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## **The Death of the Securities Regulator - Globalization**

**By**

**James D. Cox**

Technology has made the world a smaller and more integrated world for investors and firms seeking capital through public offerings. U.S.-based investors and issuers invest and raise capital in foreign markets at an every increasing pace; foreign investors acquire securities in U.S. capital markets and foreign issuers raise significant amounts of capital through public offerings in the U.S. Indeed, there is an accelerating pace of such transnational investing and offerings.<sup>1</sup> An important component of these developments is the scope of mandatory disclosure requirements that issuers must satisfy to list their securities for trading or to conduct their offerings in a country. Presently, the requirements that must be satisfied are those of the host market. Thus, a Japanese firm seeking to list its securities on the New York Stock Exchange must abide by and must also comply with U.S. disclosure requirements when it conducts in the U.S. a public offering of its securities. However, if a U.S. investor purchases the Japanese issuer's security on the Tokyo Stock Exchange, that investor depends not on the protective provisions of the U.S. securities laws but those that apply to Japanese companies.<sup>2</sup>

Because the world we live in is a shrinking one, there is good reason to question the continuing practicability of territorially-based securities laws. Because investors and issuers have a choice of which disclosure requirements apply by where they each choose to place their transaction, those who champion the status quo in which disclosure requirements are territorially determined may well find that technology has facilitated a world without borders. Thus, globalization forces us to reexamine the fundamental premise of regulation: the territorially-based scope of national securities laws. There are at least three distinct regulatory paths that diverge from the status quo. One path leads us to multilateral agreements whereby participating nations agree to a single set of disclosure standards which would be applied to companies of all signatory nations.<sup>3</sup> Another path takes us in another regulatory direction where, instead of a single, monolithic set of mandatory disclosure requirements, globalization may instead lead to multiple standards to be represented in a single market. Such an approach essentially collapses into their home market the environment in which all investors essentially have access to a world market where there are numerous disclosure regimes. The third

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<sup>2</sup> The notable exception to such territoriality is the passport enjoyed by issuers within the European Union whereby compliance with the disclosure requirements of one member state permits an issuer to raise capital and to list its securities in another member state without the necessity of satisfying the disclosure requirements of that state. This approach, however reflects that each member state's laws satisfy the minimum requirements broadly called for by the various directives of the EU.

<sup>3</sup> The approach taken by the EU is a variation of such a multilateral approach. *See* note \_\_, *supra*.

approach is a mixture of the two preceding alternatives. The focus of multilateral agreements would be to establish minimum disclosure standards among signature nations, but allow some nations to impose more demanding greater requirements. The template for this third approach is the practices authorized within the European Community. The cornerstones of securities regulation in the EC are the principles of minimum standards and mutual recognition,<sup>4</sup> whereby minimum disclosure standards for members are set by various EC directives<sup>5</sup> and an issuer's compliance with the requirements of one member provides it with a "passport" to sell or list its securities within another member state. Interestingly, a few member countries impose disclosure requirements substantially more rigorous than the minimum level demanded by the applicable EC directives.<sup>6</sup> Thus, within the EC, multiple standards can exist within a single market. An approach significantly more extreme than that within the EC would occur if there were no agreement respecting minimum standards. This is the regulatory path suggested by the second alternative. To the extent that all the above approaches lead to some form and scope of mandatory disclosure requirements they each provide at least an obvious advantage to investors: the avoidance of added transaction costs investors now incur if they place their trade in a country different from the one in which they live will be avoided. This reduces the costs they now incur when they make an investment choice that also substitutes the protections of their home country's securities laws for those of the country hosting their purchase or sale.<sup>7</sup> One may well see that such a future approach, in which the applicable disclosure laws are not determined solely by the host country, as the natural movement toward a globalized economy.

The organization of this article is straight forward. Part I considers the implications of security regulation of the on-going debate among political scientists of globalization's consequences for, and strategies to be pursued by, individual nations. Centering the arcane topic of securities regulation within this debate provides a sharper focus for assessing the options the U.S. Securities and Exchange Commission, presently the leading international force on the topic, will face as it confronts the unrelenting forces of globalization. Part II describes several regulatory options the SEC may consider. As will be seen, each option is market based and contemplates, much like the EC experience, multiple disclosure standards within the host market. The effect of having multiple regulatory regimes within a single host market raises a profound question: can the well-recognized objectives for regulating securities markets commonly pursued by a host country be accomplished when its regulator is not the exclusive standard setting for disclosure practices followed in its capital markets? This question is addressed in the next two parts of the article. In undertaking this analysis, the analysis in each part is build upon its own distinct assumption regarding the overall efficiency of the host capital markets. Part III proceeds on the assumption that the multiple disclosure standards approach applies only to securities that are traded in efficient capital markets. Because market efficiency has many possible meanings, I am careful to confine my usage of this term. I use the term to describe market conditions in which securities prices accurately and rapidly reflect the intrinsic value of the issuer's shares in light of all

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6 *See* Howell Jackson & Pan

7 One beneficial effect of the EC's Investment Services Directive has the significant reduction in of cross border securities transactions within the EC. *See*

publicly available information. This is sometimes referred to as markets being fundamentally efficient.<sup>8</sup> We might consider the assumption that underlies Part III as the best case scenario for those championing the multiple disclosure standards approach. As will be seen, that approach depends heavily upon investors impounding in their trading decisions the value to them of more or less disclosure. Obviously our confidence in pricing securities is higher if we have confidence that the parties can reach defensible judgments regarding the value each attaches to an additional unit of disclosure. After all, to the extent that risk is impounded in the price of the underlying security, our comfort level in a regime that allows parties to opt for the disclosure regime of their preference should be influenced by our belief that the security will be priced to reflect the bargain that is struck, including the disclosure risks implicit in the bargain. In Part IV, I assume that markets are not fundamentally efficient. The analysis in Part IV proceeds on the assumption that neither issuers nor investors can *accurately* price for a particular security the value of an additional unit of disclosure or, more globally, the incremental value of the U.S. over French disclosure requirements, or, for that matter, the incremental value financial statements prepared according to U.S. GAAP instead of pursuant to International Accounting Standards. Part IV does, however, assume that security prices do change in response to the public release of financially significant information. I refer to this condition as markets that are informationally efficient.<sup>9</sup> The reader may appropriately consider that Part IV is not solely focused upon the acceptability of a multiple disclosure standards approach for markets that are not efficient, but also inquires into the capacity of securities regulation to fulfill its objectives with respect to securities that are not accurately priced.

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<sup>8</sup> Scholars frequently find it useful to distinguish between information and fundamental efficiency. *See e.g.*, Ian Ayers, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. Rev. 945, 965-75 (1991); Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907, 912-13 (1989)(distinguishing between trading and value efficiency). For the view that markets are fundamentally efficient and hence there is no analytical benefit to separately consider informational efficiency, *see* Jonathan R. Macey, & Geoffrey P. Miller, *The Fraud-on-the-Market Theory Revisited*, 77 Va. L. Rev. 1001, 1012-15 (1991). For a crisp overview of the distinctions among types of efficiency, *see* Victor Brudney & Wm. W. Bratton, *Cases and Materials on Corporate Finance* 130-31 (4<sup>th</sup> ed. 1993).

In contrast, informationally efficient markets are those where the securities prices respond rapidly to the release of financial relevant information; however, such a state of efficiency does not mean that a security's price so reflects its intrinsic value. The distinction between informationally and fundamentally efficient market also explains the causes of the division found in the literature regarding whether markets are in fact efficient. Those who study whether stock prices are independent of one another and the rapidity by which securities prices changes in response to financially significant information conclude securities markets have conditions that are consistent with market efficiency. On the other hand, those who question whether securities markets perform in a manner consistent with the intrinsic value of securities amass a good deal of evidence that securities prices at best drift toward, but do not otherwise continually reflect the traded security's intrinsic value. *See generally*, James D. Cox, et. al. *supra* note \_\_, 36-42.

<sup>9</sup> *See* Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*: 62 Geo. Wash. L. Rev. 1133, \_\_ (1994)(“informational efficiency describes a market in which all public information is reflected in the price of that security, without regard to the quality of that information. Thus, information that concerns fundamental value of a security is reflected but so is information wholly unrelated to that fundamental value, such as who won the Superbowl.”)

## Part I. Two Views of Making Law in a Globalized Economy

Though Gaul was divided into three parts, political scientists generally fall into two camps regarding their view of the possibilities of cooperation through international law: the realists perspective and the liberal/institutionalist perspective. One must regard the present thinking regarding securities regulations response to globalization by the U.S. and much of the world as being consistent with that of the realists. Despite the pressures of globalization, the realist school believes that a single national standard for each nation will be the most likely outcome. The realist perspective is generally attributed to a reaction to post-World War I Wilsonian liberal internationalism. Realist rejected Wilson's embrace of international organizations, such as the League of Nations, as well as the concept of collective security as vehicles to replace war and power politics. Realists explained international politics in terms of antimony: law versus power; the domestic real versus the international real; cooperation versus conflict, moralism/idealism/utopianism versus reality.<sup>10</sup> Though this may strike one as being a bit divorced from the arcane topic of securities regulation, we are drawn closer to these juxtapositions by their unifying thesis: nations champion only their own national interests. Incantations regarding the preeminence of U.S. capital markets and the rigors of its regulation are repeatedly joined as justifications for the status quo of U.S. regulatory treatment of foreign issuers. Only isolated accommodations are made for foreign issuers<sup>11</sup> and with the exception of Canadian issuers,<sup>12</sup> all must abide by the same disclosure standards that pertain to U.S. issuers.<sup>13</sup> The close observer of U.S. positions on transnational securities regulatory issues finds resonance in the insights of the leading contemporary realist, Professor Kenneth Walz. He views the organizing thesis of understanding international relations as that of an anarchic order because there is no higher government above the world's nations. Within this world, nations are preoccupied with power and security issues and international organizations only marginally affect prospects of cooperation.<sup>14</sup> In the important issue of war and peace, the absence of an overarching authority that creates the void into which fear and distrust among nations abound.<sup>15</sup> For the more mundane topic of

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<sup>10</sup> The founding works of modern realists are Hans J. Morgenthau, *Politics Among Nations: The Struggle For Power and Peace* (5<sup>th</sup> ed. 1973); Edward H. Carr, *The Twenty Years' Crisis, 1919-1939* (1964); and George F. Kennan, *American Diplomacy, 1900-1950* (1951). For an excellent review of these works and that of others, see Anne-Marie Slaughter Burley, *International Law and International Relations Theory: A Dual Agenda*, 87 *Am. J. of International Law* 205 (Apr. 1993).

<sup>11</sup> The annual form required of foreign issuers to satisfy the U.S. periodic disclosure requirements, Form 20-F, was amended so that it conformed to that embraced by the International Organization of Securities Commissions, but the change the accommodation did not change the overall scope and degree of disclosure so required. See *International Disclosure Standards*, Securities Act Rel. No. 7745 (Sept. 28, 1999). And, some requirements regarding accounting reconciliations to U.S. GAAP are relaxed for foreign issuers. See generally James D. Cox, et.al., *Securities Regulation* 327-28, 678-79 (3d ed. 2001).

<sup>12</sup> See *Multiple-Jurisdiction Disclosure System*, Securities Act Rel. No. 6902 (June 21, 1991).

<sup>13</sup> Foreign issuers with shares listed on a U.S. exchange are exempt from U.S. proxy disclosure requirements and the short-swing profits filing and disclosure requirements. See Rule

<sup>14</sup> See Kenneth Walz, *Theory of International Politics* (1979).

<sup>15</sup> *Id.* at 113. Joseph M. Grieco, *Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism*, 42 *Int'l Org.* 485, 497-98 (Summer 1988).

securities regulation, we find the independent pursuit of the content of securities regulation. In such a world, the realists posit that public policy is guided not by the goal of achieving the highest individual payoff from a domestic initiative, but rather to prevent others from achieving advances in their own capabilities.<sup>16</sup> Simply put, nations are more concerned with maintaining their position with an emphasis on preventing others from improving their capabilities.<sup>17</sup>

It is on the last two points that the realists thesis diverges from objective evidence of practices pursued by the SEC. Though the SEC has remained a relatively inflexible rampart against pressures to reduce the rigors of U.S. disclosure standards for foreign issuers, it has been anything but an obstructionist in the efforts of sister nations to raise their own regulatory standards and capabilities. Indeed, a important focus of the SEC has been its interaction with individual nations and international organizations to promote their development of regulatory standards that approach those of the U.S.<sup>18</sup> At this level, the SEC appears to reflect the view of the liberal/institutionalist school that it is possible for nations to adopt and adhere to international or multiple regulatory standards in a sustainable fashion. The rise of transnational corporations and the expansion of international trade are among the events that challenge the realist view of the continued supremacy of the rules of an individual nation as an instrument of international politics. And, with the collapse of the Soviet Union, security concerns, certainly for developed countries, were replaced by economic concerns.<sup>19</sup> The focus of the liberal/institutionalist is:

[how] interactions among states and the development of international norms interact with domestic politics of the states in an international system so as to transform the way in which states define their interests. Transnational and interstate interactions and norms lead to new definitions of interests, as well as to new coalition possibilities for different interests within states.<sup>20</sup>

There are important illustrations supporting the hopefulness that underlies so much of the cooperative scheme the liberal/institutionalist believe possible are the willingness of states.<sup>21</sup> Among those are the willingness of certain nations, such as those in Europe, to cast aside important aspects of their sovereignty and integrate their economies<sup>22</sup> as well as the well-documented practices of most states to voluntarily adhere to international law

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<sup>16</sup> See Joseph M. Grieco, note \_\_, *supra* at 498; Edward H. Carr, note \_\_, *supra* at 111; Robert Gilpin, *War and Change in World Politics* 87-88 (1981).

<sup>17</sup> See Emerson M.S. Niou & Peter C. Ordershook, *Realism versus Neoliberalism: A Formulation*, 35 *Am.J. Pol. Sci.* 481, 483 (May 1991); Grieco, note \_\_, *supra* at 499.

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<sup>19</sup> See Joseph S. Nye, Jr., *Neorealism and Neoliberalism*, 40 *World Politics* 235, 235-36 (Jan. 1988).

<sup>20</sup> *Id.* at 238.

<sup>21</sup> See generally Charles W. Kegley, Jr. *The Neoidealist Moment in International Studies? Realist Myths and the New International Realities*, 37 *Int'l Studies Quarterly* 131 (June 1993).

<sup>22</sup> See C.W. Kegley, Jr., *The New Containment Myth: Realism and the Anomaly of European Integration*, 5 *Ethics and International Affairs* 99 (1991).

even in circumstances where compliance runs counter to their immediate self interest.<sup>23</sup> A leading scholar in this area is Professor Robert Keohane who has shown how international regimes or institutions can and have facilitated cooperation among governments, not by mandating what they should do, but rather by helping governments pursue their own interest through cooperation.<sup>24</sup> Thus, the liberal/institutionalist do not reject the importance of national self interest, but see that international cooperation, perhaps through an international organization, can indeed empower nations.<sup>25</sup>

There is no central supreme authority by which all nations securities regulators are accountable. Nations share a common view of the importance of securities regulations. As set forth later in this article, there are four very broadly recognized objectives that are sought to be achieved by securities laws. Though these objectives have broad support across nations, they vary widely in the details how these objectives are to be achieved and, most particularly, the costs issuers and others must bear for their achievement.

A central issue, however, is whether, given certain assumptions about the efficiency of capital markets, the objectives are compromised, and to what extent, if a nations' regulatory cannot control the minimum level of disclosure that is to apply in its markets. If regulators and nations were persuaded that ceding local control did not seriously compromise the domestic interest embodied in objectives of its securities laws, even the realist would envision cooperative action among nations. On the other hand, if regulatory objectives are seriously compromised, the liberal/institutionalists school provide a hopeful note that strong national interest may overtime interact to lead to cooperative efforts that reduce differences. But to do so, there needs to be an understanding just what local objectives are compromised, and to what extent, when a nation forsakes its approach for that of another what it gains and what is loses. Parts III and IV of this article provide the first such consideration of these questions.

## Part II - Strategies To Confront Globalization: The Rise of Multiple Disclosure Standards

Choice generally is a wonderful thing. With choice there is the freedom to pursue what one believes is in his best interest. Choice therefore is the cornerstone of our market-based economy since it is the freedom to pursue what one believes is in his self interest that ultimately decides what gets produced and how capital is allocated among competing producers. More productive uses are funded and at a higher return on investment compared with ventures that are seen as less attractive. Issuers also have a choice of financing means and, in today's global market, many issuers can choose in which country they will seek funds. The U.S. has long been committed to a market economy. In large measure it is the success of our system that has persuaded most of the world to be similarly committed. But whatever the cause, capitalism has never had a greater following than it has today.

Even though there is a world-wide commitment to the allocational function of capital markets, each country shapes the capital raising process by *its own* set of mandatory disclosure rules. Thus, though nations

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<sup>23</sup> See D. V. Jones, *Code of Peace: Ethics and Security in the World of Warlord States* (1991); C.C. Joyner, *The Reality and Relevance of International Law*, in *The Global Agenda 202* (3d ed. 1992).

<sup>24</sup> Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (1984).

<sup>25</sup> *Id.* at 244.

have a common goal, they vary widely in how they seek to achieve it. Investors, therefore, enjoy a choice of investment opportunities and in a global trading world they have competing regulatory regimes. On the other hand, within any single market investors' assessments of those opportunities is affected by mandatory disclosure requirements over which neither the investor nor the issuer have a choice. This occurs because mandatory disclosure rules within each country are territorially-based so that all issuers traded in the local market are subject to the same requirements.<sup>26</sup> We find, for example, that baseline disclosure requirements for offerings and trading in securities in France are regulated by disclosure requirements administered by the *Commission des Opérations de Bourse*, those in the U.S. are regulated by its SEC, and so forth. Correlatively, the securities regulator's jurisdiction to prescribe is confined to the borders of the nations in which it sits so that transactions within its jurisdiction are regulated exclusively by its disclosure rules, even though investors and issuers may prefer a different regime.<sup>27</sup> In this way, each securities regulator enjoys a regulatory monopoly over securities transactions within its nation's borders.

There are four well recognized interrelated objectives sought to be achieved by mandatory disclosure requirements of the securities laws.<sup>28</sup> Each objective reflects the regulator's fear his intervention is necessary to address a harmful market failure. First, mandatory disclosure is argued necessary to provide investors with information they need to make informed intelligent investment decisions. Stated simply, absent mandatory disclosure requirements investors will not receive the information they need to assess competing investment opportunities; the information they do receive will vary widely across issuers so that comparability among

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<sup>26</sup> To be sure, investors and issuers who prefer opportunities governed by one regulatory regime over those of their home country can direct their transactions to that jurisdiction. Thus, choice does exist, but its exercise entails additional costs to both the issuer and the investor that would not exist if the issuer and the investors could have matched their interest in their home jurisdiction rather than in another regulatory jurisdiction. For a review of the fundamental components of the securities laws across major markets, *see* Marc I. Steinberg & Lee E. Michaels, *Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity*, 20 *Mich. J. of Int'l L.* 207, 210-235 (1999).

<sup>27</sup> In any country, there is always the option for issuers to provide greater disclosure than required by the host country where the issuer believes this is in its best interest. The regulatory rubber hits the pavement where the issuer and investors may prefer less disclosure than is mandated in the host country. It is the latter - less disclosure - situation in which the issue of menus exist. In the former - more disclosure - there is no serious conflict between regulators, issuers and investors.

The territorial orientation of a nation's jurisdiction to prescribe and to enforce its regulatory objectives is the predominant approach, so that exceptions arise in those rare instances when conduct committed outside its borders threaten harm or cause actual harm to its national interest. *See* Restatement (Third) of Foreign Relations Law of the United States §§ 402 & 403 (1986); *Id.* reporters note 1. *See generally* James D. Cox, et. al., *Securities Regulation Cases and Materials* 1201-1204 (2d ed. 1997). The U.S. jurisdiction to prescribe in the securities area is even more narrowly based on territorial considerations. *See* Restatement (Third) of Foreign Relations of the United States § 416 (1986).

<sup>28</sup> *See e.g.*, International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* § 4.1 at 6 (Sept. 1998); Richard W. Jennings, et. al. *Securities Regulations* 1-6 (8<sup>th</sup> ed. 1998); John C. Coffee, Jr., *Market Failure and the Economic Case for Mandatory Disclosure System*, 70 *Va. L. Rev.* 722, \_\_\_ (1984); and Joel Seligman, *The Historical Need For A Mandatory Corporate Disclosure System*, 9 *J. Corp. L.* 1, 5 (1983).

them is not practicable.<sup>29</sup> A core feature of this objective is comparability among investment choices, at least with respect to choices among securities competing for the investor's funds. Comparability implicates the scope and detail, and to a lesser extent its presentation format, of the information the regulator requires all issuers to disclose. Second, securities laws seek to enhance the allocational function of capital markets.<sup>30</sup> Adam Smith's invisible hand is believed to operate more effectively if, on the basis of disclosed information, investors can differentiate risk and return relationships among competing opportunities. Mandatory disclosure rules are believed to facilitate allocational efficiency because uniform disclosure will lead to sharper comparative judgments respecting the relation of risk and return. Third, mandatory disclosure rules are justified as a useful prophylactic to reduce the frequency and scale of fraudulent offerings and other manipulative practices. The connection between mandatory disclosure rules and manipulative practices is illustrated by the pump-and-dump schemes that plague penny stock markets. A key feature of these schemes is public trading in securities of issuers about which there is no reliable public information. This permits the unscrupulous promoter to pique investor interest through rumors and false reports; with large numbers of credulous investors providing upward price momentum for the security, the promoter can dispose of her holdings at a substantial profit. Thus, mandatory disclosure rules fill what otherwise would be an information void that allows the unscrupulous promoter to carry out her fraudulent scheme. Finally, mandatory disclosure both empowers stockholders vis-a-vis the firm's managers and restrains opportunistic behavior by company managers. Disclosure not only nurtures the managers' responsiveness to their stockholders, certainly in connection with any regulated proxy solicitation, but also can attract a bid for control. Additionally, there is a fear that in the absence of mandatory disclosure is that managers will time their disclosures so as to

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<sup>29</sup> Note that investors may overcome some initial lack of comparability with the aid of information from other sources and additional effort (for example, to overcome differences in methodology used by issuers) to make meaningful comparisons. *See e.g.*, [studies on Lifo/fifo etc] For this type of disclosure issue, the utility of mandating uniformity is to put upon the issuer the cost of uniformity in the belief this will result in lower overall costs vis a vis the collective costs of numerous investors undertaking individual efforts to acquire the same information.

<sup>30</sup> The connection between mandatory disclosure rules and the allocational function is easiest to understand with respect to issuer transactions as contrasted with trading transactions since issuer transactions are directly linked to the issuer's cost of capital with respect to its present offering. *See e.g.*, Hirschleifer, *The Private and Social Value of Information and the Reward for Incentive Activity*, 61 *Am. Econ. Rev.* 561 (1971). Financial theorists also support the link between risk-return judgments embodied in trading transactions and the allocation of capital among competing investment opportunities. James Tobin, *On the Efficiency of the Financial System*, *Lloyds Banking Rev.* 1 (July 1982)(Though questioning whether informationally efficient markets necessarily also reflect fundamental value of the traded securities, more meaningful stock prices plausibly improve allocation of capital); Artyons Durnev, et.al., *Does Firm Specific Information In Stock Prices Guide Capital Allocation*, NBER Working Paper (Jan. 2001)(firms with more firm-specific variation in their stock prices are hypothesized to trade in more efficient markets and study findings reflect such firms allocate capital with greater precision than firms whose securities are not classed as being priced in an efficient market). These connections are accepted by many as a fundamental, even a priori step in considering regulatory choices. *See* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 *U. Cinn. L. Rev.* 1023, 1032 (2000)("If the market can efficiently price securities, the market will also efficiently allocate capital. . . .In order to efficiently price securities, investors must have a constant flow of complete and accurate information.").



maximize gains they can reap through insider trading. A further fear is that absent reliable information managers may capture a disproportionate value of the firm through artful timing of going private transactions or other restructuring. By providing in a timely manner information regarding the company's performance and its managers' stewardship, mandatory disclosure rules are believed to reduce the frequency of these ill-effects.

With the prevalence of globalized securities offerings and trading, there has been a good deal of thoughtful reexamination of why securities laws should enjoy such a regulatory monopoly. The commentators favor choice of disclosure regimes over the present-day territorially- oriented one-size-fits-all approach.<sup>31</sup> Professor Paul Mahoney argues that disclosure requirements should be set by the exchange on which the securities are listed,<sup>32</sup> whereas Professors Merritt Fox and Roberta Romano defer to the nation of the issuer's domicile.<sup>33</sup> And Professors Choi and Guzman favor a system of portable reciprocity whereby issuers could

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<sup>31</sup> Another perspective champions cooperation and ultimately convergence among regulatory bodies. The leading proponent of this view is Professor Amir N. Licht. *See* Amir N. Licht, *Games Commissions Play: 2 X 2 Games Of International Securities Regulation*, 24 *Yale J. Int'l Law* 61, 85-104 (1999)(globalization increases need for cooperation but individual nations face the classic prisoner's dilemma so that a common response is a desirable policy but is unlikely to occur without a strong, centralized regime); Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 *Va. J. Int'l L.* 563, 627-633 (1998)(cross listing of stocks stimulates forces that cause national regulatory regimes to converge); Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 *Cardozo L. Rev.* 227, 277-284 (1998)(Path dependent corporate governance patterns that exist within individual nations may well prevent securities regulation among nations from converging). Convergence is a strategy long pursued by the SEC and the International Organization of Securities Commissions. *See also* David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 *Tex. Int'l L.J.* 281 (1998)(discussing the SEC's influential role within IOSCO to bring about convergence with U.S. regulatory approaches).

<sup>32</sup> Paul G. Mahoney, *The Exchange as Regulator*, 83 *Va. L. Rev.* 1453 (1997).

<sup>33</sup> Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 696 (1997); Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 *Mich. L. Rev.* 2498 (1997). Professor Romano initially focused exclusively upon the positive effects of U.S. states competing among themselves. *see* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359 (1998). More recently, she has expanded her thesis to international regulatory competition. Roberta Romano, *The Need For Competition In International Securities Regulation*, Yale Int'l Center for Finance Working Paper 00-49 (June 30, 2001).

One identified negative of any choice of law rule based on a formalistic requirement such as the issuer's domicile is it lends itself to manipulation and, of course, formalistic results. *See* Paul B. Stephen, *Regulatory Cooperation and Competition: The Search for Virtue*, U. Va. School of Law Legal Studies Working Paper Series No. 99-12 (June 1999). However, much greater opportunities exist for managerial opportunistic choice when applicable disclosure standards depend upon the market in which the issuer's securities are traded. For a close studies revealing such opportunistic practices, *see* Amir N. Licht, *Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions*, 2000 *Colum.*

select the regulatory regime that will govern its offerings and continuous disclosure requirements.<sup>34</sup> Professor Alan R. Palmiter also calls for greater issuers choice with respect to the scope and depth of disclosure, albeit subject to minimum prescribed levels of disclosure and the maintenance of strong antifraud protection.<sup>35</sup> All such approaches that do not call for minimum standards to be met are collectively referred to here as the multiple disclosure standards approach, since each embraces an approach that would authorize multiple regulatory standards to apply to securities transactions occurring within a country's capital markets with no assurance that all issuers within a single host market would meet the minimum level of protection the host market's regulator imposed upon its domestic companies.

Even though the commentators advocate different substitutes for the contemporary mandate that all offerings and trading transactions are regulated exclusively by the laws of the host country, advocates (the exception here is Professor Fox) of multiple disclosure standards share several common theses. Each believes that busting up the monopoly presently enjoyed by the host country securities regulator will foster socially useful regulatory competition.<sup>36</sup> Competition in turn will lead to improved disclosure standards across

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Bus. L. Rev. 51.

<sup>34</sup> Stephen J. Choi & Andrew T. Guzman, 71 So. Cal. L. Rev. 903 (1998).

<sup>35</sup> See Alan R. Palmiter, Toward Disclosure Choice in Securities Offerings, 1999 Colum. Bus. Rev. 1.

<sup>36</sup> See Choi & Guzman, *supra* note \_\_ at 916 (regulatory competition would empower investors and issuers to influence how they should be regulated); Mahoney, *supra* note \_\_, at 1456, 1477 (tendency of governmental regulatory initiatives is to nurture anti competitive practices within capital markets); Romano *supra* note \_\_ at \_\_. But see Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment, 85 Va. L. Rev. 1335, 1343-49 (1999)(Mandatory disclosure requirements defended on the ground that issuer choice will lead to suboptimal rules). On the point that regulatory competition leads to sub optimal results because managerial self interest will dwarf shareholder welfare in selected areas, see Lucian A. Bebchuck, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1435 (1992). The record of the states when they have competed is not a reassuring one. See Lucian Arye Bebchuk, Federalism And Corporate Law: The Race To Protect Managers From Takeovers, 99 Colum. L. Rev. 1168, 1198 (1999)(states in competing in the development of anti takeover laws have developed "bad, even indefensible, results").

It should be noted here that though Professor Fox disagrees that regulatory competition is desirable, he nevertheless supports a regulatory regime identical to that favored by Professor Romano, a regulatory competition advocate. Professor Fox and Professor Romano, as observed earlier, each believe issuers should be governed by the disclosure requirements of their corporate domicile. See *supra* note \_\_. Professor Fox believes that it is the issuer's domicile that has the greatest interest to develop disclosure requirements that will balance the social costs and benefits while being sensitive to the individual costs and benefits of its issuers. See Fox '97 *supra* note \_\_, at 783-797. He reaches this conclusion on the strength of his belief that there will be insufficient incentives to attract foreign issuers to high quality disclosure regimes. For the opposite view, see John C. Coffee, Jr., The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications, 93 Nw. U. L. Rev. 641 (1999)(strong disclosure requirements attract foreign issuers to the U.S. who thereby bond themselves not to exploit their home country's weak corporate governance requirements); James D. Cox, Rethinking U.S. Securities Laws In The Shadow of International Regulatory Competition, 55 L. & Contemp. Prob.

nations: inefficient conventions will be reexamined by regulators and other policy makers in light of regulator innovations of competing regimes. Second, a core feature of the argument for replacing regulatory monopoly with multiple disclosure standard approach is that markets will provide their own discipline for regulatory excesses or deficiencies. This occurs because investors will take into consideration differences in the level of disclosure and enforcement of the regulating regime.<sup>37</sup> Issuers choosing to adhere to a regime generally perceived to impose lax disclosure requirements will find their securities are accordingly discounted by an amount reflecting their greater risk of disclosure-related abuses. Issuers who wish to signal their higher quality will opt for disclosure regimes that pose lower risks of disclosure-related abuses, namely the higher-quality regime or will employ other strategies to effectively overcome the risk attributable to the governing regime's weaker disclosure requirements.<sup>38</sup> In broad overview, a signaling hierarchy will develop across issuers reflecting the relative demands of their respective regulatory regimes. Third, the commentators believe that issuers and investors who have a choice as to the disclosure requirements that apply to their transactions can better match their respective interest and their related costs than is possible under the one-size-fits-all approach that prevails today.<sup>39</sup> This feature is argued to facilitate efficient contracting between issuers and investors.

There is an important distinction worthy of mention that sets the position taken by Professors Fox and Romano apart from that customarily supported by neoclassical economists. Those who customarily favor market solutions frequently embrace regulatory strategies that foster free and open contracting among market participants. This indeed is the position of Professor Choi and Guzman, since the portable reciprocity regime they advance permits issuers and investors to opt for the disclosure standards that are mutually optimal. Their choice occurs in securities markets where the investors' consent to become bound by the securities law adopted by an issuer is memorialized through their purchase of the adopting issuer's security. In contrast, both Professors Fox and Romano envision a world of much less freedom. Indeed, each prefer to constrain the issuer's freedom to choose the applicable regulatory regime because each would limit it to the country which for all practical purposes is the issuer's legal center of gravity, a venue not easily changed. With the issuer's ability to relocate itself so confined, choice is much more confined than under the free and open contracting mode that is preferred by Professors Choi and Guzman.

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157, 160-162 (1992)(issuers and investors will take into consideration the effect that the applicable mandatory disclosure rules will have on their cost of capital and return on investment, respectively).

<sup>37</sup> Choi & Guzman *supra* note \_\_, at 916-18; Mahoney *supra* note \_\_, at 1458-59 (exchanges will develop rules to attract issuers and investors to the extent disclosure benefits exceed their related costs); Romano *supra* note \_\_, at \_\_.

<sup>38</sup> This is the standard strategy for managers to address the agency costs that are impounded in the securities prices. *See e.g.*, Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure, 3 J. Fin. Econ. 305 (1976). *See generally*, Frank Easterbrook & Daniel Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 682-684 (1984).

<sup>39</sup> *See* Mahoney *supra* note \_\_, at 1457-59 (Exchanges have strong incentives to adopt disclosure rules that attract issuers and investors and will be successful in doing so to so long as the marginal benefit in an additional unit of disclosure does not exceed its costs); Choi & Guzman *supra* note \_\_, at 917 (higher return seeking investors will not be discouraged by weaker disclosure regime but more risk averse investors will be). Romano *supra* note \_\_, at \_\_. *But see*, Fox *supra* note \_\_, 97 Mich 745-757 (providing issuers a choice will result in a market failure for disclosure standards).

Recently I questioned the soundness of the theses on which the proponents of the multiple disclosure standards approach premise their arguments.<sup>40</sup> This paper raises a new concern posed by the multiple disclosure standards approach recommended by Professors Choi, Fox, Guzman, Mahoney, Palmiter and Romano: is the multiple disclosure standards approach antithetical to the well-recognized national objectives, described above, of a country's securities laws?

### Part III - Multiple Standard and Regulatory Objectives in the Perfect World of Fundamental Efficiency

To illustrate the pricing of securities in an market that is fundamentally efficient, assume that all securities are the same except that one half have an intrinsic value per share of \$22 (the X Issuers) and the value for the other half is \$20 ( the Y Issuers).<sup>41</sup> Assume further that even under the existing disclosure requirements investors will be unable to distinguish X Issuers from Y Issuers. Without additional disclosures, X and Y Issuer securities can be expected to trade at \$21 per share, so that the securities of X Issuers are undervalued and those of Y Issuers are overvalued.<sup>42</sup> The local securities regulator is disturbed by this result, because there is the gnawing feeling that some group of investors (those purchasing more Y than X securities) receive a below average return for the level of risk embraced. Moreover, allocational concerns arise if either X Issuer or Y Issuer raise capital in transactions in which the market price for their respective security influences the issuer's cost of capital. The securities regulator may therefore consider disclosure requirements that will bring about greater pricing accuracy for securities. Suppose that the baseline disclosure requirements in the above illustration do not include demanding line of business reporting requirements and that if such information were disclosed it would distinguish X from Y issuers.<sup>43</sup> The securities regulator could pursue the objective of improved pricing of securities and allocational efficiency by adopting line of business reporting so that investors are able to distinguish X Issuers from Y Issuers with the result that after this new information each security trades at its intrinsic value. Upon disclosure of line of business information, X Issuers will trade at \$22 and the Y Issuers will trade at \$20.<sup>44</sup>

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<sup>40</sup> See James D. Cox, Regulatory Duopoly In U.S. Securities Markets, 99 Colum. L. Rev. 1200 (1999)(examining the policy implications of diverse disclosure standards in the same jurisdiction).

<sup>41</sup> **Set forth the variables of price via the Gordon valuation formula**

<sup>42</sup> One of the paradoxes of just such a view of capital markets is what incentives there are to reward arbitrageurs to drive securities to their intrinsic values. Does efficiency rest upon some mispricing in any case so as to provide significant rewards for arbitrage behavior? See Sanford Grossman & Joseph Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 393 (1980)(speculating that private information in the possession of arbitrageurs provides such rewards).

<sup>43</sup> There is extensive literature supporting the usefulness of line of business information to investors such that its disclosure has a significant effect on the price of the disclosing firm's securities. See

<sup>44</sup> This is consistent with the view that securities prices change in response to firm specific information is due mostly to risk arbitrage. See Kenneth R. French & Richard Roll, Stock Return Variances: The Arrival of Information and the Reaction of Traders, 17 J. Fin. Econ. 5 (1986); Richard Roll, R2, 43 J. Fin. 541 (1988). Fairly dramatic evidence of such a result was captured in a recent study of German companies who switched to the more rigorous reporting standards of U.S. GAAP or International Accounting Standards. Those so switching narrowed considerably the bid-ask spread for

Opponents of mandatory disclosure, of course, argue that this same result will occur without any regulatory requirement. The managers of X Issuers are aware that their securities are being underpriced and will pursue strategies to distinguish their firms from the justifiably lower priced Y Issuers.<sup>45</sup> They could, for example, volunteer line of business information. However, there may well be X Issuers who would choose not to make such disclosures. For example, firms who believe either that their future is not nearly as bright as the general group of X Issuers may not wish to disclose their line of business information that would so distinguish them. Here we can introduce two variations of the X Issuer: X Issuers-Lite and X Issuers-Gold where the former has the prospect of falling back to being a Y Issuer and the latter are firms entering a new more valuable class whose intrinsic value will be \$23. In this paradigm, not all present X Issuers will wish to disclose their line of business information. Only the pure X Issuers are likely to make this disclosure. The X Issuer-Lite cannot be expected to disclose line of business information because they do not wish their shares to fall below \$21. The X Issuer-Gold may be reluctant to trumpet their forthcoming success for fear this may erode a present competitive advantage upon which that success depends.<sup>46</sup> Thus, dependence on voluntary disclosures could result in mispricing. X Issuers that do disclose will be priced at their appropriate intrinsic value. Non disclosing issuers will be seen as being made up of a composite of X Issuers, X Issuers-Lite, X Issuers-Gold and Y Issuers which will be traded at a blended price. To be sure, there could be additional signaling by the issuers, but this seems hardly likely due to the same strong motives that caused the managers not to disclose important line of business information. Absent such signaling, however, the resulting blended price for all issuers means that there is less efficiency in the allocation of capital among these competing uses. That is, as a result of the blended price, lower risk issuers must reward their investors with the same return as higher risk issuers.<sup>47</sup>

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their securities, a result consistent with investors perceiving less risk with the information released by the switching firms. *See* Christian Leuz & Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, Working Paper (July 1999). On the other hand, arbitrageurs may be unwilling to commit sufficient resources to cause a securities price to so react or fully react. *See* Fisher Black, *Noise*, 41 *J. Fin.* 529 (1986).

It should also be noted that changes in a securities return is not the only effect of a change that one can expect with increased or reduced disclosure. Reduced levels of liquidity also are associated with lower disclosing firms. *See e.g.*, T. Copeland & D. Galai, *Information Effects on the Bid-Ask Spread*, 36 *J. Fin.* 1457 (1983); L. Gloster & P. Milgrom, *Bid, Ask, and Transaction Prices In a Specialist Market with Heterogeneously Informed Traders*, 14 *J. Fin. Econ.* 71 (1985). *See generally* Albert Kyle, *Continuous Auctions and Insider Trade*, 53 *Econometrica* 1315 (1985).

<sup>45</sup> *See* Easterbrook & Fischel *supra* note \_\_, at \_\_. More generally, this signaling approach is examined closely by Professor Seligman, *see* Seligman *supra* note \_\_, at 5-8 n.24.

<sup>46</sup> That is, a clear cost of mandating a single disclosure standard is that the mandated requirement may be set too high in terms of the social costs it leads to such as reducing the rewards for incentive behavior by greatly reducing any first mover advantage by alerting others to the gains the disclosing firm has garnered through its innovative efforts. *See* Ed Kitch, *The Theory and Practice of Securities Disclosure*, 61 *Brook. L. Rev.* 763, \_\_ (1995).

<sup>47</sup> The resulting information hierarchy is consistent with studies that have found that increased levels of disclosure by firms reduce investor concerns respecting the informational advantages between the firm and outside investors such that when the firm offers its securities so that the higher disclosing firms incur a lower cost of capital. *See* D. Diamond & Robert E. Verrecchia, *Disclosure, Liquidity, and The Cost of*

From this illustration we can consider the operation of a multiple disclosure standards approach. Within the same host market, assume that foreign issuers, X' Issuers and Y' Issuers, that have intrinsic per share values of \$22 and \$20, respectively, and investors are not able to distinguish on the basis of publicly available information X' and Y' Issuers. As seen above, each can be expected to trade at \$21.<sup>48</sup> Thus, under a multiple disclosure standards approach, securities prices will reflect their respective levels of disclosures when those disclosure standards are related to the value of the underlying security. The above assumes the securities are traded in a fundamentally efficient market. With this illustration of market efficiency as background, I next consider which of the traditional objectives of securities regulation can be achieved by the local securities regulator in a multiple disclosure standards approach.

#### A. Informing Investors

If the sole objective of securities regulators is facilitating investors' ability to make meaningful comparisons among issuers on the basis of publicly available information, regulators should champion a multiple disclosure standards approach as fervently as any other regulatory approach, provided securities are priced in a market that is fundamentally efficient. Investor judgments respecting investment opportunities are at a socially desirable level of acuity if investors can accurately price securities so that any disclosure lacunae of one issuer vis-a-vis another issuer is reflected in a heavier discounting of the price of the former over the latter. Importantly, under the assumption made here, i.e., that securities are traded in a market that is fundamentally efficient, the amount of that discount will accurately capture the disclosure risk posed by the lower disclosing firm. Here we can see the strong similarity between the arguments in support of multiple disclosure standards and the longer-lasting debate regarding the social benefits of mandatory disclosure rules. Opponents of mandatory disclosure requirements have argued that mandatory disclosure rules are superfluous and impose costs in excess of their benefits. To such critics, the costs of mandatory disclosure rules are unnecessary because they believe investors in a *laissez faire* environment can self protect through discounting the returns of issuers based on the relative completeness and trustworthiness of their disclosures.<sup>49</sup> It is also

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Capital, 46 J. Fin. 1325 (1991).

<sup>48</sup> As seen in note \_\_, *supra*, some but not all X' Issuers will voluntarily disclose line of business information so as to distinguish themselves from Y' Issuers. Nevertheless, not all X' Issuers will so disclose with the same concomitant mispricing as discussed earlier.

<sup>49</sup> The fount of the empirical battle over the utility of mandatory disclosure rules was the classic work George Stigler, *Public Regulation of the Securities Markets*, 37 J. Bus. 117 (1964). Professor Stigler's assault was followed by a series of articles by George Bentson arguing that mandatory disclosure rules provide no significant protection to investors that were not present prior to 1933. *See e.g.*, George Bentson, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, \_\_ Am. Econ. Rev. 132 (1993); George Bentson, *The Value of the SEC's Accounting Disclosure Requirements*, 44 Acct. Rev. 515 (1969). The empirical weaknesses and overall validity of the findings of Stigler and Bentson have long been the source of lively debate and analysis. *See e.g.*, Seligman *supra* note \_\_, 10-18; Friend & Hermanns, *The SEC Through A Glass Darkly*, 37 J. Bus. 382 (1964). Most recently Professor Fox has provided a fresh and insightful critique of this work and how the data amassed by Professors Stigler and Bentson poorly support their attack on mandatory disclosure rules. *See Fox supra* note \_\_, 1369-1393. More recent advocates that private and open-ended contracting should replace mandatory disclosure rules thinly veil their positions in arguments championing the benefits of

argued that those who advocate mandatory disclosure requirements ignore the incentives managers have to voluntarily disclose information.<sup>50</sup> Professors Choi, Guzman and Romano similarly argue their disclosure approaches. Thus, we can see there is at best a slender divide between the arguments of those who question the mandatory disclosure rules and those who champion a multiple disclosure standards approach.<sup>51</sup> Such similarity is understandable, even predictable, since, if markets are fundamentally efficient, investors do not need the paternalism provided by the costly mandatory disclosure requirements to appropriately price securities. While the purpose here is not to review the debate on the necessity of mandatory disclosure requirements, it is relevant to place in context the concept of multiple disclosure standards.

The same divide that separates advocates of multiple disclosure standards from those who favor the host market setting minimum standards for its markets is a belief that managers will not eagerly volunteer information when it does not maximize their own utility to do so. Support for the latter is found in the numerous studies that have examined the behavior of managers in the one area where voluntary disclosure is the norm, the proffering of financial forecasts. Studies of financial forecasts consistently reflect the grave reluctance of managers to disclose unexpected bad news.<sup>52</sup> In light of such analogous evidence, we might speculate on just what we would expect to find in a world without mandatory disclosure requirements with respect to any type of information. Here our expectations are informed by insights from the behavioral sciences and we could reasonably conclude that the incentives needed to cause managers to disclose information is driven upward by the so-called “status quo bias” which naturally exists and causes greater rewards to be expected to change behavior from the norm believed to be acceptable. Thus, if the norm is that of voluntary disclosure, much greater incentives must be provided managers to encourage disclosure than in world in which mandatory disclosure is the norm<sup>53</sup>.

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regulatory competition and a multiple disclosure standards approach. *See* Choi & Guzman *supra* note \_\_\_ ; Romano, *supra* note \_\_\_; and Jonathan R. Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, 15 *Cardozo L. Rev.* 959 (1994).

<sup>50</sup> *See e.g.*, Frank Easterbrook and Daniel Fischel, Mandatory Disclosure and the Protection of Investors, 70 *Va. L. Rev.* 669, 682-684 (1984).

<sup>51</sup> Fox, *supra* note Va. 1340:

The proponents of issuer choice . . . offer a different alternative to mandatory disclosure from the one presented by its earlier opponents. Mandatory disclosure’s early critics would have allowed issuers to be bound by no regime. Romano and Choi and Guzman, on the other hand, would require each issuer to follow some disclosure scheme but would permit the issuer to choose which one. This new alternative to mandatory disclosure, however, shares with the old alternative at least one core feature: Each grants issuers substantial freedom to choose their disclosure levels.

<sup>52</sup> Not only is there evidence that managers systematically delay the release of unexpected bad news forecasts, but that the managers also systematically time their purchases and sales of their company’s securities so as to reap significant insider trading profits based on their private knowledge of the information to be disclosed in the financial forecasts. For a review of the studies, *see* James D. Cox, Insider Trading Regulation and the Production of Information: Theory and Evidence, 64 *Wash.U.L.Q.* 475, 493-95 (1986).

<sup>53</sup> *See* Bainbridge note \_\_, *supra* at 1048.

To be sure, in a market that is fundamentally efficient and when the goal is solely to facilitate comparability, the life of the securities regulator would be a quiet one. The classic goal of facilitating informed investment decision would reduce the regulator to the rather menial tasks of making sure that issuers disclosed enough information so that investors are aware of the nature of the disclosure differences among issuers.<sup>54</sup> Thus, if they were evaluating issuers X, Y, X' and Y', where X and Y provide line of business disclosures that distinguish them from one another, but X' and Y' do not, because their disclosures are guided by the requirements of another nation's laws, investors would price the securities according to the information that was available so that they would have a market price of \$22, \$20, \$21 and \$21, respectively. The role of the securities regulator would be to assure that the disclosure differences among the four issuers were adequately discernible so that these pricing differences would occur.<sup>55</sup>

Even though the presence or absence of line of business disclosures would be expected to be readily apparent to sophisticated investors, there are many other disclosure items where differences would be less apparent for which the host market's regulators could sharpen the investor's focus on their differences. Examples of such reporting methods are the treatment of foreign exchange transactions, the profits and dealings of subsidiary corporations, and management's discretion in creating and withdrawing financial reserves.<sup>56</sup> Even more subtle differences exist with respect to the rigor with which financial statements are audited and widely different standards for determining whether the auditors are truly independent from their audit clients. Certainly, if investor distrust over such matters reaches a high enough level, there will be no viable market for the issuer's security. Short of that, a market will exist and the champions of multiple disclosure standards tell us that the security's price will reflect its disclosure risks. Furthermore, such issuers can be expected to undertake non trivial efforts to isolate the various disclosure risks they do not pose.

But as we saw before, this is a question of balancing of interests so that the types of considerations that may cause X or X' not to signal their true value may well cause less than perfect signaling by the various issuers in the market. Here we should ponder whether at a minimum there still is a role for the securities regulator, such as requiring that issuers engage in certain disclosures that highlight non obvious disclosure lacunae that exist within the disclosure regime it is using. More challenging to the regulator is their need to be sufficiently conversant in reporting practices of sister nations so that they can require issuers to give appropriate disclosures of the differences (but not necessarily of their impact, as occurs now with the foreign issuer's obligation to reconcile to U.S. GAAP its financial statements that were prepared according to foreign-based accounting principles) whenever the host country believes that efficient pricing would not otherwise reflect such difference. That is, even in a fundamentally efficient market there is a need for information that at least bears on the disclosure differences among available regimes.

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<sup>54</sup> Regulators would, of course, continue to have an important role in prosecuting fraudulent or manipulative practices. *See e.g.*, Easterbrook & Fischel *supra* note \_\_, \_\_.

<sup>55</sup> Professors Choi and Guzman would call upon the regulators to assure there was minimal disclosure of any disclosure differences. *See* Choi & Guzman *supra* note \_\_, 926. ("Domestic lawmakers . . . may play a duty on broker-dealers to notify investors of the law governing transactions in a particular jurisdiction.").

<sup>56</sup> Any lack of transparency in reporting choices such as those that permit managers to act opportunistically with no probable expectation they will be reflected in the firm's securities prices will likely lead to managers to act opportunistically. *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).



## B. Allocational Efficiency<sup>57</sup>

As seen earlier, in the host market where X and Y trade, the securities regulator contributed to allocation efficiency by mandating line of business reporting. This occurred under the example because disclosure of revenues and profits for the issuer's line of businesses caused X and Y issuers prices to separate so that each type of issuer would be priced at its intrinsic value. Now consider the impact of the entry of X' and Y'. Their presence returns mispricing to the market because at least for these two securities they will either be over- or under-priced.<sup>58</sup> At the same time, both X' and Y' are riskier than X or Y since their expected value is the combination of their future potential outcomes which have a greater variance than for X or Y individually. Investors will not shy away from purchasing either X' or Y' provided the expectation of accurately identifying which stock is X' and reaping a \$1 gain is sufficient compensation for the risk involved in making that investment choice.

To illustrate the connection with allocational efficiency, assume that each of the four issuers will undertake a public offering of 50 million shares. The distribution will therefore result in Y' receiving \$50 million more and X' receiving that much less than if their shares were efficiently priced.<sup>59</sup> The regulator will view the loser in this process as not solely X' but its country's investors who choose Y' over the other three investment choices. The regulator has good cause to believe that if all issuers selling securities within its jurisdiction abided by its mandatory disclosure rules that there would have been more accurate pricing of the issued securities and investors could have better maximized their investment return. And, assuming that capital is not unlimited, some issuers may have been able to distribute more of their own securities if there had been a level disclosure field since factors disclosed in line of business reporting may reflect greater future risks for X' and Y' than for other capital-hungry issuers.

Accurate securities prices also affects the disciplining effects of the market for control which has its own impact on the role that securities markets play in the allocation of capital. Mandatory disclosure rules enhance the likelihood that managers who perform poorly in terms of making suboptimal uses of the resources under their control will be displaced. Those who replace them can be expected to better deploy the firm's resources. Thus, if the cause of differences between X and Y issuers is that X firms have talented managers and Y do not, the pricing of Y firms so that they are indistinguishable from X firms will mean their managers will continue to be immune from the disciplining effects of a takeover or proxy contest so that Y firms' resources will continue to be misallocated.<sup>60</sup>

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<sup>57</sup> For an tightly developed argument why a market that is fundamentally efficient will not necessarily lead to allocational efficiency, because managers may themselves misinterpret the risks and returns of business opportunities, *see* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. Rev. 761, 767-69 (1985).

<sup>58</sup> *See* text accompanying notes \_ to \_, *supra*.

<sup>59</sup> Readers are reminded of the earlier stated assumption that share prices are efficiently priced in light of information that is *publicly* available. Thus, X' indeed has an intrinsic value greater than the value embedded in its market price because the market price does not reflect the private information that would call for a higher market valuation.

<sup>60</sup> Thus, we would find that if bidders could not distinguish X' from Y' issuers, the effect would be to insulate underperforming firms from takeovers since their securities are overpriced. This problem may well be deminimus in the host market, because an insignificant percentage of the company's securities are

Thus, under a multiple standards approach, the well-meaning regulator loses its ability to influence the allocation of capital. Even Y issuers may suffer because investors are attracted to the prospects of the rewards of identifying a X issuer by investing in Y. Domestic issuers lose, indeed all issuers lose, if investment funds are diverted to lower disclosing firms. As developed above, the lower disclosing firms will pose greater risk but this will not prevent them from attracting capital if investors perceive the reward of accurately picking an X class issuer. And, the lower disclosing firms's managers also face a reduced likelihood of being disciplined by the market for control.<sup>61</sup> Each effect interferes with the regulators' quest to enhance allocational efficiency in their market.

### C. Reduction of Fraudulent Offerings

The securities regulator's role in deterring fraudulent offerings occurs on two fronts: *ex ante* through disclosures that reduce the likelihood of such an offering because the mandatory disclosures and accompanying verification procedures have a high probability of exposing the promoters' schemes<sup>62</sup> and *ex post* enforcement of applicable antifraud provisions so that the sanctions imposed deter others from engaging in fraudulent securities offerings. A multiple disclosure standards approach would not adversely impact the securities regulator's important role of deterring fraudulent offerings through its enforcement of applicable antifraud provisions, provided the securities regulator's enforcement of the applicable antifraud provision and the sanctions to be imposed for a violation are not fundamentally different from those of the host market.<sup>63</sup>

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traded within the host market in contrast with its home market. The disciplining effects of takeovers can, therefore, be seen as a governance issue that is traditionally commended to the home market. Though there may be some unequal treatment of investors in the host market, the same deminimus considerations can cause regulators to permit departure from the host market's traditional rules regulating the conduct of tender offers as the regulator balances the benefits of those rules versus the social cost of bidders structuring their tender offer so as to foreclose participation by investors outside the target's home market. This thinking is reflected in the SEC's rules regarding cross-border tender offers involving non domestic issuers. *See* Rule 14d-1(b), 17 C.F.R. § 240.14d-1(b)(2001). *See generally* Jill Fisch, *Imprudent Power: Reconsidering the U.S. Regulation of Foreign Takeovers*, 87 NW.U.L.Rev. 523 (1993).

<sup>61</sup> A key component of the argument that managers should be completely passive in the face of a hostile takeover of their company is the view that the target company's shares are efficiently priced. *See* Easterbrook and Fischel *Harv. L. Rev.*

<sup>62</sup> Professor Stigler's analysis of performance relative to a market index of securities offered between 1949-55 with those offered in 1923-28 led him to conclude that an ill effect of mandatory disclosure is the systematic exclusion of risky companies from public markets. Stigler *supra* note \_\_\_, 122. Such exclusion is seen more positively by others who conclude that the greater disclosure and verification that was introduced by the securities laws had the natural effect of fewer risky offerings since enhanced disclosure that risky issuers would have to make could be expected to cause investors not to purchase their offerings and thus discouraged the would-be issuers from making the offering at all. *See* Friend & Hermanns *supra* note \_\_\_, 390-391.

<sup>63</sup> Note in this respect how the multiple disclosure standard approach inherently transforms the securities laws from public to private law. *See generally* Robert W. Hillman, *Cross-Border Investment, Conflict of Law, and Privatization of Securities Laws*, 55 *Law & Contemp. Prob.* 331 (1992). Consider

But differences both in the regulator's sanctioning powers and the content of antifraud prohibitions do exist among even the most developed regulatory regimes. For example, the enforcement powers of the SEC are vastly greater than those enjoyed by regulators in London, Frankfurt or Paris. Moreover, there will always be significant interpretative questions surrounding elements key to the prosecution of a violation, such as the definition of "materiality" or whether there was a duty to disclose information.<sup>64</sup> Obeisance to a multiple disclosure standards approach requires that such matters be resolved according to laws or doctrines of the adopted disclosure regime. Consequently, any substantive weaknesses in the protection afforded investors in the adopted regime will carry forward to the enforcement actions by the host regulators and will weaken the deterrent effects of its enforcement actions. As a consequence, fraud will occur with greater frequency if issuers opt for a weaker disclosure standards so that the host country is hobbled in deterring the occurrence of fraud because the selected regime's laws provide weaker enforcement procedures and powers than do the host country's laws.

Moreover, the assumption that offerings will be priced efficiently does not protect investors from

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here the analogy to the courts' enforcement of choice of law clauses entered into between sophisticated investors and issuers. Such choice of law clauses provide that any claim of misrepresentation will be governed by the laws of the nation chosen by the parties. The courts have consistently upheld such choice of law provisions when applied to allegations of misrepresentation in securities transactions, provided the chosen nation provides defrauded investor with rights similar to those the investor would have had in the U.S. *See e.g.*, *Bonny v. The Society of Lloyds*, 3 F.3d 156 (7<sup>th</sup> Cir. 1993); *Roby v. Corporation of Lloyds*, 996 F.2d 1353, 1365-66 (2d Cir. 1993). The multiple disclosure standards approach provides investors less protection than accorded them under the approaches embraced in *Bonny* and *Roby*. The regulatory regime chosen under the multiple disclosure standards approach governs the parties' rights and obligations even though the substantive and procedural protection selected weaken the protection otherwise available to investors under the laws of the host country.

<sup>64</sup> Two interesting illustrations of the uncertainty the host country will face in considering whether under the laws of the selected disclosure regime there was a duty to disclose. First, there is the general question whether the information in fact was required to be disclosed and whether failure to disclose the information gives rise to a duty that is enforceable by the investor. *Cf Raab v. General Physics Corp.*, 4 F.3d 286 (4<sup>th</sup> Cir. 1993)(obligation of issuers to disclose information pursuant to Item 303 of Regulation S-K is not a duty enforceable in private litigation under the Exchange Act's antifraud provision); \_\_\_ (Item 303 disclosure requirements are enforceable when suit is under Section 11 of the Securities Act).

More vexing will be decisions whether, and to what extent, a disclosure obligation arises on the part of the issuer so as to avoid engaging in a half truth. *See Donald C. Langevoort, Half-Truths: Protecting Mistaken Inferences By Investors And Others*, 52 *Stan. L. Rev.* 87 (1999)(exploring the many environmental considerations that justify instances of disclosure duties and nondisclosure privileges).

It is interesting how many of the arguments pertaining to enforcement that are advanced by Professors Choi and Guzman in support of portable reciprocity in fact support the present territorial orientation of the securities laws. *See Choi & Guzman supra* note \_\_\_, 929 ("courts in the investors' jurisdiction may lack the expertise to completely analyze the regime's jurisdiction's laws"); *Id.* (the host jurisdiction "may lack the expertise to analyze and interpret the laws of the regime jurisdiction"); *Id.* 930 (investors located in the jurisdiction of the regime selected by the issuer are more likely to better understand its disclosures and that country's regulators are more likely to enforce vigorously its provisions because they will be upholding their own nation's laws).

fraudulent offerings. This pricing assumption assumes disclosure of enough information so that investors can appropriately discount the security the purchased security by the disclosure risks it presents. Fraudulently offered securities by definition will be indistinguishable from other securities, except that securities opting for more rigorous disclosure regimes pose a lower risk of fraud than those securities choosing a less rigorous disclosure regime. To be sure, investors can be expected to impound in their pricing decisions the average risk of fraud for all securities. Such an averaging however is a tricky, and most likely indeterminate, calculation. Theoretically, investors should divide securities according to the disclosure regime each has opted to use and discount each security within the group by the average risk of fraud posed by all securities in that group. So viewed, this risk is systematic so that it cannot be diversified away; the larger and more diverse one's portfolio the closer the portfolio's overall risk of holding fraudulent offering will be to the risk of fraud in the market as a whole. The significance of the risk of a fraudulent offering not being a diversifiable risk is that when the well-diversified investor has the misfortune (statistically predictable though it is) to hold a fraudulently offered security that becomes worthless, or nearly so, the investor's loss is not recouped from the other securities in the investor's portfolio. Each of the remaining securities remain subject to the disclosure risks that were embedded in them when the investor acquired them and those disclosure risks will cause them when resold by the investor to carry the same discount for their respective disclosure risks. This merely reflects the well-recognized principle that the presence of fraudulent offerings that can not be detected *ex ante* through prevailing disclosure procedures lowers the value of all offerings. At the same time, the risk being systematic does lead to all investors expecting compensation for their bearing this risk; thus, the return available to all investors is greater than if this risk were not present. Stated differently, much like the rising tide that lifts all boats, fraudulent offerings that cannot be identified *ex ante* raises the cost of capital for all issuers. Though this increases the cost of capital for all companies issuing securities and, as such can be seen as not posing allocative questions among them,<sup>65</sup> as seen in the preceding section, it implicates allocative issues when one considers that companies raising capital by issuing securities compete with investment opportunities that do not raise funds in securities markets and that involve no risk of managerial oppression.

The securities regulator seeking to prevent fraudulent securities offerings *ex ante* in a multiple disclosure standards approach faces a very circumscribed agenda. Powerless to regulate substantive disclosures of issuers opting to be governed by another disclosure regime, the most the regulator can hope to accomplish is to inform investors of the greater likelihood of fraud associated with the disclosure regime selected by an issuer. This course is similar to that discussed earlier in terms of the host regulator's task in facilitating the efficient pricing of securities so that differences in disclosure practices are impounded in the security's price. The most that can be accomplished through such generic warnings is to cause each purchased security to be priced at an amount that reflects the average risk of fraud among securities opting for that particular disclosure regime. But as seen above, even so discounted, if the investor experiences a loss from a fraudulent offering the magnitude of that loss is not offset by discounts for the other securities in the investor's portfolio. However, as seen, this risk does give rise to a larger return being demanded by all investors.

#### D. Managerial Responsiveness to Owners and Opportunistic Behavior

Mandatory disclosure rules are a central component of corporate governance. For example, proxy voting for public U.S. corporations is conditioned upon the proxy solicitor making extensive disclosure of

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<sup>65</sup> See James D. Cox, *Insider Trading and Contracting: A Response to the Chicago School*, Duke L. J.

information germane to shareholders exercising informed decisions when executing their proxies.<sup>66</sup> Absent such disclosures, shareholders would be left to the weak disclosure requirements of state law and the vagaries of fiduciary-based disclosure duties of directors and controlling stockholders.<sup>67</sup> Federal disclosure requirements overcome these weaknesses so that managers approach the proxy season with a healthy understanding that their stewardship in the prior fiscal period must be adequately disclosed in their proxy materials. Among the disclosures compelled by any SEC filing requirement are detailed revelations regarding various self dealing transactions between the corporation and its promoters, managers, or controlling stockholders,<sup>68</sup> including extensive information regarding executive compensation.<sup>69</sup> The securities laws' requirement that the annual financial statements must be independently audited is a further effort to provide owners with a neutral perspective of management's stewardship.<sup>70</sup> In this way, many of the disclosures required to accompany management's proxy solicitation materials mirror disclosures mandated by the home country's periodic disclosure requirements. A major objective of periodic disclosure requirements is to overcome the fear that absent such a mandated disclosures financially important information would otherwise not be released until the managers had reaped for themselves the financial benefits of that information by trading in their company's securities before releasing the information.<sup>71</sup> And, without adequate disclosure of information bearing on the value of the firm, managers can through self dealing transactions and going private transactions abuse their insider positions by capturing a disproportionate share of any undisclosed future gains of the firm.<sup>72</sup> Though periodic disclosure rules address these various abusive practices, there are two distinct disclosure issues posed by the before-identified objective. First should the rules governing the type and detail of disclosures in proxy materials be uniform for all proxies solicited in the domicile of the voting shareholder. Second, should the periodic disclosure requirements be uniform for all securities traded in the host market, or more particularly, should such governance-based objectives be regulated by, for example, the laws of the issuer's domicile. In combination, these two issues question whether the securities regulator's role in addressing governance and managerial opportunism is compromised if the scope of mandatory disclosure rules designed to address these two sets of issues are limited to corporations domiciled in the regulator's country?

In addressing this question an analogy to the internal affairs doctrine of corporate law is instructive. The internal affairs doctrine of corporate law holds that a broad range of governance and fiduciary-based issues are customarily resolved according to the law of the corporation's domicile. Just as the law of

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<sup>66</sup> The disclosures that must be satisfied by a U.S. reporting company in connection with the election of directors is set forth in Schedule 14A and also there is the further requirement that management's solicitations relating to a meeting at which directors will be elected must be accompanied by an annual report to shareholders. *See* Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (1999).

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Delaware regulates the relationship of owners and managers for firms incorporated in Delaware, so it is that the law of Panama governs whether a Delaware corporation may, for example, vote the shares it holds in its parent Panamanian corporation.<sup>73</sup> The well established choice of law rule calls for the forum to defer to the law of the corporation's domicile on such questions. The doctrine can also be seen as raising a strong presumption that the securities laws are designed to complement, but not supplant, the primacy of the corporation's domicile in regulating such matters.<sup>74</sup>

Further support for the primacy of the corporation's domicile in regulating disclosures directed toward improved governance and curbing self dealing is found in the SEC's prescription of the scope of key provisions of the Exchange Act. The proxy requirements of Section 14 and the short-swing profit provisions of Section 16 do not apply to foreign issuers.<sup>75</sup> Moreover, the periodic disclosure requirements are greatly lifted for foreign issuers whose securities are listed for trading in the U.S. Such foreign issuers meet their disclosure requirements by annually filing with the SEC the less demanding Form 20-F so that other quarterly reports are not required to be filed with the SEC. Thus, managers of foreign issuers that are publicly traded in the U.S. are not subject to the same disclosure requirements in their proxy statements, do not face the same proscriptions of their short-swing trading gains they garner, and do not provide information about themselves to the same degree information or frequency as U.S. issuers.<sup>76</sup>

The most ardent proponent of the view that disclosure requirements should be those mandated by the corporation's domicile and not by another country's regulators where the corporation's securities are traded have been put forth in a series of articles by Professor Fox. The central thesis of his argument is that the jurisdiction of the corporation's domicile and not the jurisdiction where its securities are traded, is the only jurisdiction that is impacted by the social costs and benefits of mandatory disclosure requirements.<sup>77</sup> Interestingly, Professor Fox concludes there are no social welfare implications for the host market by the imposition of its disclosure requirements, so that any disclosures mandated by the host market beyond those required by the issuer's domicile gives rise to social costs to the reporting issuer with no significant social benefits within the host market.<sup>78</sup> Thus, for Professor Fox, the social calculus should be focused only upon the home country and any regulatory burdens imposed by the host country is a dead weight loss.

[The earlier analysis in Part II of this article demonstrates there are social welfare implications when the host market does not have exclusive control over the disclosure requirements in its markets. We saw there that allocational efficiency is adversely affected if some issuers comply with weak disclosure rules that do not permit investors to determine a security's fundamental value.]

There is much in the literature of comparative corporate governance that supports deferring to a

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<sup>73</sup> See *McDermott Inc. v. Lewis*, 531 A.2d 206 (Del. 1987).

<sup>74</sup> See *CTS Corporation v. Dynamics Corporation of America*, 481 U.S. 69 (1987).

<sup>75</sup> See Exchange Act Rule 3a12-3, 17 C.F.R. § 240.3a12-3 (1999).

<sup>76</sup> See generally Edward Greene, et.al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 *Bus. Law.* 413 (1995).

<sup>77</sup> See Fox *supra* note \_\_, 97 *Mich* 732-34; Fox *supra* note \_\_, 95 *Mich.* 2585-91.

<sup>78</sup> See Fox *supra* note \_\_ 97 *Mich* 746-757.

corporation's domicile on disclosure obligations that will reinforce the firm's governance. It is well accepted that mandatory disclosure requirements are not nearly as necessary in a culture where ownership is concentrated than they are in the U.S.-style public corporation that is characterized by disperse ownership.<sup>79</sup> Thus, for family owned firms and companies with a strong bank at the center of its financial activities there are mechanisms quite distinct from the discipline of the proxy solicitation to address managerial opportunism or simply shirking.<sup>80</sup> More generally, it is difficult to dispute that the country where the corporation is formed has the best perspective of what relationships and their related duties are optimal for carrying on business in that country in light of a host of social considerations, such as the country's cultural values, legal infrastructure, and political system. These considerations, however, lose much of their force when the foreign-based firm transforms itself into a multinational corporation with its securities traded in markets other than the nation of its domicile. Can we really say that Daimler-Chrysler, with over forty percent of its shares held by U.S. citizens, is only a German corporation? The first step in examining whether the host securities market should totally defer to the requirements of an issuer's home country on matters focused upon self dealing and insider trading is to question what benefits, if any, the host country will derive by imposing additional disclosure requirements focused on such issues.<sup>81</sup>

Any additional disclosures mandated by a host country will likely visit costs upon the foreign issuer. The question is to gauge whether those costs produce any compensating benefits. For example, as seen earlier, disclosure of line of business information may attract the attention of competitors so that over time the profits garnered in that segment of the reporting company's operations will decline. Similarly, the type of candor called for by the management discussion and analysis of SEC filings may reveal business strategies that erode the timing advantages the issuer had expected to realize. These adversely impact social welfare for the issuer's home country and, therefore, are a concern for the home country's policy makers.<sup>82</sup> Agreement with this observation, however, does not necessarily lead one to conclude that the imposition of such disclosures and their related costs are to be solely determined by the issuer's domicile. We need also to consider the social benefits such disclosure may produce for the host market. Just where do the impacts occur of self dealing, insider trading and other forms of managerial misbehavior? To consider closely the probable impact of the various types of opportunistic practices managers may engage invites consideration as well whether their harmful effects can more efficiently be addressed through diversification. If so, then disclosure rules that reduce their frequency do so at a net social cost since investors could instead avoid the ill effects of such opportunism through diversification.<sup>83</sup> For example, Professor Fox concludes that in an efficient market, the price of the security should not be affected by disclosure of such firm specific information because no rational investor will pay a premium for a risk that could be addressed by

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<sup>81</sup> After all, under a realist's perspective of globalization, if a host country correctly views social welfare is increased by regulation, it would at least consider such regulation to be in its interest. And, the liberalist perspective would not disagree and would also envision that the host and home country would find a disclosure result that is in their collective welfare.

<sup>82</sup> See Fox *supra* note \_\_\_, 97 Mich 746-754; 95 Mich. 2550-51.

<sup>83</sup> See Fox *supra* note \_\_\_, Va. 1345-46.

diversification.<sup>84</sup> As will be seen below, this argument claims too much and misapplies financial theory to the problem at hand.

Placing theory into a practical context, consider again the social costs and benefits of line of business disclosures for the earlier illustration of X and Y. Without this disclosure, both would trade at \$21, since investors would be unable to distinguish which was a \$22 stock (X) and which was a \$20 stock (Y). Do we really believe that upon disclosure of this line of business information, i.e., firm-specific information, that no one will purchase X shares for more than \$21 or that investors will continue to purchase Y shares at \$21? Investors do value firm specific information and this is reflected in the price of the securities.<sup>85</sup> Not so, however, to Professor Fox. He counsels that well informed investors hold efficient portfolios. As such, they would be unwilling to pay a greater price for a risk that can be handled through diversification. How then is it that all studies document market price reactions counter to those predicted by Professor Fox? Here there are several explanations.

No doubt the case that Professor Fox envisions is where the non disclosed information bears on the riskiness of the security's future returns and where that risk is *exclusively* firm specific. Here, unlike the X and Y example, we are dealing with a less finite inquiry (although, line of business information does bear importantly on items that affect the firm's overall risk). Even such a diffuse type of information bears on the riskiness of the firm's security, disclosure would yield social benefits to the host market. To illustrate, assume that the returns of two securities, O and P, which are both in the same industry classification. For each, sixty percent of their past returns are attributable to their co-movement to the market and an additional fifteen percent is associated with their industry classification. The balance of each firm's returns is the unexplained variable - their price and dividend changes in response to firm specific information. An investor who is guided by portfolio theory will construct a portfolio so that the addition of either O or P is evaluated in terms of their impact on the portfolio's overall risk. Investors so guided are said to maintain an efficient portfolio. An individual security's impact on the overall risk of the investor's portfolio is of special importance when the investor is considering whether to add or remove a security from her portfolio. Thus, in considering O or P, the investor will be interested in how the systematic risk of either security will impact the total riskiness of the portfolio. And, the theory further holds that the investor can diversify away the twenty five percent of the security's variance that is associated with firm-specific events by holding enough different securities in the portfolio.

Accepting the above model and illustration, we can find several reasons why the host market's regulators could believe that social welfare is adversely affected by mandatory disclosure rules targeted toward reducing the frequency and scale managerial opportunism. Notice that in the above example, the systematic risk is historically determined. We could then conclude that information that is firm specific may well portend a future change in the security's systematic risk. Just such information is sought by both line of business and management discussion and analysis disclosures. For example, if increasing amounts of Company O's returns arise from business unrelated to its historical industry classification this information would be socially beneficial in considering whether the past measurement of systematic risk are presently

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<sup>84</sup> See Fox *supra* note \_\_ Va. 1357-58. [add block quote]

<sup>85</sup> There are many illustrations, but the most pertinent is how investors react to improved disclosure that occurs when, for example, companies use more demanding U.S. GAAP or IAS, instead of the less revealing German accounting standards. See, Christian Leuz & Robert E. Verrechia, note \_\_, *supra*



appropriate for Company O.<sup>86</sup> Similarly, if the management discussion and analysis forced disclosure of its intention to shift the firm's focus and resources in such a way as to transform its business, the historically-based measures of systematic risk would no longer be applicable to consider adding O to the investor's portfolio. Thus, even in the ideal world of all investors holding efficient portfolios, mandatory disclosure of firm-specific information is socially beneficial when such disclosure enables investors to determine if post is prologue with respect to the level of risk for an individual security.

Even if we assume the information to be disclosed does not change the systematic or industry risk of either O or P, this information can still be socially beneficial (and in turn raises the question of whether the marginal social cost of its production exceeds the expected marginally social benefit) even though it is firm specific. Large numbers of investors are not well diversified and many that are pursue strategies that seek to maximize portfolio returns by considering the individual characteristics of the security not merely its covariance to the market. For both sets of investors, the notion that the price of security O will not rise on the announcement of unexpected good firm-specific news is antithetical to their trading strategies and how the market will respond to positive firm specific news about security O. Just as investors armed with line of business information that distinguishes X from Y will no longer Pay \$21 for each of these stocks, investors armed with information that provides greater certainty, even in just the near term, that O will have higher profits than P, will respond with more than a simple yawn. Indeed, the entire learning of event studies is that stock prices do respond to firm specific information. Firm specific information does alter the price of the underlying security and its disclosure can thereby provide social benefits to the host market.<sup>87</sup>

But the most fundamental weakness of the portfolio approach recommended by Professor Fox is it fails to distinguish between returns and risk when considering the benefits of diversification. Adding more stocks to an investor's portfolio is a strategy for reducing the random variable within the return of individual stocks. The unexpected gains of some stocks are offset by the unexpected losses of others. However, to the extent that stock have a common risky characteristic, e.g., they are all shares in pharmaceutical companies, the more pharmaceutical shares that are added to the investor's portfolio the more the *risk* of the portfolio becomes that of pharmaceutical companies generally. In this way, diversification does not render the risk equal to zero, but causes the portfolio's risk to reflect that of the dominant group of stocks. Thus, using the examples earlier, a portfolio made up of X' and Y' securities would have greater risk than a portfolio made up of X and Y securities, where X and Y are understood to being higher disclosing firms than are X' and Y'.

Thus, with the debunking of the major claim to the unimportance of the host country regulating disclosure bearing upon firm specific matters, such as managerial opportunism, it remains to be considered how the host country's social welfare is affected by such disclosure. Two types of managerial opportunism that is very much the focus of host and home country securities regulators are self dealing and insider trading.

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<sup>86</sup> See e.g., *In the Matter of Caterpillar, Inc.*, Exchange Act Rel. No. 30532 (March 31, 1992)(disclosure violation asserted by the SEC where company failed to disclose that 23 percent of its net profits were derived from macroeconomic conditions related to foreign exchange translations related to its Brazilian subsidiary and that the on-going national elections in Brazil could affect monetary and fiscal policies of Brazil which may alter the future contributions by the subsidiary to Caterpillar's overall profitability).

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Self dealing poses the threat that managers and control individuals will appropriate a disproportionate share of the firm's value through transactions between themselves and the controlled company.<sup>88</sup> There are three distinct objects of disclosure rules focused on such transactions. First, disclosure of such wrongdoing is likely to reduce its occurrence, especially if there are public or private sanctions that may follow the disclosure. More than one securities lawyer has told his client, "If you do this you will be sued by Milberg Weiss." Second, disclosure of self-dealing transactions reflects on the integrity of private agenda of the firm's managers. This is material to investors because among other reasons it bears on the trust they place in the managers to serve the corporation's rather than the managers' interests.<sup>89</sup> This information thus can be expected to be impounded in the price of the firm's security so that it implicates the earlier issues related to comparative assessments and allocational efficiency. Third, managers who will engage in self dealing transactions to the detriment of the firm are likely to cover their tracks. Thus, managers who weaken the firm through misappropriating its assets or business opportunities face powerful incentives to cook the books.<sup>90</sup> We can therefore see that disclosure of self-dealing transactions provide regulators and investors with an warning to scrutinize even more closely the disclosures made in other portions of the issuer's reports. Note that the host country regulator has a legitimate concern that self-dealing transactions, including going private transactions, are harmful to local interests because an opportunistic grab for assets by managers or control persons leads to a wealth transfer from domestic investors it is more than fair game for the host market's regulators to protect their investors.

In a market in which security prices reflect their fundamental value, the choice between disclosure and non disclosure of self dealing is but one among many matters to be disclosed so that the earlier analysis carries forward. Thus, the allocational efficiency implications are not different when the disclosure item bears upon line of business information than when the disclosure item deals with managerial self dealing. What is new with the securities regulator's objective in this, the fourth and final received objective of securities regulators, is an attempt to expand the protection they provide investors beyond merely providing investor-friendly information. Regulators guided by this fourth objective seek to proscribe and effectively prevent certain forms of managerial conduct. To the extent this is an accepted objective and, hence, a perceived benefit of the host country's securities laws, the objective is obviously compromised if issuers or some issuers can escape disclosing managerial misconduct by abiding by the weaker disclosure requirements of another

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<sup>88</sup> Self Dealing transactions were among the major mechanisms by which unscrupulous managers and controlling stockholders have drained the assets from newly privatized companies in Russian and the Eastern Europe. *See* Fox and Heller, LaPorta et. al. Tunneling and Coffee articles.

<sup>89</sup> The classic U.S. holding on this point is *In the Matter of Franchard Corp.*, 42 S.E.C. 163 (1964). *See also*, *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d. Cir. 1979)("Since self-dealing presents opportunities for abuse of a corporate position of trust, the circumstances surrounding corporate transactions in which directors have a personal interest are directly relevant to a determination of whether they are qualified to exercise stewardship of the company.").

<sup>90</sup> *See e.g.*, *United States v. Dixon*, 536 F.2d 1388 (2d Cir. 1976)("loans" to executive were concealed for years by a process of reversing entries just before the close of the fiscal year so that the financial statements did not reveal outstanding amounts due from the executive). **Check** Carney and Arlen data

country. Whether social welfare in the host country is advanced or harmed by forcing disclosure of managerial misbehavior such as self dealing, depends upon the allocational efficiency implications of such disclosure. As seen in Part IIIB, allocational efficiency is better advanced by compelling all issuers in the host market to abide by the minimal disclosure requirements of that country. If allocational efficiency were not so implicated, host country investors can self protect by pursuing the tandem strategies of appropriate discounting all securities by the expected level of harm caused by managerial misconduct for all securities and maintaining efficient portfolios. However, to the extent regulators correctly understand that investors do not hold efficient portfolios, they can believe some investors will be harmed disproportionately even though they engage in some discounting while other poorly diversified investors will be benefitted. Even in such a world, the host country's regulator would be hard pressed to justify this objective since the weaker disclosing firms' productive assets are located elsewhere and its greater cost of capital will impact the social welfare of its home, not host, country. This analysis, however, assumes that weak disclosure practices with regard to items bearing on management's honesty are not so pervasive or grave as to drive investors from the market.

Insider trading poses somewhat related considerations. Insider trading customarily involves the managers' misuse of firm specific information.<sup>91</sup> A large mineral discovery, an acquisition that will occur at a premium price or a serious decline in earnings are the type of events that provide opportunities for insiders to garner a gain or avoid a loss by trading on their secret information. The potential harm of going private transactions is a larger scale of that posed by insider trading. Viewed in isolation, the information that drives the insider to trade or those in control of the company to take it private is of the type that is diversifiable. But this does not mean that the risk of harm to investors that is related to insider trading is itself diversifiable. Mandatory disclosure rules do not seek to prevent mineral discoveries, acquisitions or earning declines. Regulators do, however, seek through mandatory disclosure rules to prevent the temptation for insiders to magnify their gains in connection with such events by acting opportunistically. Such opportunism may occur by purposely delaying the release of financially significant information or otherwise misrepresenting events all with the purpose of maximizing the insiders' trading gains.<sup>92</sup> Weak disclosure rules that permit such manipulative practices yield market-wide risks for all securities governed by those rules.<sup>93</sup> Thus, lacunae within disclosure rules that facilitate insider trading introduce systematic not firm specific risks. Investors are indeed well advised to hold an efficient portfolio - the mineral discovery by one holding will off set losses suffered by another. But in pricing their securities investors will consider the overall trustworthiness of the market information produced pursuant to the governing country's mandatory disclosure laws. To the extent those laws provide weak protection to investors and thus better position insiders to manipulate disclosures to their private agenda, this is a risk of the type that raises the cost of capital for all the boats in the regulator's

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<sup>91</sup> Not always, cite to T-bill rate cases

<sup>92</sup> For the view that insider trading regulation should be premised, among other possible bases, upon such regulation being a needed prophylaxis to remove the incentive for managers and other employees to manipulated disclosure practices, such as delaying the release of financially significant information, *see* James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 Duke L. J. 628.

<sup>93</sup> *See* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, Working Paper \_\_ (based on data gathered for 103 countries, enforcement, not solely the existence of insider trading prohibitions, yields a five percent reduction in the cost of capital). *See also*, Laura Beny, \_\_

waters. Stated differently, insider trading is an important market abuse and as such produces only bad effects that cannot be diversified away. To illustrate this point, assume that the difference between X and Y firms are that Y managers can lawfully engage in insider trading and the managers of X cannot. In this situation, investors may only partially self protect by imposing a greater discount for Y shares vis-a-vis X shares. The holders of X shares remain at risk that Y managers, learning that their firm might enter into a mutually beneficial contract with X might negotiate with X to embargo news of their arrangement and thereafter exploit the embargo by secretly purchasing X shares.<sup>94</sup> Similarly, advances by Y over its competitor X may be the basis for Y's manager to short X's shares before the ill-effects of such a competitive advantage are made known by X's or Y's managers.<sup>95</sup>

Similarly, it misconceives the impact of managerial opportunism and insider trading to argue that the social costs and benefits of these practices are confined within the borders of a company's home country. To be sure, one well-recognized fear of insider trading is that the managers' use of confidential corporate information can harm the corporate interest that underlies the justification for that information not having been disclosed. For example, the right of the corporation's domicile to proscribe insider trading activity is well recognized.<sup>96</sup> However, that right is co-extensive to the jurisdiction of the host market to also regulate, even in a very different manner, insider trading that occurs in its markets. This power arises from the host market's regulators' belief that insider trading adversely affects the integrity of its markets, even when such insider trading occurs in foreign shares and is engaged in by foreign nationals. That is, the host market can always be expected to have the primary interest in regulatory issues germane to the orderly and fair operation of its securities markets.<sup>97</sup> Regulatory issues related to manipulation of stock prices, a host of market micro-structure issues related to trading in securities, and the financial, professional and ethical qualifications of market participants are just a few of the regulatory issues that are inherently within the prerogatives of the regulators of the host market. Stated differently, insider trading has negative externalities on the host market

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<sup>94</sup> See Ayers and Choi, *Outsider Trading Article cf. State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1983)(abnormal trading and price change occurred during period that contract with third party mandated embargo of news of the third party awarding contract).

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We should also understand that under a multiple disclosure standards approach investors would not be able to discriminate among firms based on the law of their home country disclosure rules so that shares of issuers with strict insider trading prohibitions will have a lower discount than issuers subject to weak insider trading rules. We would expect all securities would bear a discount that reflects the average risk of insider trading abuses for *all* firms traded in that market. This occurs because a manager of firm W that is bound by weak insider trading rules could use confidential information secured by virtue of her employment relationship to purchase the shares of S, a firm whose insiders are bound by strong insider trading rules. Admittedly this risk could be addressed by modifying the choice of law rule so that it is the insider trading laws selected by the issuer of the security that the manager trades that governs. First, this adjustment would then erode the principle that would cause firm W's regulators to have tilted in favor of insider trading: the justifications for licensing insider trading in W's securities would appear to be equally compelling for trading in any other issuer's securities.

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<sup>97</sup> Exchanges typically impose their own governance conditions as conditions of listing their shares. On the future role of listing conditions in a globalized market, see Roberta Karmel

such that one objective of insider trading is to force issuers to bear some of the costs of removing such externalities by complying with mandatory disclosure rules. Because insider trading is seen as a necessary extension of regulations for fair and orderly markets, insider trading is a legitimate focus of the host market's regulators. One of the objectives of mandatory disclosure rules is to erode the information advantage of company insiders who otherwise can artfully time disclosures to maximize their insider trading strategies. It would not be under a multiple disclosure standards approach.

#### Parr IV - Regulation in an Informationally Efficient Market

The case for capital markets being fundamentally efficient, the assumption made in Part III, is not a strong one. There is abundant evidence that conditions that would so characterize such a market do not exist.<sup>98</sup> Indeed, efforts to observe the connection between a security's intrinsic value and its price in the market have with some regularity documented statistically significant differences between the forecasted intrinsic value and the price that is observed. To be sure, any such study can be faulted for weaknesses in the methodology used to forecast the security's intrinsic value so that variances from the observed market price from the forecasted value can be attributed to the forecasting model and not to imperfections in the operation of capital markets. Nevertheless, since the forecasting models so employed are of the type sophisticated investors are likely to use in making their own investment decisions, the recurrent differences between forecasted and observed values does not support the belief that securities markets are fundamentally efficient.

On the other hand, even studies that reject the hypothesis that securities markets are fundamentally efficient are not inconsistent with the belief that securities prices respond rapidly to financially significant information.<sup>99</sup> This state of efficiency, referred to here as securities markets being informationally efficient,

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<sup>98</sup> For reviews of the numerous studies noting the disconnect between between observed securities prices and underlying value as well as more general studies of why conditions are not conducive to security prices reflecting intrinsic value, *see* Eugene F. Fama, Market Efficiency, Long-Term Returns, and Behavioral Finance, 49 J. Fin. Econ. 283 (1998); Cunningham, note \_\_, *supra*, Donald C. Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. Pa. L. Rev. 85, \_\_ (1992).

<sup>99</sup> Hence, informational efficiency, the operating assumption for Part IV, focuses upon the degree to which securities prices are responsive to financially significant information. This has been the classic approach to the nature of market efficiency. *See* Ronald J. Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549 (1984); Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383 (1970).

Gilson and Kraakman explain the relative strengths of the weak, semi-strong and strong forms of market efficiency on the relative costs to investors to acquire and interpret information (e.g., in the case of the weak form of efficiency, past stock price movements). Professor Lynn Stout provides a further explanation of grades of efficiency, reasoning that some forms of information is easier to interpret than other forms and, hence, the easier forms are more widely circulated by the media (e.g., merger announcements) with the concomitant effect such information is more rapidly impounded in a security's price. *See* Lynn A. Stout, Stock Prices and Social Welfare, Harv. L.School Working Paper No. 301 at 11 (Nov. 2000).

A "rapid response" as used here refers to an observable material change in a security's price

poses a more difficult environment for justifying a multiple disclosure standards approach under the traditional objectives of securities regulation.

#### A. Pricing Securities in an Informationally Efficient Market

To illustrate the functioning of an informationally efficient market (that is assumed to exist for the analysis in Part IV), return to the earlier illustration of two firms, X and Y where without line of business information investors are unable to distinguish the higher valued X firms (\$22) from the lower valued Y firms (\$20). Investors estimate the value based upon broad sets of information bearing on each firm's past, present and future performance. In a market that is only informationally efficient, investors will have heterogeneous expectations regarding what to make of each bit of information within these sets so that the security's resulting price will reflect their ranging estimates.<sup>100</sup> Thus, it is not possible to conclude, as we did earlier, that in an informationally efficient market that investors would, absent line of business information, price X and Y securities at their combined weight of \$21. Instead, investors can be expected to disagree about the value of X and/or Y firms generally so that the security's price will reflect, most likely on an on-going basis, their disagreement whether the intrinsic value of X shares is greater or less than \$22 and similar disagreements will occur for Firm Y shares. Thus, investors in an informationally efficient market will not price X and Y shares at \$21 when they cannot distinguish X from Y firms; instead, each share will be priced in a range around \$21 per share. The breadth of that range being directly related to the degree to which their expectations diverge.<sup>101</sup>

Investor expectations also diverge when line of business information is disclosed. To be sure, this new information will continue to enable investors to distinguish X from Y firms so that they will not longer be priced by investors as a composite of both X and Y firms. Yet in pricing X firms as X firms, investors will

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once information becomes publicly available. It does not mean that the observed price change occurs in a single step or that its duration is for only a short time. Rapid as used here refers to the time between the information's public release and when the price change begins. As used here, a security's price may well continue to change, i.e., there will be statistically observable volatility in the security's price, after the release of publicly available information. The focus therefore on rapid is the time between the release of the information and the commencement of the price change, not between the information's release and when a security's price ceases to reflect changes in response to the released information.

<sup>100</sup> See Lynn A. Stout, *How Efficient Markets Under-Value Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 *Cardozo L. Rev.* 475 (1997). In addition to investors having heterogeneous expectations, they may simply act irrationally or their time horizons may widely diverge. Each of these possibilities can cause prices to diverge from their fundamental value. See generally Lawrence Cunningham, note \_\_, *supra* at 255-57.

<sup>101</sup> There are a number of reasons why risk averse arbitrageurs can be expected, and most assuredly do, limit their trading so as not to drive securities to the level each believes is the individual security's intrinsic value. See e.g., Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 *J. Fin.* 35 (1997). Indeed, their risk aversion is driven by the necessity of pacifying investors whose anxiety grows with losses not soon offset by gains sufficient to reward them for the uncertainties that abound in arbitrage activities. See Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* Ch. 4 (2000).

again bring their varying opinions respecting the intrinsic value of X firms. Though in theory arbitrage opportunities may abound when their combined judgments yield prices that differ materially from a security's intrinsic value, there is much evidence that arbitrageurs consistently do not ameliorate these differences. Here we should further consider the impact of a new compelled disclosure, such as the line of business disclosure in the illustration. A new disclosure requirement of financially significant information in an informationally efficient market will likely elicit varying judgments among investors regarding that information's impact on a security's price. Widely varying assessments of the new information's impact will be layered onto the already varying assessments of the firm's risk and return that were formed on the basis of information already publicly available before the new disclosure. Thus what we observe with the release of financially significant information are security prices that reflect the price changes of such heterogeneous expectations.

### B. Enter a Multiple Standards Approach

Just how satisfying is the life of the securities regulator in a world in which securities prices do not on average reflect their intrinsic value? The answer is a crisp "not very", if securities prices bore no observable relationship to the public disclosure of financially significant information. In such a world, the costs of disclosure would be hard to justify since the conclusion that disclosure bears no relationship to securities price changes would suggest that mandatory disclosure has only negative social welfare implications. This is not, however, the world in which markets are informationally, but not fundamentally, efficient. Regulatory efforts that change investor expectations such that securities prices change in response to their reaction to the release of information produce a social benefit, even though the resulting prices do not reflect intrinsic value, provided the price change is in the direction of the security's intrinsic value. i.e., prices over- and under-react but over time migrate toward a security's intrinsic value. Thus, we can see that the security regulator's life is a satisfying one, even if the markets are only informationally efficient.

Consider here the objective of facilitating investors' comparative assessments among securities competing for their funds. As was seen above, even in an informationally efficient market, the disclosure of line of business information can be expected to move the price of X and Y securities from their composition price - a price that ranges around \$21 - toward their respective intrinsic value. The information therefore sharpens the risk and return assessments posed by each security. An important policy question confronts the regulator if X' and Y' securities trade in the same market as do X and Y, and their disclosures are guided by the laws of a country other than those of the host country. In an informationally efficient market investors cannot be expected to accurately price the effect of another country's stronger or weaker disclosure requirements. With respect to a security whose issuer chooses to abide by materially weaker disclosure requirements we would expect the rational investor to view such a security as presenting a greater inherent risk and to take this into account in determining the price the investor is willing to pay for that security so as to garner a return expected to compensate for the totality of the security's risks. That is, the availability of another country's disclosure regime in a host market introduces a new investment variable for the adopting issuer's shares that are traded in the host country. The policy question this raises for the host country's securities regulator is whether there is a net social benefit of permitting this new variable. To be sure, investors will be able to make sharper comparisons if X' and Y' are bound by the same disclosure rules as apply to X and Y. Permitting X' and Y' to adopt different disclosure requirements will result in their prices reflecting greater uncertainty respecting their intrinsic value than will occur for the securities of X and Y. More importantly, investors in a market that is only informationally efficient cannot be expected to accurately reflect these differences in relative risk between, on the one hand X' and Y', and, on the other hand, X and Y. In contrast, for a market that is fundamentally efficient comparability is assured - even subsumed in the

conclusion that the market is so efficient - because investors are concluded to have the power to accurately price the risk posed by X' and Y'. Just as the objective of comparability was advanced when the securities regulator imposed line of business disclosure requirements with the intended effect of sharpening the distinction between X and Y, the objective is undercut if X' and Y' can enter U.S. markets without complying with line of business requirements. Simply put, there is no comparability when issuers can provide different levels of disclosure that cannot be reduced to differences that can be accurately reflected in differences in value.

The objective of facilitating allocational efficiency can be achieved in an informationally efficient market, but is poorly served by the new disclosure variable that would be introduced under a multiple disclosure standards regime. As seen above, in an informationally efficient market disclosure requirements that cause a security to trade closer to its intrinsic value or reduce the variance around its intrinsic value necessarily allows investors to make sharper comparisons among investment opportunities. In contrast, as seen in the preceding in the preceding paragraph as well as Part IIIB, the introduction of a disclosure standard that causes uncertainty regarding a security's risk and return do not enhance investors' comparative judgments. So viewed, any embrace of a multiple disclosure standards approach reduces the allocational efficiency of the host markets, thus frustrating this securities regulator's quest of this objective. This can be expected to occur because the greater the variance in the price at which X' and Y' securities trade vis-a-vis X and Y securities the more likely that expected returns associated with X' and Y' securities will be inappropriately matched with their risk. In a market that is not fundamentally efficient, this greater variance will not be reflected accurately in the price of X' and Y' securities just as the price of X and Y firms' securities will not accurately reflect their intrinsic value.

To be sure, the allocational efficiency of a security market is greater if the market is one that is fundamentally rather than only informationally efficient. Nevertheless, allocational efficiency in an informationally efficient remains a worthy goal whereby regulators impose disclosure standards that improve upon the ability of investors to make informed judgments regarding the risks and returns posed by individual securities. The ability of X' and Y' firms to employ weaker disclosure requirements in the host market necessarily will have an adverse impact on that market's allocational functioning. X' and Y' shares because this results in their being mispriced than if they adhered to the more demanding disclosure standard of the host country. The result is a market where resources will be allocated among X, Y, X' and Y' projects differently, and less efficiently, than if they each abided by the same strong disclosure requirements.<sup>102</sup>

As we saw earlier, the securities regulator's quest to protect its market's investors from fraudulent offerings is an objective that is thwarted by an issuer's ability to use the weaker disclosure requirements of another nation. This result is all the more present when securities markets cannot accurately price the likelihood or magnitude of the potential fraud because the market is only informationally efficient. In such a market, the regulator seeks to protect host country investors by exposing the offering to disclosure and certification processes that will reduce the offering being made in the host market. Here the deterrence effects of mandatory disclosure rules and their accompanying certification procedures are unaffected by whether the market accurately reflects the individual security's intrinsic value. Fraudulent offerings are less likely to occur and their issuers' reputationally conscious accountants, lawyers, and underwriters are less likely

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<sup>102</sup> And, if allocational efficiency is misserved by multiple disclosure standards when markets are fundamentally efficient then they should be similarly misserved if the market is only informationally efficient.



to participate in offerings whose disclosures indicate or strongly suggest the likelihood that they are fraudulent.<sup>103</sup> With the option of such issuers to use in the host country another country's weaker disclosure requirements, investors in an informationally efficient market will not be able to price the likelihood of the fraudulent offering. Hence, there is no assurance that over time their losses in connection with such offerings will be compensated by the discounts they have demanded in all such offerings. With their inability to accurately price this risk, the investors may over time be net gainers or losers. The uncertainty as to which of these results will occur strengthens the regulators' quest for reducing the overall incidence and scale of fraudulent offerings, especially when the disclosure and certification processes also support the regulator achieving other socially desirable objectives.

Finally, the case for regulation to protect the host market as well as the steps to enhance the integrity of that market, is even stronger when the host market is understood to be informationally, but not fundamentally efficient. When investors cannot self protect by accurately pricing securities to reflect the expected level of managerial misbehavior, non systematic over- and under-priced securities will abound. Much like the variances to be expected by investors inability to compensate for the absence of line of business reporting by X' and Y', self dealing, insider trading and other opportunistic behavior by managers will also confront investors with a risk that is imperfectly impounded in securities prices. The host regulator's success in reducing the frequency of such abuses lowers the cost of capital for all issuers in the host market regardless of the issuer's home so that positive social welfare effects are felt within and without the host market. Moreover, because investors cannot accurately price the expected costs of misbehavior, regulatory efforts in the host market can be expected to cause security prices to migrate so that the firms posing a lower level of risk of managerial misbehavior will enjoy lower costs of capital than firms with higher risks of such abuse. And, to the extent there is reason to expect that investors underestimate the frequency and scale of harmful managerial misbehavior, regulators make positive contributions to social welfare in the host market by their regulatory efforts to curb the frequency or scale of managerial misbehavior so long as their own efforts are efficient.<sup>104</sup>

### III. Conclusion

[forthcoming]

[Another point worthy of consideration is that the objectives of securities regulation can at least be traced back to the enacting of the U.S. securities laws, a time when the concept of market efficiency was not the framework within which all disclosure debate takes place as it does today. We might well wish to reconsider whether market efficiency should have the impact that it has today. As heretical as this might seem, we should regard it less so if we assume, as all evidence would suggest we should, that the best that can be said

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<sup>103</sup> Among the important qualities of such gatekeepers is their dependence upon customary traditions for discharging their tasks and a broad understanding that they do so. *See* Stephen Choi, Lessons for Gatekeepers. To this end, evidence that customary practices have enriched investor protection is set forth by Professors Howell Jackson & \_\_, who observed the introduction of heightened American-based due diligence and disclosure practices in London because of the migration of U.S. lawyers to London to participate in such transactions. *See* Howell Jackson & \_\_, note \_\_, *supra*.

<sup>104</sup> *See generally* Karni article

for U.S. securities markets are that they are informationally efficient. This assumption robs the efficient market framework of its precision and focuses attention on the role of mandatory disclosure: let investors make of the information what they will. This view may strike some as casual, but it is a purpose that is supported by Congress' intent when it enacted the securities laws. The legislative history of the Securities Act and Exchange Act are devoid of any reference that securities prices will in fact reflect their intrinsic value. Instead, the objective, identical to that discussed above, was to permit investors to make the comparisons among issuers as they could. As seen, the sharpness of the comparison is eroded if issuers are permitted to choose from more than one disclosure standard.]