Toward a New Regulatory Paradigm for the Trans-Atlantic Financial Market and Beyond: Legal and Economic Perspectives

by

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Hardly a day passes without the emergence of some new evidence of the inter-connectedness of the world's financial markets. Losses on sub-prime mortgage made in the United States pass immediately onto European and Asian balance sheets and pose vexing questions for regulatory policy for the Bank of England, the British FSA, and other financial supervisors across the globe. Responses to recent instances of market volatility and credit constraints are advanced through coordinated statements of regulatory officials in multiple jurisdictions, as modern pricing mechanisms transmit market disruption around the world at the speed of light. Any serious discussions of domestic financial reforms in major markets must now be debated with an eye towards international competitiveness for it is now widely recognized that both capital and financial services firms are highly mobile, and relatively small differences in regulatory requirements can cause financial business to move to more friendly markets.

Against this market reality, the problem of regulatory coordination across national boundaries is becoming increasingly important. Whereas national authorities have traditionally imposed local oversight on all financial transactions and firms that do business within the territory of the state, increasingly it has become clear that this approach may be redundant,

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costly, and potentially counter-productive in reducing the competitiveness and attractiveness of local financial markets. While the limitations of old territorial approaches are apparent, it is less clear how financial regulators should alter their approach to cross-border transactions and global firms in the 21st Century. As events of the last year demonstrate, inadequately supervised financial transactions in one jurisdiction can impose private and public costs elsewhere, costs well beyond direct losses incurred by investors who make poor investment choices. Local interests in the quality of cross-border transactions are, therefore, genuine, and a purely laissez-affaire attitude is unlikely to be desirable or sustainable in the long run.

As students of private international law will recognize, the problem I am discussing is fundamentally a choice-of-law question. Which nation's regulatory system (or combination of national regulatory systems) should govern cross-border transactions or apply to financial firms doing business on a cross-border basis? Unlike traditional choice-of-law questions, jurisdictional decisions in the financial arena are not usually supplied by a presiding judge applying choice-of-law principles. Nor are these matters routinely resolved through choice of law provisions in private contracts. Rather, the allocation of regulatory jurisdiction is ordinarily determined prospectively through some combination of statutory provisions and administratively promulgated regulations. Sometimes the rules are decided unilaterally, other times through treaty negotiations or less formal memoranda of understanding among administrative units.

What I propose to discuss in this essay is how American financial regulators, particularly those at the SEC, have approached and are now starting to reform the extra-territorial application of U.S. financial regulation. This is a major issue of the U.S.-E.U. financial regulatory dialog, as America's most important financial interactions are with the London markets and other markets of EU member states. Comparable questions, however, arise within our own hemisphere and also on a trans-Pacific basis and so the matter is one of global significance. As I will explain, the unique regulatory structure of European regulation makes it difficult for the United States to coordinate its regulatory structure with EU member states. Accordingly, American authorities are conducting our initial experiments in regulatory coordination with Australia and Canada, much smaller markets but ones with regulatory systems that are more similar to that of the United States, at least with respect to the oversight of capital markets. The manner in which the United States moves forward with Australia and Canada are to have a strong influence on future dealings with the EU and EU member states, and so I will

focus on those on-going initiatives.

I. The Rise and Impending Fall of the SEC Modified National Treatment

The need for trans-Atlantic financial regulatory cooperation has been apparent for several decades. Back in 1974, the closure of the Herstatt Bank in Cologne sent shock-waves through New York as numerous U.S. counter-parties found themselves facing losses on unsettled foreign exchange transactions. That crisis gave rise to a new term in financial regulation – "Herstatt risk" – and also led to the creation of the Basel Committee on Banking Supervision and the adoption of the so-called Basel Concordat, which established a new principle of international banking supervision that the home country supervisory – Germany in the case of Herstatt Bank – would have responsibility for overseeing off-shore branches, such as ones in New York.[1] And, as a corollary, regulators in a host country, such as the United States, now routinely demand that new foreign banks demonstrate that there exists effective and comprehensive oversight in their home jurisdictions. While the application of this standard has often been tested over the years – with the failure of BCCI being the most notorious example – the notion that qualified home country oversight should be a pre-requisite for the establishment of cross-border banking offices has long been accepted in the field of banking.

In the area of capital market oversight, in contrast, the principle that the quality of home country oversight should factor into host country regulatory standards was slower to develop and is still less well recognized.[2] In part, banking regulators led the way in cross-border coordination because the banking market became global ahead of capital markets and also because the Bank of International Settlements in Basel provided a ready and well-respected

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[1] See Committee on Banking Regulations and Supervision, Report to the Governors on the Supervision of Banks' Foreign Establishment (Sept. 26, 1975) (available at http://www.bis.org/publ/bcbs00a.pdf?noframes=1).

[2] A prominent counter-example is the European Union's internal market, which has a well developed system of host country deference to home country oversight, within the highly structured framework of EU directives and Lamfalussy implementation and coordination. The new paradigm which I discuss in this lecture differs from the EU approach because it does not take place within a well-developed treaty system such as the European Union, but rather exists between regulatory systems that are linked by nothing more than memoranda of understanding between regulatory official and shared experiences in coordinating organizations such as IOSCO or the Financial Stability Task Force.

vehicle for coordinating international banking policy. Public capital markets, in contrast, were largely national affairs several decades ago, and relatively undeveloped in many jurisdictions – particularly continental European jurisdictions – in the post-War period. But, by the 1980's, the volume of cross-border securities offerings and multiple listing were on the rise, and since the early 1990's, much attention turned on the appropriate regulation of cross-border linkages involving capital markets, especially capital markets located in the United States.

Rather than a foreign bank with a cross-border branch, the characteristic cross-border capital market transaction was a stock offering from a large European corporation – perhaps a British public utility sold off in Margaret Thatcher's privatizations – that was listed on the New York Stock Exchange as well as on the London Exchange. (Figure One.) The traditional American approach was to impose something close to national standards on foreign firms seeking access to US markets, without regard to whether the applicant company was already regulated in a well-regarded market such as London or based on one of those sketchier island locations, better known for good scuba-diving than good financial supervision. Though this approach to cross-border regulation (what might be called modified national treatment) is coming to an end -- or at least that is the thesis of my talk today – I think it worth taking a few minutes discussing how the system worked and how it could survive through several decades of intensifying globalization.

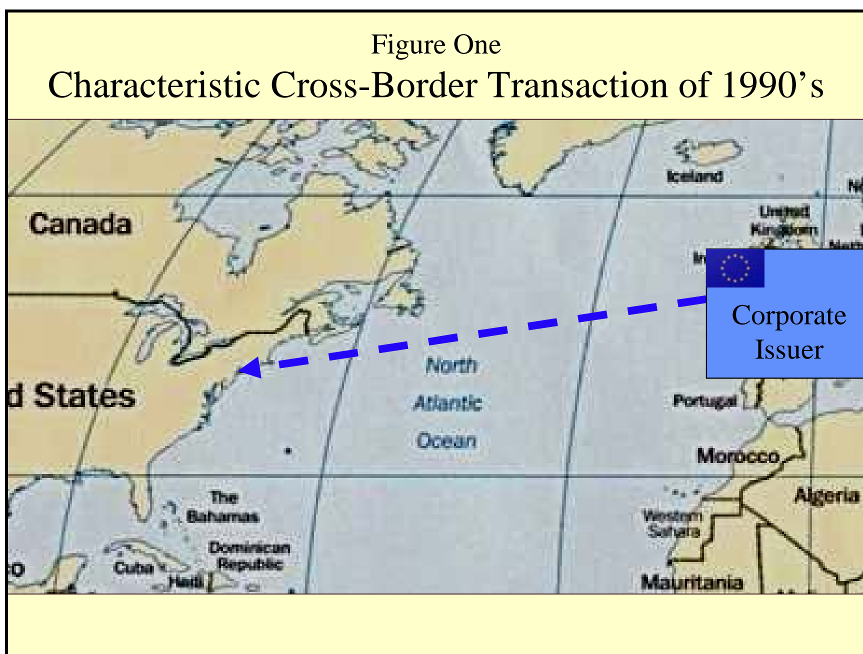

Figure One
Characteristic Cross-Border Transaction of 1990's

The trick lies in the nature of the modifications to national treatment the SEC offered foreign firms. While American regulators often assert that if foreign firms want to do business in the United States, these firms must comply with American rules, the United States never

imposed truly national treatment on foreign issuers. The SEC has long recognized that foreign firms cannot be treated in exactly the same manner as domestic firms, and over the years has gone to considerable lengths to articulate bright line rules that clearly define when foreign issuers will be subject to U.S. regulation. So, for example, since the 1960's, all American firms with more than 500 shareholders and assets above a minimal threshold have had to comply with SEC reporting requirements. But for foreign firms, the reporting rules apply only if the firm's securities are listed for trading on a major US market – a well-defined action that foreign firms can usually avoid without difficulty. Moreover, since the 1990's as a result of another SEC regulation (Rule 144A) foreign issuers have even been able to raise capital in the United States without complying with SEC reporting requirements as long as they limited their offerings in the United States to large institutional investors and structured their sales of securities outside of the United States to comport with a provision known as Regulation S.[3] As a result of these bright line rules, foreign issuers can maintain a relatively high degree of interactions with U.S. investors in the United States without being subject to the SEC extensive reporting and accounting requirements.

The second component of U.S. modified national treatment was a host of pragmatic accommodations for those foreign firms that did choose to subject themselves to SEC reporting and registration requirement. Roughly speaking, the SEC exempted foreign issuers from those aspects of our securities laws addressing issues of corporate governance, where US standards were likely to conflict with applicable requirements of the issuers home country regulations. Examples of these exemptions include the proxy rules, mechanical restrictions on inside trading under section 16 of the Securities Exchange Act of 1934, as amended, certain disclosure requirements (such as those requiring specific details of executive compensation), and also the application of many specialized rules governing tender offers and mergers.[4] Perhaps not

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[3] For technical reasons known as the "fungibility requirement,"U.S. public firms are generally not permitted to raise equity through 144A offerings, but may only use the exemption for debt issuances.

[4] See SEC Concept Release on Multinational Tender and Exchange Offers, 55 Fed. Reg. 23,751 (June 6, 1990). The application of these rules to foreign issuers has remained a continuing source of complexity and the Commission has recently proposed yet another set of accommodations in this area. See SEC Proposal for Revisions to the Cross-Border Tender Offer, Exchange Offer, and Business Combination Rules and Beneficial Ownership Reporting Rules for Certain Foreign Institutions, 73

surprisingly, the Commission has faced considerable complexity in determining just what accommodations of this sort were appropriate, with the Sarbanes-Oxley Act of 2002 representing what has been widely regarded – on both sides of the Atlantic – as a deviation from past practices as the Act, at least initially, imposed a number of corporate governance standards on foreign issuers, often conflicting with local practices such as the composition of supervisory boards in Germany and other jurisdictions. While the most egregious of the conflicts have now been smoothed over, the Sarbanes-Oxley Act experience awoke foreign firms to the perils of exposing themselves to overlapping securities oversight and prompted pressures (to which the SEC succumbed last year) to make it easier for foreign issuers to exit US reporting requirements, a decision which is itself another example of modified national treatment,[5] as the rules governing foreign delistings are now (in important respects) more liberal than those applicable to US domestic firms.

Aside from the shock of the disturbance of Sarbanes-Oxley, a number of other factors have put increasing pressure on America's traditional treatment of foreign firms. A few are legal, but most are economic. On the legal side are US anti-fraud rules, as enforced through our peculiarly idiosyncratic and draconian system of class action securities litigation. The SEC's approach to accommodation is limited to regulatory requirements – registration and reporting rules. Thus, the US courts, not the SEC, determine the scope of jurisdiction to hear securities cases, and there are now few clear rules defining when foreign issuers may be drawn into US courts. While the actual incidence of successful cases involving securities law claims was relatively infrequent before 2000, a number of prominent cases have been brought against foreign issuers over the past decade. And, for many foreign issuers, the potential threat of litigation more than offsets the accommodations that the SEC offers on more mechanical aspects of compliance.[6]

Fed. Reg. 26,876 (May 9, 2008)

[5] See SEC Final Rule on Termination of a Foreign Private Issuer's Registration of a Class of Securities, 72 Fed. Reg. 16,934 (Apr. 5, 2007).

[6] See John C. Coffee, Jr., *Global Class Actions,* NAT'L L. J., June 11, 2007, at 1. See also Hannah L. Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 26 COLUM. J. TRANS. L. 15 (2007); Interim Report of the Committee on Capital Market Regulation § 3 (Nov. 30, 2006) (avail. as revised at

Another, perhaps even more important factor has been the new found mobility of investors (as well as issuers). The traditional SEC approach tied US regulatory jurisdiction to foreign activities that reached into American territories, with the characteristic transaction being the sale of foreign stock to US-based investors. But, this conceptualization presupposes that American investors were trapped in the United States. In reality, however, investors are mobile too. For a host of reasons – some regulatory and some operational – American institutional investors in the 1990's began locating operations outside of the United States and nearer to foreign financial centers, such as London, Tokyo, and Hong Kong.[7] So too, retail investor began following a similar path, finding that they could direct order through foreign intermediaries to purchase foreign securities directly on foreign markets rather than just limiting themselves to foreign securities dual listed on American exchanges.[8]

To some degree, the SEC's modified territorial approach to foreign capital market activities facilitated its own erosion. As I mentioned earlier, to accommodate an increasingly global world in the 1980s and 1990s, the SEC established those bright-line, highly administrable standards for determining when foreign issuers were located in the United States. These precise rules provided clear-cut guideposts for avoiding US jurisdiction and thus allowed practitioners to devise strategies for foreign firms to reach an increasingly large share of US investors without becoming formally subject to SEC registration and reporting requirements. Thus, the economic incentives for foreign issuers to seek "official" access to US capital markets has declined over time. At the same time, the traditional practice of the SEC to offer partial accommodations to foreign issuers that were subject to SEC jurisdiction has proved to be an unreliable and imprecise form of relief, as both the vagaries of US liability rules and the perhaps epiphenomenal lessons of Sarbanes-Oxley Act have left foreigner issuers with a high degree of nervousness in remaining

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http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf).

[7] Howell E. Jackson & Eric Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe – Part II*, __ VA. L. & BUS. REV. ___ (forthcoming 2008). See also, Erica Fung, *Regulatory Competition in International Capital Markets: Evidence From China in 2004-2005*, 3 N.Y.U.J.L. & BUS. 243 (2006).

[8] Howell E. Jackson, Mark Gurevich, & Andreas M, Fleckner, *The Controversy Over the Placement of Remote Trading Screens from Foreign Exchanges in the United States,* 1 CAPITAL MARKETS LAW JOURNAL 54 (2006).

subject to on-going SEC jurisdiction, hence the flight of delistings from the NYSE in the latter half of 2007, when the Commission's new rules on deregistration went into effect.[9]

A full account of the transformation of the past few years must also include a recognition of the declining relative importance of U.S. capital markets in recent years.[10] Not only is it less essential for foreign issuers to access US capital markets (because of the migration of American investors for foreign markets), but the relative importance of US capital markets has also declined. with the growth of major financial centers in both Europe and Asia over the past decade. A number of considerations have contributed to this phenomenon. Increased reliance on capital markets as compared to bank financing in many countries. The success of the Eurozone, coupled with a preference for some major new sources or capital (e.g., Mideastern and Russian) for market venues outside of the United States. Plus the explosion of wealth in Asia, especially when measured against the late 1990's when many Asian markets were suppressed from the then recent financial crisis.

There has also been a demonstrable shift in the relative quality of financial market oversight in the United States. While ten to twenty years ago, the SEC and other US regulators could plausibly claim to provide the world's premiere system of financial oversight, the case for US primacy is much less clear today. This is not so much a product of the decline in US supervision – although some in the United States do claim that our supervision has become too costly. But an even more important factor, at least in my view, has been the enhancement of financial market supervision in other jurisdictions around the world both in terms of developing consistent and comprehensive legal requirements (often modeled on US, ISOCO or EU templates) and also improvements in both the quality and quantity of supervisory staffing in many countries. At the same time, the professional expertise supporting the financial services industry, once largely concentrated in New York, has now distributed itself around the world, with leading investment banks, law firms, and accounting firms operating in all major markets.

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[9] See Committee on Capital Markets Regulation, The Competitive Position of the U.S> Public Equity Market 21-23 (Dec. 4, 2007) (avail. at http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf).

[10] See Luigi Zingales, Is the U.S. Capital Market Losing its Competitive Edge? (Nov. 2007) (ECGI Finance Working Paper No. 192/2007) (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1028701).

So, the relative quality of US capital markets has almost certainly declined with respect to other leading markets around the world, providing yet another explanation of the decreasing power of US capital markets.

Finally, there have been some important changes in the political economy of policy debates within the United States. Some are readily apparent. The declining importance of New York has implications for employment and financial well-being in an important region of the country, and feeds into concerns about national competitiveness, previously limited to the manufacturing and back office service sectors. While other financial centers have long been self-conscious in their efforts to attract and retain international business, the US has until recently taken its post-war financial leadership for granted. But this is no longer the case. Hence the prominent role of New York politicians, such as New York Mayor Bloomberg and NY Senator Charles Schumer, in pushing for regulatory reforms.

But there are also more subtle changes in U.S. political considerations. One is the increasingly global perspectives of U.S. financial institutions, who are finding themselves disadvantaged by US regulatory requirements that inhibit their ability to coordinate offshore and US operations. A prime case in point is the merger of the NYSE and Euronext. Whereas the old New York Stock Exchange traditionally has resisted SEC reforms that will have facilitated the direct sale of foreign securities to US investors (without first obtaining a listing on the NYSE), the new integrated firm is more cognizant of the constraints that US regulation impose on the operations and opportunities of Euronext.

Another important influence is the perspective of US financial firms seeking to expand their operations in many developing markets around the world, in Asia, Latin America, and elsewhere. By operating in multiple, national markets, these firms are finding themselves subject to an increasing number of disparate regulatory structures, many modeled in general terms on SEC standards but often including distinctive and costly local variations. While US financial firms have traditionally benefitted from the somewhat protectionist aspects of the SEC's modified national treatment in fending off foreign competition in the United States, jurisdictional rules of this sort cut in the opposite direction for US firms seeking to expand overseas. Accordingly, to the extent that the movement of the SEC away from its modified national treatment could be tied to a world-wide trend towards a broader acceptance of home country oversight, the potential US domestic constituencies facing such a reform increase

considerably.[11]

II. Two Competing Approach to the Regulation of Cross-Border Finance

With the SEC's traditional approach to extra-territorial jurisdiction under increasing pressure, we may be poised on the edge of a paradigm shift in our approach to cross border financial regulation. Within the last year, we have witnessed two glimpses of what I think could become the new US paradigm to extra-territorial jurisdiction in the financial field, a regime known as selective substitute compliance. The balance of this essay will chiefly focus on the content of this new approach to jurisdiction and the principle problems that he SEC can be expected to encounter in its implementation. But at the outset it is important to note that the old paradigm – modified national treatment – remains very much alive at the SEC, and another recent initiative is best characterized as a rejuvenation of that older approach. Quite conceivably, the Commission will make use of both approaches in the immediate future, and an important issue of policy analysis will be ascertaining the relative merits of the two approaches.

A. Selective Substitute Compliance

The first example of the SEC's new approach to extra-territorial jurisdiction came last year in the SEC's decision to allow foreign issuers to prepare their financial statements in accordance with appropriately implemented International Financial Reporting Standards (or IFRS).[12] At first blush, this reform might look like another example of an exemptive accommodation of foreign issuers, like the relief foreign issuers have traditionally enjoyed from the SEC corporate governance rules. But there are several important differences. First, the SEC is not offering foreign issuers a blanket exemption from US accounting standards. Rather it is

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[11] For a recent report partially reflecting this view, see Margaret E. Tahyar et al., Draft Report of the Securities Law Subcommittee of the Task Force on Extraterritorial Jurisdiction of the International Bar Association (Jan. 1, 2008) (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1109061). For an earlier article sketching out the advantage of home country oversight for developing countries, see Howell E. Jackson, *Selective Incorporation of Foreign Legal Systems to Promote Nepal as an International Financial Services Center* in REGULATION AND DEREGULATION: POLICY AND PRACTICE IN THE UTILITIES AND FINANCIAL SERVICES INDUSTRY (1999) (Christopher McCrudden, ed.) (Clarendon Press, Oxford).

[12] See SEC Final Rule, Acceptance from Foreign Private Issuers of Financial Statements Prepared I Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, 73 Fed. Reg. 986 (Jan. 8, 2008) (adopted by the SEC on Dec. 21, 2007).

an exemption for only those foreign issuers that comply with IFRS, not whatever other form of accounting rules that might apply in their home jurisdiction. Moreover, not even all applications of IFRS are eligible for this relief, only versions of IFRS that have been appropriately implemented in the eyes the SEC. In other words, this new reform entails an element of subjective evaluation over the quality of IFRS implementation. So, in a break from tradition, the SEC has put itself in the business of opinion on the quality of accounting standards around the world.[13]

The SEC's acceptance of IFRS for foreign issuers is such a striking departure of past practices that it is worth considering the factors that lead to the Commission to take this step. One consideration is no doubt pragmatic, the previously-required reconciliation of foreign accounting standards to U.S. GAAP has long been a source of aggravation for foreign issuers, imposing costly and time-consuming computations with only marginal value to investors. But more important than long-standing complaints was multi-year efforts on the part of US and international accounting standard setters to more closely align their substantive rules. While US GAAP and IFRS are still a long way from being harmonized, the relative quality of the two systems are generally agreed to be much closer than they have been in the past, and there are now plausible arguments for the relatively superiority of either approach. Here is an instance where narrowing of qualitative differences in regulatory standards allowed the Commission to accept foreign legal requirements as an acceptable substitute for home country requirements, the characteristic feature of the new standard.

Political and market factors no doubt also played into the decision. By relaxing the accounting standards applicable to foreign issuers, the Commission no doubt hoped to dissuade some foreign issuers from exiting US public markets and similarly to entice new entrants to enter notwithstanding the trauma of Sarbanes-Oxley and perceived risks of US litigation. Also, the European Union wielded a regulatory stick that would have been unusual a few years ago.

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[13] There are only two other important examples of the SEC engaging in such subjective evaluations of the quality of other jurisdictions in the past. The first is the MJSD system with Canada whereby Canadian issuers since the 1990's have been allowed to access US capital markets under special exemptive relief that recognizes the comparability of US and Canadian securities regulation. Second , under Regulation S, the Commission grants special privileges to securities traded on certain designated exchanges, but applies the standard in a liberal manner, including all the of the world's leading markets and many minor ones. See 17 C.F.R. § 230.901 et seq. (2008).

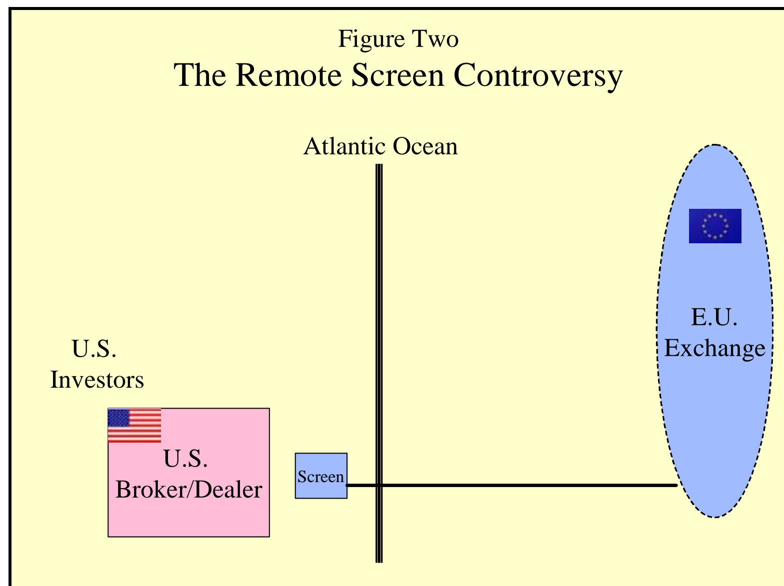
European exchanges have long allowed dual-listed US firms to prepare financial statements in accordance with US GAAP, a reasonable practice as long as US accounting standards were consider the world's gold standard. But with the rise of IFRS and the patent shortcomings of US GAAP during the Enron/Worldcom era of accounting standards, senior European officials quite clearly signaled that reconciliation to IFRS might be required if US authorities did not see their way to accepting IFRS for foreign issuers. So, while the SEC decision to accept IFRS was plausible as a matter of public policy, it also reflects an element of realpolitik.

The second example of the new paradigm concerns a long-simmering dispute over the placement of remote trading screens for foreign exchanges within US territory.[14] (See Figure Two.) This is actually an issue with a strong German heritage, as the Deutsche Börse has been one of the most active foreign exchanges seeking exemptive authority to enter the United States without subjecting itself to full SEC registration and oversight. The SEC has, however, been resistant to the idea. In contrast to its accommodating modified national treatment with respect to foreign issuers, the Commission has been relatively inflexible in dealing with foreign exchanges and (though to a somewhat lesser degree) to foreign brokerage firms. Generally speaking access to US markets subjected the foreign exchange to full regulation under US laws, including both substantive and issuer disclosure rules that made it all but impossible to operate simultaneously in the United States, except through the creation of wholly separate subsidiaries dedicated exclusively to US activities. While justified in the United States as essential for the protection of investors, Europeans widely interpreted this approach as a protectionist requirement designed to protect the NYSE franchise.

In January of 2007, the first signs that the Commission might soften its views on cross-border transactions first emerged. In an academic paper written by senior SEC officials, Ethiopis

[14] For background on this dispute, see Howell E. Jackson, Mark Gurevich, & Andreas M, Fleckner, *The Controversy Over the Placement of Remote Trading Screens from Foreign Exchanges in the United States,* 1 CAPITAL MARKETS LAW JOURNAL 54 (2006). (avail.as John M. Olin Center Working Paper No. 549 at http://www.law.harvard.edu/programs/olin_center/papers/549_Jackson_et%20al.php).

Tafara and Robert Peterson,[15] the possibility was raised that perhaps the Commission should allow foreign exchanges and securities firms to enter the United States without having to comply with US registration and reporting requirements. Provided these entities came from jurisdictions that could offer acceptable forms of "substitute compliance" and themselves had good reputations, perhaps the Commission could offer fairly broadly devised exemptive relief. As with the Commission's IFRS initiative, this approach requires a subjective evaluation of the quality of supervisory oversight in individualized jurisdictions.



And unlike the Commission's traditional modified national treatment, the accommodations afforded foreign firms are not limited to areas of specific conflict with US requirement, rather the approach contemplates wholesale acceptance of home country supervision.

The Tafara-Peterson article constitutes the most complete articulation of the justifications for moving towards a new approach to jurisdiction. In addition to familiar considerations emanating from concerns over the declining competitiveness of U.S. capital markets, the Tafara-Peterson article emphasized the potential benefits that the new approach would offer U.S. retail investors. Traditionally, the SEC has cited the needs of retail investor protection as a principal reason for forcing foreign firms to comply with most U.S. regulatory standards a precondition to accessing U.S. capital markets. But Tafara and Peterson countered that these requirements may actually impede the ability of retail investors to diversify internationally in a cost effective manner. At least with respect to transactions originating from other well-regulated financial markets, Tafara and Peterson argued, retail investors might well benefit from a more relaxed

[15] Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

approach to SEC oversight. Thus, they reasoned, once the SEC determined that foreign regulation was an acceptable substitute for U.S. requirements, a more hands off approach to cross-border transactions might well be in the public interest.[16]

Since last January, the Tafara-Peterson framework has been much discussed – being the subject of an on-line academic symposium at Harvard and a roundtable discussion at the SEC just a year ago.[17] In the Spring of 2008, the Commission itself announced that it intended to move forward with a pilot project on mutual recognition involving Australia[18] and two months later announced that it planned to conduct a similar experiment with Canada.[19] Both the Commission's choices to use Australia and Canada as test cases and the manner in which it is approaching these choices are illustrative of what I believe will become a new paradigm in global supervision of cross-border transactions and transnational financial firms. As the implementation of this new system of selective substitute compliance raises some challenging questions or regulatory policy, I will in Part III of this essay consider in some detail the issues that are likely to arise as the Commission attempts to determine which jurisdictions should be eligible for this treatment. But before turning to those issues of implementation, I consider another recent SEC initiative concerning jurisdiction over foreign firms.

B. Proposed Expansion of Rule 15a-6

When the Commission first announced that it was planning to move ahead with a pilot program involving mutual recognition, it also signaled that the Division of Markets and Trading would also be undertaking a review of rule 15a-6, which exempts certain foreign broker dealers

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16 For a more complete discussion of this aspect of the Tafara-Peterson argument, see Howell E. Jackson, *A System of Selective Substitute Compliance*, 48 HARV. INT'L L.J.105 (Winter 2007) (avail at http://www.harvardilj.org/attach.php?id=77).

17 Available at http://www.harvardilj.org/online/90 .

18 See SEC Chairman Cox, Prime Minister Rudd Meet Amid U.S.–Australia Mutual Recognition Talks, SEC Press Release 2008-52 (Mar. 29, 2008). See also SEC Announces Next Steps for Implementation of Mutual Recognition Concept, SEC Press Release 2008-49 (Mar. 24, 2008).

19 See Schedule Announced for Completion of U.S. Canadian Mutual Recognition Process Agreement, SEC Press Release 208-98 (May 29,2008)

from registration under the 1934 Act.[20] This complicated rule, first adopted in 1989, exempts from the 1934 Act registration of foreign brokers that have only a limited amount of contact with U.S. institutional investors, and offers somewhat more lenient treatment for transactions involving U.S. institutional investors with more than $100 million of assets under management. The regulation, which is highly technical and often requires foreign broker-dealers to obtain "chaperoning" services from U.S. registered firms, has long been the source of criticism from practitioners and the Commission has long been under pressure to liberalize the rule.[21] In June of 2008, the Commission proposed such a change.[22] Under the Commission's proposal, foreign broker dealers would have much wider latitude to do business with U.S. investor, both relaxing many of the technical requirements of the current rule and also lowering the level of favored institutions to those with less than $25 million under management and for the first time also granting relief for contacts with natural persons managing portfolios of similar size.

The Commission's proposed reform of rule 15a-6 is best understood as a continuation of the Commissioner's older modified national treatment approach; it narrows the scope of domestic regulation for foreign firms that constrain their US activity within clearly defined boundaries and does so without consideration of the quality of supervision in the firm's home jurisdictions. The proposal is thus available for broker-dealers based in any jurisdiction around the world, and not just dominant financial centers, such as London or Tokyo, where large numbers of major securities firms are based. Among Commission staff, the proposal is sometimes portrayed as being in competition with the mutual recognition pilot programs with Australia and Canada, and it is somewhat telling the principal grounds on which the debate over these two approaches is being conducted.

A critical issue is the proposed rule's treatment of retail investors. Especially among traditionalists at the Commission there is concern that the rule will expose qualifying retail investors – that is, those with more than $25 million in investable assets – to unregulated and possibly also unscrupulous securities firms. While a number of SEC exemptions turn on the net

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[20] 17 C.F.R. § 240.15a-6 (2008).

[21] See, e.g., Tahyar et al, supra note 10.

[22] See SEC Proposed Rule, Exemption of Certain Foreign Brokers or Dealers, SEC Release 34-58047 (June 27, 2008) (avail. at http://www.sec.gov/rules/proposed/2008/34-58047.pdf).

worth of individual investors and often employ much lower thresholds than the new $25 million level proposed in rule 15a-6, those exemptions traditionally have involved domestic transactions that take place against an institutional setting where federal anti-fraud rules clearly apply and dispute resolution through judicial venues or arbitration is readily available.[23] Under the SEC's new proposal, retail investors with sufficient assets will be able to engage in largely unregulated interactions with foreign brokerage houses, even those located in unsavory jurisdictions or without good reputations in their home markets. By eliminating any element of SEC pre-approval, the proposed 15a-6 reform relies almost exclusively on principles of caveat emptor, requiring simply that U.S. investors be informed that domestic regulatory safeguards do not apply.

Another criticism of proposed rule 15a-6 reforms concerns those retail investors that are excluded from its coverage. Under the proposal, foreign broker-dealers would be denied exemptive relieve if they did business with natural persons managing portfolios of less than $25 million. Accordingly, the proposal will do nothing to increase the access of most retail investors to foreign brokerage firms, and indeed might reduce access if some foreign firms were to choose to close up existing U.S. subsidiaries and to rely instead on the SEC's new exemption. To the extent that the Tafara-Peterson framework was motivated out of a concern to increase the international diversification of retail investors, the 15a-6 proposal could actually be viewed as counter-productive.

A perhaps related concern about rule 15a-6 concerns the loss of SEC bargaining power that the proposal entails. A somewhat counter-intuitive factor motivating the Tafara-Peterson approach of selective substitute compliance was a desire to influence the regulatory systems in other jurisdiction. While substitute compliance entails deference to home country oversight, the negotiations leading up to such arrangements afford an opportunity for the Commission to seek various accommodations from other jurisdiction. The Tafara-Peterson framework contemplated the creation of memoranda of understanding to deal with the coordination of enforcement activities – a process already in place with most jurisdictions likely to participate in these new

[23] See Rule 501(a) of Regulation D under the Securities Act of 1933 (including within the definition of accredited investor individuals with net worth of more than $1 million). See also Section 2(a)(51) of the Investment Company Act of 1940 (defining qualified purchasers, who are generally eligible to invest in hedge funds, to include natural persons with investments of more than $5 million).

arrangements. But the process could also give the SEC an unprecedented opportunity to influence more substantive components of foreign regulatory systems and one might expect the Commission staff to look especially hard at foreign oversight of market volatility and systemic risk of the sort that has confronted the Commission with Bear Stearns and other US investment houses in recent months. In contrast, the proposal for rule 15a-6 is based on unilateral action of the SEC and grants exemptive relief without regard to the quality of supervision in foreign jurisdictions. Not only does the proposal deny the Commission any opportunity to influence the securities market oversight of other jurisdictions, it may also reduce the Commission's bargaining power in areas where a regime of selective substitute compliance governs, as foreign jurisdictions will have less to gain from SEC validation.

C. Comparing the Two Approaches

Taken together, the Commission's proposed rule 15a-6 amendments offer and its initiatives involving mutual recognition represent two separate visions of how to approach extra-territorial application of U.S. financial regulation, each with its own advantages and disadvantages. The former represents an extension of modified national treatment, with a contraction of direct SEC oversight for an expanded range of transactions consisting of wealth individuals and institutional investors. An advantage of this approach is that it can be undertaken unilaterally, without bilateral negotiations or subjective evaluation of foreign supervision. However, it also exacerbates what's been called the "deretailization" of securities markets, an ongoing process whereby securities markets are segmented into a growing but less regulated market limited to institutional investors and wealthy individuals and a shrinking and more heavily overseen market open to all investors.[24]

The mutual recognition exemplified in the Tafara-Peterson framework envisions a more fully integrated global system of capital markets, at least among countries with well-developed systems of regulatory oversight, with greater investment opportunities made available to all retail investors. It contemplates a fairly large amount of collaboration across national borders and depends upon a reasonable amount of regulatory convergence of the sort that preceded the SEC's acceptance of IFRS as an alterative to U.S. GAAP reconciliation. Thus an indirect benefit of the

[24] For an interesting recent discussion of this phenomenon, see The Future of Securities Regulation, Speech by SEC General Counsel Brian G. Cartwright (Oct 24, 2007) (avail. at http://www.sec.gov/news/speech/2007/spch102407bgc.htm).

mutual recognition approach is the dialog it creates among national supervisors through peer-review mechanism with substantial benefits for countries whose supervisory systems are deemed to meet international standards. A potential drawback of the mutual-recognition approach, to which I will turn in a moment, is the complexity of vetting foreign regulatory structures and devising mechanisms for ensuring that foreign supervision applies effectively and consistently to cross border transactions.

Conceivably, the relative merits of the two approaches might counsel for the application of modified national treatment in some contexts but mutual recognition in another. Though beyond the scope of this essay, one might imagine that difficulties of ascertaining the quality of broker-dealer oversight and ensuring its effective application to off-shore transactions might militate against the use of selective substitute compliance for securities firms. Conversely, the regulation of corporate issuers and even exchanges might more easily validated through objective standards and fully capable of protecting remote investors. But that is a subject for a separate inquiry.

III. Measuring the Quality of Regulatory Oversight in Foreign Jurisdictions

Returning now to the Commission's pilot program for mutual recognition. Consider for a moment the task the SEC now confronts. How should the Commission go about determining whether Australia offers a sufficiently comparable system of securities market oversight so as to allow the Australian stock market and perhaps also Australian brokerage firms to have unrestricted access to American markets? One possibility would be simply to rely upon the reputation of Australian authorities, based on the SEC staff's experience of working with Australian authorities over a number of years. While a plausible approach – and undoubtedly a consideration that will play some not-inconsiderable role in the Commission's decision-making – such an informal process is unlikely to produce sufficient legitimacy for the acceptance of foreign regulatory systems in the United States nor is it likely to be an attractive approach when the Commission comes to jurisdictions that it is not prepared to accept as an adequate substitute for compliance with US reporting requirements. What is needed is something considerably more objective.

Another possible alternative would be a review of the formal legal requirements applicable to Australian capital markets with a view towards assessing whether all the relevant

regulatory bases were covered – disclosure, market manipulation, trading practices, etc. But while substantive legal standards may be a necessary condition for ascertaining the comparability of another regulatory system, legal rules alone are unlikely to be found sufficient. The formal adoption of legal requirements do not, after all, ensure their compliance. Some elements of supervision and enforcement are also needed. Thus, the SEC is likely to consider as well the level of regulatory intensity in foreign jurisdiction, and this dimension of evaluation is one of the reasons why the SEC has chosen to start with Australia.

A. Regulatory Intensity as Measured Through Budgets and Staffing

Though a relatively small capital – with a domestic stock market capitalization of US$1.3 trillion at the end of 2007 as compared to London's US$3.8 trillion and Japan's US$4.3 trillion – Australia distinguishes itself in the very substantial amount of supervisory resources dedicated to policing its capital markets. Based on 2005 data reported in a recent paper that I co-authored with my colleague Mark Roe, Australia deploys just under 40 staff members to securities market oversight for every million in the country's total population, whereas the United States and the United Kingdom dedicated closer to 20 and civil law jurisdictions such as Germany and Italy maintain in the range of 4 to 8 staff per million of population.[25] Comparable differences emerge if one looks at regulatory budgets as a fraction of gross domestic product or stock market capitalization. Australian securities officials also distinguish themselves when it comes to enforcement activity, dedicating a higher proportion of regulatory staff to enforcement activities and bringing many more enforcement actions per trillion dollars of stock market capitalization than do many other jurisdictions.[26]

So, quite plausibly, the SEC might be expected to consider both the level of regulatory

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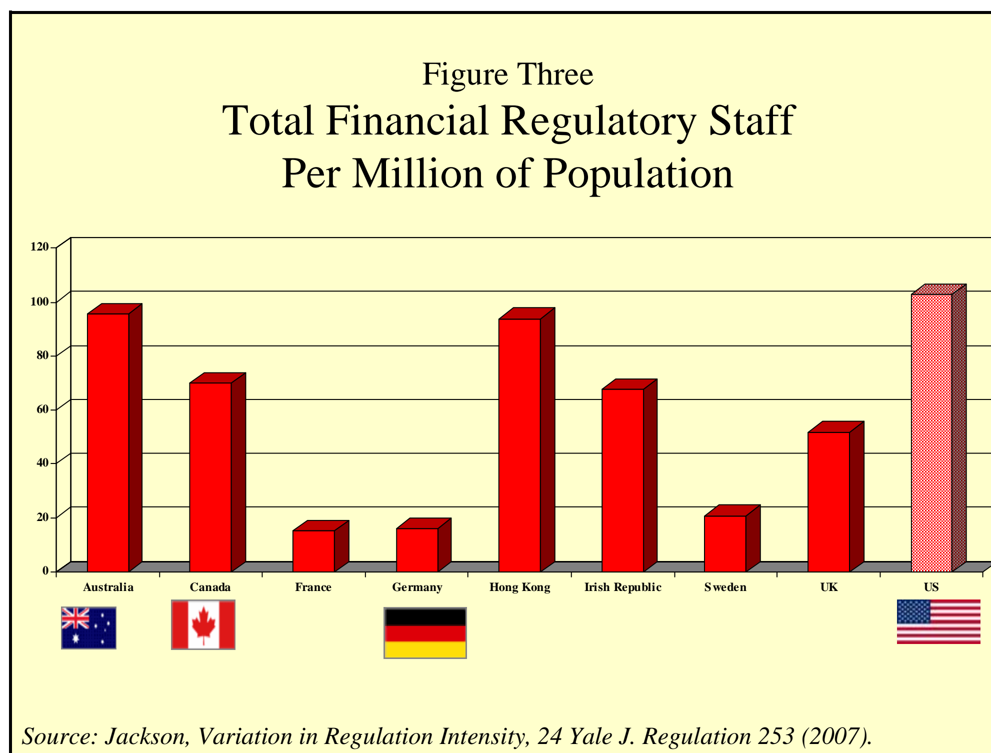
[25] Howell E. Jackson & Mark J. Roe, Public and Private Enforcement of Securities Laws: Resource Based Evidence (Feb. 22, 2008)(avail at. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1000086).

[26] John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007).

inputs (staffing and budgets) as well as some measures of regulatory outputs (enforcement activities and other objective measures of supervision). (See Figures Three, Four and Five.)



Source: Jackson, Variation in Regulation Intensity, 24 Yale J. Regulation 253 (2007).

While there is a growing body of empirical evidence supporting the use of both measures in accessing the quality of a country's supervisory apparatus, there are also limitations to these approaches, which could be categorized as incompleteness, misdirection, and inadequate granularity.

1. Incompleteness

No matter how one attempts to measure regulatory intensity across jurisdictions, there is always a concern that one has failed to identify all relevant regulatory inputs. This problem is most apparent for staffing and budget measures. The United Kingdom offers a good example. While the U.K.'s Financial Services Authority (FSA) is perhaps the premiere example of a consolidated supervisory agency, the British actually maintain several other regulatory bodies that fulfill functions comparable to those of the U.S. SEC. The British Financial Reporting Council employs a staff of fifty-five with a budget of £14.5 million, polices auditing firms and the accounting statements of corporate issuers, and undertakes activities comparable to those of the SEC's Division of Corporate Finance and the Public Company Accounting Oversight Board

(PCAOB). The Panel on Takeovers and Mergers also plays an important role, somewhat comparable to the SEC's with respect to proxy fights and tender offers. Regulatory comparisons that rely solely on FSA staffing or budget levels miss these other important regulatory components.

The supervisory functions of stock exchanges also complicate comparative head counts. In the United States, the supervisory activities of the NYSE and NASD have, for a number of years, been isolated in separate operational units, and are now fully removed into the Financial Industry Regulatory Authority (FINRA). Around the world, the supervisory roles of exchanges have diminished with the demutualization of all major exchanges and the dictates of EU listing directives.[27] However, regulatory functions do still take place in many exchanges, especially with respect to the review of new listing applications, where exchange personnel often take on roles similar to, though invariably less intensive than, those of SEC staffers who review registration statements for IPOs. The Hong Kong stock exchange's oversight of new listings would be a good example of this role.

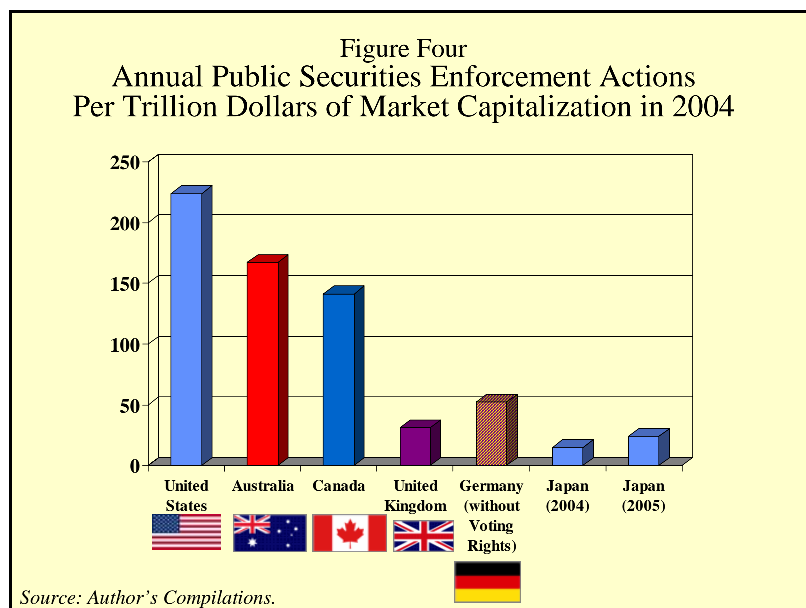


Figure Four
Annual Public Securities Enforcement Actions
Per Trillion Dollars of Market Capitalization in 2004

Source: Author's Compilations.

Finally, there is variation in the reliance that different regulators make of private assistance. Within the German civil law tradition, this reliance seems particularly striking. Germany's BaFin, for example, makes use of outside audits to supplement regulatory oversight. The Swiss Federal Banking Commission makes even more extensive use of outside auditors, requiring them to undertake annual supplemental (and confidential) reports with respect to

[27] See Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S.C. L. REV. 1239 (2007) (previously avail. as John M. Olin Center Working Paper No. 579 (Oct. 6, 2006) at http://www.law.harvard.edu/programs/olin_center/papers/579_Jackson_Gkantinis.php).

regulatory compliance. These reports are comparable to what the SEC's Office of Compliance Inspections and Examinations might produce, but the Swiss personnel who undertake these reviews do not show up on government payrolls.

Similar problems of completeness exist in collecting comprehensive data on enforcement outputs. For example, in evaluating enforcement efforts in the United Kingdom, one would want to consider both the oversight functions of the Financial Reporting Council mentioned above and also the Financial Ombudsman Service, which provides mediation services for a large number of matters each year, but whose enforcement actions are not included in FSA's own enforcement data. One should also probably take into account the predilection of some regulatory bodies to resolve enforcement actions informally and without public disclosure. Again, this is a common practice for the British FSA, but it is also employed by many other jurisdictions, including, for example, Switzerland, where many enforcement actions are reported only on an anonymous basis.[28]

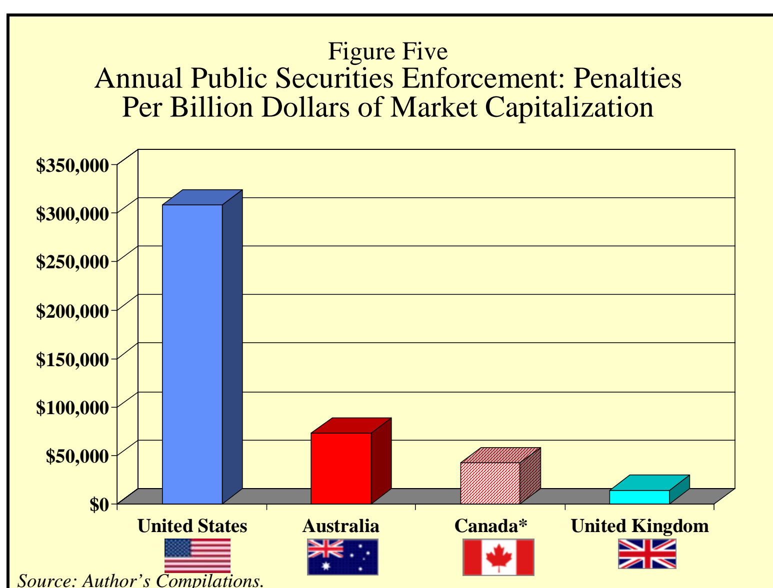


Figure Five
Annual Public Securities Enforcement: Penalties Per Billion Dollars of Market Capitalization

Source: Author's Compilations.

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Misdirection

By misdirection, I mean the possibility that both publicly reported regulatory resources and enforcement outputs may not actually be intended to produce supervisory services. To begin with, there is an obvious question of whether all resources allocated to regulatory agencies are

[28] One might also note a reciprocal problem of over-inclusion. In some jurisdictions, the task of corporate oversight is combined with securities matters – both Germany and Australia share that characteristics. And so simple comparisons of actions brought against firms and their officers and directors is not fully comparable to SEC actions in the United States, where corporate matters are left to state laws. A similar problem arises with respect to the jurisdictions of consolidated supervisors, such as the British FSA or German BaFin, whose responsibilities (unlike the SEC) extend to banks an insurance companies.

in fact employed in bona fide supervisory functions, as opposed to serving as sinecures for cronies of political elites or positions from which to extract bribes and other economic rents. While all of the major financial centers of the world--the United States, the United Kingdom, Hong Kong, Luxembourg, Singapore, and Amsterdam--do report above-average levels of regulatory staffing and budgets, one can also find some more surprising jurisdictions (like Nigeria and Jordan) that report devoting substantial resources to regulatory agencies. The possibility of graft and sinecures may produce nontrivial levels of "noise" in measures of regulatory input, especially for samples that include the developing world.

One might also imagine similar misdirection in reported enforcement activities, if, for example, financial sanctions were being imposed to penalize political opponents of the parties in power, or to punish industry participants for failing to pay bribes to regulatory officials. While this may seem to be the kind of problem one would encounter in seriously corrupt jurisdictions, there is a possibility that the problem is more widespread. In the United States, for example, the monetary penalties imposed earlier this decade by state authorities, led by former New York Attorney General Eliot Spitzer, materially increased the level of overall U.S. monetary sanctions. The most uncharitable critics of Mr. Spitzer claimed that these actions were primarily designed to advance his own political ambitions; if true, the inclusion of these actions in aggregate U.S. data could confound analysis that proceeds on the assumption that all monetary sanctions are imposed to deter wrongful market behavior.

3 Inadequate Granularity

One can easily imagine improving basic staffing data to provide greater granularity to the subject of regulatory inputs by examining the portion of regulatory staffs dedicated to enforcement activity. One could, for example, decompose the allocation of staffs into supervisory building blocks of rule formulation, examination and inspection, enforcement, and other sectors. While one would face considerable challenges in assembling such data--currently regulatory agencies are remarkably eclectic in job classifications, and the lines between examination and enforcement often blur--the development of more refined staffing data would be of considerable interest. One might, however, imagine other ways in which to subdivide regulatory personnel to generate equally interesting granularity. The professional backgrounds of regulatory personnel vary substantially across jurisdictions. The SEC hires many lawyers and accountants; in contrast, the British FSA employs more economists and high-level staff drawn from industry ranks. There

are also differences in the extent to which regulatory personnel move back and forth between industry and government, as opposed to staying largely within a civil service path. In addition, the degree to which regulatory personnel turns over with changes in political leadership also varies a good deal across jurisdictions. It is not entirely clear which staffing divisions are most closely tied to strong financial markets, but to the extent that staffing allocations are significant then one might want to examine the relationship on multiple dimensions.

One could also make similar distinctions with respect to enforcement actions and penalties. In most jurisdictions, regulatory officials have jurisdiction over a wide range of activities--including the quality of corporate disclosures, insider trading and market manipulation, the sales practices of securities firms, and a host of technical rules regarding financial institutions' solvency and the technical operation of markets. The distribution of enforcement efforts varies a good deal from jurisdiction to jurisdiction, with the SEC placing more emphasis on the review of disclosure documents and enforcement actions against other issuers than do other jurisdictions. And, of course, the incidence and distribution of private enforcement actions against both issuers and securities firms varies from country to country. Aggregate data about overall enforcement actions and sanctions may obscure important differences across enforcement categories.

B. Understanding the Mechanisms of Enforcement

Even assuming the SEC could assemble data, with an appropriate degree of granularity, about the real resources allocated to legitimate public oversight of financial markets and the associated measures of formal enforcement actions, the Commission might still be a long way from divining whether a particular jurisdiction's level of regulatory intensity ensures an adequate level of compliance or sufficient oversight to foster robust capital markets. The linkage between regulatory intensity and positive economic outputs is not well understood and may vary from jurisdiction to jurisdiction.

Consider, for example, the possibility that the regulated entities in one jurisdiction--think Sweden--are more apt to comply with newly promulgated legal rules than their counterparts in other jurisdictions--say Italy. This commonly accepted stereotype of the North-South European divide would imply that fewer enforcement actions are necessary in some jurisdictions than in others in order to generate the same impact on private market behavior. One does not, however, need to posit trans-jurisdictional variation in inherent lawfulness in order to have concerns about the comparability of enforcement efforts from one country to the next. The means by which

regulators enforce legal requirements may well differ materially around the world. The light-touch regulation of the British FSA includes numerous mechanisms of public-private exchange, ranging from the raised eyebrow on official Albion foreheads to the quite complex network of advisory committees and consultations that characterize British supervisory practices. Somewhat similar in effect is the use of informal guidance in Japan. All of these alternative mechanisms of social control are plausible substitutes for the formal enforcement actions that characterize the regulatory activity in the United States and a few other jurisdictions. The relative scarcity of enforcement actions in these other jurisdictions does not necessarily imply greater noncompliance or economic drag.

It is also important to examine the relationship between public enforcement efforts and private sanctions. Private litigation in the United States often follows on the heels of public sanctions. And thus the significance of public enforcement efforts in the United States, as compared with the United Kingdom or Germany, may be even greater than the raw numbers suggest. However, litigation may not be the only, or even the most, important private response to public enforcement actions: market movements in the form of price declines for shares and career consequences for implicated individuals may be far greater. Plus, to the extent that violators are public firms, the proxy process and voting power may impose additional sanctions on management. At this stage, most of the work done on market reactions to public enforcement efforts has focused on U.S. markets; thus we do not know whether foreign markets impose similar knock-on sanctions. It is, however, conceivable that in some foreign jurisdictions private monitors do a better job of amplifying public sanctions than do U.S. markets. In London, for example, shareholders are said to have more power in the boardroom and so British investors may respond to FSA sanctions more effectively than their U.S. counterparts respond to SEC sanctions.

C. Globalization and Enforcement

Globalization also complicates comparative evaluations of enforcement data on many dimensions. Cross-listed firms are one case in point. If one considers the number of enforcement actions in Canada and adjusts for the relative size of the Canadian market, one would likely conclude that the level of securities enforcement in Canada is substantially lower than in the

United States[29]. However, it turns out that quite a large number of leading Canadian firms are cross-listed in the United States, and therefore are also subject to many U.S. regulatory requirements, supervisory standards (including exchange oversight), and even private liability rules. Accordingly, the Canadian system of securities oversight does not constitute the entire universe of legal constraints on a major portion of the Canadian stock market. To some degree, Canadian securities markets free-ride off of U.S. regulatory intensity.

The increasing collaboration across jurisdictional boundaries complicates our evaluation of national regulatory efforts in other ways as well. With the globalization of financial markets, regulatory officials routinely refer matters to their counterparts in other jurisdictions. Often, a problem like insider trading or market manipulation will be detected in one market but will be referred to a second or third jurisdiction, where the investor making the trades or the firm in whose stock the trade is affected is located. Referrals of this sort happen hundreds and perhaps even thousands of times each year, and greatly expand the investigatory powers and enforcement reach of national regulatory authorities. For many jurisdictions, these cooperative arrangements may substantially enhance their regulatory capacity beyond those suggested by the countries' own supervisory forces.

A similar point can be made about the development of new regulatory policies and legal standards. In the past, such activities were largely conducted independently at the national level, with relatively little cross-border collaboration. In recent times, however, a relatively small number of jurisdictions--the United States and the United Kingdom being the most prominent examples--have dedicated substantial resources to policy analysis and the development of new rules for emerging issues such as hedge funds and derivatives transactions, and then have shared their conclusions with other jurisdictions (often with the assistance of multilateral bodies, such as IOSCO or the Basel Committee, or regional treaty arrangements, such as the European Union). As a result, smaller countries--even those with quite substantial financial markets--benefit from policy and rule development occurring beyond their borders. Analyses that focus solely on local resources miss this important regulatory networking.

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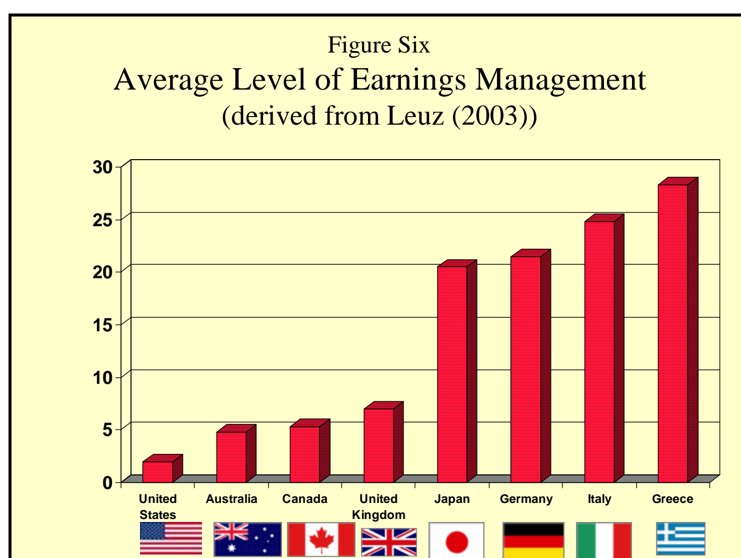
[29] See Howell E. Jackson, Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches (July 30, 2006) (Study Commissioned by the Task Force to Modernize Securities Legislation in Canada) (avail. at http://www.tfmsl.ca/docs/V6(2)%20Jackson.pdf).

D. How Else Might We Measure the Adequacy of Regulatory Intensity?

How might we go about determining whether the United States or some other jurisdiction was devoting adequate resources to supervising and policing financial markets? While comparisons of regulatory staffing and budgets, or overviews of enforcement intensity, may help identify instances where a country differs dramatically from international standards--as does the United States in the case of securities class action suits--these measures of regulatory inputs and outputs are likely to be too crude to make sharp distinctions across a wide range of jurisdictions. What other measures of quality exist? In my view, there are two plausible, alternative approaches.

The first would focus on technical measures of financial performance.[30] With respect to corporate issuers, one might consider the cost of capital across jurisdictions on the assumption that if domestic firms within a jurisdiction can raise capital at reasonable prices, that jurisdiction must have a reasonably acceptable legal system to oversee the issuance of securities, or, at least, local markets must have developed adequate mechanisms to police serious agency costs by corporate insiders or controlling shareholders. Or one could look at objective measures of the degree of earnings manipulation in stock prices. (See Figure Six.) In a similar spirit, one could look to the behavior of trading markets--bid-ask spreads, price synchronicity, and evidence of trading on inside information--to draw inferences about regulatory quality. (See Figure Seven.) The evidence of equity premiums for cross-listed firms has similar probative value, but is potentially available for only a limited



[30] The analysis in this subsection draws on forthcoming work of my colleague Professor Allen Ferrell, who is currently working on a paper discussing this approach to evaluating foreign regulatory regimes.

number of jurisdictions--the United States, the United Kingdom, and perhaps Hong Kong or Luxembourg--which attract substantial numbers of cross-listings. The vast majority of national stock markets do not compete for foreign listings, and are quite happy if they can simply retain their domestic firms.

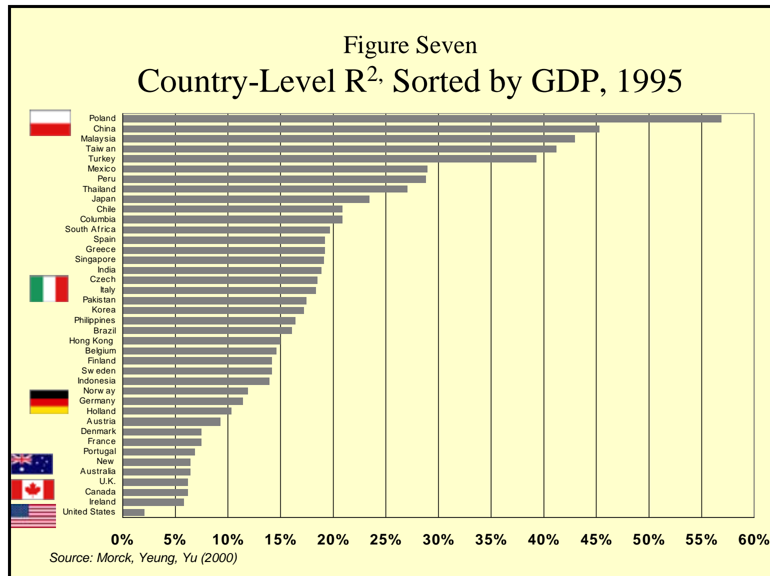


Figure Seven
Country-Level R^2, Sorted by GDP, 1995

Another metric for evaluating financial markets can be found by examining the behavior of market participants. This kind of evidence is often cited in the unfolding debate over U.S. capital market competitiveness. The declining number of new foreign listings and the spike of foreign firm deregistrations in the latter half of 2007 have been seen as evidence that American regulation has become too onerous. Conversely, one could see evidence of a rising number of new foreign listings as a measure of the quality of those markets that actively compete for foreign listings. More widely applicable would be a market test based on the increasing presence in foreign markets of institutional investors (as well as retail investors) from the United States and other developed nations. When sophisticated institutional investors make substantial investments in a country's financial markets and depend on that market's trading systems and

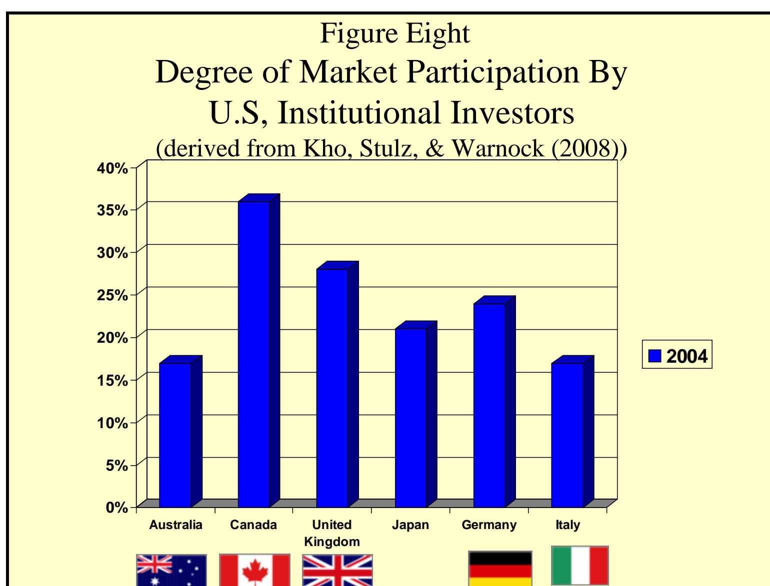


Figure Eight
Degree of Market Participation By U.S, Institutional Investors
(derived from Kho, Stulz, & Warnock (2008))

support mechanisms, such as custodial services and clearing arrangements, that confidence represents another source of market-based information on the quality of foreign markets and may well have some probative value in corroborating the quality of local regulation and legal regimes. (See Figure Eight.)

E. A Multi-Faceted Approach (and an Opportunity for Self-Reflection)

So what of analysis would we expect to see the SEC undertake in evaluating the regulatory systems of Australia and other jurisdictions? The short answer, I think, is that no single approach will suffice. Clearly the Commission will want to ensure itself that an appropriate and comprehensive system of legal rules are in place. And reputational considerations as well as past experience in regulatory cooperation will also be important. Analysis of regulatory intensity-- both in terms of regulatory inputs and outputs – also has undoubted value. But one must be careful to draw the comparisons accurately with considerable attention to institutional variation across jurisdictions. Confident normative judgments about the implications of observed variations in regulatory intensity should await empirical validation. One should also consider evidence available from objective measures of quality that are more directly tied to financial performance, as well as the additional information one can derive from observing how market participants, both corporate issuers and sophisticated institutional investors, vote with their feet and their dollars.

An important, incidental benefit of these cross-country comparisons will be the opportunity they provide for domestic self-assessment. In developing objective standards for reviewing other countries, the SEC will have an opportunity to consider the efficacy of its own system of regulatory oversight. In addition, it will have the opportunity to consider whether the highly complex and expensive system of regulation that has evolved in the United States is actually necessary to maintain effective oversight of a modern economy.

Finally, continuing the theme of self-reflection, the considerations I've outlined above are also of potential relevance to the development of an internal EU financial market, based on the principles of home country supervision and the passporting of financial services. My discussion of the issues confronting the SEC in implementing a system of selective substitute compliance point to the fact that one cannot simply rely on the adoption of formal legal rules to ascertain the adequacy of regulatory oversight. One must look to many other aspect of supervision, including regulatory inputs and outputs as well as the actual performance of financial markets and investors.

Similar considerations are quite possibly relevant to determining the efficacy of financial supervision in the EU. While CESR has undertaken a good deal of work along these lines in implementing the Lamfalussy process, some additional learning might well be obtained through an analysis of how the SEC approaches a problem of regulatory coordination that is strikingly similar in many respects.

IV. Additional Problems in Applying a System of Selected Substitute Compliance

Let's accept for a moment that the Commission can develop some reasonably objective and well grounded system for determining the adequacy of regulatory oversight in other jurisdictions. And assume further that this system ascertains that a dozen or so financial regulatory systems around the world do actually measure up to the SEC's standards of quality and comprehensiveness. What other issues arise in accepting foreign oversight as a substitute for domestic oversight? In my mind, there are several potentially important issues to consider.

A. Limits on the Exportation of Supervisory Services

In certain areas of financial oversight, the efficacy of financial services might not travel well across large distances. This is not so much a problem for disclosure requirements that are quickly impounded into market prices around world nor is a problem of policing home country market venues to which foreign investors are given access. But it could be an issue for supervisory standards applicable to market conduct, for example, governing the manner in which securities firms do business with retail customers. One source of difficulty could lie in the fact that home country regulators could have trouble detecting violations involving foreign customers in remote locations. Defrauded foreign investors could also face geographic constraints in utilizing dispute resolution procedures – for example, the ombudsman operations of the British FSA – from a distance. Yet another problem could be the political imperatives driving regulatory operations, whereby the threat of political repercussions could lead home country authorities to focus their supervisory efforts on activities that affect home country constituents and not the victims of misconduct who reside outside of the local political system.[31]

[31] Howell E. Jackson, *Selective Incorporation of Foreign Legal Systems to Promote Nepal as an International Financial Services Center* in REGULATION AND DEREGULATION: POLICY AND PRACTICE IN THE UTILITIES AND FINANCIAL SERVICES INDUSTRY (1999) (Christopher McCrudden, ed.) (Clarendon Press, Oxford).

These potential difficulties suggest attention needs to be given to ensuring that supervisory attention is appropriately extended to foreign markets that rely on off-shore oversight. One could imagine utilizing local authorities – for example the SEC or even US state securities commissions – to convey customer-facing information about potential problems back to home country officials. And, the original Tafara-Peterson proposal envisioned a requirement of pre-existing memoranda of understanding to deal with precisely this issue. But, further attention needs to be given to monitor the actual extension of supervisory oversight to foreign markets and perhaps even include expanded consumer complaint services and dispute resolution procedures to ensure that the full set of home country protections follow regulated firms and transactions into foreign markets.

B. The Problem of Regional Confederations

Another unique set of concerns arise when mutual recognition procedures are extended into regional confederations, such as the European Union, which are themselves built on inter-connected systems of mutual recognition among member states. The issue here is ascertaining which is the appropriate entry point for cross-border collaboration. On the one hand, the SEC could consider the European Union as a possible point of contact. As a result of the EU internal market initiative, all member states are required to organize their local financial regulations in accordance with EU derivatives, and considerable effort has gone into ensuring that all member states, even the new entrants in the East, have complied with this process. So the consideration of the formal legal requirements with the EU would be relatively straight-forward. The problem comes, however, when one gets to the more difficult questions of regulatory intensity and quality of financial markets. Here there is considerable variation, especially between the larger and well-established markets in London, Frankfurt and other traditional financial centers, as compared with certain southern European jurisdictions and the new members states in the East. On almost any plausible metric of objective performance, regulatory resources, enforcement efforts, objective indicia of market performance or presence of foreign investors, the distance between the better developed and less developed European markets is substantial.

The variation in supervisory and market quality militates in favor of a focus on individual member states as a preferable point of contact, starting for example with the UK or perhaps Germany as likely partners for initial European linkages. But the problems of regional confederation don't fully disappear. The genius of the EU internal market is the free flow of goods and services, which permits issuers located in one jurisdiction to list their securities in

another member-state markets and allows financial services firms to branch across the region's boundaries. Thus, even if the Commission were to conclude that market oversight within a single EU jurisdiction was comparable to that of the United States, concerns would still arise whether products sold in that countries market and all firms doing business in that market were fully subject to the member states oversight.

These not inconsiderable difficulties may explain why the Commission chose to undertake its first experiment in mutual recognition with Australia, which maintains largely a freestanding national system of financial regulatory oversight (albeit one with fairly close ties to New Zealand) and its second with Canada, which though complicated by a federalized structure has a close and long-standing history of regulatory cooperation with the US.

C. Potential Limitations on the Scope of Accommodation

Limitations on scope are likely to be an element of any new system of U.S. recognition. Partially, these limitations could be used to deal with the Commission's inability to satisfy itself of the quality of all aspects of a jurisdiction's supervisory system. This issue might arise, for example, with respect to objective measures of stock market efficiency that might well vary between large and small sized companies. In the face of such evidence, one might imagine the commission to allow foreign brokers to offer US customers only the securities from issuers above a certain size or for similar limitations to be imposed on the securities included on remote exchange terminals placed in the United States.

Somewhat different limitations might be imposed on arrangements involving members states of the EU, perhaps limiting cross-border transactions with US customers to those securities and other financial products fully overseen by the signature member state. So, for example, if the United Kingdom entered into the first such arrangement with the SEC, then the sale of securities in UK listed firms might be eligible for sale to US customers but perhaps not structured products listed on the Frankfurt exchange and then passported into UK markets.

Yet another and more radical kind of limitations would be to restrict the kind of US investors eligible to purchase securities or otherwise do business with foreign firms operating under these new arrangements. Such an approach would, in essence, convert mutual recognition into a new form of institutional or accredited investor exemption. But, as it would entail an evaluation on the quality of foreign supervisory oversight, it would still represent a manifestation of the new regulatory paradigm.

D. The sticky problem of private litigation/enforcement

Another foreseeable issue that is likely to arise if the SEC moves forward with this new approach to regulatory cooperation is the interaction between US regulatory requirements and US liability rules. As I mentioned earlier, an anomaly of the SEC's old approach to foreign transactions – the modified national treatment – was that a good deal of effort went into narrowing the application of the commission's formal requirements, but very little attention was given to the extra-territorial application of federal-anti-fraud rules, as that aspect of jurisdictional division was left to the federal courts. To the extent that a major impetus of the Commission's new paradigm is to make a wider range of investment choices available to US investors, then some attention needs to be given to this aspect of US regulatory oversight lest foreign entities avoid the SEC's new system of substitute compliance out of fears that it may enhance the scope of liability.

In other contexts, the Commission has experimented with limited anti-fraud safe harbors, and it is possible that it would be open to similarly spirited rules in connection with selective substitute compliance. Exactly how this relief might be formulated is unclear, but it might consist of an administrative determination that reliance on the Commission's exemptive relief should not be used as a factor in extending US judicial jurisdiction to other aspects of the firm's business or to investors outside of the United States. In addition, one might imagine allowing foreign firms to opt into alternative and potentially less costly dispute resolution mechanisms, such as arbitration, which have recently been recommended in some quarters as a potential option for all US corporations, but not yet endorsed by the SEC.

Whether or not the Commission staff could soon find its way to imposing restraints on private liability provisions is, of course, a matter of considerable speculation. But as a matter or regulatory design the point to recognize is that the United States maintains an overlapping system of public and private securities market oversight. The logic of substitute compliance is that, when a foreign jurisdiction provides adequate supervision – even if that supervision is not identical to what is imposed in the United States – we may reasonably rely on that foreign oversight in certain contexts and avoid the costs and distortion of overlapping US supervision. Because private litigation is such a powerful component in the United States, the logic of substitute compliance counsel for some accommodation in this area as well.

E. Domestic Political Consequences and Reactions

Finally a few words on several political dimensions of this new regulatory paradigm. All concern domestic US reactions to proposals to move towards a system of substitute compliance. But if other jurisdictions should move towards this new regulatory paradigm comparable concerns will likely arise elsewhere

The first are claims for "equal treatment" on the part of domestics firms and issuers. One of the premises of substitute compliance is that somewhat different foreign regulatory regimes can provide acceptable alternatives to domestic arrangements. The key operational consideration, which has been the focus of much of the foregoing discussion, is how a domestic regulatory agency such as the SEC should go about determining which foreign systems have obtained acceptable standards. But from the perspective of domestic regulated firms, the most striking aspect of these arrangement is that foreign entities are allowed to do business locally without complying with the same domestic standards as have been applied under our traditional system of modified national treatment. Hence local constituents are quite likely to argue that some or another feature of domestic regulation should be relaxed to equal foreign rules on the subject or at least that domestic firms should be granted the option of complying with either the domestic or foreign standard on various issues. A good example of this response has arisen in the current debate of whether US domestic issuers should be allowed to prepare their financial statements in accordance with IFRS instead of traditional GAAP. Another example would be NASDAQ's recent proposal that SEC exemptive procedures should be modernized to equal exemptive procedures available to certain foreign exchanges before foreign stock exchanges are permitted to enter US markets under a system of substitute compliance.

These pleas for equal treatment pose a challenge for the new paradigm. The danger of acquiescing in piecemeal accommodations of this sort is that specific elements of foreign regulatory structures may depend on the presence of other regulatory elements that do not exist in the United States and cannot easily be replicated. For example, the clubby atmosphere of the City may allow the British FSA to rely on more open-ended regulatory principles than might be necessary in America's large and anonymous financial markets. Or the relatively law abiding nature of German firms may explain BaFin's ability to rely on outside auditing services rather than the kinds of regulatory examinations that the SEC typically conducts. In other words, the distinctive institutional context of certain foreign markets may be essential to the less stringent regulatory requirements that exists in those markets.

Of course, not all aspects of foreign supervisory structure will be so intricately connected to other unique features of local regulation, and so domestic constituents may often seek accommodations that are both sensible and necessary to allow for fair competition. Indeed, one of the virtues of substitute compliance is that it can facilitate productive forms of regulatory competition. The trick of course is for regulatory authorities to be able to distinguish regulatory adjustments that move the race upward and not downward.

A related concern involves not changes in domestic regulation but movement of domestic firms and transactions to offshore markets that are eligible for substitute compliance. Just as domestic US corporations have long been permitted to move their corporate seat to Delaware in order to reap the benefits of that state's corporate laws, US issuers and financial services firms might contemplate relocating off shore to operate under an alterative regulatory market while still doing business with US customers. Whether such relocations should be permitted – or how strenuously they should be policed – raises another political complexity for domestic regulators. As with the selective adoption of foreign oversight, the movement of domestic corporations to nominal offshore locations can dilute or compromise regulatory standards. If, for example, issuer supervision in a foreign jurisdiction depends in part on the presence of local institutional investors with large block holdings, that regulatory system may not work as effectively for a relocated foreign firm with few or no large block holder resident in the foreign jurisdiction. On the other side, once again, is the possibility that jurisdictional choice might improve the quality of supervision in both jurisdiction. The proper balance of these considerations again is likely to vary from context to context.

A final political consideration is the likely reaction when the first scandal arises involving a foreign firm operating domestically but under the primary jurisdiction of home country oversight. Such situations will no doubt arise, and will no doubt generate intense political scrutiny of the agency and officials who allowed the foreign firm to enter under such arrangements. The treatment of these political recursions is one of the great impediments to moving toward a system of substitute compliance, as the officials who champion the reforms have much to lose from adverse political reactions down the road. One partial solution to such adverse political repercussions to ensure that appropriate dispute resolution and compensation arrangements are available for injured parties, especially individuals of moderate means. Another form of insulation is to maintain good records of the incidence of failures and losses for

comparable domestic firms in order to be able to place the problems generated by foreign entities into a larger context. But the potential of negative publicity and political backlash from future scandals under this new regime is an important political factor that must be acknowledged and, to the extent possible, addressed.

V. The Longer View

Let me conclude by pulling back for a moment from the details associated with implementing a system of selective substitute compliance and say a few words about what the world of international financial regulation might look like several decades down the road. Here, if you permit, I will be intentionally and perhaps recklessly speculative, but I think we might be able to see the faint outlines of a new system of regional financial oversight, built not around nation regulatory systems but rather around geographic regions, of which one might see the EU as an initial prototype. You could imagine North America creating another similar region, based on pending US-Canadian negotiations and then spreading out to include the rest of NAFTA and perhaps extending into Latin America. Asia might constitute another natural regulatory compact. And perhaps two or three other in other regions around the world. Financial firms and issuers based in those regions would could operate seemlessly across national boundaries within each of those regions but then also be permitted to extend their operations and capital raising functions more broadly to other corners of the global, remaining subject to the same regulatory structures as within their home region but under special licenses to operated globally.

In this global market, financial regulation would not be fully harmonized just as today's production of automobiles or pharmaceuticals are not fully harmonized. But there would be several major competing systems of financial regulation, adapted to reflect regional variations in ownership structures and social preferences. Each system would be large enough and important enough to regional economic well-being to ensure the basic integrity of operations. That is, this would not be a game in which off-shore financial centers would compete. But it would also be sufficiently dynamic and competitive to prevent the sort of regulatory ossification that could bedevil world-wide regulatory standards.[32]

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[32] This regulatory model will have elements of regulatory competition, but would be considerably narrow that proposals in which the source of competition is the nation state or even trading exchange. See Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2

While this vision of regional financial oversight may seem futuristic, the steps that the SEC has begun over the past year could point us all in this direction. If, once the Commission works out the kinks of substitute compliance with Australia, Canada, and perhaps a few more test cases within the EU, it will be forced to consider whether the full EU system should be eligible for trans-Atlantic integration. At that point, one would expect Asian countries to request similar privileges, and at that point the vast majority of the world's capital markets would be interconnected through a system for regulatory mutual recognition.

With a bit of imagination and effort, one can almost see this distant shore.

THEORETICAL INQUIRIES IN LAW 649 (2001).