior to the FASB when accounting standards were established exclusively through a process dominated by the accounting profession.¹⁸ To assure that the force of IAS in harmonizing international disclosure standards would not be eroded by differing national interpretations, the IASB in 1997 created the Standing Committee on Interpretations to prepare interpretations of IASB pronouncements.¹⁹

Much like the problems faced by the U.S. standard setters prior to the creation of the full-time FASB, the IASB has a very limited staff and depends heavily on member organizations to contribute staff to its projects.²⁰ Even though both the FASB and the IASB are strapped for resources, the FASB budget dwarfs that of the IASB.²¹ Neither the IASB nor the FASB have the power to independently enforce their standards; ultimately, the force of their standards depends in each case on their acceptance by country regulators as authoritative support for acceptable disclosure practices within that country.

C. Enter the SEC

There has been a concerted effort in the last couple of years to enhance the stature of the IASB so that its standards would be widely accepted by regulatory authorities, most particularly by the SEC. Even though the SEC has the authority to prescribe accounting and auditing standards for SEC documents,²² its practice has been to defer to the pri-

17. See *id.* at 57.

18. See *id.*

19. See *Guidance on International Standards*, Australian Accountant, Feb. 1997, at 9. The rulings of the SIC have the same force as the standard itself. See *Interpretations Body Proposed for IASB*, Accountancy, June 1996, at 7.

20. See *FASB Comparison Project*, *supra* note 9, at 45–46 (identifying a staff of three to five full-time professionals).

21. The FASB budget for 1996 was \$16 million, whereas that for the IASB was \$1.8 million. See James A. Schweikart et al., *An Interview with Sir Bryan Carsberg, Secretary-General of the International Accounting Standards Committee*, *Acct. Horizons*, Mar. 1996, at 110, 115.

22. In a sense, the SEC's power over accounting standards is consistent with the broader philosophy of the U.S. securities laws to interject self-regulatory organizations into the regulatory process. This philosophy was crisply summarized by former SEC Chairman and later Supreme Court Justice William O. Douglas: while remarking on the fact that the Exchange Act allowed self-regulatory organizations to take the lead in establishing rules for the industry, he observed that government would nevertheless "keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the hope that it would never have to be used." William O. Douglas, *Democracy and Finance* 64–65 (J. Allen, ed., 1940).

vate sector—specifically the FASB and AICPA—as the principal authoritative sources for accounting and auditing standards.²³ In this regard, the SEC serves something of an ongoing certification function of the U.S.-based accounting profession to promulgate the standards and practices that are in the public interest. Today, the twin forces of increasing internationalization of capital markets and the rising stature of the IASC confront the SEC with its most difficult decision, namely, whether this certification function should be exercised to recognize IAS for SEC filings.

The SEC's engagement of the IASC has thus far occurred on two fronts.²⁴ As an important member of the International Organization of Securities Commissions (IOSCO),²⁵ its voice has joined that of other country regulators in calling upon the IASC to develop a core set of accounting standards that could become the basis for financial reporting in cross-border securities offerings. Separately, the SEC continued to engage the IASC in an ongoing dialogue as the IASC developed its core standards called for by IOSCO. To complete its core set of accounting standards, the IASC increased its staff, undertook a far reaching review of its prior standards, and initiated several new standard setting projects.

In doing so, it has been solicitous of the *basic* criteria set forth by the SEC. The SEC has stated it would assess the acceptability of the IASC's core standards by inquiring into whether the standards constitute a comprehensive body of accounting, whether the standards are of high quality and result in comparability and transparency and provide for full disclosure, and whether they will be rigorously interpreted and applied.²⁶ Because of the obvious ambiguity of these criteria, the true guidance the IASC has received from the SEC has been through the stream of comment letters from the SEC's staff. These letters have commented on substantially all of the IASC's draft proposals in which the staff has assessed a proposed standard.²⁷

The criteria the SEC has identified for its possible acceptance of IAS are troubling. The issue posed by the IASC is its power to become a co-equal with the FASB in formulating financial reporting standards for SEC

23. The SEC's "delegation" to the private sector was made in Accounting Series Release No. 150 (SEC 1973) and was upheld in *Arthur Andersen & Co. v. SEC*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,374 (D.C. N.D. Ill. 1978). For more about the power of the SEC over accounting, see James F. Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 Vand. L. Rev. 201 (1975).

24. For a complete examination of the SEC's involvement with the IASC and IOSCO, see SEC Report, *supra* note 12, at 11–12, which was submitted to the Congress pursuant to Section 509 of the National Securities Markets Improvement Act of 1996.

25. Among 135 members are twelve U.S.-based members, including the SEC, the Commodity Futures Trading Commission, the North American Securities Administrators Association, Inc., the NASD Regulation, and the New York Stock Exchange. See *id.* at 6.

26. *Id.* at 15.

27. *Id.* at 12. The SEC has committed significant resources to this project, with four staff members of the Office of the Chief Accountant who devote full-time to commenting on IASC proposals. See *id.*

filings. The SEC's statement that it will focus on IAS's comparable rigor to U.S. GAAP at some future point does not appear to afford enough weight to the fact that accounting standard setting is an *on-going* process that is not locked to a specific point in time in which close comparisons are to be made. The issue before the SEC is whether, on a continuous basis commencing at some future point, certain SEC registrants may comply with U.S. disclosure demands by adhering to IASC derived standards that will, as is the case with the FASB, continue to evolve over time.

So viewed, we might well ask whether the comparison the SEC proposes to undertake is for the purpose of satisfying itself that the IASC has come of age. In other words, that it has the political structure, the expertise, and the experience to function at a level commensurate with that of the FASB. If this is indeed the focus for the SEC's inquiry, it adds a very different dimension to the comparability inquiry. The emphasis should not be upon whether IASC standards are mirror reflections of the FASB; the focus should instead be upon whether they embody qualities, such as precise measurement standards, that immunize reporting from the influence of the accountants' clients, and whether they are thoughtful responses to challenging reporting questions. Equally important is for the SEC to assure itself that the IASC has a governance structure and operating processes sufficient to assure it can continually establish high-quality financial reporting standards.²⁸ Otherwise, the comparability focus would appear to require that the IASC be something of a regulatory echo for the FASB—its contributions to reporting standards would always be judged in terms of their refinements or reflections to FASB-derived reporting standards.

The decision to accept IAS for SEC filings implicates changes broader than the mere adoption of measurement standards embraced by IAS. Regulatory decisions focused on financial reporting involve not just assessments of the standards by which measurements are to occur and to be presented, but, more importantly, must include close consideration of the rich professional culture that is popularly known as public account-

28. For example, recently the FASB took issue with several reorganization proposals for the IASC that were made in December 1998 by a special working group of the IASC (the Strategy Working Party). The FASB response identified eight essential functions "a quality" international standard setter should possess (leadership, innovation, relevance, responsiveness, objectivity, acceptability and credibility, understandability, and accountability) and five essential characteristics the organization must have (an independent decision-making body, adequate due process, adequate technical qualified staff, independent fundraising and independent oversight). See Letter from Edmund Jenkins, Chairman FAF, and Mr. Manuel Johnson, Chairman FASB, to Sir Bryan Carsberg, Secretary-General, IASC 3-4 (Mar. 10, 1999) (on file with the *Columbia Law Review*). Of paramount concern to the FASB were IASC proposals that would weaken the independence of the IASC's Standards Development Committee (roughly analogous to the FASB but with staff being "contributed" and financially supported by home country organizations) by increasing the influence of the IASC's governing board that would be dominated by professional accounting groups which would have a veto power over any action by the Standards Development Committee. *Id.* at 18-22.

ing. Accounting, despite strong economic pressures to garner revenues from consulting and systems management, remains a profession rather than simply a business. Foremost among their professional requirements, public accountants must be independent of their clients, have extensive training and experience as auditors, and must conduct their audits pursuant to well-accepted standards of the profession. Being a culture, public accounting reflects a host of influences of the auditor's home country. Thus, distinct characteristics and practices are observable in cross-country comparisons. These differences are not ameliorated by the existence of global accounting firms. The SEC currently mandates that U.S. auditing practices and procedures must be complied with for SEC filings submitted by foreign registrants. Any consideration of whether IAS may be used in SEC filings must certainly pay close attention to the culture within which the measurements called for by IAS occur. Accepting IAS merely invites the next question—namely, whether auditing practices that prevail in the foreign issuer's home country are comparable to those the SEC demands for its U.S. issuers. Therefore, the decision to accept IAS for SEC filings may be just the first in a series of problems facing the SEC.

Thus far, the SEC has framed the debate solely in terms of the comparability of IAS measurement standards vis-à-vis U.S. GAAP. The SEC has thus quietly preserved the status quo of requiring adherence to U.S. auditing standards and procedures for all its registrants. With the comparability of measurement standards being the present focus of the international disclosure debate, we should turn our attention to assessing, from an international perspective, the overall value of mandating foreign issuers to abide by measurement standards that are comparable to those imposed on U.S. companies. This topic is examined below.

II. GAUGING THE BENEFIT OF COMPARABILITY

Although full and fair disclosure is the credo of the U.S. securities laws, an even more precise summary of their orientation is comparability.²⁹ 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. The notion that public companies present a "basic information" package to investors applies whether the company's security regulatory transaction is that of raising funds or listing its securities.³⁰ Investors in this way receive information when purchasing a security of-

29. See Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 *Fordham Int'l L.J.* S77, S88–90 (Supp. 1994) (comparability is severely compromised if home country standards are accepted for U.S. markets).

30. This is the core concept underlying the SEC's integrated disclosure format. See SEC, *Adoption of Integrated Disclosure System*, Securities Act Release No. 6383 (1982); see generally James D. Cox et al., *Securities Regulations Cases and Materials* 240–45 (2d ed. 1997).

ferred by the issuer similar to that they have available to them when trading a security in an organized securities market. The globalization of trading and offering of securities poses the greatest challenge to comparability: though most countries subscribe to the fundamental accounting conventions that call for the use of historical cost, the realization of income before it is recognized, the necessity of matching expenses with related revenues, and consistent application of accounting principles within the same reporting period, significant differences arise among countries. These differences are reflected in their measurements of assets, liabilities, and expenses due to the differing treatments of multinational consolidations, business combinations, changing prices, deferred taxes, discretionary reserves, foreign exchange translations, goodwill, leases, and pensions.³¹

For example, in 1995, Finnish telecommunications giant Nokia, Europe's twentieth largest company, posted net profits of 1,971 million Markka under Finnish accounting standards, 2,232 million Markka under IAS, and 2,162 million Markka under U.S. GAAP.³² Though the scientist may inquire which of the above numbers is the correct observation, the financial analyst will likely ask what causes the figures to vary so greatly. Her inquiry into the cause of such differences is not for the purpose of identifying the correct profits, but to gain a sharper insight into Nokia's performance and financial position. Differences among accounting standards reflect that when it comes to their metrics few truths exist, except in those rare instances when accounting purports to measure absolutes, such as the historical cost of a nondepreciable asset. In this context, the valuable contribution of comparability is the standard's transparency, so that the users of financial statements prepared under one system can extrapolate from that statement information that can be understood under a rival system. Transparency therefore is the key issue in addressing the continued exclusivity of U.S. GAAP.

Comparability does not mean that two measurement standards lead to the same absolute reported figure for a firm's revenues, assets, or liabilities. Comparability in the case of Nokia should be found between the systems if analysts armed only with financial statements prepared according to IAS could extrapolate net profits, assets, etc. that would have been reported pursuant to U.S. GAAP. This ability requires not only clarity

31. See Frederick D.S. Choi & Richard M. Levich, *The Capital Market Effects of International Accounting Diversity* 19 (1990). Even within the European Union, accounting standards vary widely among member states. See Doreen McBarnet & Christopher Whelen, *International Corporate Finance and the Challenges of Creative Compliance in The Internationalization of Capital Markets and the Regulatory Process* 129, 132-33 (John Fingleton & Dirk Schoenmaker eds., 1992). In a not too subtle jab at IAS, the FASB has identified 255 differences between U.S. GAAP and IAS in its detailed report on the gulf between the two standard setting bodies. See FASB Comparison Project, *supra* note 9.

32. See *Accounting: Plotting the Way Ahead for International Harmonization*, Eur. Rep., Mar. 15, 1997, Section 2207.

and consistency in Nokia's application of IAS, but also that IAS measurement standards themselves have sufficient precision so that an analyst can, if she wishes, interpret Nokia's financial statements using U.S. GAAP. Thus, comparability does not mean comparable measurements as such but the ability to extrapolate different measurements pursuant to U.S. GAAP from the data that is presented according to IAS, and vice versa.

The debate surrounding the exclusivity of U.S. GAAP for companies traded in the U.S. focuses on the 2300 foreign corporations who meet the NYSE listing standards but are not listed on any U.S. securities exchange.³³ There is a good deal of intuitive appeal, and modest empirical support, for the proposition that a significant reason more foreign firms do not list in the U.S. is because of the increased disclosure costs that accompany a U.S. listing, most notably the need to reconcile their financial statements to U.S. GAAP.³⁴

The comparability issue is an interesting one. Comparability does not, and in practice could not, require that one standard setter's principle be the mirror image of the other. The standard of comparability necessarily anticipates that differences will exist between the principles and approaches embraced by the IASC and those set forth by the FASB. Nevertheless, we should note that by making comparability the issue, both the SEC and the FASB have lifted a double-edged sword to protect their

33. Two organizations that are especially interested in regulatory developments that reduce the friction issuers incur in listing in the U.S. are the NYSE and NASD. Though the New York Stock Exchange fulfills an important public mission and is a non-profit organization, it nevertheless seeks a healthy bottom line. The NYSE's net income in 1997 exceeded \$86 million, with sixty percent of its \$639 million in revenues arising from listing fees and trading fees. See 1997 NYSE Annual Report 47. Listing fees are an on-going expense of companies whose shares are traded on the NYSE and are not less than \$51,550. Similarly, issuer-based fees are the second major source of revenue for the NASD: When coupled with fees earned from the distribution of market data and transaction-based fees each being dependent on the number of issuers traded within the NASD market, they account for sixty percent of the NASD's overall revenue. See 1997 NASD Annual Report 44, 48. Specifically, the NASD received fees of \$267,811,000 and \$113,019,000 for market information and transaction service fees, and issuer fees, respectively, in 1997, and reported total revenues of \$634,380,000. See *id.* at 48.

34. See Gary C. Biddle & Shahrokh M. Saudagaran, *The Effects of International Disclosure Levels on Firms' Choices Among Alternative Foreign Stock Exchange Listings*, 1 *J. Int'l Fin. Manag. & Acct.* 55 (1989) (providing empirical evidence that relative demands of disclosure requirements play an important role in the decision where to obtain a foreign listing). Survey results of 35 foreign listed companies and 40 unlisted firms (whose ADRs are traded in the U.S. over-the-counter market) found that 51 percent of the listed firms experienced problems reconciling their financial statements to U.S. GAAP and 55 percent of the unlisted firms identified the reconciliation requirement as a reason for not listing their securities in the U.S. See James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 3 *Stan. J. L. Bus. & Fin.* 51, 64, 69 (1997). But see Pat McConnell, *Practical Company Experience In Entering U.S. Markets: Significant Issues and Hurdles From the Advisor's Perspective*, 17 *Fordham Int'l L.J.* S120, S122-24 (1994) (investment banker reporting experience that once foreign issuers appreciate the strength provided by U.S. GAAP they no longer view the reconciliation requirement as a disadvantage).

present high ground. On the one hand, evidence of many or even a few important differences separating IAS from U.S. GAAP can easily be seen as supporting the position that the IASC is the brewer of GAAP-lite: having come up short, it must return to further distill its standards before they will be accepted in SEC filings. On the other hand, as the differences separating IAS from U.S. GAAP become fewer and fewer, both the burdens on the issuer and the information value to investors of reconciling to U.S. GAAP diminish. What then may be the SEC's position? With diminished additional information value through the reconciliation process, we might easily conclude that the battle is over and IAS are acceptable in SEC filings. But such a process, as discussed later, invites a host of political considerations that challenge both the regulatory sovereignty and continuing vitality of the SEC with respect to financial reporting.³⁵ Thus, politically, the near comparability of IAS may well be invoked *against* those urging the acceptability of IAS in SEC filings. The proponents of the status quo can easily argue that the burdens of complying with the need for such sovereignty are not great given the small differences that separate the IAS from U.S. GAAP.

So viewed, the friction that surrounds the continuing requirement that foreign issuers reconcile their financial statements to U.S. GAAP is significant only when there are material differences between IAS and U.S. GAAP. When this exists, issuers incur non-trivial costs to carry out the reconciliation, and the materiality of differences between GAAP and IAS raises concern that investors not armed with the reconciliation cannot make meaningful comparisons between U.S. and non-reconciling firms. On the other hand, if the gulf between IAS and U.S. GAAP is minor, the SEC's acceptance or non-acceptance of IAS is largely formalistic since the reconciliation burden to issuers is not great and investors would have little need for the issuer to perform the reconciliation since they could easily do it themselves. Thus, the SEC's consideration of IAS on the grounds of comparability has its own Catch 22: IAS will be acceptable when there is the least interest by issuers and investors whether the SEC filings conform to U.S. GAAP or IAS. Some may even argue that the time has already come when the SEC's position on IAS is irrelevant. Here we should take note of the significant increase in recent years in the number of

35. The biggest political issue is whether to limit IAS to foreign issuers or to permit domestic firms to also satisfy SEC reporting requirements with IAS. Not to do so will provoke self-selecting and self-serving complaints by domestic issuers that the SEC has facilitated a situation in which their foreign competitors have lower capital costs in U.S. markets than U.S. firms have because of the lower disclosure demands imposed by IAS. See Donald J. Moulin & Morton B. Solomon, *Practical Means of Promoting Common International Standards*, CPA Journal, Dec. 1989, at 38. As observed earlier, comparability of measurement standards, while important, is not the sole or even dominant concern. The SEC must also decide whether the foreign firm's auditors are likely to meet the auditing procedures, practices and professional standards it demands of their U.S.-based counterparts. Comparability of measurement standards may, therefore, be found, but comparability with respect to the foreign firm's home auditing profession may be lacking.

foreign issuers subjecting themselves to U.S. reporting requirements by listing their shares in the U.S.³⁶ Additionally, critics of the SEC's adherence to U.S. GAAP argue that foreign issuers' reconciliation to U.S. GAAP is not useful to investors, a point examined in the remainder of this section.

A well-accepted way to examine whether investors value a particular type of financial information—for example, a foreign company's earnings as determined by U.S. GAAP—is through event studies. These studies examine whether the disclosure of the type of information being studied has a statistically significant impact on the disclosing company's stock price.³⁷ Such investigations occur through event studies which seek to isolate whether the disclosed information has an observable impact on the disclosing company's stock price. If, on the one hand, the event study supports the view that the disclosure practice has no observable impact on the stock's price or volume, it is easy to conclude that the costs associated with the information's disclosure are not worth their meager benefits. On the other hand, if the information does have a statistically significant impact on the security's price, the next question is whether the costs of disclosure outweigh their social benefits. In a global economy, therefore, an important source of disclosure cost is the penalties incurred by U.S. investors who are forced to pursue their investment objectives in foreign markets where transaction costs are higher, the bid and asked spreads are greater, and they face less liquidity.³⁸

36. Between 1994 and 1998 the number of foreign firms listed on the NYSE grew from 204 to 379, thus representing 12% of the 3114 firms listed on the NYSE. See 1998 NYSE Annual Report 28. The number of foreign issues traded on NASDAQ increased from 350 to 484 between 1994 and 1995. See NASDAQ ADRS and Foreign Securities 1984-1999, <<http://www.nasdaq.com/mr3g.html>>.

37. But see Carol A. Frost & Grace Pownall, A Comparison of the Stock Price Response to Earnings Disclosures in the United States and the United Kingdom, 11 *Contemp. Acct. Rev.* 59, 79-80 (Summer 1994) (markets have different clienteles and, because the U.S. is less of an institutional market than the London Stock Exchange, there is likely to be systematically greater stock price change to information in the U.S. than in London). But to the extent the U.S. market reflects statistically significant price or volume changes in response to the new disclosure of a U.S. GAAP reconciliation that is based on previously disclosed foreign accounting information, it would appear such a clientele effect of different markets is irrelevant.

38. See William J. Baumol & Burton G. Malkiel, Redundant Regulation of Foreign Security Trading and U.S. Competitiveness, *J. App. Corp. Fin.*, Winter 1993, at 19, 27. To the extent that investors do not acquire the foreign issuer in a foreign market, the burdens of regulation are the impairment of investors' ability to diversify internationally. See *id.*

Since the users of financial information are not required to bear the costs of disclosure, their demand for this free good is necessarily inelastic. Thus, from the user's point of view, more is always better. See generally John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 *Va. L. Rev.* 717 (1984). But more is not always better from the issuer's perspective. Disclosure costs transcend the direct financial statement preparation costs, though preparation costs are by no means trivial. Disclosure costs also include such important considerations as potentially inviting competitors to geographical or product markets because SEC-mandated product line information reveals that extraordinary profits are being earned, or alerting competitors of

The leading event study on the issue of GAAP reconciliation examines 101 firms representing 20 countries for a total of 467 reconciliations over a ten year period ending in 1991.³⁹ Stock price reaction to earnings reconciled to U.S. GAAP failed to provide strong evidence that the reconciled earnings were useful to investors, especially with respect to reconciliations bearing on shareholder equity and earnings.⁴⁰ On closer analysis, the process of reconciliation to U.S. GAAP has its greatest relevance to investors in terms of the new information reconciliation provides. Reconciliations that reported differing asset values, such as the treatments of goodwill arising from acquisitions or adjustments related to taxation differences existing between financial and tax accounting, were most important to investors.⁴¹ Nevertheless, the study cautions that in light of the nature of the reporting differences highlighted in the reconciliation related to "goodwill, asset revaluations, taxation, and a conglomeration of other items, it seems plausible that a careful investor may be able to reconstruct the value-relevant data from the reports presented in the home country."⁴² Moreover, removal of such asset value differences between U.S. GAAP and non-U.S. GAAP makes the reconciliation less relevant to investors.⁴³

An important qualification to the study's finding that earnings reconciliations yield information that is not helpful to investors is the fact that the average reconciliation was published five to six months following the close of the firm's fiscal year. This implies that the utility of reconciliation was greatly eroded by the more current and, hence, significant information then available regarding the firm's operations. Simply stated, the reconciliation's usefulness to investors was all but eliminated by the tardiness of the disclosure of the reconciled information. Reconciled disclosures become available months after the fiscal period on which they bear.⁴⁴ By the time of the reconciliation, the events on which the reconciliation reports are stale and the investors have other, more current in-

a forthcoming initiative because of significant prospective capital expenditures that are revealed in the firm's management discussion and analysis portion of its SEC filings. See Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 *Brook. L. Rev.* 763, 772 (1995). Issuers may therefore seek to avoid such risks by raising their capital in markets whose disclosure demands do not portend such ominous consequences.

39. 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).

40. See id. at 246-47.

41. See id. at 251.

42. Id. at 262.

43. See id.

44. The latest date for filing Form 20-F is six months after the fiscal year; the average for the sample was between five and six months. See id. at 234. More than 96 percent of the earnings announcements for the sample that appeared in the *Wall Street Journal* were earnings determined pursuant to non U.S. GAAP. See id. at 236. Hence, the Form 20-F reconciliation does not receive the same publicity as do earnings measured by non U.S. GAAP.

formation that bears on the firm's financial performance and position, albeit information that is prepared according to the standards of the issuer's home country.⁴⁵ Thus, in spite of its problematic focus on the information content of financial statements reconciled to U.S. GAAP when there is much more current information available regarding the issuers, the leading event study does support the view that the reconciliation process produces new and useful information regarding certain measurement differences related to asset balances. Its findings are consistent with the belief that investors would benefit even more if the revelations produced through reconciliation to U.S. GAAP were released in a more timely way. The problem appears to be not so much with the benefits of the new information produced through reconciliation, as with the tardiness of the information reconciliation generates.

III. SEEKING LINKS BETWEEN RECONCILIATION AND THE BENEFITS OF A U.S. LISTING

The overall evidence indicates that companies experience an increase in the market value of their shares upon obtaining a secondary listing. However, studies are mixed as to whether the initial price increase dissipates over the year following the initial listing.⁴⁶ Interestingly,

45. One early study found that U.S. capital markets do not reap the full benefits of reconciliations to U.S. GAAP. A phenomenon common to foreign issuers is that they are much less timely in making their SEC filings than are U.S. companies. See Carol A. Frost & William R. Kinney, Jr., *Disclosure Choices of Foreign Registrants in the United States*, 34 J. Acct. Res. 67, 81 (1996). Moreover, they systematically fail to comply fully with SEC requirements in their reconciliations and disclosures. See *id.* Professors Frost and Kinney also observed that foreign issuers chose strategically when opting for Item 17 over Item 18 of Form 20-F such that those preferring greater secrecy chose the former. See *id.*

More recent analysis, however, supports the view that as foreign issuers have gained greater experience under SEC reporting requirements, their record for timeliness, thoroughness, and voluntary reporting has improved, at least for those whose shares are required to comply with the demands of Form 20-F because their securities are listed in the U.S. See Christian A. Botosan & Carol Ann Frost, *Regulation, Disclosure and Market Liquidity* 18-20 (July 1998) (unpublished manuscript) (on file with the author).

Differences in the approaches towards disclosure taken by U.S. and foreign issuers are illustrated by evidence comparing disclosure practices of U.S. issuers to those of British companies. This comparison supports the view that the observed time lags by foreign issuers satisfying U.S. disclosure demands do not reflect friction within the regulatory system but rather deeper cultural forces. See Carol A. Frost & Grace Pownall, *Accounting Disclosure Practices in the United States and the United Kingdom*, 32 J. Acct. Res. 75 (Summer 1994). For a study documenting that there are great variations in the timeliness of disclosures and information content across countries, see Andrew Alford et al., *The Relative Informativeness of Accounting Disclosures in Different Countries*, 31 J. Acct. Res. 183, 213 (Supp. 1993) (finding Denmark, Germany, Italy, Singapore and Sweden the weakest of 17 countries studied in terms of timeliness and information content of disclosures).

46. See Gordon J. Alexander et al., *International Listings and Stock Returns: Some Empirical Evidence*, 23 J. Fin. & Quantitative Analysis 135 (1988) (13 percent decline for non-Canadian shares following secondary U.S. listing); Vihang R. Errunza & Darius Miller, *Market Segmentation and The Cost of Capital In International Equity Markets* (Sept.

such post-listing declines are also experienced by U.S. firms that migrate to the NYSE from either the Amex or NASDAQ. It is plausible that post-listing declines, whether experienced by a U.S. firm listing on the Big Board or a foreign firm obtaining a secondary listing in the U.S., are market reactions to company-specific factors: firms that obtain a secondary listing typically do so during a period of abnormal growth or when they have entered the mature end of their life-cycles.⁴⁷ Thus, the negative post-listing price effects appear not to be in response to the listing decision itself.⁴⁸ The most positive impact of a secondary listing is improved liquidity for the company's shares,⁴⁹ with improvements frequently even in the firm's home market.⁵⁰ Studies show that cross-border listings lead

1998) (unpublished manuscript) (on file with the author) (thirty-seven percent decline in cost of capital persists three years following listing in the U.S.); Stephen R. Foerster & G. Andrew Karolyi, *The Effects of Market Segmentation and Illiquidity on Asset Prices: Evidence from Foreign Stocks Listing in the U.S.*, Ohio State Working Paper (1996) (abnormal positive returns in the week of secondary U.S. listing followed by 10 percent decline during the 12 months following such listing) [hereinafter, *Effects of Market Segmentation*]; Stephen R. Foerster & G. Andrew Karolyi, *International Listings of Stocks: The Case of Canada and the U.S.*, 24 J. Int'l Bus. Stud. 763 (1993) (11 percent decline in share value of Canadian stocks in year following listing on NYSE, Amex or NASDAQ) [hereinafter *International Listings*]; Darius P. Miller, *The Market Reaction to International Cross-listings: Evidence From Depositary Receipts*, 51 J. Fin. Econ. 102, tbl.4, part A (1999) (insignificant abnormal returns follow secondary listing). Of interest is that there is a similar post-listing decrease for U.S. firms that obtain a secondary listing abroad; however, the decline is not nearly as great as that experienced by foreign firms who seek a secondary listing in the U.S. See, e.g., John J. McConnell & Gary C. Sanger, *The Puzzle in Post-Listing Common Stock Returns*, 42 J. Finance 119 (1987). For other studies on market reactions associated with secondary listings see Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 Va. J. Int'l L. 563, 578-80 tbl.2, 585 tbl.3, 593 tbl.4, 601 tbl.5 (1998).

47. See John J. McConnell et al., *A Survey of Evidence on Domestic and International Stock Exchange Listings with Implications for Markets and Managers*, 4 Pac. Basin Fin. J. 347 (1996) (larger and more mature companies tend to seek secondary listings).

48. See Foerster & Karolyi, *Effects of Market Segmentation*, supra note 46; Foerster & Karolyi, *International Listings*, supra note 46.

49. There are several benefits from increased liquidity. A "deeper" market makes the security more attractive to institutional investors for whom fiduciary obligations or trading strategies require the ability to quickly dispose of portfolio securities. Also, in a deeper market the spread between bid and asked prices is usually lower, thereby reducing overall transaction costs for purchasers and sellers. See Seha M. Tinic & Richard R. West, *Marketability of Common Stocks in Canada and the U.S.A.: A Comparison of Agent Versus Dealer Dominated Markets*, 29 J. Finance 729 (1974). Cf. Paul Clyde et al., *Trading Costs and Exchange Delisting: The Case of Firms that Voluntarily Move from the American Stock Exchange to the NASDAQ*, 52 J. Finance 2103, 2103 (1997) (quoted and effective spreads widen for firms moving from AMEX to NASDAQ). And, the so-called "liquidity hypothesis" provides that informed traders much prefer deeper markets, which enable them to conceal their trading intentions. See Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 Econometrica 1315 (1985).

50. Increased liquidity is the most frequent explanation given by foreign managers for seeking a secondary listing in the U.S. See U. Mitto, *Managerial Perceptions of the Net Benefits of Foreign Listing: Canadian Evidence*, 4 J. Int'l Fin. Mgmt. & Acct. 40 (1992).

to an increase in total and domestic trading volume.⁵¹ Though trading volume tends to concentrate in the market with the lowest trading cost, there is evidence that the trading volume in the home market is not adversely affected by obtaining a listing in a highly competitive foreign market.⁵² Though liquidity generally improves in the home market, this comes with the correlative effect of greater turnover of home market shares following a cross-border listing than before obtaining such a listing.⁵³ There is also evidence that cross listings, on average, enhance the value of the stock in the home market.⁵⁴

The bulk of the advantages gained from cross listing come from the foreign (secondary) market effects on the company itself. Indeed, the primary reason quoted by executives for seeking a secondary listing is to gain access to a broader pool of investors and the sources for capital. On the latter point, the U.S. presently excels in having available more investable capital at lower costs than any other market. Thus, financial officers, like Willie Sutton,⁵⁵ steer their enterprises toward where the money is. A secondary listing also addresses important domestic market risks that may adversely impact a firm's securities.

With markets segmented, those stocks traded within individual markets are affected by the regulatory restrictions, information demands, economic and political forces, and foreign exchange considerations that affect the riskiness of each market. Though diversification is customarily viewed from the investor perspective, its benefits can also fall on a security's issuer. For example, Asian companies that have secondary listing in the U.S. market have fared much better than their counterparts with only domestic listings.⁵⁶ In the quarter following the recent current currency crisis that started in Thailand, Southeast Asian companies with a secondary listing experienced a 38 percent market decline whereas large

51. See Kent Hargis, *ADRs in Emerging Equity Markets: Market Integration or Fragmentation* (1997).

52. See *id.*

53. See Katherine Smith & George Sofianos, *The Impact of an NYSE Listing on the Global Trading of Non-U.S. Stocks*, NYSE Working Paper 97-02 (June 1997) (average holding periods in the home market dropped from two years to one year following listing on the NYSE).

54. See *id.* (during the time covered by the study of 128 non-U.S. stocks listed with a secondary listing on the NYSE, there was an average 24 percent increase in the primary market value of the cross listed stocks).

55. When asked why he robbed banks, Sutton is said to have responded, "that's where the money is." A smart man, but not very successful at his trade, Sutton, during one of his many incarcerations, denied ever making the remark. He attributed it "to some enterprising reporter." Paul F. Boller, Jr. & John George, *They Never Said It—A Book of Fake Quotes, Misquotes, and Misleading Attributions* 121 (1989).

56. See Edward Luce, *US Listing Boosts Asian Companies*, *Fin. Times*, Nov. 4, 1997, at 29 (Asian companies with a secondary listing on the NYSE or NASDAQ outperformed their domestic rivals over five years). This no doubt also reflects the influence of the firms diversifying not only market risk but their operating risks by engaging in business in more than one country or region.

Southeast Asian companies with no secondary listing declined 43.5 percent.⁵⁷ Thus, secondary listings tend to buoy stocks against domestic and regional shocks. At the same time, the returns of ADRs remain closely correlated with the prevailing market index of their home country. Thus, even though the risks of the home market are somewhat moderated by the secondary listing, the macro economic impacts of their home market continue to affect the securities' return.⁵⁸

Individual firms considering a secondary listing, therefore, are most likely to do so because they believe it will reduce their cost of capital.⁵⁹ Using the classic measurement of risk—the individual security's co-variance to the market as a whole—there is strong evidence that a secondary listing reduces the individual security's volatility with corresponding favorable effects on the firm's cost of capital.⁶⁰ Other measurements of changes in risk and return following a secondary listing also support the view that a secondary listing favorably affects the firm's cost of capital.⁶¹

Finally, a secondary listing can produce a range of positive externalities. A secondary listing tends to lead to greater media coverage and exposure to analysts, both of which can have a positive impact on the share's value and overall market liquidity. Similarly, a secondary listing transforms a company from a foreign company into a global company so that its products enjoy a broader appeal internationally. Furthermore, diversification of share holdings across several markets introduces significant regulatory and practical obstacles in the path of anyone contemplating a hostile takeover of the firm.⁶² Not only do conflicting regulatory

57. See *id.*

58. See Philippe Jorion & Darius Miller, *Investing in Emerging Markets Using Depositary Receipts*, *Emerging Markets Q.*, Spring 1997, 7, 12 (small number of ADRs of 7 emerging market countries reflect nearly ninety percent co-variance of composite emerging market index even though the composite index is comprised of a larger number of companies from the same countries with proportional weighting per country).

59. For a theoretical discussion of how multiple listings should reduce the firm's cost of capital, see Gordon J. Alexander et al., *Asset Pricing and Dual Listing on Foreign Capital Markets: A Note*, 42 *J. Finance* 151 (1987); Fischer Black, *International Capital Market Equilibrium with Investment Barriers*, 1 *J. Fin. Econ.* 337 (1974); Rene Stulz, *On the Effects of Barriers to International Asset Pricing*, 25 *J. Finance* 783 (1981).

60. See Alexander et al., *supra* note 46. (non-Canadian firms obtaining a U.S. listing experience a statistically significant 3.16 decline in return following listing). Similar positive effects have been observed for U.S. companies. See Oscar Varela & Sang H. Lee, *International Listings, The Security Market Line and Capital Market Integration: The Case of U.S. Listings on the London Stock Exchange*, 20 *J. Bus. Fin. & Acct.* 843 (1993) (240 basis point decline in annual cost of capital for 168 U.S. firms listing on London Stock Exchange).

61. See, e.g., Anant K. Sundaram & Dennis E. Logue, *Valuation Effects of Foreign Company Listings on U.S. Exchanges*, 27 *J. Int'l Bus.* 67, 67 (1996) (secondary listing has favorable impact on price-to-cash earnings, price-to-book value and price-to-earnings).

62. The literature on this topic is extensive. See, e.g., Jill E. Fisch, *Imprudent Power: Reconsidering U. S. Regulation of Foreign Tender Offers*, 87 *Nw. U. L. Rev.* 523 (1993); Roberta S. Karmel, *Transnational Takeover Talk—Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66

demands pose formidable obstacles to the conduct of hostile takeovers, but foreign investors may also have less appetite for accepting high-yield corporate debt in leveraged buyouts than would their American counterparts.⁶³

SEC disclosure standards, of course, cannot accept full credit for the benefits that foreign issuers reap through listing their shares in the U.S. For example, there are many other features of U.S. markets that can easily be seen as powerful contributors to their greater liquidity. The extensive financial infrastructure that is localized in New York City and the regulatory and cultural forces that provide the inertia that retains substantial investable funds within the world's richest nation both powerfully influence the greater liquidity that so characterizes U.S. markets. Against such other forces, one might ask, just what role does the SEC's adherence to U.S. GAAP have in contributing to such observable phenomena as foreign firms having lower risk or greater volume following their being listed in the U.S.? We might argue that the greater transparency provided by reconciling their financial statements to U.S. GAAP is reflected in investors accepting a lower return for owning the shares than if less information were disclosed. A volume increase would similarly arise for foreign issuers who reconcile their financial statements to a more trustworthy reporting system. On the other hand, the SEC's critics will argue that there is weak evidence that SEC disclosure standards, and rigid adherence to U.S. GAAP in particular, contribute materially to the benefits foreign issuers reap with a secondary listing in the U.S. Indeed, this is just a part of the long-simmering debate on the social benefits of the U.S. securities laws. Data has been amassed by both camps in the long running battle over whether the mandatory disclosure standards are beneficial or superfluous.⁶⁴ It is likely that the question of whether SEC disclosure stan-

U. Cin. L. Rev. 1133 (1998); Arthur R. Pinto, *The Internationalization of the Hostile Takeover Market: Its Implications for Choice of Law in Corporate and Securities Law*, 16 *Brook. J. Int'l L.* 55 (1990). For an illustrative discussion of thoughtful accommodations to domestic investors in foreign firms who may be disadvantaged if local takeover requirements are not relaxed, see SEC, *Cross Border Tender Offerings, Business Combinations and Rights Offerings*, Sec. Act. Rel. No. 7611, Exch. Act. Rel. No. 40678, Nov. 13, 1998, in [Current] *Fed. Sec. L. Rep. (CCH)* ¶ 86,060.

63. See Michael R. Sesit, *More U.S. Concerns Seek To Be Listed Overseas*, *Wall St. J.*, June 10, 1985, at 6.

64. The classic works on this topic are George Bentson, *The Value of The SEC's Accounting Disclosure Requirements*, 44 *Acct. Rev.* 515 (1969) (62 percent of NYSE listed firms voluntarily disclosed financial information prior to mandated disclosure in 1934), and George Stigler, *Public Regulation of Securities Markets*, 37 *J. Business* 117, 122 (1964) (though finding that stocks were less volatile after 1934, he argues this documents they have harmfully closed capital markets to riskier firms). See also Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359, 2373-83 (1998) (reviewing empirical research and commentary on the benefits of the securities acts' mandatory disclosure requirements). The most elegant and ardent proponent of the benefits of the securities laws mandatory disclosure rules is Dean Joel Seligman. See Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 *J. Corp. L.* 1 (1983).

dards in fact cause more harm than good, by deterring foreign issuers from listing their securities in the U.S., will prove as problematic as the overall debate on the merits of mandatory disclosure rules ushered in by the U.S. securities laws seven decades ago.⁶⁵

There is, however, important evidence of the benefits foreign issuers reap by reconciling their financial statements to U.S. GAAP. This evidence is presented in the recent study by Professor Darius Miller examining firms that upgraded from a Level I to listing in the U.S.⁶⁶ Such an upgrade requires the upgrading firm to comply with the additional SEC demand of annually filing Form 20-F, which mandates reconciliation of its home country financial statements to U.S. GAAP. Miller found a statistically significant positive reaction to the announcement of the upgrade.⁶⁷ The data must, however, be interpreted cautiously. Miller examines a relatively small sample, there being only 16 firms that undertook the upgrade for the years 1985–95. Moreover, the observations are consistent with several different interpretations. It is possible that investors respond favorably to the enhanced disclosure standards, most significantly prospective reconciliations of their financial statements to U.S. GAAP. However, one must also consider the likelihood that investors respond favorably to such an upgrade because of the increased liquidity they will enjoy on the NYSE, AMEX or NASDAQ.⁶⁸ It is not easy to separate these two possible explanations from each other based on the observations captured in Miller's study. Some support for the former, without detracting from the latter, is the fact that Miller's results are consistent

65. Compare Carol A. Frost & Mark H. Lang, *Foreign Companies and U.S. Securities Markets: Financial Reporting Policy Issues and Suggestions for Research*, 10 *Acct. Horizons*, March 1996, 95, 101–02 (reviewing lack of clear evidence that SEC disclosure requirements deter foreign companies from listing in the U.S.) with William J. Baumol & Burton G. Malkiel, *Redundant Regulation of Foreign Security Trading and U.S. Competitiveness*, 5 *J. Applied Corp. Fin.* 19, 21 (Winter 1993) (U.S. disclosure regulation deters foreign issuers from listing in the U.S. and forces U.S. investors to incur nontrivial costs to pursue foreign investments).

66. See Miller, *supra* note 46.

67. See *id.* tbl.6 (observed an abnormal positive return of 0.0135 on the date of announcement which is statistically significant at the 0.01 level; cumulative abnormal return doubles in the 25 days following the announcement). His finding for upgrades is consistent with his analysis of the impact on share values following the announcement of a secondary listing in the U.S. where the observable increase in return is far greater when that listing is on the NYSE or NASDAQ than it is for the OTC pink sheets. See *id.* tbl.4, panel A.

68. Increased liquidity is related to the home country's restrictions on capital flows in and out of its country which can chill offshore investors' desire to pursue a firm's security solely in its home country. A secondary listing avoids such home country restrictions and thus addresses this cause for weak liquidity in the home country. Professor Miller finds that secondary listings of foreign firms from countries with greater capital controls are associated with greater abnormal returns following such listing than are experienced by firms from countries with no or fewer such controls. *Id.* at 12–14.

with the earlier discussed event study finding that the enhanced disclosure of reconciling to U.S. GAAP is value-relevant to investors.⁶⁹

Nevertheless, we must recognize that there is not overwhelming or even strong empirical support for an unwavering commitment to U.S. GAAP reconciliation as a condition for listing shares in the U.S. Though the empirical results discussed are certainly consistent with the view that there are benefits flowing from the U.S. GAAP reconciliation, any linkage between the benefits that are observed and the reconciliation process is confounded by other influences which are likely to produce the same observed benefits. Also lacking from this calculus is any measure of the costs that arise from continuing the reconciliation process. Once again we are confronted with the question of whether comparability has come at too great a price. Indeed, there is yet another question, addressed in the next section, of whether the SEC has undercut the benefits of comparability through its other regulatory initiatives.

IV. QUALIFIED DEPARTURES TO THE COMPARABILITY PRINCIPLE

A. *The Level I ADR Market*

Because the weighing of disclosure costs and benefits is a quarrelsome endeavor, we might first ask whether the issue is worth fighting over. On this point, consider that at the end of 1997, 851 foreign companies were traded in U.S. markets without reconciling their financial statements to U.S. GAAP or otherwise conforming their disclosures to SEC guidelines.⁷⁰ Pursuant to Rule 12g3-2(b), foreign issuers that are not listed on either NASDAQ or a national securities exchange may satisfy the Exchange Act's continuous reporting requirements by filing with the SEC whatever disclosures they are required to make in their home country.⁷¹ This market is more commonly referred to as the Level I ADR market.⁷² Simply stated, Rule 12g3-2(b) turns a blind eye to comparability. It assures that U.S. investors are confronted daily with the choice of purchasing, in the U.S. over-the-counter market, the securities of foreign issuers whose disclosures, both in terms of format and attention to detail, do not rival that of U.S. firms. Therefore, the SEC may have already so compromised the comparability principle that, much like the genie who has escaped from the lantern, it is too late to reverse events. On close analysis, this is not the case: The SEC has not compromised the comparability principle.

69. See Amir et al., *supra* note 39 and accompanying text.

70. Letter of Mr. George Sofiano, New York Stock Exchange, citing data from the Bank of New York [hereinafter Sofianos Letter] (on file with the *Columbia Law Review*).

71. See 17 C.F.R. § 240.12g3-2(b) (1997).

72. Level II ADR's are those listed on an exchange or NASDAQ and, therefore, must comply with the periodic filing requirements set forth in Form 20-F. Level III ADRs involve foreign issuers that enter U.S. markets to raise capital through public offerings and which, in addition to Form 20-F, must also comply with the disclosure requirements of the Securities Act of 1933 by registering with the SEC the securities to be offered to the public.

In practice, Rule 12g3-2(b) and the Level I ADR market it facilitates represent a small compromise in the principle of comparability. In 1997, the overall trading volume of the Level I ADR market was \$200 million whereas the trading volume for listed foreign equities in the U.S. the same year was \$2.7 billion.⁷³ The trading in Rule 12g3-2(b) securities pales further in comparison to the nearly \$7 trillion trading in the U.S. for all securities in 1997. Even though the Level I ADR market is insignificant in comparison with markets in which domestic issuers trade, there appears nevertheless to be an encroachment on the principle of comparability. Lifting U.S. disclosure demands for foreign issuers whose securities were not listed in the U.S., while imposing those demands on domestic issuers regardless of whether they were listed or traded in the over-the-counter market, seems antithetical to comparability.

The lack of comparability posed by Level I ADRs is exacerbated by several other characteristics of the Level I ADR market. First, firms traded there provide fewer interim reports than do foreign firms who are listed (Level II ADRs); this is true even among Level I firms whose market capitalization exceeds \$1 billion.⁷⁴ Second, many fewer analysts follow Level I firms than follow foreign firms subject to SEC reporting requirements.⁷⁵ Finally, Level I firms provide less disclosure overall and in a less timely fashion than do their regulated counterparts.⁷⁶ Thus, Level I ADR firms provide significantly less disclosure about their affairs than do other firms, foreign or domestic, that are traded in U.S. markets.

In 1990,⁷⁷ the NASD, through NASDAQ, initiated its OTC Bulletin Board Service (OTCBB) for non-NASDAQ OTC securities with the purpose of enhancing its members' market making functions in over-the-counter securities. The OTCBB provides real-time access to quotation information through authorized NASDAQ workstations. At first, the SEC embraced the system, believing it would provide better executions of customer orders, enhance price discovery and facilitate surveillance in the non-NASDAQ over-the-counter securities.⁷⁸ Its action favored liquidity and price execution concerns for investors over their information needs, since OTCBB facilitated an active market for unregistered securities that

73. See Sofianos Letter, *supra* note 70, citing as sources Bank of New York and Citibank.

74. See Botosan & Frost, *supra* note 45, at 20. The Level I firms in this study were hardly "small" since their average market capitalization was greater than the mean value of the 100 largest nonfinancial firms listed on NASDAQ. See SEC Report, *supra* note 12, at 9.

75. See Botosan & Frost, *supra* note 45, at 28 tbl.3.

76. See *id.* at 18.

77. See Securities Exchange Act Release No. 27975 (May 1, 1990). Permanent approval of the OTCBB was sought in 1992. See Securities Exchange Act Release No. 30766 (June 1, 1992).

78. However, brokers were permitted to update quotation for unregistered foreign securities—the Level I ADRs—only twice a day: once between 8:30 and 9:30 a.m. and once between noon and 12:30 p.m. See NASD Notice to Members 98-7 (1998); Securities Exchange Act Release No. 38456 (March 31, 1997), 62 F.R. 16,635, 16,638 (April 7, 1997) [hereinafter SEC Release].

do not provide disclosure comparable to other publicly traded securities. The SEC recently reversed course.⁷⁹ After March, 1998, the securities of foreign issuers relying on the exemption in Rule 12g3-2(b) will no longer be quoted on the OTCBB, and will instead trade on the National Daily Quotation Sheets,⁸⁰ more commonly known as the "pink sheets."⁸¹ By confining trading in Level I ADRs to the inefficient pink sheet market the SEC has taken an important step towards containing encroachment on the principle of comparability that exists when foreign issuers are permitted to satisfy SEC disclosure requirements solely through their home country disclosure materials. This step nevertheless poses to many issuers a Hobson's choice: the issuer must either undertake what it perceives to be the burdens of reconciling its financial statements to U.S. GAAP, or have its shares traded in the U.S. in a less transparent and more inefficient market. Consequently, 335 Level I ADRs were removed from the OTCBB on April 1, 1998. Interestingly, among those choosing the pink sheets were such international corporate icons as Bayer, Credit Suisse, Deutsche Bank, Mitsubishi, Nestle, Novartis, Peugeot, Siemens, and Volkswagen.⁸²

The pink sheet market has disadvantages of its own. Since securities traded in the pink sheets are thinly traded,⁸³ there are large spreads between bid and asked prices and investors incur high transaction costs when trading. A former director of the SEC's enforcement efforts referred to the market as "a national problem and a serious one."⁸⁴ Thus, one penalty incurred by issuers who opt for the pink sheet market is their

79. See SEC Release, *supra* note 78, at 16,638. See also James Cochran et al., *Foreign Equities and U.S. Investors: Breaking Down the Barriers Separating Supply and Demand*, 2 *Stan. J.L. Bus. & Fin.* 242 (Spring 1996).

80. See SEC Release, *supra* note 78.

81. A few Level I ADRs have filed Form 20-F and continue to be traded on the OTCBB; however, the trading volume of these securities is extremely low. For example, in August 1998 the average daily share volume was less than 1.7 million shares with an average dollar volume of \$1,119,681; this compares with domestic securities, whose share volume was in excess of 100 million shares with an average daily trading volume approaching \$80 million. See NASD, 1998 OTC Bulletin Board Fact Book and Company Directory, Trading Data, August, 1998. Nevertheless, some very substantial international companies, for example Nestle, Nintendo and Deutsche Bank, choose to trade only in the pink sheets rather than comply with the more rigorous SEC disclosure standards that apply to listed companies.

82. See *Unregistered Foreign Equities and ADRs Will Be Ineligible for OTCBB*, OTC Bulletin Board, General News, March 11, 1998.

83. To be sure, most of these companies are too thinly traded to capture the attention of institutional investors whose trading dominates larger securities markets. But this factor merely points to the irony of the U.S. securities laws providing less paternalism for securities traded in markets dominated by individual investors than it provides for securities traded on the NYSE or NASDAQ where more sophisticated traders are found.

84. Bruce Ingersoll, *School for Scam: Fraud is Rife in Market for Pink Sheet Stocks*, *Securities Officials Say*, *Wall St. J.*, Feb. 2, 1988, at 1. (quoting Mr. Gary Lynch, Director of Enforcement, Securities and Exchange Commission).

shares trade at a deep discount versus those quoted on the OTC Bulletin Board and deeper yet compared to listed securities.⁸⁵

B. *The Rule 144A Institutional Market*

Any discussion of comparability also needs to consider Rule 144A,⁸⁶ which establishes an institutional trading market. The major contribution of Rule 144A is that it facilitates foreign and domestic issuers in raising capital in the U.S. without the hurdles associated with the full registration process. Absent the rule, shares that have not been registered with the SEC cannot be resold for one year, and then only pursuant to limitations related to the availability of public information, volume of shares sold and the manner of sale.⁸⁷ Overall, Rule 144A allows the rapid resale of certain securities to qualified institutional buyers. With such resale possible, unregistered securities are more attractive to institutional investors, which in turn makes it possible for foreign and domestic issuers to raise capital by offering shares to those qualified to participate in the Rule 144A market for unregistered securities. Rule 144A, like Rule 12g3-2(b), turns a blind eye toward the comparability principle; it imposes an information requirement only for issuers that are not subject to the Exchange Act's reporting requirements or exempt by virtue of Rule 12g3-2(b). And, even for those issuers that must meet Rule 144A's information requirement, its disclosure burdens are very light. Rule 144A requires issuers that are not reporting companies or exempt under Rule 12g3-2(b) to make available, *upon request* by the purchaser, certain general information including "the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation. . . ."⁸⁸ There is no requirement that such financial statements comply with any particular authoritative body. Moreover, such statements need only be audited "to the extent reasonably available."⁸⁹

85. See Rhonda Brammer, *In the Pinks*, *Barrons*, Feb. 5, 1996, at 20 (median price/earnings ratio of non-pink sheet banks is 13.3 whereas pink sheet traded banks median ratio is 11.9).

86. See 17 C.F.R. § 230.144A (1998).

87. Resales of unregistered securities customarily occur pursuant to the safe harbor provided in Rule 144 which conditions resale on a holding period of not less than one year and subjects such resales to further limitations regarding the number of shares sold and the manner of sale as well as there being certain publicly available information regarding their issuer. See 17 C.F.R. § 230.144(d) (1998). These requirements disappear if the securities have been outstanding for at least two years. See 17 C.F.R. § 230.144(k) (1998).

88. 17 C.F.R. § 234.144A(d)(4)(i) (1998). Though disclosure is not required for reporting companies or those exempted from being such by Rule 12g3-2(b), marketing concerns and fears regarding material omissions or misstatements persist so that the practice is for a good deal of information to be circulated in connection with Rule 144A distributions. See Bradley Jay Gans, *The Mechanics of Rule 144A/Regulation S Underwritings in Securities Offerings* 449-51 (P.L.I. 1998).

89. 17 C.F.R. § 234.144A(d)(4)(i) (1998).

The Rule 144A market clearly dominates all other avenues for foreign issuers to access U.S. capital markets: the yearly dollar amount of securities placed through Rule 144A is approximately 5 percent of the dollar amount of all securities registered with the SEC, and approximately 30 percent of this amount are the securities of foreign issuers.⁹⁰ In addition, at least one-third of the companies that use Rule 144A to raise capital have a market capitalization in excess of one-half billion dollars.⁹¹ Rule 144A, therefore, is used by companies of the size that commonly list their shares on the New York Stock Exchange and that, by definition, are attractive to a broad range of institutional investors. Thus, the SEC exemptions have created an exclusively institutional market as well as an individual investor dominated market for which comparability is not a guiding regulatory standard.⁹²

C. Understanding the SEC's Departure from Comparability

The vibrancy of the Rule 144A market and the broad spectrum of foreign issuers that make up the Rule 12g3-2(b) market reflect the convergence of U.S. regulatory practices with sister countries.⁹³ Their existence underscores the eagerness of investors to participate in markets in which minimal disclosure is mandated by the SEC.⁹⁴ In fact, what we see

90. See SEC, Staff Report on Rule 144A, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,428, 85,687 (Aug. 18, 1994). The number and dollar volume of Rule 144A offerings peaked in 1994. This may reflect attraction of the alternative created by the London Stock Exchange. In 1994, the London Stock Exchange adopted its "Red Book" guidelines for listing Global Depositary Receipts which require only home country accounting and are traded exclusively among institutional investors. Thus, whereas the number of Rule 144A ADR programs increased from 33 to 100 between 1993 and 1994, declining to 45 in 1995, the number of non-U.K. companies traded on the LSE (which includes both traditional listings and Red Book listings) declined from 485 to 464 between 1993 and 1994, but increased to 525 in 1995. See Sofianos Letter, *supra* note 70, citing data of London Stock Exchange and Bank of New York.

91. See Sofianos Letter, *supra* note 70, citing data that is available for 181 of 344 Rule 144A ADR programs (Bank of New York reports there have been 373 such programs since the adoption of Rule 144A in 1990) where 121 of the companies had a market capitalization in excess of \$500 million as of the date of the offering.

92. For some issuers, Rule 144A is an interim step toward listing their shares on the New York Stock Exchange. The NYSE reports that 26 Rule 144A issuers have upgraded to full listings (23 on the NYSE). See Sofianos Letter, *supra* note 70.

93. See Edward F. Greene et al., Concepts of Regulation—The U.S. Model, in *The Future for the Global Securities Market: Legal and Regulatory Aspects* 157, 175-77 (Fidelis Oditah ed., 1996).

94. Nevertheless, we should also be aware that in the case of Rule 144A there are limited competitive disadvantages posed to domestic issuers since they too may resort to Rule 144A to raise capital. There is one distinct disadvantage faced by domestic issuers that is not encountered by foreign issuers: Though both domestic and foreign issuers may not resort to Rule 144A by selling a security already listed in the U.S., this falls more harshly on the domestic issuer than the foreign issuer since the latter may use Rule 144A to syndicate a security that is listed in its home market for which there is ready liquidity whereas domestic issuers may not distribute through Rule 144A a security that is listed in its home market. Because any restriction on resale translates to a discount in the value of

here is a market and regulatory hierarchy within the U.S. which is stratified by varying disclosure obligations and regulatory requirements that restrict investor participation. Economists have long argued that investors are capable of addressing the various disclosure risks presented by issuers by imposing a higher discount to the expected returns of firms whose disclosures pose greater uncertainty.⁹⁵ The SEC's policies actually nurture further stratification.

On the one hand, the SEC imposes no disclosure requirements for its Rule 144A market, but limits that market's investors to qualified institutional buyers.⁹⁶ On the other hand, the SEC permits foreign issuers to meet its continuous disclosure requirements through home country filings, but relegates that trading to the much less transparent pink sheet market. Thus, disclosure itself is not the sole force separating these markets and their relative risk discounts.

V. A MARKET OF MULTIPLE REPORTING STANDARDS

From the preceding section we find that comparability has not been seriously compromised by the SEC; rather, when considering regulatory strategies to address the acceptability of competing disclosure standards such as IAS, comparability has been a central regulatory objective. As seen earlier, as a practical matter, disclosure standards adopted by two separate organizations will not be mirror images of one another—inherent differences exist and will continue to arise. The issue here arises from the inherent differences that necessarily exist between standards set by the FASB, whose culture and focus are exclusively on practices within the U.S., as contrasted with IASC, whose members and focus are much more pluralistic. Even though comparability and rigor are the baseline criteria invoked by the SEC to weigh the acceptability of IAS, there is every reason to believe that they are not being used as criteria for judging the acceptability of IAS in U.S. filings, but rather as criteria for assuring that IAS will always be found wanting. The issue of acceptability of IAS

the security, the availability of the home market for the foreign issuer's security syndicated through Rule 144A suggests it faces a lower cost of capital in such transaction than do domestic issuers. Simply put, the rational QIB should not view the domestic and the foreign issuer as identical, assuming all other factors are the same except the impact of the SEC's nonfungibility requirement.

95. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 682–85 (1984).

96. See 17 C.F.R. § 230.144A(d)(3) (1998). A further limitation is that the securities syndicated pursuant to Rule 144A cannot be fungible with a securities listed in the U.S. See *id.* Because resale of Rule 144A securities is restricted, the securities are commonly priced at up to ten percent below their value if the restriction did not apply. See SEC, *Report of the Advisory Committee on the Capital Formation and Regulatory Processes* (1996). This burden is lightened somewhat by the issuer undertaking at some future date to register with the SEC securities into which the holder of the restricted Rule 144A securities can be converted so that their holder will then have nonrestricted securities. See, e.g., Shearman & Sterling No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,704 (July 2, 1993).

poses more than semantic distinctions between comparability and congruence. Accepting an alternative standard setter poses two profound regulatory questions, either of which can be invoked to preserve the status quo. There is the question we have discussed thus far, namely, the ability of investors to deal with multiple disclosure standards in a single market. Certainly evidence or a belief that investors will be disserved by more than one reporting standard in U.S. securities markets will end consideration of IAS in SEC filings. Even if investors are not so disserved, there still remains the question of whether recognition of foreign-based standards in SEC filings raises serious administrative and enforcement issues, and will thus weaken the political force of the SEC. If this is the case, multiple standards should be rejected on this basis alone despite their comparable rigor. Each of these questions is examined in this section.

A. *The Signaling Hierarchy Argument*

Academic debate thus far has argued forcefully for multiple disclosure standards in U.S. markets. Even though the commentators are alike in favoring more than one standard setter for U.S. markets, they vary widely on the issue of which body's standards would apply to issuers whose securities are traded in U.S. capital markets.⁹⁷ Both Professors Roberta Romano and Merritt Fox call for disclosure standards to be set by the state or nation of the issuer's domicile.⁹⁸ The most aggressive ap-

97. For a discussion of regulatory strategies the SEC might follow as an alternative to multiple disclosure standards, see Cox, *supra* note 1, at 177-82, 185-90.

98. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 Mich. L. Rev. 2498, 2618 (1997); Romano, *supra* note 64, at 2408-10. An obvious concern with either of these 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. See William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 Geo. L.J. 201, 267-68 (1997). Although Professors Romano and Fox argue that issuers that have a secondary listing will pressure their home state to address any harmful laxness in its regulations, we should also understand that issuers who so argue are likely to be a minority voice that would be overwhelmed by the needs of its purely domestic issuers who are content with the status quo. So viewed, the responsiveness of the home state to competition from other states is doubtful when the home state understands that increasing the disclosure demands for its purely domestic issuers may indeed cause those issuers to take flight to another incorporation site. If this occurs, it at least retards a regulatory march toward the top. Furthermore, the notion that managers will pressure home regulators to stiffen requirements imposed on them must be subjected to the lens of the manager's self-interest. See Melvin Aron Eisenberg, *The Structure of Corporate Law*, 89 Colum. L. Rev. 1461, 1473, 1510-11 (1989); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 Colum. L. Rev. 1526, 1528 (1989). As reasoned later in the text, managers are not likely to champion disclosure requirements that pose any risk to their continued stewardship of the firm. The very self-interest that influences the managers' decisions as to whether and where to seek a secondary listing can be expected to

proach is that of Professors Choi and Guzman, who set forth a system of "portable reciprocity" in which issuers may freely choose from among any regime's disclosure requirements.⁹⁹ And, the closest commentator to being a traditionalist is Professor Paul Mahoney, who counsels that the exchange where the securities are listed should regulate disclosure,¹⁰⁰ which is the traditional approach in most other Western countries. Even under Professor Mahoney's approach, multiple standards would thus confront U.S. investors, as it would then be possible for the disclosure requirements of the NYSE to differ from those for shares listed on NASDAQ. Underlying each of these proposals is the belief that regulatory competition, whether among the states, nations or exchanges, is more likely to result in disclosure standards that are optimal for investors and issuers.

The argument for regulatory competition's strength in producing optimal rules is fairly easy to state. It is essentially a market approach toward regulation by which demand and supply influence the state's regulatory choices.¹⁰¹ Investors contemplating a transaction in two competing markets will not be neutral to otherwise equal reported financial risks

guide their positions on home country disclosure demands. Certainly absent from the impressive research amassed by both Professors Romano and Fox was any citation of an instance in which management pressed regulators for heightened disclosure or regulation of their stewardship.

99. See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. Cal. L. Rev. 903 (1998) [hereinafter *Portable Reciprocity*]. The article builds on principles earlier examined in Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation In A Global Capital Market*, 65 Fordham L. Rev. 1855 (1997).

The approach recommended by Professors Choi and Guzman is more than theory. The courts of appeal have consistently upheld choice of law clauses in which issuers and investors agree at the moment of a foreign securities sale within the U.S. that any claim of misrepresentation will be resolved by the law of a designated foreign country. See, e.g., *Bonny v. Society of Lloyd's*, 3 F.3d 156 (7th Cir. 1993); *Roby v. Corporation of Lloyd's*, 996 F.2d 1353 (2d Cir. 1993). Although the cases thus far involve choice of law clauses pertaining to misrepresentations rather than more general concerns of which nation's laws will regulate the issuer's mandatory disclosures, the cases nonetheless pose the substantial public policy question of whether the securities laws are public or private law. See Robert W. Hillman, *Cross-Border Investment, Conflict of Laws, and the Privatization of Securities Law*, 55 Law & Contemp. Probs. 331 (Autumn 1992). The approach recommended by Professors Choi and Guzman would carry this line of cases to the next level because it extends the consensual basis embraced in cases such as *Bonny* and *Roby* to mandatory disclosure requirements.

100. See Paul G. Mahoney, *The Exchange As Regulator*, 83 Va. L. Rev. 1453 (1997).

101. The theoretical base for an economic analysis of disclosure practices can be traced to George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. Econ. 488 (1970). His work was important in the richer development of signaling theory. See generally A. Michael Spence, *Market Signaling: Informational Transfer in Hiring and Related Screening Processes* (1974). The connection of signaling theory to SEC disclosure practices, and more specifically to the role of a disclosure hierarchy, was advanced in Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory in Issues in Financial Regulation* 177 (Franklin R. Edwards ed., 1979).

and returns of the security if they recognize that the incidence of fraud, manipulation, unfairness or untrustworthiness of information is significantly greater in one market than it is in the other. The rational investor, *ex ante*, will discount the price of the security in each market by the combined value of the average likelihood and magnitude of the feared misconduct posed by all securities in that market. The securities traded in the market with the greater likelihood of such abuses will, all else being equal, trade at a greater discount than under a more regulated and more trustworthy regime. This effect is not limited to the investor's *ex ante* assessment. Issuers will quickly note that any penalty investors impose through their *ex ante* assessment translates to a higher cost of capital than the issuer will encounter if it offered its securities in the more regulated market. Issuers will therefore gravitate to markets whose disclosure standards offer the optimal cost of capital.

Obeisance to the view that regulatory competition will provide discipline adequate to insure an optimal disclosure regime rests on a series of classic assumptions that underlie any market approach.¹⁰² Among the critical assumptions relevant to disclosure standard setting is the existence of a large number of competing regulators, the size of each regulatory jurisdiction being such that it can compete with its rivals, perfect information being available regarding the benefits and costs of disclosure, and the absence of externalities or monopolies that will distort the

102. The classic statement of the regulatory competition model is Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 *J. Pol. Econ.* 416 (1956). The literature in this area is examined in Bratton & McCahery, *supra* note 98. For an analysis of how a state can foreclose effective regulatory competition so as to preserve its dominance, see Ehud Kamar, *A Regulatory Competition Theory Of Indeterminacy In Corporate Law*, 98 *Colum. L. Rev.* 1908 (1998) (Delaware has preserved its dominant position by opting for indeterminate standards that will be interpreted by a judiciary committed to preserving the state's dominant position).

A further concern is whether regulatory competition assumes an anthropomorphic conception of the regulating states. Here we may seriously question whether rent-seeking behavior on the part of politicians, bureaucrats and issuers will always lead to results which in the long term enhance the reputation of the regulating state. Certainly if we adopt the approach suggested by the above commentators, so that enforcement lies with the regulating nation rather than the nation where the sale occurs, we would expect substantial conflicts of interest to arise. Consider the natural preference of the regulating nation to prefer the capital formation by its resident issuers who are in financial distress. It would appear irresistible for the regulating state to withhold its enforcement of any disclosure violations when the impact of such violations affects a sister nation. This concern is heightened by evidence that states change their laws not in response to competition from sister states but in response to local interest groups that are competing with nonlocal interest groups. See William J. Carney, *The Production of Corporate Law*, 71 *S. Cal. L. Rev.* 715, 741-55 (1998).

For evidence of how competition can cause a once unchallenged monopoly to discard long-held principles designed to protect investors, consider the willingness of the NYSE to abandon its prohibition of listing common shares if the firm also had shares outstanding with super voting rights. See Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 *Colum. L. Rev.* 979 (1989).

effects of interjurisdictional competition.¹⁰³ Interestingly, those who embrace regulatory competition do so not because they believe such conditions prevail in capital markets around the world but because of a general distrust they have for governments as standard setters. For example, many of the justifications for multiple disclosure standards championed by Professor Romano are directed toward the overall unimportance of mandatory disclosure standards ushered in by the depression-era federal securities laws.¹⁰⁴ Although she argues that states should have the power to set disclosure standards for SEC filings, her arguments are equally persuasive that there should be no mandatory disclosure standards, by states or by any other organization. Similarly, distrust for government is advanced by Professor Mahoney, who argues for exchange-based standards on the ground that as a private organization an exchange is more susceptible to commercial influences than is the SEC.¹⁰⁵ Lost in their analysis is whether the conditions are ripe for meaningful regulatory competition, such that an optimal disclosure hierarchy will develop across standard setting bodies around the world. On this point, we should return to the assumptions necessary for forceful competition among markets.

We may question whether there are indeed a sufficient number of regulatory jurisdictions for competition. To date, the markets that compete with one another are those based in London and New York, with some threatening competition from Frankfurt. There are important infrastructure considerations in London and New York that should at least in the short term qualify as important externalities that provide each of these markets with important monopolistic characteristics. The established networks of electronics and professionals are not easily or quickly relocated or replicated. Another important anticompetitive consideration is the role of time zones in segmenting markets. Here we should take note that no single market has achieved 24-hour trading—to be sure, London and New York compete, but not after hours. And certainly there is abundant cause for concern over whether there can ever be perfect information regarding the costs and benefits of competing disclosure standards. Financial reporting standards, because they have so many facets, are difficult to compare. An issuer's preference for one regime over another may be due to some arcane lax disclosure requirement which is

103. See Tiebout, *supra* note 102, at 419.

104. See Romano, *supra* note 64, at 2372–81.

105. See Mahoney, *supra* note 100, at 1457–59. Professor Mahoney concludes indefinitely. He believes, but marshals no evidence in support of his belief, that the SEC is not inherently a more efficient protector of property rights. Even his review of the several regulatory matters undertaken over the years by the exchanges raises doubts as to whether they truly pursue competition, or whether they pursue strategies designed to garner rents for their members. See *id.* at 1496. For an insightful response to Professor Mahoney, see Marcel Kahan, *Some Problems With Stock Exchange-Based Securities Regulation*, 83 Va. L. Rev. 1509 (1997).

especially attractive, even though overall the chosen disclosure regime is otherwise understood to have demanding requirements.¹⁰⁶

Thus, there is reason to doubt that conditions are ripe for regulatory competition with respect to competing disclosure policies. There are also several other negative features of allowing more than one disclosure standard within a single market. These features draw into question the attractiveness of the regulatory hierarchy model championed by those who prefer multiple disclosure standards.

The first concern is the indefiniteness of the discounting process that underlies the regulatory competition paradigm. The approaches recommended by Professor Romano and Professors Choi and Guzman do not envision an important role for regulation. In their view, an issuer is free to select the disclosure standards it elects for itself, and the host market's regulatory role is limited to enforcing compliance with the standard so selected. Thus, it is not the objective of the host market to place all issuers on the same footing; any adjustment among issuers occurs through the impact of discounting that will arise by market forces. The strength of this model obviously depends on the power of investors, or more particularly arbitrageurs, to fine-tune pricing differences among securities to reflect relative differences in disclosure practices. In addition, there will also be efforts by issuers to moderate discounting through various steps, such as bonding, certification, or various monitoring strategies.¹⁰⁷

It is difficult to believe these forces will produce as clean and crisp a hierarchy among disclosure regimes as to justify the substitution of multiple standards for the current SEC standard setting process. Certainly there is little evidence that arbitrageurs can be expected to fully guide the hierarchy.¹⁰⁸ It is well understood that arbitrageurs heed the wisdom of

106. This is an aspect of the distorted choice feature developed by Professor Bebchuk in his consideration of the inefficiencies that likely abound in the market for corporate charters. See Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820, 1836-40 (1989).

107. See Ross L. Watts & Jerold L. Zimmerman, *Agency Problems, Auditing, and the Theory of the Firm: Some Evidence*, 26 J.L. & Econ. 613 (1983). The problem of managerial opportunism is essentially the classic concern of agency costs where managers will seek to maximize their own utility but not inherently that of the firm's owners. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

108. The only study regarding investor responses to issuers using different disclosure standards in the same market is that discussed earlier. See *supra* text accompanying note 39. See also Darius P. Miller & Mathew R. Morey, *The Intraday Pricing Behavior of International Dually Listed Securities*, 6 J. Int'l. Fin. Markets, Institutions & Money 79 (1996) (providing empirical evidence consistent with arbitrage between prices of British securities traded in London and their ADRs that are traded in the U.S.). We should also note studies of so-called "Siamese Twin" companies, companies such as Royal Dutch Shell and Shell Transport Trading plc, which are corporate pairs whose charters fix the division of future cash flows between each twin. Studies of twins consistently demonstrate that arbitrageurs fail to eliminate pricing differences between the two companies: their

Dirty Harry: they know their limitations. Arbitrageurs are sometimes wrong, at least often enough to be averse to the prospect of being wrong. Faced with declining marginal utility for money, the arbitrageur may well forego investing further sums to correct a price imbalance between a U.S. GAAP disclosing security and an IAS disclosing security.¹⁰⁹ And, of course, being certain that a security is overpriced or underpriced does not mean, at least not to the experienced arbitrageur, that it will not continue to be mispriced. These are, of course, the arguments that explain the noise theorists' view that there are many causes and mechanisms that cause securities markets to be inefficient.¹¹⁰ Before we embrace multiple standards in the belief that a disclosure hierarchy will develop among the securities of a particular market, we need better evidence that securities markets are capable of making discrete judgments among issuers using different disclosure standards. Certainly the evidence amassed by researchers suggesting that capital markets are noisy markets, i.e. that stock prices do not on average reflect a security's intrinsic value,¹¹¹ does not support subjecting investors to multiple disclosure standards.

Even if there were evidence that securities markets were so efficient that the securities of different issuers using different disclosure standards would be discounted in part by the disclosure standards each used, we should still be sensitive to the social cost implicit in the pricing of the securities. There are at least two distinct concerns here. First, the multi-

respective prices reflect their respective local market differences because their price differences are not due to any differences with respect to the timing and measurement of future cash flows. See Kenneth A. Froot & Emil Dabora, *How Are Stock Prices Affected By The Location Of Trade?*, National Bureau of Economic Research Working Paper No. 6572 (May 1998); Leonard Rosenthal & Colin Young, *The Seemingly Anomalous Price Behavior of Royal Dutch Shell and Unilever N.V./PLC*, 26 J. Fin. Econ. 123 (1990).

109. An additional consideration is the limited funds arbitrageurs have to commit to overcoming any individual price imbalance. For example, recent gaps between the friendly takeover bid and market price for Atlantic Richfield and Mobil have each been attributed to these firms having such large market capitalizations that they have exceeded the capacity of the arbs to correct the imbalance. See Robert McGough & Steve Liesman, *Traders Leave Billions On the Table in Oil Deals*, Wall St. J., May 11, 1999, at C1.

110. To be sure, there is substantial empirical support that stock prices respond so quickly to information upon it becoming publicly available that investors on average cannot garner abnormal returns by trading on the information upon its public disclosure. For a review of this literature, see generally Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. Finance 1575 (1991). Still, there is abundant evidence that questions whether securities prices do not drift over long periods of time around an equilibrium point before stabilizing, during which time we can find a security's price to be under- or over-priced. See, e.g., Bernard & Thomas, *Post-Earnings Announcement Drifts: Delayed Price Response or Risk Premium*, 27 J. Acct. Res. 1 (1989). Excellent reviews of this literature appear in Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 Geo. Wash. L. Rev. 546 (1994) (noting that securities prices appear to have long periods of price inefficiencies); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851, 851-72 (1992) (examining the disconnect between SEC policies and theory and evidence regarding operation of securities markets).

111. See discussion *infra* text accompanying note 145.

ple disclosure standards regime will have a disproportionate impact on those investors whose portfolios are not so diversified that their holdings represent the risk posed by all securities in the market. To be sure, those with sufficiently diversified portfolios will be assured that they win as much as they lose due to any heightened disclosure risk of investing in non-U.S. GAAP disclosing entities. Even though their portfolios include securities of firms that decline more than the amount of the *ex ante* discounting due to events not revealed in their financial statements, other portfolio holdings that do not incur such problems will yield higher returns due to their having been purchased at a discount appropriate for their disclosure class. This netting of gains and losses, however, will not be the case for the less well-diversified investor whose portfolio does not reflect the average risks posed by all non-U.S. GAAP issuers. Indeed, a multiple disclosure standards regime would add a new dimension to diversification since portfolio balance would no longer be driven solely by the customary considerations of industry, market capitalization and international exposure.

In a multiple disclosure regime, the investor must also consider that the disclosure risks of securities are not identical, but instead will vary according to the disclosure regime invoked by that security. For example, if the regulatory setting were only a choice between IAS and U.S. GAAP, the investor would be underbalanced if only a few IAS disclosing firms were held and many more of her shares were issued by U.S. GAAP disclosing firms. Her portfolio would not in this case be reflecting the average risks of all IAS firms. Being underbalanced with IAS firms, any resulting loss on such a firm linked to a disclosure matter would not be recouped by the gains garnered on her other IAS firms. Thus, dependence upon a disclosure hierarchy within a single capital market introduces a regulatory skewing in the design of the investor's portfolio. Though we may well wish to formulate public policy on the ideal of each investor holding an efficiently balanced portfolio, policymaking should proceed with a full appreciation that many investors do not have ideally balanced portfolios and will bear the burdens of pursuing such an ideal. Certainly this should caution us to better understand the benefits of a multiple disclosure standards regime before we visit such distinct risks on underdiversified investors.

A second consideration in the evaluation of a multiple disclosure regime is the prophylactic role that rigorous mandatory disclosure standards, in this case U.S. GAAP, play in deterring fraudulent offerings. This point is conceded even by the neo-classical economists who acknowledge that one of the consequences of the enactment of the Securities Act of 1933 was a great reduction in the number of risky or fraudulent public offerings.¹¹² To the extent that U.S. GAAP imposes greater transparency

112. See, e.g., Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & Econ. 613, 646–50 (1981); Stigler, *supra* note 64.

on both management action and the relative risks of the offering than does IAS, we can measure the social costs of allowing weaker disclosure standards by the likely increase in fraudulent offerings and transactions in securities. Although this may be further grist for the class action lawyers' mill, we must be aware that private litigation can hardly be said to make whole every investor harmed by fraudulent practices.¹¹³ Moreover, if we recognize the link between rigorous mandatory disclosure practices and fraudulent offerings, then any acceptance of less rigorous disclosure standards in SEC filings may simply shift regulation from the SEC to the litigation process,¹¹⁴ a result that will hardly be welcome by those urging a more cost effective solution.

Important components of the regulatory competition hierarchy are the actions and, more precisely, the incentives of the issuer's managers. Managers can well pose the type of externality that is inconsistent with competitive forces among capital markets. Managers, not the firm's owners, make the decisions regarding whether and where to obtain a secondary listing or in which market to raise capital. These decisions are made with an eye not only towards the likely benefits of listing or offering securities in the U.S., but also towards the impact of that decision on the manager's own utility function.¹¹⁵ Certainly the increased transparency of Daimler Benz's operations following its listing on the NYSE and consequent reconciliation to U.S. GAAP reminds us that not all managers are likely to welcome the spotlight that a U.S. listing places on their stewardship. Correlatively, there is every reason to believe that some managers will act opportunistically with financial reporting practices when such practices permit them to do so. This observation reflects the source of the greater discounting investors may apply to firms using disclosure standards that accord managers greater freedom to act opportunistically.

Finally, if the SEC accepts IAS for foreign firms, U.S. firms will likely argue they should have the choice of complying only with IAS. We might ask why a U.S. firm, whose books otherwise are maintained according to U.S. GAAP, would wish to comply instead with IAS. In general, managers prefer disclosure standards that better portray their stewardship. Therefore, to the extent that there are differences in measurement and report-

113. For a close analysis of settlements in relation to the damages suffered by investors who are members of securities class actions, see Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 *Ariz. L. Rev.* 491 (1996).

114. See Cox, *supra* note 1, at 191-97 (invoking analogy of squeezing an inflated balloon where any reduction in mandatory disclosure standards likely will lead to concomitant expansion in private liability).

115. See James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 *Hastings Int'l & Comp. L. Rev.* 149, 164-66 (1993) (stating that U.S. should not accept disclosure standards that facilitate manager's concealment of real economic events, such as do hidden reserves, discretionary reporting of affiliated company's income, and lax foreign exchange accounting practices that prevail in Japan).

ing between IAS and U.S. GAAP, managers will not be blind to a disclosure regime's impact on their utility function.

B. Factors Favoring A Single Standard Setter

When considering whether IAS are appropriate for SEC filings, it is also important to reflect on what effect such acceptance will have on the future role of the SEC in the development of an international regulatory quilt. The SEC's acceptance of IAS would clearly manifest the quilt's existence, but we must also question whether this would not also remove an important seamstress from the process of weaving future quilts. The adherence to GAAP has been a bully pulpit for the SEC and other policymakers to champion improving regulatory developments in many foreign markets. We should, therefore, consider whether the SEC's position as a leader on disclosure issues would change if it were to accept IAS or embrace any of the other options advanced by the commentators.

International standard setting in the face of the globalization of securities markets is consistent with the theory of international regimes developed by Professor Robert Keohane.¹¹⁶ Because there is no centralized power within an international system, states will form international regimes, often in the form of international agreements, to increase efficient interaction in commercial transactions.¹¹⁷ Because regimes often involve high initial costs (bringing all sides together, negotiating an agreement, etc.), they tend to be created under the leadership of a single dominant state which has the will and the power to bear these costs.¹¹⁸ The structure and content of these regimes are frequently reflections of the policies of the dominant state. The SEC has long been a dominant voice on the subject of international securities regulation. Through its unilateral, bilateral and multilateral efforts, the SEC has greatly enhanced the quality of securities regulation worldwide.¹¹⁹ Certainly its voice in the interna-

116. See Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (1984).

117. The theory of international regimes is not limited to commercial transactions. See Stephen D. Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables in International Regimes 1* (Stephen D. Krasner ed., 1983).

118. A fundamental tenet of hegemonic power theory is that regimes are created by the hegemonic state because it has the ability and the willingness to bear the costs, and the power to force others to agree. As is developed above, the U.S. through the SEC illustrates this impact in the area of securities regulation.

119. A important example of its unilateral efforts is the SEC's Annual International Institute for Securities Market Development. This is a two-week, executive level institute which the SEC considers "the cornerstone of the SEC's international technical assistance program." It brings together experts from the private sector, the exchanges, and government to provide training for over 650 officials from five continents. See SEC Announces 1998 International Institute, SEC Press Release (April 17, 1998) (visited Nov. 7, 1998) <<http://www.sec.gov/news/press/98-41.txt>>. Also illustrative of its important unilateral efforts has been its aggressive posture with respect to insider trading. See *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111, 113 (S.D.N.Y. 1981) (order granting SEC request that New York branch of Swiss bank reveal customer names even though Swiss

tional arena would be weakened substantially if the proposals of any of the above commentators were accepted. For example, Professor Romano would accord the SEC one voice among fifty other U.S.-based standard setters¹²⁰ and Professor Mahoney would remove its voice entirely.¹²¹ International regimes can create true gains in the international system by reducing uncertainty.¹²² Because these gains provide a powerful disincentive to the dismantling of existing regimes,¹²³ we should be careful of any regime which would remove such an important voice as the SEC from the international regulatory stage.

In contrast, the acceptance of IAS would not deprive the SEC of its important functions any more than its prior recognition of the FASB reduced SEC's authority as a standard setter. The SEC would still retain the power to impose additional disclosure demands as its gloss to any accounting standard it finds deficient, regardless of whether it be one established by the FASB or IASC. Because accounting standard setting is an on-going process, the review of proposed and newly adopted standards is an important aspect of the system's dependence on the private sector. Thus, even though the IASC may one day meet the criteria established by the SEC to allow the use of IAS in SEC filings, the decision to accept IAS does not remove the SEC's regulatory hand from accounting standard setting any more than did the recognition of the FASB. Furthermore, the SEC's acceptance of IAS does not pose the same enforcement problems

secrecy statutes blocked such disclosure). See generally Roberta S. Karmel, *Transnational Takeover Talk—Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66 U. Cin. L. Rev. 1133, 1167 (1998) (recounting the SEC's success in persuading sister countries such as Germany to more aggressively regulate insider trading).

The classic illustration of SEC bilateral efforts is the numerous memoranda of understandings it has negotiated regarding the mutual investigative and enforcement efforts of fraudulent securities practices. See, e.g., Andrew S. Brooslin, Note, *Enforcing Insider Trading Laws: The Need for International Cooperation*, 20 Suffolk Transnat'l L. Rev. 397 (1997) (discussing the importance of SEC-sponsored transnational accords in the form of both mutual legal assistance treaties and memoranda of understandings); Practising Law Institute, *International Developments: The SEC Speaks in 1998*, 1037 PLI/Corp 149 (1998) (discussing recent MOUs and outlining the SEC's MOU program).

The SEC's active involvement with IOSCO and its engagement of the IASC are illustrative of significant multilateral efforts. See David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 Tex. Int'l L.J. 281 (1998) (outlining the SEC's "overwhelming influential role in IOSCO"); Securities and Exchange Commission, *Report on Promoting Global Preeminence of American Securities Markets* (October 1997) (Dec. 12, 1997) <<http://www.sec.gov/news/studies/acctgsp.htm>> (SEC report on its role and goals in establishing international accounting standards).

120. See Romano, *supra* note 64, at 2401–02 (disclosure pursuant to issuer's domicile should be an alternative to compliance with SEC's requirements).

121. See Mahoney, *supra* note 100, at 1498–99 (permitting exchanges to regulate disclosure is superior to SEC standard setting).

122. See Douglas C. North, *Institutions, Institutional Change and Economic Performance* (1990).

123. See Keohane, *supra* note 116, at 83.

as the other regulatory approaches calling for multiple standard setters within a single securities market.

The most troubling feature of any multiple standard regime would be enforcement. For example, both Professors Choi and Guzman¹²⁴ and Professor Fox¹²⁵ propose a regime whereby an issuer could purport to comply with U.S. disclosure standards when making a public offering of its securities in France. Should there be a violation of those disclosure standards, Professors Choi and Guzman envision that appropriate disciplinary agency would be the U.S. SEC. Here we might well see the practical arguments in support of a U.S. and not a French based enforcement action. Since U.S. disclosure standards are violated, the agency with the overall responsibility for their development and meaning would be better able to gauge both whether there has been a violation and whether its severity merits the expenditure of the agency's enforcement resources.¹²⁶ It has long been the case that the SEC's enforcement efforts have defined the edges of its disclosure guidelines. Indeed, disclosure guidelines set forth in the SEC's regulations are broadly written and, therefore, are

124. See Choi & Guzman, *Portable Reciprocity* supra note 99.

125. See Fox, supra note 98, at 2582-83, 2591-98.

126. This is the approach Professor Fox embraces, arguing that the U.S. could enforce its standards extraterritorially *at least* with respect to a U.S. issuer that purports to comply with U.S. standards. See *id.* at 2583. Indeed, the entire thrust of his position is that the issuer's domicile is the body most sensitive to the considerations called for to balance the needs of issuers and investors, even though investors are residents of another nation. *Id.* at 2587-88. Professor Fox provides a more expansive analysis of his recommendation that the issuer's disclosure obligations should be determined solely by its home country in 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). He reasons that cultural differences exist among countries so that the social costs and benefits associated with mandatory disclosure requirements will vary from nation to nation. *Id.* at 758-60. This causes him to conclude that the optimal level of disclosure is best determined by the issuer's home country, regardless of the location of the market where its securities are issued or traded. *Id.* at 762-68.

At least two important points are not addressed by Professor Fox. First, he considers optimality only in terms of its effect on the issuer without considering the effect of disclosure benefits on investor welfare or the allocational efficiency of its securities markets. Indeed, he appears to reject the notion that optimality should even be addressed on an issuer-by-issuer basis, and instead concludes that optimality should be determined for all issuers with the same home country. He reasons that when a foreign issuer agrees to conform its disclosures to the more demanding U.S. standards, as many have, this "simply means that the issuer's gains from having a U.S. market for its shares exceed the extra costs, not that the extra costs are justified." *Id.* at 739. Certainly a far richer social accounting is called for in the design of an optimal disclosure regime than merely to focus on the costs and benefits to a nation's issuers; consideration should also be given to the impact disclosure has on investors as well as the overall attractiveness of a nation's markets to all issuers and its allocational efficiency. Second, though Professor Fox does address the jurisdictional issues posed by his approach, he does so only from the narrower perspective of a country's jurisdiction to prescribe. See *id.* at 722-30. He does not consider well-recognized limits on a nation's jurisdiction to enforce its prescriptions; had he done so he would have had to confront the issues discussed later in this Article. See *infra* note 130; text following note 129.

quite similar in their overall commands to those of, for example, the United Kingdom.¹²⁷ The differences between the demands made by the SEC and another country are in the agency's interpretation by its staff. Thus, from the standpoint of truly fulfilling the objectives sought by Professors Choi, Guzman, and Fox, there is much to be said for the argument that the agency with whom the issuer purports to comply should assume responsibility for assuring that those standards are indeed satisfied. Yet, the results of this conclusion pose terrific political and international issues these authors do not address. Problems are equally present if the host market is called upon to enforce a violation of another nation's standards.

We might well question the political commitment of the host market, whose disclosure standards are not nearly as great as the United States, to nevertheless expend its limited enforcement resources to address disclosures that are acceptable for its home country issuers. This situation is very similar to earlier instances in which the SEC met with a lack of cooperation from foreign governments in its efforts to investigate insider trading launched from a foreign country with less stringent regulation.¹²⁸ One can well expect that the host country will not be an aggressive enforcer of foreign standards in its markets when the disclosures made were not also a violation of the host country's laws.

An even larger issue in this debate is the international consequences of a regime that invites the SEC to enforce in a sister nation any breach of its standards. Unlike the analogy to the earlier problems the SEC encountered with its investigation of insider trading activities launched from a foreign country with lax or no regulation of insider trading, the disclosure violation examined by Professors Choi, Guzman and Fox does not occur within the U.S. They nevertheless envision that the SEC would enforce its standards against conduct that occurred exclusively in another nation.¹²⁹ If the SEC were to do so, it would raise a serious question of international law: prevailing international law recognizes the power of a nation to enforce its standards against conduct that occurs exclusively in another nation only when that conduct poses a threat to its national security or substantially interferes with its governmental functions.¹³⁰ Even

127. See Michael J. Halloran & Richard Scudellari, *Securities Offerings Abroad by Domestic Issuers, Both Public and Private*, 6 *Int'l Tax & Bus. L.* 262 (1988).

128. See Note, *Secrecy and Blocking Laws: A Growing Problem as the Internationalization of the Securities Markets Continues*, 18 *Vand. J. Transnat'l L.* 809 (1985).

129. See Choi & Guzman, *Portable Reciprocity*, *supra* note 99, at 922-23, 933-34; Fox *supra* note 98, at 2583.

130. See Restatement (Third) of Foreign Relations Law of the United States § 402(3) (1997) (referring to the "protective principle" as a basis for enforcement jurisdiction). The protective principle is criticized because it has no objective limits. See Ian Brownlie, *Principles of Public International Law* 304 (3d ed. 1979); Mark Petersen, Note, *The Extraterritorial Effect of Federal Criminal Statutes: Offenses Directed at Members of Congress*, 6 *Hastings Int'l & Comp. L. Rev.* 337, 392 (1983). Overall, the concern is "the

setting international law aside, we might well question whether the U.S. Congress can be expected to appropriate funds for enforcement efforts that were not intended to protect local markets and the politicians' constituents. On this point, consider that while in 1988 Congress empowered the SEC to assist foreign regulators' investigative efforts, they did so only in the belief that their assistance would better enable the SEC to obtain cooperation from foreign regulators in the SEC's own investigative efforts.¹³¹ Simply stated, though capital raising and trading in securities occurs today in a world without borders, enforcement of local laws re-

State has the right to exercise jurisdiction within the limits of its sovereignty, but is not entitled to encroach upon the sovereignty of other states." F. A. Mann, *The Doctrine of International Jurisdiction Revisited*, 186 *Hague Recueil* 9, 20 (1984). To this end, there are five bases for claiming jurisdiction under international law: territorial, nationality, passive personality, universal jurisdiction, and the protective principle, with the latter being the most limited and controversial. See Barry E. Carter & Phillip R. Trimble, *International Law* 725-89 (2d ed. 1995); William R. Solmanson, *Fundamental Perspectives on International Law* 195-205 (2d ed. 1995). Territorial jurisdiction does permit the extraterritorial application and enforcement of U.S. law to foreign-based conduct, provided sufficient effects of that conduct occur within the U.S. Compare *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945) (requiring evidence of an intent to affect commerce into the U.S.); with *Timberlane Lumber Co. v. Bank of America*, 549 F.2d 597 (9th Cir. 1976) (requiring a balancing of effects within the U.S. against such considerations as the enforcement efforts by the sister nation). The well-received formulations for the extraterritorial application of the U.S. securities laws for the benefit of foreign nationals who purchase securities abroad requires substantial culpable acts by the defendant within the U.S. See, e.g., *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir. 1975). Greater 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. Similarly removed from this hypothetical is a nation's power to protect its citizens abroad under the passive personality principle. This approach, however, only applies when a nation seeks to protect its citizens when they are outside the normal reach of their home country's protective mechanisms. Universal jurisdiction is equally inapplicable, being the source of power invoked by nations to condemn such widely-condemned offenses as piracy and genocide.

The closest authority we can find for supporting a nation's exercise of power for conduct that occurs exclusively in a foreign nation is jurisdiction based on the protective principle. This principle is a highly subjective principle under which a nation acts to protect what it believes is a vital national security or economic interest. One example of its exercise was in *U.S. v. Pizzarusso*, 388 F.2d 8 (2d Cir. 1968), where it was used to gain jurisdiction over a Canadian citizen who made false statements while attempting to gain a visa in Montreal to enter the U.S. The court upheld the power of the U.S. to prosecute the defendant, reasoning that the defendant's action had potentially adverse effects on the United States, although it did not require that such effects actually occur. See *id.* at 9-13. It would clearly seem that any move by the U.S. to extend the SEC's enforcement powers under the protective principle would face enormous opposition in the world community.

131. In 1988, Congress amended the Securities Exchange Act to add Section 21(a)(2), 15 U.S.C. § 78u(a)(2) (1998), Pub. L. No. 100-704, 102 Stat. at 4677, to empower the SEC to provide *investigative* assistance to a requesting foreign country "without regard to whether the facts stated in the request would also constitute a violation of the laws" of the U.S. However, the statute requires the SEC to "consider whether (A) the requesting authority has agreed to provide reciprocal assistance in securities matters to the commission." *Id.* See also Senate Report on the International Enforcement Cooperation Act of 1988, S. Rep. No. 100-461, 100th Cong., 2d Sess. 9 (1988).

mains very territorial.¹³² Thus, commentators who champion issuers' ability to use disclosure standards that were formulated in a market other than the host market have not sufficiently considered the serious enforcement issues inherent in their recommended approach. The approach suggested by Professor Romano avoids serious international enforcement issues, since she recommends that each of the individual states should have authority over disclosure standards co-equal to that of the SEC. Under her approach, the SEC would not be called upon to enforce any U.S.-based standard in another country nor would another country be called upon to enforce U.S. standards in its market. Nevertheless, the proposal that the states should emerge as disclosure standard setters is puzzling in light of their poor record with respect to disclosure requirements. Building on her earlier work regarding the social benefits of competition among the states for corporate charters,¹³³ Professor Romano envisions a world in which issuers could select from among the fifty states (and presumably the District of Columbia as well) the disclosure standards used in SEC filings.¹³⁴ The twin pillars of her argument for challenging the regulatory monopoly presently enjoyed by the SEC are her

132. Serious problems would also arise even under a more moderate approach where enforcement would continue to be territorial so that the host country would be expected to enforce in its markets the standards established by a sister nation. See Fox *supra* note 98, at 2583 (foreign issuer exempt from U.S. standards so long as its U.S. offer complies with the disclosure demands of its home country). Disclosure regulations are not free of ambiguity. Their content comes to life through the diverse ways that the regulatory agency undertakes to communicate its prevailing interpretation of its disclosure guidelines. One such medium are the messages the regulating body emits in choosing the enforcement actions it initiates and the theory advanced in the enforcement action. An example is the management discussion and analysis portions of SEC filings. Here the SEC attempts to place the historical financial information of financial statements in context and to give that information forward-looking qualities by requiring its registrants to discuss, among other factors, "any known trends or uncertainties that . . . the registrant reasonably expects will have a material favorable or unfavorable impact" on operations. Item 303 of Regulation S-K. The demands of this disclosure requirement are underscored by the releases issued by the SEC setting forth what it expects of issuers to fully comply with their management discussion and analysis disclosures. Importantly, through its enforcement efforts, the SEC further emphasizes and sharpens the meaning of this disclosure requirement. See, e.g., *In the Matter of Caterpillar, Inc.*, Exchange Act Rel. No. 30532 (Mar. 31, 1992). Regulation occurs not through rulemaking, but through the agency's enforcement efforts that regulate by example. Thus, the content of regulation is extremely sensitive to the culture of the regulating agency.

133. See Roberta Romano, *The Genius of American Corporate Law* (1993); Roberta Romano, *The Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225 (1985).

134. See Romano, *supra* note 64, at 2408-09 (expressing preference for either the issuers corporate domicile or the state specifically identified in the offering document for the regulation of the securities to be sold believing each provides the greatest flexibility in choice as contrasted to the site of the issuer's principal place of business). Professor Romano's approach, therefore, parallels that recommended by Professors Choi and Guzman, see *Portable Reciprocity*, *supra* note 99, because each set of commentators call for the issuer having the utmost flexibility in choosing which standard setter's requirements will apply to its offering.

beliefs that mandatory disclosure rules have not increased social welfare¹³⁵ and that the benefits states have conferred through competition in corporate chartering would also be present if states competed with one another on disclosure standards that applied to their domestic corporations.¹³⁶

Professor Romano does not consider why the states have not taken the regulatory course she recommends. Until 1996, when Congress preempted the states' powers to regulate disclosure for public offerings,¹³⁷ the states had the power, if they chose to exercise it, to impose their own disclosure demands on firms offering securities through their local blue sky laws. For public offerings of the type that Congress ultimately preempted the state from regulating, blue skying the offer was a bothersome formality, but not one that imposed any additional disclosure requirements.¹³⁸ We therefore see that for seven decades prior to Congress' preemptive efforts in 1996, the states chose not to exercise their power to impose their own disclosure demands. Indeed, the most pointed criticism of the 1996 legislation centers on the type of offerings it exempted from state regulation. In fact, states were not regulating these offerings, and therefore the act failed to address the areas where state regulation was seen as adversely affecting capital formation.¹³⁹ To be sure, many states did at one time wield their power to deny a permit to offerings they believed were unsuitable for investors within the regulating state. But over time, the states increasingly became less willing to take this course, because the effect was that the issuer could obtain a permit to offer the security in a sister state where the regulating state's investors could through a correspondent broker acquire the security.¹⁴⁰ A weakness in the states' resolve to aggressively regulate disclosure practices for public offerings, therefore, can be found in the declining role of merit regulation that has occurred over time.

135. See Romano, *supra* note 64, at 2373–80.

136. See *id.* at 2409–10.

137. In 1996, The National Securities Markets Improvement Act amended section 18 of the Securities Act to preempt the power of states to register offerings of "covered securities," a term that reaches securities that are or will be listed on the NYSE, AMEX or the NASDAQ National Market System. See National Securities Market Improvement Act, Pub. L. No. 104-290, § 102, 110 Stat. at 3417 (codified as amended at 15 U.S.C. § 77r).

138. For an overview of the state disclosure requirements and, more importantly in this context, their exemptions, see Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 Md. L. Rev. 1027 (1987).

139. See, e.g., Rutherford B. Campbell Jr., *The Impact of NSMIA on Small Issuers*, 53 Bus. Law. 575, 579–83 (1998) (NSMIA does not address the regulatory burdens blue sky laws impose on small issuers); Mark A. Sargent, *The National Securities Markets Improvements Act—One Year Later*, 53 Bus. Law. 507 (1998) (NSMIA "essentially ratified existing state exemptive practices.").

140. See Report on State Merit Regulation of Securities Offerings by the Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, 41 Bus. Law. 785, 837 (1986).

Thus, the history of the blue sky laws dramatically documents that the natural tendency of state regulatory competition is a race to the bottom. We find not only a weak interest among the states to impose disclosure demands greater than those of the SEC, but also that in those instances in which a state's restrictions are a burden, the issuer's tendency is to shop for a less demanding state where its offering can occur. Certainly this is not a record to suggest that the states will have a balanced view toward the needs of investors and issuers. Their own history illustrates that competition for offerings has caused a weakening and not a strengthening of securities regulation standards. Moreover, the proposal also has the potential to badly fragment the U.S. voice on international regulatory matters.

VI. A COURSE OF ACTION FOR THE SEC

The preceding analysis reports several important insights. The IASC is not yet the mirror image of the FASB and it may well never become such because it has yet to garner the same institutional support the FASB enjoys through the FAF. To date, there is mixed empirical evidence regarding the value to investors of reconciliations to U.S. GAAP; here we might even find that what evidence exists tilts favorably toward preserving the reconciliation process, even hastening its requirement so it comes closer to the foreign issuer's release of its home country financial statements. Furthermore, Rule 12g3-2b and Rule 144A do not seriously qualify the Commitment of the SEC or investors to comparability—each market is bounded by its own limiting factors that in turn cabin any encroachment that otherwise would occur to comparability. So viewed, it is natural for me to champion the view that the SEC should continue to hold the line on accepting IAS in SEC filings. This preference is even more strongly felt in light of the huge cultural differences that exist in public accounting across borders. The accounting profession that certifies the financial statements of U.S. issuers is not the same as that servicing the needs of Japanese, German or Chilean firms.

At the same time, we must recognize that all of these bases for preserving the status quo are not without qualification and each ground lacks hard evidence bearing on the intrinsic merits of the exclusivity of U.S. GAAP. It is into this breach that a variety of forces of the market place—the exchanges eager to acquire new listings, the U.S.-based brokerage community desirous of enhancing its commissions through trades executed in the U.S., and U.S. based professionals who will garner fees by guiding their foreign clients through whatever regulatory thickets await them in U.S. markets—will continue to exert pressure on the SEC to lift the disclosure barriers that are keeping foreign issuers from listing in the U.S.

Even though the SEC is an independent regulatory agency, it remains amenable to the politics of standard setting. As has occurred in the past, the strong inertial forces within the SEC will be overcome by the

reality that the world has changed. The decision to accept IAS will ultimately be a political decision.

The SEC has on past occasions moved in new directions in response to political forces and without abundant empirical support for its initiatives. The most significant shift in the SEC's regulatory culture occurred in 1982 with its adoption of an integrated disclosure process for large, established, publicly-traded firms. Firms that met a relatively high capitalization level and that had been subject to the SEC's continuous reporting requirements for 36 months could greatly lighten the demands of the registration process by incorporating into the registration statement information filed with the SEC to satisfy its continuous reporting requirements. They could also promote the security with an extremely abbreviated prospectus, and could register securities for the shelf so that securities could be sold when market conditions were ripe.¹⁴¹ The SEC supported its adoption of integrated disclosure by reasoning that it was consistent with the theory and empiricism from economics and finance that the market for large publicly traded firms was efficient, at least in the semi-strong form. The SEC did not emphasize, in its release adopting integrated disclosure, the many political factors that made it untenable for the SEC to continue to apply to all issuers a burdensome process that had not changed materially in nearly half a century. In the early 1980s, the U.S. was experiencing the worst recession since the Great Depression. Ronald Reagan had been elected President on a cresting sentiment that government imposed heavy regulatory costs that placed U.S. firms at a serious disadvantage in international markets. One of the Congress's first acts in addressing this problem was the passage of the Small Business Investment Incentive Act of 1980 with the objective of lowering the cost of capital formation for U.S. firms by liberalizing the exemptions in the Securities Act of 1933.¹⁴² Most importantly, integrated disclosure and its shelf registration procedures were adopted to address the competition that U.S. markets, and more particularly U.S. investment banking, faced from London. For over a decade, large U.S. issuers increasingly found it cheaper, quicker, and less risky to raise capital in London, where the regulatory burdens were less onerous. Integrated disclosure leveled the playing field.

The disconnect between the broad range of firms eligible to use the integrated disclosure system and the scope of market efficiency further

141. See Adoption of Integrated Disclosure Systems, Securities Act. Rel. No. 6383 (1982) and Securities Act. Rel. No. 6499 (1983). As originally adopted, both Forms S-2 and S-3 limited eligibility to firms that had been reporting companies for 36 months. See Adoption of Integrated Disclosure Systems, Securities Act Rel. No. 6383 (1982). Since their adoption, both the eligibility requirements as well as the overall disclosure demands of Form S-2 and Form S-3 have been increasingly relaxed over time. For example, Form S-3 is now available to issuers that have been a reporting company for only 1 year, provided they have a market float of common stock of at least \$75 million (as originally adopted the market float was \$150 million). See Securities Act Rel. No. 6964 (Oct. 22, 1994).

142. Pub. L. No. 96-477 (Oct. 21, 1980).

reveals the importance of politics when the SEC formulates policy. In its release proposing integrated disclosure, the SEC estimated that approximately 1,600 companies would be eligible—roughly 32 percent of the companies traded on the NYSE, AMEX and NASDAQ.¹⁴³ Interestingly, an earlier SEC study reported that no more than 1,000 companies were followed sufficiently by analysts, research departments, and institutional investors such that their shares would be traded under conditions consistent with the efficient market hypothesis—the hypothesis upon which the SEC purported to premise its adoption of integrated disclosure.¹⁴⁴ Thus, the SEC embraced a radically new disclosure mechanism for a class of issuers on a premise of market efficiency, and did so even when there was no empirical basis for believing in an efficient market for a significant number of those issuers.

There are several important lessons to learn from the SEC's adoption of its integrated disclosure system. As seen in Parts II and III, there presently is a weak empirical base for measuring the benefits, and their related costs, of requiring foreign issuers to reconcile their financial statements to U.S. GAAP. The leading event study focusing on this issue provides a positive, albeit blurred, report supporting the information value of the reconciliation process. As observed earlier, there is reason to believe that the report's support would be even stronger if the studied reconciliations had promptly followed the release of the foreign-prepared financial statements. Nevertheless, there is no evidence of the attendant cost of such reconciliations, so all that is measured is their utility to investors. Furthermore, the evidence of the many benefits foreign issuers derive by listing securities in the U.S. is confounded by possible multiple explanations as to the source of those benefits; it is hard to believe that compliance with U.S. GAAP is in any way the cause of the positive effects that are observed. As desirable as it is for the SEC to have a firm empirical base for its decision to accept IAS, that base does not exist now and may not be present before impatience overtakes the SEC.

As seen in Part V, the protective effects of a disclosure hierarchy depend on there being discrete pricing differentials among securities to account for the risks posed by differing disclosure regimes. Here the empirical support is even weaker than it was for the level of market efficiency invoked by the SEC to support its adoption of integrated disclosure. In the case of integrated disclosure, it was sufficient that capital markets were informationally efficient. This level of efficiency exists when stock prices rapidly respond to publicly available information. Integrated disclosure casts aside the need to physically deliver a prospectus to investors

143. See Securities Act Rel. No. 6331 (1981).

144. See Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, H.R. Rep. No. 29, at 41–42 (1977). For a close analysis of the weak empirical base for the SEC's integrated disclosure system and shelf registration procedures, see Langevoort, *supra* note 110, at 878–85.

and substitutes the filing of the mandated information with the SEC.¹⁴⁵ It thus proceeds on the assumption that resourceful investors can access information filed with the SEC and their actions will be reflected in the security's price. Whereas integrated disclosure depends on markets being informationally efficient, the regulatory hierarchy argument depends on the securities being priced in markets that are *fundamentally* efficient. Such markets exist when prices reflect the intrinsic value of the shares. Even though a finding that markets are informationally efficient is a predicate to finding that securities prices reflect their intrinsic value, a finding of informational efficiency is not inconsistent with finding that securities prices are in a constant drift toward such a value, but rarely reflect it. This is the position taken by the noise theorists whose research findings overall paint a picture that in the pricing of a security there are multiple influences that are unrelated to a security's value.¹⁴⁶ Absent a strong case for rejecting the noise theorists, and thus cause for believing that securities prices do reflect intrinsic value, the self-help approach offered by the disclosure hierarchy argument will not work.

Without a firm empirical base, the SEC must resort to the course it has followed so many times before: that of relying on its experiences and responding to the politics it faces. Truly there is an expectation that IAS will at sometime be acceptable in SEC filings. Indeed, even the chairman of the FASB has recognized the inevitability of IAS.¹⁴⁷ As seen earlier, the SEC's focus on the comparable rigor of IAS in comparison to U.S. GAAP should be understood as a surrogate investigation of the prevailing culture of the IASC. Stated more simply, has the IASC reached the point where it is no longer a provincial organization that is the captive of the accounting profession and its member nations? Because standard setting is an on-going activity, focusing on the organizational integrity of the IASC would seem to be the most important focus for the SEC in considering the acceptability of IAS in SEC filings. We should also understand that even after the SEC agrees to accept IAS, it will continue to have a potent influence over continuing independent engagement of international reporting issues. We can expect the SEC to not only continue its active involvement in the IASC's agenda, but to retain as well the power to require those who use IAS to supplement their disclosures to overcome any deficiencies the SEC believes they pose. Even the threat of such a curative regulatory provision will surely steel the resolve of the IASC to

145. See James D. Cox, *The Fundamentals of an Electronic-Based Federal Securities Act*, 75 Wash. U. L.Q. 857, 865-75 (1997) (arguing that information dissemination rather than price accuracy is the objective of the federal securities laws).

146. Excellent reviews of the literature appear in Cunningham, *supra* note 110, at 563-65, and Langevoort, *supra* note 110, at 854 fn.10 & 11.

147. See Remarks of Edmund L. Jenkins before the Annual SEC and Financial Reporting Institute Conference, reported in BNA 30 Securities Reg. L. Rep. 768 (May 15, 1998).

steer its course closer to that championed by the SEC.¹⁴⁸ Moreover, the SEC can be expected to exert a powerful influence over the development of auditing practices, procedures, and professional standards of other countries. The SEC's decision will likely transcend whether a foreign registrant's reporting practices conform to IAS. As seen earlier, measurement standards are only part of the story. There remains the question of whether the reported measurements have been independently scrutinized in a professional manner by the firm's outside auditors. Thus, by accepting IAS, the SEC will have to decide, most likely on a nation-by-nation basis, that the practices, procedures, and standards adhered to by the registrant's auditors' home country are sufficiently rigorous and trustworthy. Somewhat ironically, the SEC's acceptance of IAS broadens rather than weakens its regulatory influence.

Experimentation with disclosure standards is always a good idea and not without precedent. For example, the SEC used a two-year trial period for its shelf registration procedure before making it a permanent feature of the U.S. securities law regime. On this point, the SEC would be well advised to consider, on a pilot basis, permitting "world-class" issuers of the type advocated by the NYSE.¹⁴⁹ As discussed above, there is a weak empirical base for identifying which class of issuers is more likely to be worthy of regulatory dispensations than another. Part of the NYSE's reasoning for exempting such issuers from reconciling their financial statements to U.S. GAAP is the type of world-class firms that U.S. investors regularly pursue in foreign markets. Thus, an "if you can't beat them, join them" litmus test may well be invoked to identify the type of firms for the initial group permitted to use IAS. Such pragmatism is well justified by understanding that there is significant trading in foreign markets of such issuers by U.S. investors.¹⁵⁰ The social costs of facilitating such trades in the U.S. could be reasonably measured; however, as seen earlier, the burdens and benefits of continuing to require foreign issuers to reconcile their financial statements to U.S. GAAP are at best indeterminate.

148. The relationship of the SEC to the IASC called for here is consistent with the SEC's role vis-à-vis the many self regulatory bodies within its powers. We may even find that this will enhance its influence over the agenda and standards pursued by IASC.

149. Under its proposal, world-class companies are those with annual revenues of at least \$5 billion and a market capitalization of \$2 billion, or an average weekly trading volume outside the U.S. of at least \$1 million or 200,000 shares. See James L. Cochran, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 *Fordham Int'l L.J.* S58, S63 (1994). There are about 200 non-U.S. companies that meet these criteria.

The NYSE proposal envisions that world-class issuers would be permitted to use their *home* country accounting principles and provide a narrative, but not a quantitative, discussion of any differences from U.S. GAAP. See *id.* For a critique of the NYSE proposals, see Sherbet, *supra* note 3, at 888-92 (arguing U.S. GAAP still provides incrementally useful information to investors and that the increasing numbers of foreign firms listing in the U.S. is inconsistent with the argument that U.S. disclosure standards are a burden to foreign issuers).

150. See James D. Cox et. al., *Securities Regulation Cases and Materials* 29 (2d ed. 1997).

An additional consideration is that large issuers generate fewer instances of fraudulent reporting practices.¹⁵¹ Large issuers attract a greater number of financial analysts, are pursued by a larger number of sophisticated investors, have managers with a greater concern for their reputations for honesty and fair reporting, and are counseled by outside professionals with a larger stake in their reputations than are smaller issuers.¹⁵² Acknowledging that one of the justifications for mandatory disclosure requirements is reducing the incidence of fraudulent or risky securities offerings, one must admit that limiting IAS to such world-class issuers would not seriously jeopardize this benefit of mandatory disclosure. This would be true even if IAS were generally perceived as marginally weaker than U.S. GAAP.

Finally, the SEC would be well advised not to limit IAS to foreign issuers. As argued earlier, the SEC is vulnerable to complaints of treating U.S. issuers more rigorously, or at least according them less choice, than foreign issuers.¹⁵³ In a global economy, such disparate treatment is difficult to justify, especially when the force driving the SEC to accept IAS is the global nature of securities trading and capital formation. Thus, borders are important when deciding who regulates what, but nationality of the firm should be irrelevant for deciding which standards apply to whom. Thus, issuers, both foreign and domestic, would have two optional sets of standards—U.S. GAAP or IAS—with no on-going duty to reconcile one to the other. Abandoning, at least for the pilot group, the need to reconcile the two reporting systems poses two new issues.

First, not requiring IAS-prepared financial statements to be reconciled to U.S. GAAP creates a fertile area for the type of managerial opportunism discussed earlier.¹⁵⁴ Managers can be expected to place the best possible financial presentation of their stewardship. If not restricted, managers could deftly undertake year-to-year switching between IAS and U.S. GAAP to select the reporting system that casts the more favorable light on their stewardship. The SEC could address this problem in a vari-

151. The only study of the characteristics of firms releasing false financial information is the recent study of 200 randomly selected cases prosecuted by the SEC between 1987 and 1997. The study was made by the Committee of Sponsoring Organizations of the Treadway Commission, and it found that most fraud in financial reporting was committed by companies whose assets were well below \$100 million. See Accounting Industry Group Releases Fraud Study Fed. Sec. L. Rep. (CCH) No. 1866 (April 14, 1999).

152. See Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. Chi. L. Rev. 567, 580–87 (1997) (reviewing market-based antifraud mechanisms that exist for large issuers).

153. See Ed Greene et al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 Bus. Law. 413 (1995). It is unlikely that U.S. firms would wish to undertake a wholesale adoption of IAS. A wholesale adoption of IAS could pose serious challenges to the firm's internal and external accountants in terms of the education and experience base needed to deal with foreign standards. A firm likely will prefer to make discrete selections of IAS standards that would be substituted for particular U.S. GAAP.

154. See discussion *supra* text accompanying notes 2–4.

ety of ways. First, it could impose an arbitrary requirement that the same accounting system must be used for a certain number of consecutive fiscal years before a switch to an alternative system. This would assure some minimal comparability of financial reporting with the registrant's prior performance and position of prior years. Furthermore, the SEC would most definitely treat a switch from, for example, IAS to U.S. GAAP as a change in accounting method so that the effects and their causes in assets, liabilities, and income, were separately isolated as they are required to do when, for example, a registrant changes its method of depreciating a fixed asset.¹⁵⁵ This response by the SEC would discourage an opportunistic use of the IAS-U.S. GAAP option by making it known that there would be even fuller disclosure of management's stewardship when such a switch is made. Finally, the SEC could condition any switch between IAS and U.S. GAAP on the approval of the firm's audit committee.¹⁵⁶ To give emphasis to this procedural requirement, the SEC should consider requiring the audit committee to separately opine that the use of the new accounting method more clearly presents the financial position and performance of the firm.

A second problem posed by accepting U.S. GAAP or IAS for SEC filings is that U.S. investors will be confronted by competing investment opportunities whose disclosures are similar, but not perfectly comparable. As seen earlier, we cannot expect that IAS will continually be the mirror image of U.S. GAAP. Differences between the two will surely abound with IAS being more rigorous on some matters and U.S. GAAP on others. Important differences can be addressed if the SEC mandates selective disclosures to supplement the standard setter whose pronouncement is found the more deficient. More generally, the SEC should require, certainly for those using IAS, a detailed narrative on the authority of the firm's audit committee. The narrative would fall short of a full reconciliation to U.S. GAAP. It would instead discuss the areas of difference between IAS and U.S. GAAP which, for that issuer's reporting period, the audit committee, in consultation with the firm's independent accountant, believes are significant measurement differences from U.S. GAAP. Aside from facilitating investor comparisons to U.S. GAAP reporting firms, the auditor's and the audit committee's engagement of this task are likely to produce useful transparency to the decisions of managers' preference to use IAS.

155. Such a decision would likely be seen as a change in accounting methods whose effects are required by existing accounting standards to be elaborately disclosed. See APB Opinion, 20 Acct. Changes (Aug. 1971); Item 301, Regulation S-K, Instruction 2 (setting forth requirement to discuss changes in accounting methods).

156. The analogy could well be made to the SEC's effort to address concerns that executive compensation sometimes fails to bear a relationship to the firm's financial performance. The SEC has required extensive disclosures by its registrants of their directors' review of their executive's compensation and the firm's performance. See Item 402 of Regulation S-K.

CONCLUSION

There are few truths in formulating disclosure policy and certainly accounting standards are no better. Intuition and experience are important factors, but most dominant is surely the culture that has developed. The U.S. has for most of the last century enjoyed a level of economic prosperity that has allowed it to develop a regulatory culture vastly more rigorous than its foreign counterparts. With the globalization of securities markets, we must now rationalize our culture in a larger world. But one of our strengths remains our stewardship over the most trustworthy capital markets in the world. The increasing flow of foreign issuers to U.S. markets provides evidence that the expected benefits of offering and listing securities in the U.S. still exceed the regulatory burdens they occasion. What we do not know is whether the attractiveness of U.S. markets is due to infrastructure considerations that may over time be replicated in rival markets. Certainly capital and investment banking houses may freely move to London or Frankfurt. However, the U.S. has a strong interest in preserving its position as the host country of the preeminent and most vibrant capital markets in the world.

For now, the U.S. appears secure in its position and should be reasonably satisfied with the disclosure mechanisms that have evolved for its capital markets. But to be secure does not mean one need be unreasonably intransigent to alternative approaches. As the IASC becomes a more formidable accounting standard setter, the SEC will find itself increasingly more isolated if it continues to reject use of IAS by its registrants. With that isolation it will also weaken its impact on the future of the IASC. This would be a great loss for all nations.

This paper has provided a cautious approach that the SEC can take to preserve its influence over international securities law and standards developments while also accepting IAS in SEC filings. The approach recommended preserves the comparability principle, which this paper demonstrates remains a vital component of the U.S. disclosure regime, and also preserves, contrary to the position championed by other commentators, the SEC as the principal regulator for U.S. capital markets. As described at the beginning of this paper, disclosure standards embody a wide choice of social, economic and political choices. This paper has shown that the decision facing the SEC regarding IAS has all these features.

Because the approach recommended here preserves the exclusivity of all other SEC mandatory disclosure requirements—allowing alternatives only with respect to the standards that apply to the registrant's financial statements—it is far less sweeping than that recommended by the commentators reviewed in Part V. Moreover, the position advanced here assures that the SEC retains a quasi-certification function with respect to IAS since the SEC can compel supplementary disclosure for any IAS it

finds deficient.¹⁵⁷ However, the approach recommended here is a significant initial step for the SEC in its journey toward perhaps a more sweeping recognition of IAS, and perhaps recognition of a wider range of foreign-based disclosure standards. The present need for foreign firms to reconcile their financial statements to U.S. GAAP is by far the most visible and controversial of the SEC requirements. It should be the first addressed. Experience gained by the SEC's incremental embrace of IAS not only highlights the rising stature of the IASC, but will surely provide experience that the SEC can apply when considering foreign-based disclosure standards in the future.

157. Thus the approach recommended here is far short of the full reciprocity the SEC has extended to Canadian issuers, its only acceptance of another nation's disclosure standards. See Multi-Jurisdictional Disclosure System, Securities Act Rel. No. 6902 (June 21, 1991).