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International Diversity in Securities Regulation:

Some Roadblocks on the Way to Convergence

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JEL Class: K22; G18; G3; G38

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ABSTRACT

This Paper is motivated by a seemingly growing gap between the dominant themes in two closely related fields -- securities regulation and corporate governance -- especially in what regards their international, or comparative, aspects. In the field of securities regulation the dominant trend is one of harmonization and convergence of domestic national regimes. The opposite is true in the field of corporate governance. The few initiatives toward convergence have so far failed and current analyses either acknowledge or champion international diversity. Concentrating on international securities regulation, the Paper critically assesses these trends and the degree to which they may be reconciled. After an overview of recent harmonization projects, the Paper argues that corporate law and securities regulation are best viewed as two integrated components of one larger field. The two fields can also be classified as private law and public law, respectively. The Paper then demonstrates how the inertia and relative stability (path dependence) of corporate governance systems may interject similar features into processes of international convergence in securities regulation. The harmonization project of IASC and IOSCO is discussed in this context and regulators are urged to conduct a corporate governance impact assessment on a general basis. Finally, the Paper argues that the public law/private law distinction could further exacerbate path dependence dynamics where the distinction carries legal weight such as in many Civil Law countries. Evidence from three decades of harmonization initiatives in the European Union is consistent with the argument.

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INTERNATIONAL DIVERSITY IN SECURITIES REGULATION: SOME ROADBLOCKS ON THE WAY TO CONVERGENCE

I. Introduction

This Article is motivated by a seemingly growing gap between the dominant themes in two closely related fields -- securities regulation and corporate governance -- especially in what regards their international, or comparative, aspects. In the field of securities regulation the dominant trend is one of harmonization and convergence of domestic national regimes. The opposite is true in the field of corporate governance. The few initiatives toward convergence have so far failed and current analyses either acknowledge or champion international diversity. Concentrating on international securities regulation, the Article critically assesses these trends and the degree to which they may be reconciled.

A noticeable trend among securities regulators and practitioners is an on-going movement towards harmonization and unification of securities regulation laws. A considerable number of projects of this kind have been undertaken or are still under way. By far the most ambitious in terms of international scope is the project undertaken by the International Accounting Standards Committee (IASC) together with the International Organization of Securities Commissions (IOSCO) which would produce by March 1998 a body of international accounting standards that could be used universally for cross-border listings.[1]

Less comprehensive in its membership scope but more effective and successful is the European Union's (EU; formerly, the European Community) project of the Single European Market -- the "1992 Plan". EU Directives promulgated as part of this plan cover many of the major issues in securities regulation such as disclosure, anti-fraud, and broker-dealer and stock exchange regulation. Earlier in 1991, the Securities and Exchange Commission (SEC) and securities regulators from three Canadian provinces established the Multi-Jurisdictional Disclosure System (MJDS). Under MJDS, disclosure statements of corporations from each jurisdiction are recognized by the others.

In terms of theoretical analyses, academic writing on securities regulation during most of the 1980s tended to deal with reforms in the domestic disclosure regime, e.g., the introduction of shelf registration and the law of insider trading. Discussion of international aspects of securities regulation started in earnest only after the SEC's 1987 report on the internationalization of securities markets.[2] The bulk of the academic literature[3] considers regulatory diversity as part of the opening conditions for an international regulatory competition, with the familiar debate over a race for the bottom

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[1] For a more detailed overview of the IASC/IOSCO project as well as of EU Directives and the MJDS *see* below Part II.A

[2] SECURITIES AND EXCHANGE COMMISSION, INTERNATIONALIZATION OF THE SECURITIES MARKETS, REPORT OF THE STAFF OF THE U.S. SECURITIES AND EXCHANGE COMMISSION TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS (1987).

[3] *See infra* text to note 21 *et seq.*

(or top) now taking place in the international arena. In this respect, it is worth noting that no matter where such a race may be heading to -- the important point is that race dynamics of this sort would tend to lead to convergence among the racing jurisdictions -- either at the top of at the bottom.

In the field of corporate law, the only efforts to harmonize corporate laws were made in the EU and they have so far all failed.[4] Nevertheless, interest in the field on behalf of academic scholars and business people alike has been an increasing over the last decade or so. Earlier in the 1980s, the literature on corporate governance in the United States was mainly introspective, examining the traits of and advocating reforms in the domestic corporate law regime. Central topics were the desirable structure of takeover regulation and the appropriate degree of freedom in the production of corporate law both by states and by entrepreneurs (the “race to the bottom” and the “contractual freedom” debates, respectively). By the mid-1990s, these topics were largely abandoned without reaching a consensus on many, if not all, of them. Instead, the focus shifted to the ways in which other countries regulate such issues. “Comparative corporate governance” became in vogue and theories about “path dependence” followed suit shortly thereafter.[5]

If one is to distill a common theme from the comparative corporate governance literature it is clearly an acceptance of legal and structural diversity in this area at the *normative* level. The emphasis is on the normative aspect since as a descriptive argument,

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[4] *See infra* text to note 39 *et seq.*

[5] *See infra* Part II.B.

international diversity in corporate governance structures is neither surprising nor very interesting. Diversity becomes relevant when there are lessons to be learnt from foreign systems for improving existing regimes or when new corporate governance systems need to designed *de novo*.

These trends are explored further below. But at this point it should already be evident that a serious discrepancy exists between the international trends in corporate governance and securities regulation. Corporate law and securities law[6] together constitute one larger body of law which -- in its entirety -- governs the relationships between corporate constituencies. As I will show, the division between the two legal fields is tenuous at best. If diversity in corporate governance is so deeply rooted in national legal and economic systems, how can it be that the counterpart securities regulation regimes can be harmonized and even unified, thus uprooting all their unique distinguishing features?

Put more bluntly, the question is whether modern scholars are wrong in endorsing international diversity in corporate governance regimes (namely, that there *does* exist a most efficient governance structure towards which all nations move or should move); or, whether the harmonization projects in the securities field -- most notably that of IASC and IOSCO -- are misguided?

[6] In this Article, I use “securities regulation” and “securities laws” interchangeably. “Corporate governance” is sometimes used interchangeably with “corporate law” when the context refers to the legal regime governing the structure of the corporation rather than the corporate structure itself.

The stakes in having the answer right could be quite high for many countries around the globe. In the United States, prominent scholars have advocated reforms in corporate governance-related laws oftentimes with a view to imitate a successful feature of foreign systems or to facilitate its emergence. In the securities regulation field there is a heated debate over the desirability and wisdom of lowering US disclosure duties -- either selectively or across the board -- in order to accommodate foreign issuers and improve the global competitiveness of US securities markets. The stakes could be even higher for developing and formerly-communist countries which are now establishing market economies. Unlike the United States and other developed countries, such countries often start from a clean slate rather than trying to improve an existing and functioning regime at the margins. It is thus more critical for these countries to choose not only independently good regimes but also a good match of related legal regimes. More concretely, in a good match securities laws could remedy existing deficiencies in corporate laws. But if a deficient corporate law regime is supplemented by a deficient securities law regime -- say, in curbing self dealing -- the problem could go completely unchecked.

The Article offers a new perspective for analyzing current developments in international securities regulation. To do so, the Article returns to first principles and explores the relations between corporate law (and corporate governance) and securities regulation. The Article identifies two related levels where the these legal fields interact. One level may be seen as functional, i.e., the manner in which the two fields together form an integrated regime for corporate affairs. The other level is more abstract -- it is the canonical distinction between the private and the public, or private law and public law.

The Article argues that the securities regulation and corporate law may be difficult to distinguish between on both levels, but despite the considerable gray area they retain their independent character and their nature as public and private law, respectively.

Based on these observations, the Article moves on to derive the implications for international harmonization and convergence in securities regulation. In light of the recent advances in the study of comparative corporate governance, it argues that rigidities and "sticky points" which exist in national corporate governance systems are bound to affect the structure and content of their securities regulation counterparts, and vice versa. From a regulatory viewpoint, corporate governance should therefore be seen as the normative basis for securities law, i.e., as a template against which regulatory rules should be judged and later, priced by the market. Furthermore, any program for inducing convergence through harmonization or for enabling convergence through regulatory competition must take this bi-directional effect into account. Caution in implementing projects of this sort is thus warranted. The Article also advances a proposal for a "corporate governance impact analysis" for such programs.

As to the implication of the public/private distinction, the Article argues that for structural and substantive reasons, public laws -- including securities regulation -- may be more susceptible to harmonization projects. Private laws in general -- and company law in particular -- tend to be less so, as is evidenced by more than two decades of experience in the European Union. Since the two fields are connected, the strong national character of company laws may be the factor that facilitates harmonization of securities laws by preserving the core national preferences which are embodied in the system. At the same time, this very factor may also put a limit on the scope of securities law harmonization insofar as it bears directly on corporate governance.

The remainder of the Article is organized as follows. Part II explores the recent trends in international securities regulation and corporate governance, both in terms of actual convergence trends and the relevant academic analyses. Part III analyzes the relations between corporate law and securities regulation, first as a legal and functional matter and then against the public/private distinction. Part IV identifies some roadblocks on the way to international convergence of securities regulation regimes. It discusses the role of disclosure and insider trading regulation in this context. It further assesses the prospects of harmonization projects and the importance of corporate governance as a normative basis for securities regulation. The Part ends with the implications of the public/private distinction on international convergence. Part V concludes.

II. Recent Trends

A. International Securities Regulation

A number of projects are presently under way with the shared goal of implementing harmonization and cooperation in securities regulation. The most ambitious project in terms of international scope is the International Accounting Standards (IAS) project undertaken by the International Accounting Standards Committee (IASC). IASC is a London-based independent private sector body with the objective of achieving uniformity in accounting principles which are used by businesses and other organizations for financial reporting around the world.[7] So far, IASC's standards have gained some success mainly among non-US companies that report according to IAS and several stock exchanges which allow or require issuers to present financial statements in accordance with IAS.[8] The primary importance of IAS, however, stems from their potential to become the basis for a uniform disclosure regime set by securities regulators around the world under the auspices of IOSCO.

In 1994, IOSCO reviewed the then existing IASC standards and identified those standards that would be considered acceptable as core standards and others that need to be improved or for which essential issues (for certain countries) remain open. The standards, when completed, would serve as a common basis for multinational securities offerings and listings. In July 1995, IASC signed an agreement with IOSCO on a work plan to be completed by the turn of the century, and in April 1996 IASC announced an intention to accelerate that plan with the objective of completing the core standards by March 1998.[9] As of March 1998, most of the work plan had been completed with certain thorny issues still open.[10]

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[7] INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE, INTERNATIONAL ACCOUNTING STANDARDS 1997 7 (1997). As at January 1997, IASC membership included all the professional accounting bodies in some 88 countries, totaling 119 members and 6 associated members. *Id.*

[8] *Id.*, at 13.

[9] Michael H. Sutton, *Financial Reporting in U.S. Capital Markets: International Dimensions,* 11 ACCT. HORIZONS 96 (1997).

[10] *Financial Assets and Liabilities: The Next Steps,* IASC Insights, December 1997, at 11; Karen M. Knoll, *Closing the GAAP?,* Industry Week, 3 November 1997, at 61; *Accounting Standards. America v. The World,* The Economist, January 17, 1998, p. 58.

Because of IASC's concentration on its "IOSCO program" for cross-border listings, it has been argued that IASC is ignoring other types of enterprises.[11] IASC's position in response was that its International Accounting Standards apply to the financial statements of all commercial, industrial and business reporting enterprises, in both the public and private sector. Thus, to the question whether "one size fits all?" IASC's Board has felt that in most cases, and with only minor exceptions, the answer is "Yes"[12].

In October 1997, the SEC reported to Congress on the outlook of successful completion of IASC and stated that it may propose changes to its current reporting requirements for foreign private registrants.[13] It emphasized, however, that before doing so it will closely scrutinize the core standards to ensure that they meet certain criteria.[14] In this context, it was reported that in one of the most problematic and contentious issues left on IASC's table -- namely, accounting for financial instruments (e.g., derivatives) -- IASC may adopt the American rules and thus avoid direct confrontation with the SEC and secure its support.[15] IASC members eventually voted the proposal down, apparently because it was American.[16]

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[11] IASC, *One Size Fits All?,* IASC Insight, June 1997, at p. 1.

[12] *Id., id.*

[13] SECURITIES AND EXCHANGE COMMISSION, REPORT ON PROMOTING GLOBAL PREEMINENCE OF AMERICAN SECURITIES MARKETS (1997), available on-line at <http://www.sec.gov>.

[14] The main criteria required from IASC standards are that they (1) constitute a comprehensive basis of accounting; (2) are of high quality and result in comparability and transparency and provide for full disclosure; and (3) can and will be rigorously interpreted and applied. SEC, *supra* note 13.

[15] Robert Bruce, *A Fudge that Could Lead to and Alliance,* The Times, September 18, 1997, available on Lexis, Busfin library, Allnws file.

[16] *Accounting Standards. America v. The World,* The Economist, January 17, 1998, p. 58. *See* also *A Fair System for Financial Instruments,* Financial Times (London), January 8, 1998, p. 10.

Another significant effort towards harmonization and cooperation is taken by the European Union (EU). Initial steps in this direction started in 1979 but the major progress was made as part of its Single European Market plan. The plan's vision deemed it necessary to integrate the securities markets in all the member states.[17] Its general strategy was to implement the principle of mutual recognition among Member States' regulatory regimes whereby licensing or regulatory approval by one national regulator would be recognized by all other regulators -- the so-called "single passport" principle. In this framework, Directives[18] were promulgated with regard to regulation of corporate disclosure, insider trading, regulation of stock exchanges and intermediaries. Relatedly, Directives harmonizing the accounting profession were also promulgated.[19]

A somewhat similar initiative was undertaken by the SEC and securities regulators from three Canadian provinces by establishing the Multi-Jurisdictional Disclosure System (MJDS). MJDS too implements the principle of mutual recognition: under it, disclosure statements of corporations from each jurisdiction are recognized by

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[17] *See* COMMISSION OF THE EUROPEAN COMMUNITIES, COMPLETING THE INTERNAL MARKET: WHITE PAPER FROM THE COMMISSIONTO THE EUROPEAN COUNCIL (1985) at Article 107. For an overview of stock market integration in the EU, *see* BENN STEIL, ED., THE EUROPEAN EQUITY MARKETS 1 (1996); Amir N. Licht, *Stock Market Integration in Europe,* CAER II Discussion Paper No. 15, Harvard Institute for International Development (1998).

[18] EU Directives are promulgated by the EU Council of Ministers and requires all Member States to implement their provisions as minimum requirements in their municipal law thereby achieving EU-wide minimum standards.

[19] For a convenient overview of EU legislation, *see* BERNARD O'CONNOR, ED., A BUSINESS GUIDE TO EUROPEAN COMMUNITY LEGISLATION (1995).

the regulators in all the others.[20] This general description is misleading, however. In practice, Canadian issuers that which to offer securities in the United States under MJDS have to comply with American generally acceptable accounting practices (US GAAP) and be subject to American liability duties. For them, the savings embodied in MJDS are mainly limited to avoiding the interaction with the SEC's bureaucracy in Washington, DC.

Academic legal writing has generally neglected this aspect of international securities regulation. By and large, academic attention has focused on the non-cooperative aspects of the field, namely, optimal rules for choice of law and assertion of extraterritorial jurisdiction in transantional securities cases,[21] and international regulatory competition in securities regulation.[22] In the latter case, convergence could be a by-product of the race dynamics but does not necessarily have to be so. According to

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[20] Multijurisdictional Disclosure and Modification to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 33-6902, 49 SEC Docket (CCH) 260 (June 21, 1991). For an assessment, *see* Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency, and Cooperation* 12 NW. J. INT'L L. & BUS. 241, 303 *et seq.* (1991) (hereinafter: Trachtman, *Recent Initiatives*).

[21] *See*, e.g., Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997); Donald C. Langevoort, Schoenbaum *Revisited: Limiting the Scope of Antifraud Protection in an Internationalized Securities Marketplace,* 55:4 L. & CONTEMP. PROB. 241 (Autumn 1992); Merritt B. Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?,* 55 L. & CONTEM. PROB. 263 (Autumn 1992), 1994 SEC. L. REV. 355 (reprinted). *See* also Stephen J. Choi an Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207 (1996); Gunnar Schuster, *Extraterritoriallity of Securities Laws: An Economic Analysis of Jurisdictional Conflicts*, L. & POL. INT'L BUS. 165 (1994).

[22] *See*, e.g., James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies* 16 HASTINGS INT'L & COMP. L. REV. 149 (1993); James D. Cox, *Rethinking US Securities Laws in the Shadow of International Regulatory Competition* 55:4 L. & CONTEMP. PROBS. 157 (Autumn 1992). *See* also Bevis Longstreth, *A Look at the SEC's Adaptation to Global Market Pressure,* 33 COLUM. J. TRANSNT'L L. 319 (1995); Richard C.

regulatory competition proponents, a good regulatory competition could yield a diversified set of regimes for market players to pick and choose from.[23]

With few exceptions, there is little theoretical discussion of institutionalized international cooperation for harmonizing securities regulation regimes.[24] The bulk of the literature on these aspects invariably revolves around the practical and administrative aspects of regulatory cooperation.[25] While these aspects are important in their own sake,[26] they leave unanswered the underlying issues of substantive regulatory diversity.

Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 FORDHAM INT'L L. J. S87 (1994).

[23] For a representative view, *see*, e.g., Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Causes and Regulatory Consequences,* in MARVIN H. KOSTERS AND ALLAN H. MELTZER, EDS., INTERNATIONAL COMPETITIVENESS IN FINANCIAL SERVICES 349 (1991); 1991 J. FIN. SERV. RES. 349 (1991).

[24] One recent contribution is Uri Geiger, *The Case for the Harmonization of Seurities Disclosure Rules in the Global Market*, 1997 Colum. Bus. L. Rev. 241. *See* also Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation,* 4. TRANSNT'L L. & CONT. PROB. 69 (1994).

[25] *See, e.g.,* Michael D. Mann, Joseph G. Mari, and George Lavdas, *International Agreements and Understandings for the Production of Information and Other Mutual Assistance,* 29 INT'L LAW. 780 (1995); Caroline A.A. Greene, *International Securities Law Enforcement: Recent Advances in Assistance and Cooperation,* 27 VAND. J. TRANSNT'L L. 635 (1994); Michael D. Mann, Paul E. Leder, Elizabeth Jacobs, *The Establishment of International Mechanisms for Enforcing Provisional Orders and Final Judgments Arising from Securities Law Violations* 55:4 L. & CONTEMP. PROB. 303 (Autumn 1992); Harvey Pitt and Karen Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade,* 7 YALE J. REG. 149 (1990); Paul G. Mahoney, *Securities Regulation by Enforcement: An International Perspective,* 7 YALE J. REG. 305 (1990).

[26] *See* Anne-Marie Slaughter, *The Real New World Order*, 76 Foreign Affairs 183 (1997); Scott H. Jacobs, *Regulatory Cooperation for an Interdependent World: Issues for Government,* in OECD, REGULATORY CO-OPERATION FOR AN INTERDEPENDENT WORLD 15 (1994).

1. International Accounting

Accounting is closely related to securities regulation in so far as disclosure rules are concerned.[27] In principle, securities regulators are authorized to promulgate rules on disclosure of which a major part is financial reporting. In practice, however, regulators in many jurisdictions -- including the SEC -- defer to national accounting bodies in what relates to financial statements. Generally accepted accounting principles (GAAP) are thus enacted by reference and constitute an integral part of a country's disclosure regime. For that purpose, the SEC is deeply involved in the content of evolving accounting rules and reserves a say with regard to the structure and policy of the Financial Accounting Standard Board (FASB).[28] Regulatory intervention comes in where the SEC deems the GAAP insufficient but such intervention is only at the margins.[29] As a consequence, international diversity in securities regulation regimes largely constitutes diversity among accounting regimes.

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[27] Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM L. REV. 1335 (1996); Joel Seligman, *Accounting and the New Corporate Law,* 50 WASH. & LEE L. REV. 943 (1993) (hereinafter: *Accounting*).

[28] For a recent review of FASB's role and its relations with the SEC *see* Martin Mayer, *FASB on Trial*, Institutional Investor, November 1997, p. 78. The SEC's main concern with regard to FASB in the last few years has been to ensure the independence of its standard setters (the trustees). *See* Paula Dwyer, *Hardball at the SEC*, Business Week, September 29, 1997, p. 50.

[29] An example in point the requirement to disclosure compensation schemes for the issuer's top five officers. Securities and Exchange Act Regulation S-K, Item 402.

The field of international accounting is vast and cannot possibly be summarized here although many topics of current research bear directly in the present context.[30] On the whole, diversity prevails internationally in both GAAP systems and actual financial reporting practices, notwithstanding significant attempts to harmonize them.[31] This diversity has costs. One type of costs stems from the need to reconcile financial statements prepared according to certain GAAP with GAAP prevailing in other countries, e.g., for the purpose of foreign listing of stock. The New York Stock Exchange (NYSE), for instance, has been arguing for quite some time that US GAAP are overly strict and deter foreign issuers from listing here, thereby depriving domestic investors of lucrative investment opportunities and US markets of profitable business.[32] Empirical data suggest that multinational corporations deem foreign disclosure requirement a major consideration in making the decision to cross-list their stock in foreign markets.[33]

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[30] *See*, generally, GERHARD G. MUELLER, HELEN GERMON, AND GARY K. MEEK, ACCOUNTING: AN INTERNATIONAL PERSPECTIVE (4th ed. 1997); SIDNEY J. GRAY AND LEE H. REDEBAUGH, INTERNATIONAL ACCOUNTING AND MULTINATIONAL ENTERPRISES (1997). For a recent review, *see*, Shahrokh M. Saudagaran and Gary M. Meek, *A Review of Research on the Relationship between International Capital Markets and Financial Reporting by Multinational Firms,* J. ACCT. LIT. (Forthcoming).

[31] Saudagaran and Meek, *supra* note 30, at 2.

[32] *See* James L. Cochrane, James E. Shapiro, Jean E. Tobin, *Foreign Equities and U.S. Investors: Breaking Down the Barriers Separating Supply and Demand,* 2 STAN J. L. BUS. & FIN. 241 (1996); James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?,* 17 FORDHAM INT'L L. J. S58 (1994). *See* also William J. Baumol and Burton G. Malkiel, *Redundant Regulation of Foreign Security Trading and U.S. Competitiveness,* in KENNETH LEHN AND ROBERT KAMPHIUS, EDS., MODERNIZING US SECURITIES REGULATION 35 (1992).

[33] Shahrokh M. Saudagaran and Gary C. Biddle, *Foreign Listing Location: A Study of MNCs and Stock Exchanges in Eight Countries,* 26 J. INT'L BUS. STUD. 319 (1995); Shahrokh M. Saudagaran and Gary C. Biddle, *Financial Disclosure Levels and Foreign Stock Exchange Listing,* in FREDERICK D.S. CHOI AND RICHARD M. LEVICH, INTERNATIONAL CAPITAL MARKETS IN A WORLD OF ACCOUNTING DIFFERENCES 159 (1994). *See* also James A. Fanto and Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies REgarding a U.S. Listing,* 3 STANFORD J. L., BUS. & FIN. 51 (1997); Susan Chaplinsky and

Another type of costs stems from the need to translate financial statements prepared under different GAAP in order to compare issuers (namely, investment alternatives) with one another. When duplicated by a large number of market participants, this allegedly constitutes a waste of resources. In a prominent survey of accounting professionals, Choi and Levich found that accounting differences significantly affect the capital market decisions of market participants.[34]

These costs are a straightforward justification for harmonization of accounting rules. In addition to the IASC project discussed above, another concerted effort toward harmonization has been made in the European Union which promulgated several of Directives for this purpose. A number of studies indicate that the EU has so far achieved minimal harmony in its accounting practices and regulations.[35] Nevertheless, a growing practice of voluntary disclosure by multinational corporations -- above and beyond their home country requirements -- may be giving rise to spontaneous harmonization, although

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Latha Ramchand, *The Rationale for Global Equity Offerings,* working paper, Darden School, University of Virginia (1996). For an analysis of the famous pioneering listing of Daimler-Benz on the NYSE, *see* Lee H. Radebaugh, Gunter Gebhardt, and Sidney J. Gray, *Foreign Stock Exchange Listings: A Case Study of Daimler-Benz,* 6 J. INT'L FIN. MGMT. & ACCT. 158 (1995).

[34] FREDERICK D.S. CHOI AND RICHARD M. LEVICH, THE CAPITAL MARKET EFFECTS OF INTERNATIONAL ACCOUNTING DIVERSITY (1990). A considerable number of respondents, however, said that such difference in fact confer a competitive advantage upon those who bear the costs of comparison. But Choi and Levich rightly emphasize that even so this practice represents a waste of resources. *Id,* at 13-15. *See* also Ravi Bhushan and Donald R. Lessard, *Coping with International Accounting Diversity: Fund Managers' Views on Disclosure, Reconciliation and Harmonization,* 3 J. INT'L FIN. MGMT. & ACCT. 149 (1992) (same findings).

[35] Saudagaran and Meek, *supra* note 30, at 17 (surveying studies).

financial statements of these companies continue to reflect the primary orientation of accounting in their home countries.[36]

In my view, caution is warranted in concluding that market forces would lead to complete global harmonization anytime soon, and -- more importantly -- that the convergence dynamics are leading toward a global optimum. The American stock market, together with London's, are the dominant ones in the international markets for equity securities. These markets further seem to be dominated by American investors who are likely to create a strong demand for US-like disclosures even if at a lesser degree than under US GAAP. In addition, the accounting industry -- particularly with regard to international transactions -- is undergoing a process of consolidation with American firms dominating the market.[37] This, in turn, would tend to create a strong supply of US-like disclosures: this is what those firms know how to do and what they were educated to believe that is ought to be done. We are still lacking a proof that such disclosures are globally optimal and thus, that the putative convergence trend is also toward the optimum.

B. Comparative Corporate Governance

Unlike the situation in securities regulation, the picture is different with regard to corporate law and corporate governance in particular. Here, there has been relatively little

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[36] Marilyn Taylor Zarzeski, *Spontaneous Harmonization Effects of Culture and Market Forces on Accounting Disclosure Practices*, 10 ACCT. HORIZONS 18 (1996); Marilyn Taylor Zarzeski, *Culture Clash?*, 117 ACCOUNTANCY 70 (1996).

(successful) activity toward institutionalized harmonization of corporate governance structures but on the other hand, there is an exploding academic literature on the subject.

The world today exhibits an astonishing degree of diversity in countries' corporate laws and existing corporate governance structures (i.e., typical patterns of stockholding, directors' affiliation, etc.). Some differences could be easily associated with the *level* of economic development: developing countries with small capital markets would tend to have less developed laws for governing capital formation and management. The *form* of economic development -- namely, whether a country has a capitalist market economy or not -- would have a similar influence. In this category one can find a large number of formerly communist countries and developing countries implementing market-oriented economic reforms. Finally, and most importantly, within the category of advanced market economies we still witness a very high degree of diversity. Considerable diversity exists even among countries who share the same legal tradition, e.g., common law countries.[38]

With respect to projects for corporate law harmonization, the European Union has been fermenting with such initiatives for some three decades now. However, the large

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[37] This, admittedly, is by impression only.

[38] For non-U.S. common law countries *see, e.g.*, Bernard S. Black and John C. Coffee, Jr., *Hail, Britannia?: Institutional Investor Behavior under Limited Regulation*, 92 MICH. L. REV. 1997 (1994); F.H. Buckley, *The Canadian Keiretsu*, Working Paper (1996); Betty M. Ho, *Restructuring the Boards of Directors of Public Companies in Hong Kong: Barking up the Wrong Tree*, 1 SINGAPORE J. INT'L & COMP. L. 507 (1997). Orderly documentation of international diversity in corporate governance is badly lacking. For an international survey of the connection between law and finance *see* Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Schleifer, and Robert W. Vishny, *Law and Finance*, NBER Working Paper No. 5661 (1996). *See* also Andrei Schleifer, and Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997). The comparative literature in English has largely concentrated on the United States, United Kingdom, Germany, and Japan, and cannot even be sampled here. For recent broader surveys, *see* KLAUS J.

majority of them -- particularly those which attempted to effect serious reforms -- proved stillborn, while the rest mostly deal with marginal issues. Those efforts have taken three forms: (1) harmonizing the company laws of member states; (2) developing a European Company (*Societas Europea*) status; (3) encouraging cross-border business combinations.[39] According to the Single European Market plan, the EU Commission abandoned the efforts to unify company laws in member states and moved instead toward establishing mutual recognition with minimum standards. Such standards were promulgated with regard to rudimentary disclosures during incorporation, shareholder preemptive rights, equal voting rights (within the same class of shares), the content of annual financial statements, and preservation of capital.[40]

Harmonization initiatives targeted at the structure and control of publicly listed companies, takeover bid procedures, and employees rights have all fallen through. The most bitter battles were fought with respect to employees rights. The Draft Fifth Directive[41] would require, among other (controversial) things, representation of employees in companies' boards of directors under two optional corporate structures. Although the Draft Directive was amended a number of times it met with vehement

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HOPT AND EDDY WYMEERSCH, EDS., COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS (1997).

[39] For a thorough overview of unification of company law in the EU *see* Terence L. Blackburn, *The Unification of Corporate Laws: The United States, The European Community and the Race to Laxity,* 3 GEO. MASON IND. L. REV. 1 (1994); Terence L. Blackburn, *The Societas Europea: The Evolving European Corporation Statute,* 61 FORDHAM L. REV. 695 (1993). *See,* generally, FRANK WOOLDRIDGE, COMPANY LAW IN THE UNITED KINGDOM AND THE EUROPEAN COMMUNITY: ITS HARMONIZATION AND UNIFICATION (1991).

[40] Blackburn, *The Unification, supra* note 39.

[41] Proposal for a Fifth Company Law Directive, 1983 O.J. (C 240) 2.

opposition from certain member states, particularly the United Kingdom, and was never adopted. In another failed attempt to empower employees the Commission proposed that companies provide them with detailed information on the financial and business situation of the company and give them prior notice and opportunity to comment.[42] In May 1997, an expert group concluded that because of significant differences in national cultures, harmonization, as originally envisaged, is not possible. Consequently, there can be no single ideal system.[43]

The second major harmonization project was aimed to create a European Company which would enjoy certain administrative and taxation advantages in cases of business combinations.[44] Such companies would be recognized in the entire union but incorporated and governed under the laws of particular member states. That proposal too tried to add worker participation to the company corporate governance mechanism but was effectively blocked because of controversies between member states. In May 1997, the abovementioned expert group offered alternative solutions to some of the problems while still enshrining a right of worker representation in the board.[45] The prospects of this proposals seem unclear at best.

Other than in the EU, I am not aware of any concerted effort of the same sort. The creeping penetration of SEC rules under the Securities Acts into the traditional field of

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[42] Proposal for a Council Directive on Procedures for Informing and Consulting the Employees of Undertakings with Complex Structure, in Particular Transnational Undertakings, 1980 O.J. (C 297) 3.

[43] *Corporate Governance Update*, 5 CORP. GOVERNANCE: INT'L REV. 256 (1997).

[44] Proposal for a Council Regulation on the Statute for a European Company, 1989 O.J. (C263) 41.

corporate governance comes closest to this, but it lacks the crucial elements of agreement between national players at the national level. Moreover, Court decisions have put some limits on that process in the context of share voting rights.[46] States' sovereignty over corporate governance issues was also underscored in the case of state anti-takeover statutes.[47]

While the static picture of comparative corporate governance is quite clear in terms of the diversity it exhibits, there is some debate as to the dynamic picture, namely, the direction in which developments take place. Until the 1980s, American scholars tended to disregard foreign governance structures as a matter for research. "[W]ith the American economy the world's leading economy, it was natural to associate most American institutions, such as a vibrant stock market and diffuse ownership of large firms, as both inevitable and efficient."[48] Initial question marks began to appear toward the end of the 1980s takeover era with the enactments of anti-takeover statutes by the states[49] and the one-share-one-vote affair.[50] Suddenly, American law was producing or preserving rules widely agreed to be sub-optimal.

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[45] *Corporate Governance Update,* 6 CORP. GOVERNANCE: INT'L REV. 71 (1998).

[46] *Business Roundtable v. SEC*, 905 F. 2d 406 (DC Cir. 1990) (vacating the SEC's "one share one vote" Rule 19c-4).

[47] *CTS Corp. v. Dynamics Corp. of America,* 481 U.S. 69 (1987) (validating state anti-takeover statutes).

[48] Mark J. Roe, *Comparative Corporate Governance*, in PETER NEWMAN, ED., THE NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS, Working Paper No. 125, Columbia University School of Law 2 (1997).

[49] *See*, generally, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW Ch. 4 (1993); FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW Ch. 8 (1991).

When the American economy went into a recession during the early 1990s, corporate governance was one of the factors scholars looked at in (then) soaring economies such as Japan and Germany with a view to adopt some of their successful features. In doing so, they have put to the one side the "evolutionary" view of corporate governance, namely, that corporate governance a la USA is the at the apex of an evolutionary process where the more fit -- the more efficient in the Law and Economics terminology -- is also more successful. Today, when countries in East and Central Europe as well as other developing countries are establishing market based economies, they look at existing models to draw lessons in designing their corporate governance regimes. Similarly, as the US market had returned to the growth path and with Asian economies facing daunting difficulties, one starts to find discussions of lessons to be taken from the former by the latter.[51]

A related development is the growing prominence of political economy analyses within the mainstream of economic analysis of corporate law. The central examples here are the works of Mark Roe[52] and Roberta Romano,[53] although one could trace the roots of

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[50] For a recent account, *see* Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation: A Comment on Mahoney, The Exchange as Regulator*, 83 VA L. REV. 1509 (1997).

[51] Ronald J. Gilson, *Reflection in a Distant Mirror: Japanese Corporate Governance through American Eyes*, John M. Olin Working Paper No. 148, Stanford Law School (1997).

[52] *See,* e.g., MARK J. ROE, STRONG MANAGERS, WEAK OWNERS -- THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996); Mark J. Roe, *Backlash*, 98 COLUM. L. REV. (forthcoming 1998); Mark J. Roe, *German 'Populism' and the Large Public Corporation*, 14 INT'L REV. L & ECON. 187 (1994). For a good political account of the German system *see* Katharina Pistor, *Co-determination in Germany: A Socio-Political Model with Governance Externalities*, Working Paper (1997).

[53] ROMANO, *supra* note 49; Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

this strand of literature at least to William Cary back in 1974.[54] This development soon came to be known as comparative corporate governance.

"In the last few years, comparative corporate governance -- German and Japanese corporate governance in particular -- has been a hot topic in U.S. law reviews and conferences."[55] That interest came hand in hand with the growing prominence of institutional investors such as pensions funds and mutual funds. If the paradigmatic shareholding structure of the past was widely dispersed -- thus creating severe collective action problems -- the rise of institutional investors brought us closer to the large blockholders of other countries -- the German *hausbank* and the Japanese main bank. While shareholder activism did rise in visibility, scholars were debating whether it could become as significant as it is (portrayed to be) in other countries.[56] Empirical evidence in this regard is mixed.[57]

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[54] William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974).

[55] Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L. Q. 367, 367 (1996) (footnote omitted). The omitted footnote includes almost a page long list of law review articles in this spirit which is nevertheless far from exhaustive. For more references *see* Roe, *supra* note 48.

[56] Jill E. Fisch, *Relational Investing: Will It Happen? Will It Work?* 55 OHIO ST. L. J. 1009 (1994); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor,* 91 COLUM. L. REV. 1277 (1991); Ronald J. Gilson and Reinier H, Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors,* 43 STAN L. REV. 863 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism,* 79 GEO. L. J. 445 (1991).

[57] Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, in PETER NEWMAN, ED., THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (forthcoming) (a review); Cathrine M. Daily, Jonathan L. Johnson, Allan E. Ellstrand, and Dan R. Dalton, *Institutional Investor Activism: Follow the Leader?*, working paper (1996) (finding no evidence that firms targeted by an

Then came path dependence. The point is relatively simple: those who produce corporate law -- legislatures, courts, entrepreneurs -- face similar problems, mainly the agency problem[58] and the impossibility of complete contingent contract.[59] They may just solve them in different ways. A lot of things can cause such a diversity. Politics was noted as part of the political economy perspective on the production of corporate laws. The economic and financial environment in each country -- e.g., the depth and liquidity of its stock market -- is another factor.[60] Industrial organization is another.[61] Culture is yet another one, although its effects are not quite clear.[62] And then there is the view, anchored in economic models, that things might happen simply because of chance or

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activist fund were characterized by higher performance); Tim Opler and Jonathan Sokobin, *Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors,* Working Paper No. 95-5, Charles A. Dice Center for Research in Financial Economics (1996) (finding evidence consistent with the view that coordinated institutional activism creates shareholder wealth); Willard T. Carlton, James M. Nelson, and Michael S. Weisbach, *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CERF,* Working Paper, University of Arizona (1997) (presenting evidence that most of most of the voice exercised by institutional investors is effective but invisible); Steven Nesbit, *Long-term Rewards from Corporate Governance,* 7 J. Applied Corp. Fin. 31 (1994) (finding a cumulative increase averaging 41.3% for each company over a five-year period subsequent to CalPERS's intervention, following a period of relative under-performance). *See also* Richard H. Koppes and Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor a Index Fund Through Relationship Investing,* 20 IOWA J. CORP. L. 414 (1995).

[58] Roe, *supra* note 48.

[59] Luigi Zingales, *Corporate Governance,* in PETER NEWMAN, ED., THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (forthcoming).

[60] *See,* e.g., Coffee, *supra* note 56; Ronald J. Gilson and Bernard S. Black, *Venture Capital and the Sructure of Capital Markets: Banks versus Stock Markets,* (forhcoming 1998).

[61] *See,* e.g., Ronald J. Gilson and Mark J. Roe, *Understanding the Japanese* Keiretsu: *Overlaps between Corporate Governance and Industrial Organization* 102 YALE L. J. 871 (1993). *See,* generally, Ronald Gilson, *Corporate Governance and Economic Efficiency: When do Institutions Matter?,* 74 WASH. U. L. Q. 327 (1996).

[62] *See*, e.g., Ronald J. Mann and Curtis J. Milhaupt, *Path Dependence and Comparative Corporate Governance: Foreword,* 74 WASH. U. L. Q. 317, 323 (1996) ("the black box of culture"); Lucian Arye Bebchuk and Mark J. Roe, *A Theory of Path Dependence in Corporate Governance and Ownership,* Working Paper, at 26 (1998).

historical accident. Once in place, such systems may sustain and even proliferate due to increasing returns, network externalities, or tactical maneuvering.[63]

In a related branch of the literature, scholars started to design corporate laws from a clean slate. These ideas were mainly for export -- to developing countries and to formerly communist countries establishing market economies. These countries tend to lack the required legal infrastructure -- both legislation and a functioning court system; they also lack historical paths such as the United Status', Japan's, or Germany's; and they may not have certain cultural patterns or habits which support law obedience, etc. In order to accommodate or overcome these obstacles corporate law and corporate governance structures may need to be tailored differently than in advanced market economies.[64]

By necessity, any argument which locates the sources of corporate governance structures in political economy accepts international diversity as a descriptive as well as a normative matter, whether explicitly or implicitly. If corporate governance and corporate law in general are indeed shaped by national political idiosyncrasies, then, descriptively, they are likely to be different; and, normatively, they may need to remain different, notwithstanding possible improvements through importation of certain foreign features.

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[63] *See,* e.g., Marcel Kahan and Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L. Q. 347 (1996). These ideas first appeared in the domestic US context. *See* Michael Klausner, *Corporations, Corporate Law, and the Network of Contracts*, 81 VA. L. REV. 757 (1995). *see* also Ian Ayres, *Supply Side Inefficiencies in the Corporate Charter Competition: Lessons from Patents, Yachting, and Bluebooks,* 43 KAN. L. REV. 541 (1995).

[64] For excellent discussions, *see*, MASAHIKO AOKI AND HYNG-KI KIM, CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS (1995); Bernard Black and Reinier Kraakman, *A Self-Enforcing Model of Corporate Law,* 109 HARV. L. REV. 911 (1996).

As an empirical matter it seems that in the main, national corporate governance structures tend to be quite stable and resist fundamental reforms.

The lesson to take home from this fingernail review is that diversity in corporate governance structures was "legitimized" by the academia and sometimes even glorified. Almost a century and a half after Charles Darwin,[65] corporate law scholars came to acknowledge that there can be many outcomes to evolutionary processes; that selection of the fit does not mean selection of one fit.[66] Moreover, according to current views, even in advanced market economies diversity is likely to remain intact for a long time, and (although not always) for good reasons.[67] Although one can find some hyperbolic views that foresee the near arrival of global convergence,[68] a more plausible conjecture is that corporate governance systems could converge functionally while remaining diverse as a matter of form.[69]

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[65] CHARLES DARWIN, ON THE ORIGIN OF SPECIES (1859; facs. Ed. 1964)

[66] *See,* e.g., Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, paper presented at the Conference "Are Corporate Governance Systems Converging?", December 5, 1997, at 9-10 (1997) (citing evolutionary theorist Stephen J. Gould). *See,* generally, Mark J. Roe, *Chaos and Evolution in Law and Economics,* 109 HARV. L. REV. 641 (1996).

[67] Bebchuk and Roe, *supra* note 62. The same view was voiced by Theodor Baums, *Corporate Governance Systems in Europe -- Differences and Tendencies of Convergence,* Working Paper No. 8/96, Osnabruck University (1996).

[68] Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law,* paper presented at the Conference "Are Corporate Governance Systems Converging?", December 5, 1997 (1997). Indeed, the collapse of the South Korean economy may have taken away a lot of the charm from its chaebol and the ongoing difficulties in Japan clearly cast a shadow on its keiretsu. *See* Ronald J. Gilson, *supra* note 51.

[69] Gilson, *supra* note 66.

III. The Relations between Corporate Law and Securities Regulation

An underlying premise of any regulatory intervention is that it requires justification. The particular justification for intervention and the exact manner in which the government should undertake it vary greatly. Inasmuch as economic activity is at issue, one major factor is the economic conditions in the market absent regulatory intervention -- e.g., whether there are externalities or information asymmetries which cannot be countered by market participants; or the existence of dominant actors (monopolies or cartels). Overriding the economic considerations are always the political ones. Depending on their political agendas, governments could abstain from intervention notwithstanding market failures which happen to benefit favorable interest groups. Governments could also take active interventionist measures to counter market-driven outcomes -- even in the absence of demonstrable market failures -- for redistributive purposes or in order to promote other social goals.[70]

The standard justification invoked for securities regulation is investor protection. Reams have been written on the subject with regard to the Securities Act of 1933 and the

[70] The statements in the text are related to the public/private distinction discussed below in Part III.B in that under certain views the original conditions for market operation are also public, i.e., the outcome of political considerations. On the (un)desirability of correction through legal rules as opposed to redistribution through the tax system *see* Louis Kaplow and Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income,* 23 J. LEGAL STUD. 667 (1994).

Securities Exchange Act of 1934 (the Securities Acts) alone. But over six decades since the enactment of the Acts, the debate over their "real" or "original" purpose has not abated.[71] I do not wish to add yet more paper to this pile. However, it would be fair to say, in a very small nutshell, that the Securities Acts were intended to restructure the informational distribution among and between participants in the securities market, compared with the pre-existing regime which was based on the states' corporate and Blue Sky laws.

Although revolutionary in many respects, the *nouvelle regime* brought about by the Securities Acts did not altogether displace the *ancien regime* provided for by state corporate laws. Rather, it supplemented it with new rules and administrative oversight. This Part explores the relations between the two regimes with a view to establish them as a normative basis for assessing each regime's performance, or efficiency. The analysis is conducted in a rather critical fashion and from different perspectives -- all in an effort to test how real and meaningful is the distinction between the two bodies of law.

A. Tenuous Distinctions

The historical origins of modern securities regulation in the United States in what concerns its disclosure and anti-fraud components are traced by Loss and Seligman to the English Companies Act of 1844.[72] In that Act, Parliament enacted the first modern

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[71] For a recent treatment of this basic question and for references *see,* e.g., Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHIC. L. REV. 1047 (1995).

[72] The Companies Act, 1844, 7 & 8 Vict., ch. 110.

prospectus requirement.[73] A later version of that Act -- the English Companies Act of 1929[74] -- served as the base for the drafting work of the Securities Act of 1933 by the team led by Felix Frankfurter.[75] Importantly, the English Act was the original source of two major components of the American securities regulation regime as we now know it -- the concept of full disclosure[76] and the civil liabilities of the registrant, its officers, directors, and experts.[77]

The importance of the legislative history goes beyond the mere anecdotal interest. After all, the drafters of the English Act were not the only ones to perceive the value of full disclosure. Frankfurter's team was indeed implementing President Roosevelt's policy which championed full disclosure as the preferable remedy to the malaise of American financial markets at the time.[78] Roosevelt himself often referred[79] to Louis Brandeis's famous maxim: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[80] The significant point here is that the very principle which constitutes the

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[73] LOUIS LOSS AND JOEL SELIGMAN, 1 SECURITIES REGULATION 6 (3d ed. 1989). Ironically, the need to regulate market professional was perceived much earlier: as early as 1285 A.D. *Id.*, at 3.

[74] The Companies Act, 1929, 19 & 20 Geo. 5, ch. 23.

[75] James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34 (1959); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 57 (2d ed. 1995); LOSS AND SELIGMAN, *supra* note 73, at 180.

[76] Landis, *supra* note 75, at 40; LOSS AND SELIGMAN, *supra* note 73, at 180.

[77] Landis, *Supra* note 75, at 35.

[78] SELIGMAN, *Supra* note 75, at 41-42.

[79] *Id., id.*

[80] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

central pillar of the securities regulation regime in one country was located -- at virtually the same point in time -- at the heart of another country's corporate law.

From a substantive point of view, the distinction between corporate law and securities regulation is very, very tenuous. There exists a considerable overlap between the two fields of law in terms of the issues they cover. More accurately, the federal regime of securities regulation in the United States today regulates aspects of corporate life that are much broader than issuance and trading of new securities -- the problems that triggered the enactment of the Securities Acts. In effect, it attempts to regulate *every* context in which communication may take place between shareholders (or potential shareholders) and the company, its management, certain third parties, and other shareholders.

Federal securities law thus regulates the core of the corporate governance system, namely, the voting mechanism, through the proxy rules.[81] "Indeed, since voting rights are so fundamental to the process of corporate governance, there are few areas of securities regulation where both the interplay and tension between federal securities law and state corporation law are as vivid".[82] It also regulates all the major forms of fundamental changes in corporate structure, such as going-private transactions[83] and hostile

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[81] Regulation 14A under the Exchange Act.

[82] JAMES D. COX, ROBERT W. HILLMAN, AND DONALD C LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 883 (4th ed. 1991).

[83] Section 13(e) of the Exchange Act and Rule 13e thereunder.

takeovers.[84] Finally, federal securities law directly regulates what is perhaps the most contentious issue in the relationships between regular shareholders and company insiders -- insider trading.[85]

A telling illustration of the overlap between securities law and corporate law can be provided by looking at the way these subjects are classified and taught by the legal academia. As a non-scientific experiment, some of the prominent textbooks and casebooks on corporations[86] and on securities regulation[87] were looked up. In each source, I checked whether its authors provide substantial discussion and analysis to six issues: three fundamental topics in securities regulation -- disclosure, fraud, and insider trading -- and the three major issues of corporate law which are regulated under the Securities Acts -- the proxy system, tender offers, and organic changes.

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[84] The Williams Act, as embodied in Sections 14(d) and 14(e) of the Exchange Act and Rules thereunder. Section 13(d) of the Exchange Act and Rules thereunder should also be considered part of this regulatory scheme as an "early warning system". *See* COX ET AL., *supra* note 82, at 929 *et seq.*.

[85] Statutorily, insider trading regulated by Section 16 of the Exchange Act, but the primary source of the regulatory regime is decision law interpreting Rule 10b-5 under the Exchange Act.

[86] The sources looked up in this category are WILLIAM L. CARY AND MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS (7th ed. 1995); JESSE H. CHOPER, JOHN C. COFFEE, JR., AND RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS (4th ed. 1995); ROBERT C. CLARK, CORPORATE LAW (1986); FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS (1995); LARRY D. SODERQUIST ET AL., CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES, MATERIALS, PROBLEMS (4th ed. 1997); LEWIS D. SOLOMON AND ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS (2nd ed. 1994).

[87] The sources looked up in this category are COX ET AL., *supra* note 82; THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION (3rd ed. 1996); DAVID L. RATNER, SECURITIES REGULATION: CASES AND MATERIALS (4th ed. 1997); LOUIS LOSS AND JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION (3rd ed. 1995); RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS, (7th ed. 1992).

The results are illuminating. It goes without saying that all the books on corporate law cover all the corporate law topics mentioned above and the same applies, respectively, to the securities regulation sources. More interesting is the fact that all the seven corporate law books deal extensively with insider trading, six out of seven deal with Securities Acts disclosure regime,[88] and four cover the anti-fraud regime of the Securities Acts.[89] Of the books on securities regulation, all five of them cover the regulation of tender offers, three discuss the proxy system,[90] and three (mostly different from the former three) deal with organic changes.[91]

This little survey reflects an interesting reality: in the minds of contemporary legal scholars in the United States, it is almost impossible to analyze corporate law without extensively covering securities regulation, and vice versa. Such overlap can be found even where the same authors have written on both subjects.[92]As a corollary, it is difficult to design and teach a course on one field without far-reaching intrusions into the other.[93]

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[88] SODERQUIST ET AL., *supra* note 86, is the exception.

[89] The sources that do not provide a discussion are CARY AND EISENBERG, *supra* note 86; CLARK, *supra* note 86; and EASTERBROOK AND FISCHELL, *supra* note 86. Note that the latter two books are purposefully selective in their choice of topics. *see* CLARK, *supra* note 86, at xxi-xxiv; EASTERBROOK AND FISCHELL, *supra* note 86, at viii.

[90] The sources that do not provide a discussion are RATNER AND HAZEN, *supra* note 87; and JENNINGS ET AL., *supra* note 87.

[91] The sources that do not provide a discussion are LOSS AND SELIGMAN, *supra* note 87; and JENNINGS ET AL., *supra* note 87.

[92] Joel Seligman is one example. John Coffee is another, being a co-author of JENNINGS ET AL., *supra* note 87, and of CHOPER ET AL., *supra* note 86.

[93] Exigencies of time in actual courses would usually dictate some arbitrary split up, but the text indicates how arbitrary such a split would be and what the authors perceive to be the ideal course structure.

The invasion of federal securities law into the traditional areas of corporate law does not stop in regulating tender offers and insider trading. According to Dean Seligman, federal securities law has become "the new corporate law."[94] In particular, he argues that by means of its disclosure standards and fraud cases, federal securities law has made significant inroads into state corporate law by augmenting its fiduciary duty concepts. He documents what in his view is a decline in state law standards of the duty of loyalty and the duty of care, and argues that securities law -- through its emphasis on preventive action and deterrence -- has profoundly changed the content of these duties. As a consequence, that new corporate law has significant implications for the process of corporate governance.[95] Other scholars also acknowledge the importance of the mandatory disclosure regime under the Securities Act to the actual management of public corporations.[96]

The recent history of corporate law in the United states -- at least by some accounts -- is of supplementing corporate law with securities regulation. Securities law will not completely supplant state corporate law anytime soon, however. Indeed, even according to proponents of federal preemption of state corporate law by enacting

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[94] Joel Seligman, *The New Corporate Law,* 59 BROOK. L. REV. 1, 2 (1993) (hereinafter: "*New Corporate Law*"); Seligman, *Accounting, supra* note 27. *Cf.* William T. Quillen, *The Federal-State Corporate Law Relationship - A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law,* 59 BROOK. L. REV. 107 (1993).

[95] Seligman, *New Corporate Law, supra* note 94, at 3.

[96] *See* Lowenstein, *supra* note 27; Edmund W. Kitch, *The Theory and Practice of Securities Disclosure,* 61 BROOK. L. REV. 763 (1995).

minimum standards,[97] securities law is not seen as the major vehicle for such intervention. There is some basic sense in which the two bodies of law are still materially distinct, even if greatly overlapping in scope. Thus, it may be true that there doesn't exist a bright distinction line between the two fields inasmuch as they relate to the same social and business activities. Perhaps it would be better to depict them as two layers having considerable overlay between them but which are definitely distinct from one another.

The discussion thus far reflects a deeper reality, namely, that the two fields are in fact highly integrated, as it is hard to imagine a good description of the law of business corporation while omitting one of them. Moreover, securities regulation and corporate law are interdependent in that deficiencies in one of them could be remedied by the other.

I would like to advance that a conceptual delineation of the distinction between securities regulation and corporate law should relate to property rights in information. The main and most prominenet feature of the securities regulation regime in the United States is that it is a regime of information. It is a legal framework for redistributing information (indeed, property rights in information[98]) from inner circles in the

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[97] Early calls in this spirit include William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974) and RALPH NADER, MARK GREEN, AND JOEL SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976). *See* also Joel Seligman, *The Case for Federal Minimum Corporate Law Standards,* 49 MD L. REV. 947 (1990); Seligman, *The New Corporate Law, supra* note 94, 60-62. For a systematic analysis of the circumstances that may warrant federal intervention *see* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law,* 105 HARV. L. REV. 1435 (1992).

[98] Jonathan R. Macey and Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory,* 42 STAN. L. REV. 1059 (1990); JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS AND POLICY ch. 1 (1991).

corporation -- management, controlling shareholders, etc. -- to the perimeter -- i.e., to shareholders, competitors, and other market participants.[99] In enacting the Securities Acts, Congress perceived investors as being harmed from the lack of information and wished to remedy that situation. This gave rise to disclosure duties and stricter prohibitions on fraud and on certain forms of informed trading in securities transactions. Later amendments -- e.g., the integrated reporting system, shelf registration, and amendments to insider trading law -- were also parts of this regime. To a certain extent, the third pillar of securities regulation -- regulation of intermediaries and markets -- was also concerned with this issue, e.g., with the establishment of the Intermarket Trading System (ITS).[100]

Issuance of new securities and secondary market transactions were the most straightforward contexts for implementing the new informational regime and preempting state company law. The ambit of the Securities Acts spreads further to other parts of corporate law -- the proxy system, tender offers and organic changes -- in so far as they involve communication with or between shareholders and therefore, informational problems.[101] Symmetrically, the SEC has ceded jurisdictional ground in cases where it

[99] There could be other strategies for securities regulation, the main alternative being merit regulation, which I will not discuss here.

[100] The System interconnects the national and regional stock exchanges through data links, features a consolidated ticker tape, and allows broker-dealers to view bid and ask prices and effect transactions from remote sites. It thus gives new content to the broker-dealer's duty to her client to effect transactions at the best price. For an overview of the ITS, *see* 5 LOUIS LOSS AND JOEL SELIGMAN, SECURITIES REGULATION 2564-67 (3d ed. 1989); Yakov Amihud and Haim Mendelson, *A New Approach to the Regulation of Trading across Securities Markets*, 71 NY U. L. Rev. 1411, 1414 (1996).

[101] It should be emphasized that the abovementioned issues exhibit a number of problems in addition to informational ones. For example, the regulation of tender offers under the Williams Act

was realized that its information regime in fact impedes the efficient working of the corporate governance system. A case in point is the 1992 reform in the proxy rules.[102]

Arguably, the boundaries of the information regime under the securities laws also delineate the border line distinguishing between securities law and company law, or corporate governance. Inasmuch as information about the corporation is concerned, company law may have a say but securities law would usually have the final word. The reason might be that information is a public good -- once an information item is disclosed, it is impossible to exclude others from using it and there is no rivalry in its use, i.e., it is cannot be physically used up, although its economic value may have a short life-span. Public or government intervention may be therefore warranted and justifiable.

B. The Dual Public/Private Character of Securities Law

Given the interdependence between securities regulation and corporate law, one may wonder why -- notwithstanding the above discussion -- do we witness a universal pattern of securities regulation springing out from the traditional corpus of corporate law and becoming an independent field? In the particular case of the United States there was a perceived need for intervention at the federal government level while company law remained in the several states' jurisdiction. But securities laws have been and still are promulgated also at the state level. Moreover, the separation between securities regulation

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addresses more that just informational asymmetry and thus does more than merely to provide information. For an overview, s*ee* CHOPER ET AL., *supra* note 86, ch. IX.

[102] Securities and Exchange Commission, Securities Exchange Act Release No. 34-31326 (October 1992). For further discussion *see* part IV.A.1 below.

and corporate law can be found in unitary countries, such as the United Kingdom, and at the sub-national level in federal countries, as is the case in Canada.

This part argues that securities regulation and corporate law differ in their basic character as public versus private law, respectively. Although seemingly simple at first glance, this statement is quite problematic. First, the private/public dichotomy in general has been subject to strong critiques in the United States. Second, the classification of corporate law in itself as "public" or "private" has been unstable over time; and similar changes may also be discernible with regard to the younger field of securities regulation. The distinction, however, survives the jurisprudencial challenge -- if not at the conceptual level then at least for practical purposes of analyzing diversity and cooperation in international securities regulation.

1. The Public Law/Private Law Distinction -- The European Perspective

It would be methodologically easier to begin with the continental European[103] perception of the public/private distinction. The distinction between public law and private law seems to many continental European lawyers to be fundamental, necessary, and, on the whole, evident. Although the distinction is often attacked, the average continental lawyer *knows* that public law and private law are essentially different.[104] The

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[103] The distinction is part of the basic jurisprudence of all the countries that belong to the civil law family of which continental European countries are the prominent examples.

[104] John H. Merryman, *The Public Law-Private Law Distinction in European and American Law,* 17 J. PUB. L. 3, 3 (1968). *See* also RUDOLF B. SCHLESINGER ET AL., COMPARATIVE LAW: CASES-TEXT-

distinction has thus been dubbed "the mighty cleavage,"[105] a "great dichotomy,"[106] and the "*summa divisio*."[107] It dates from antiquity, with its historical roots traced back to the very early sources of Roman law,[108] and is prevalent today in all the Civil Law systems.[109]

In European legal doctrine, all law is thus divided into private law and public law. Public law is the body of law which governs the relationships to which the state, in whatever capacity and shape, is a party. Private law, in contrast, applies to relationships between private persons, including legal entities, such as corporations.[110] Thus, public law is said to involve vertical relationships while private law -- horizontal ones.

The ever-increasing expansion of administrative law caused by the increased governmental interference in all spheres of social activity led to the multiplication of encroachments upon the private law sphere. A new branch of law -- a sub-part of administrative law -- called "economic law", was thus defined. This resulted in a situation

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MATERIALS 300 (5th ed. 1988) ("In a civilian mind, all law is automatically divided into private law and public law"); Rene David, *Introduction*, in RENE DAVID, ED., 2 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 3, 10 (1971) ("[I]n the eyes of Romano-Germanic lawyers recognition of a distinction between public and private law is natural, just, and necessary").

[105] Merryman, *supra* note 104, at 3, citing T. HOLLAND, THE ELEMENTS OF JURISPRUDENCE (13th ed. 1917).

[106] SCHLESINGER ET AL., *supra* note 104, at 299.

[107] Charles Szladis, *The Civil Law System*, in RENE DAVID, ED., 2 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 15 (1971).

[108] The distinction is said to have been recognized by Ulpian and reflected in Justinian's Digest. *See* SCHLESINGER ET AL., *supra* note 104, at 300; Szladis, *supra* note 107, at 15.

[109] Szladis, *supra* note 107, at 20.

[110] *Id.,* at 56.

where the public/private distinction, although still effective in practice, became blurred by the interpenetration of public law and private law.[111]

2. The Public/Private Distinction -- The American View(s)

According to the great comparativist Rene David, the distinction between public law and private law in common law countries is not rejected (as in socialist doctrine), it is simply unknown.[112] In English law, the distinction is not felt at all, having been traditionally denied by English practicing lawyers. Unlike continental Europe, there are no special courts for public law questions, only a few rules and remedies special to public law, and almost no distinctive attitude of mind.[113]

Although the United States clearly exhibits the basic characteristics of a common law system, a related dichotomy -- the public/private distinction -- has gained much discussion and importance here. The discussion has focused on the validity of classifying social phenomena as public or private and less attention was paid to classifying their governing legal fields.[114] In the eighteenth century, most American lawyers did not assume that all political and economic actors should be classified either as private parties

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[111] *Id.*, at 48, 75. Merryman, *supra* note 104, at 14-18. *See*, generally, FRANZ WIEACKER, A HISTORY OF PRIVATE LAW IN EUROPE (1995).

[112] David, *supra* note 104, at 12.

[113] Tony Weir, *The Common Law System,* in RENE DAVID, ED., 2 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 77, 94-95 (1971).

[114] *Cf.* Randy E. Barnet, *Foreword: Four Senses of the Public Law-Private Law Distinction,* 9 HARV. J. L. & POL'Y 267 (1986).

or as public officials.[115] Instead, they recognized that a variety of institutions and organizations -- including, for that matter, business corporations -- were most accurately described as partly private and partly public in character.

In the nineteenth century, lawyers began to find increasingly problematic the fact that these organizations exercised special powers and privileges usually associated with governments, e.g., taxation and eminent domain. A movement to separate the public and private "spheres" has begun, driven to a large extent by the ideology of classical liberalism. In this context, there was a "virtual obsession"[116] on behalf of orthodox judges and jurists to create a legal science that would sharply separate law from politics. Just as nineteenth century political economy elevated the market to the status of the paramount institution for distributing rewards on a supposedly neutral and apolitical basis, so too private law came to be understood as a neutral system for facilitating voluntary market transactions and vindicating injuries to private rights.[117] Towards the end of that century, a more formal and systematic distinction between public and private law began to be articulated.[118]

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[115] The history of the public/private distinction has been told in detail and need not be recounted here beyond the background necessary for discussion. For this purpose, the text draws liberally on WILLIAM W. FISHER, III ET AL., AMERICAN LEGAL REALISM ch. 4 (1993) and on Morton J. Horwitz, *The History of the Decline of the Public/Private Distinction,* 130 U. PENN. L. REV. 1423 (1982).

[116] *Id.,* at 1425.

[117] *Id.,* at 1425-26.

[118] MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1870-1960 11 (1992).

The first half of the twentieth century saw the decline of the public/private distinction in the United States as a result of relentless attacks by the Legal Realist Movement. Morris Cohen argued that because both property rights and contract rights were enforced by the state, these rights were better conceived as delegated public powers, thus giving them as much public character as private one.[119] Robert Hale argued that because respect to private property is backed by the government's use of force and property determines the distribution of income, the free private market is really an outcome of public coercion.[120] This line of argument had an important political role in vindicating state intervention in the working of private markets and social reform in general, particularly during the New Deal and afterwards.

The distinction, however, refuses to die.[121] In many doctrinal contexts it seems alive and well.[122] In light of the impressive longevity of its Civil Law counterpart and notwithstanding the considerable strains it is withstanding in modern times, there is ground to believe that the distinction will not vanish from the legal landscape anytime soon. To be sure, the distinction could be abused in legal argument and is definitely

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[119] Morris R. Cohen, *Property and Sovereignty*, 13 CORNELL L. Q. 8 (1927); Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553 (1933).

[120] Robert L. Hale, *Coercion and Distribution in a Supposedly Non-Coercive State*, 38 POL. SCI. Q. 470 (1923).

[121] This is often decried by scholars of the Critical Legal Studies movement. *See*, e.g., Duncan Kennedy, *The Stages of the Decline of the Public/Private Distinction*, 130 U. PENN. L. REV. 1349 (1982). *See* also Alan Freeman and Elizabeth Mensch, *The Public-Private Distinction in American Law and Life*, 36 BUFF. L. REV. 237 (1987).

[122] FISHER ET AL., at 100.

malleable.[123] But its vitality seems to reflect the fact that it does provide some beneficial service in helping us orient ourselves in the legal landscape. False or inaccurate theories can nevertheless be quite useful for that purpose, once their weaknesses are acknowledged and are taken into account.[124]

3. Classifying Corporate Law and Securities Regulation

From a structural perspective, company law and securities regulation exhibit a number of differences which, taken together, support the classification of the two fields as private and public law, respectively. First, like all private law, company law emanates from the primary legislative body, i.e., the national parliament. Securities regulation is more complicated: its first principles are indeed enacted by the Legislature but the greater part of its legal corpus is promulgated by a governmental ministry or an administrative agency.

Second, company law -- like other fields of private law -- is administered and enforced primarily by the court system by way of retroactive dispute resolution (except for minor roles which do not involve disputes such as company registration). By contrast, securities regulation is administered primarily proactively by an administrative agency with only secondary resort to the courts.

[123] For a fine demonstration of this malleability, *see* Kennedy, *supra* note 121.

[124] For example, it is said that the Apollo lunar mission was planned using calculations that were based on Newtonian physics. That theory is clearly false in light of Einstein's theory of relativity, but was found to be sufficiently accurate for the "limited" purpose of getting to the moon and back.

Third, company law in general is enabling. It offers a set of default rules which can be changed by company organizers to fit their preferences. Securities regulation, in contrast, is mostly mandatory and often prohibits opting out of or waiving of its provisions. These features, respectively, are characteristic of provisions of private law and public law.

Fourth, in the United States, a difference exists between the two fields in what is regarded as their sources of legal content. A primary source of content for state company law is the American Bar Associations' Model Business Corporation Act (MBCA)[125] and similar codes for other business organizations. The MBCA resembles other codification projects in private law areas foremost of them is the American Law Institute's Uniform Commercial Code (UCC). Although the MBCA and UCC do not have direct force of law without adoption by the several states, they attract a lot of academic and judicial attention -- much like their legally binding counterpart Codes from Civil Law countries. Securities regulation, like other parts of public law, is not codified and consists of a large number of scattered laws and administrative rules and forms.[126]

The public law/private law distinction between securities regulation and corporate law generally holds at the substantive level as well. In continental Europe, the division between branches of public and private law varies across Civil Law countries and also

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[125] AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT (1991).

[126] This formal distinction should not be stretched too far. A serious effort to promulgate a Federal Securities Code was made in the 1970s by the American Law Institute. Congress showed no interest in even considering the Code, and it was never formally introduced, but some of its approaches were incorporated

according to the various ends to be served by the classification of law.[127] At the core of private law stand the classic subjects of contract, tort, and property, which, together with related subjects, are invariably codified. Company law is usually classified as part of commercial law -- the most private law beyond the inner core of civil law proper.[128] In contrast, securities regulation would be classified and located well within the boundaries of public law.

In the United States, the classification of company law has taken the shape of classifying the business corporation as "public" or "private". After starting as a public entity, it became to be perceived as a private one during the nineteenth century and retained that classification despite several waves of academic and political attacks. The following paragraphs briefly recount this story and argues that the persistence of the "private" character of the corporation is due to a large extent to the rise of securities regulation as the "public" companion of corporate law.

Up until the eighteenth century, incorporated companies were relatively rare and were all incorporated by a special charter (also called "grant" or "concession") from the sovereign. As such, they were like extensions of the state and thus had an unmistakable public character. The economic activities they pursued often had a public nature as well,

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into American securities law. DAVID L. RATNER, SECURITIES REGULATION IN A NUTSHELL 12-13 (4th ed., 1992).

[127] Szladis, *supra* note note 107,, at 21.

[128] *Id.,* at 72.

e.g., public utilities, transportation, and water works.[129] As already mentioned, those corporations also enjoyed powers and privileges characteristic to public entities. This situation changed dramatically with the 1819 decision in the *Dartmouth College Case*[130] which declared that the grant by the state created a contract enforceable under the Contract Clause. Such corporations, therefore, had a private nature, distinct from municipal corporations and their like which remained governed by public law. Once freed from the grip of regulatory public law, corporations, and corporate law, retained their character as private to this day.

The remainder of the nineteenth century witnessed great changes in the legal theory of the corporation as corporations became more commonplace with the enactment of general incorporation laws. Two competing theories were replacing the charter theory. One saw the corporation as a free contract among individual shareholders, akin to a partnership. "In this conception, the corporation was not a creature of the state but of individual initiative and enterprise. It was "private," not "public.""[131]

The competing theory, which started to gain influence in the Untied States during the turn of the century, was drawing on the academic discourse in continental Europe

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[129] JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970 7-8 (1970).

[130] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

[131] Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 184-85 (1985). *See* also William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspective from History*, 41 STAN. L. REV. 1471, 1489-90 (1989); Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1463 (1987).

about “corporate personality.”[132] That theory elevated the corporation from its constituent individual shareholders and claimed that as a group it has a “natural”, “real personality.” That theory too sought to represent the corporation as private by identifying it with a private association. Since individuals and not the state supplied the creative force that brought the group into existence, respect for individuals counseled against regulation.[133]

While companies were solidifying their status as private entities during the late 19th century, they were also growing to non-human dimensions -- first the railroad companies and later on the mass production firms.[134] A major effort to regulate both corporate conduct and corporate structure was launched in 1890 with the enactment of the Sherman Act and continued in 1914 with the enactment of the Clayton Act. It took a considerable time for this early antitrust regulation to mature and achieve a real bite, but for our purposes it was the harbinger of a more general strategy: if corporations and corporate law could not be penetrated and regulated from within, then regulation could come from without -- from other legal fields, external to corporate law.

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[132] The discourse was pioneered by the German legal theorist Otto Gierke whose 1887 book on German association was translated into English in 1900. OTTO GIERKE, POLITICAL THEORY OF THE MIDDLE AGE (F.W. Maitland trans., 1900). *See* Horwitz, *supra* note 131, at 179; Bratton, *supra* note 131, at 1490.

[133] Horwitz, *id.*; Bratton, *id.*

[134] *See*, generally, ALFRED CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1983).

The Legal Realist Movement did not pass over the question of nature of the firm. In an influential 1926 article,[135] John Dewey argued that the whole debate on corporate personality was pointless and that both theories could be deployed to support both intervention and non-intervention. While Dewey's argument could not be used to advocate one particular classification, it gave equal (albeit dubious) legitimization to both. Then came the Great Depression, and in 1932, Berle and Means published their seminal book *The Modern Corporation and Private Property*.[136] In it they first observed the separation between ownership of corporate shares and control over its assets. Shareholders were said to have retained the former but to have surrendered the latter to management.

The standard Law and Economics "take" on Berle and Means is to show how the separation between ownership and control is an efficient regime for both investors and capital consumers. This, however, was not the point that Berle and Means wanted to drive home. They advocated for conceiving of corporations as public again. They wrote:

> "[B]y surrendering control and responsibility over the active property, [shareholders] have surrendered the right that the corporation be operated in their sole

[135] John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L. J. 655 (1926). *See* also Paul Vinogradoff, *Juridical Persons*, 24 COLUM. L. REV. 594 (1924); Max Radin, *The Endless Problem of Corporate Personality*, 32 COLUM. L. REV. 643 (1932).

[136] ADOLPH A. BERLE AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

interest... They have placed the community in a position to demand that the modern corporation serve not alone the owners or the control [group] but all society." [137]

Their call was not answered, and after Dewey's article the whole issue of corporate personality suddenly vanished from controversy.[138] I would like to urge that to a large extent the tension was defused with the enactment of the Securities Acts. Public individual investors were the constituency which was at the focus of public attention after the crisis in Wall Street. Instead of intruding into the perceivably private sphere of the corporation (with no apparent tools to remedy problems),[139] Congress preferred to surround it with a public law envelope of disclosure duties that had an equivalent effect. The new arrangement was a convenient one. It let management remain largely shielded from regulation in the private sphere of the corporation and allowed regulators to try to protect public investors through public law -- i.e., securities regulation.[140]

Recent theoretical developments in the theory of the firm -- particularly Jensen and Meckling's depiction of the corporation as a nexus of contracts[141] -- further strengthened the perception of corporations as private, being an outcome of contractual arrangements. Easterbrook and Fischel, among others, later turned this vision into the

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[137] BERLE AND MEANS, *id.*, cited in HORWITZ, *supra* note 118, at 166-67.

[138] Horwitz, *supra* note 131, at 175.

[139] Such a strategy would have also involved constitutional difficulties for reasons of federalism.

[140] That arrangement did not resolve the tension with regard to the third pubic constituency beside consumers and shareholders -- namely, workers. The issue remains a thorny one to this day, but is beyond the scope of this Article.

[141] Michael C. Jensen and William H. Meckling, *Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

central pillar of their theory about corporate law.[142] That perception is subject to attacks from progressive legal scholars,[143] but like its parent public/private distinction, the classification of corporations as private seems to hold.

The classification of securities regulation is also not clear cut. Judged by its structure, the field exhibits all the central features of public law as detailed earlier in this part. As to its content (and title), the field is a classic example of modern regulatory law by which the state intervenes in legal relationships that were heretofore governed by private law. At the margins, however, there exist some points of ambiguity.

First, the Securities Acts' antifraud provisions are in essence private law.[144] Other purely regulatory provisions in the Securities Acts were given private law extensions wherever private causes of action were implied by the courts.[145] More broadly, scholars have argued for allowing market participants to pick the securities regulation regime of

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[142] FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). Luigi Zingales has recently argued that corporate governance is best understood as a set of solutions for overcoming the impossibility of complete contingent contracts. Zingales, *supra* note 59.

[143] For critical analyses, *see,* e.g., Bratton, *supra* note 131; William W. Bratton, Jr., *The Nexus of Contracts Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989); David Millon, *Theories of the Corporation*, 1990 DUKE L. J. 201; Lyman Johnson, *Individual and Collective Sovereignty in the corporate enterprise*, 92 COLUM L. REV. 2215 (1992). *See* also Paul N. Cox, *The Public, The Private and the Corporation*, 80 MARQ. L. REV. 391, note 4 (1997) (collecting references).

[144] *See* Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 914 (1992).

[145] The scope of implied private causes of action under the Securities Laws has expanded and contracted over time. For an overview, *see,* COX ET AL., *supra* note 82, at 1076-78, and respective pages in JAMES D. COX, ROBERT W. HILLMAN, AND DONALD C LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS: 1996 SUPPLEMENT (1996). *See* also Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's 'Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority'*, 108 HARV. L. REV. 438 (1994); Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1994); Joel Seligman, *The Merits Still Matter: A Rejoinder to Professor Grundfest's Comment 'Why Disimply?'*, 108 HARV. L. REV. 748 (1994).

their choice in a way that is similar to choice-of-law clauses in private contracts, and thus to privatize securities law to a considerable extent. Such proposals were made with respect to international securities transactions[146] as well as domestic ones.[147]

Finally, the Securities Acts' public character has similarly been eroded somewhat over time in a line of cases about the arbitrability of litigation under the Acts. The issue of arbitrability is relevant because, typically to regulatory regimes, the Securities Acts preclude waiver of their protection. In the past, arbitration (and international arbitration in particular) was deemed inadequate for presentation and consideration of public law claims, including securities regulation ones.[148] Later, the Supreme Court narrowed the rule and held that a claim under the Securities Exchange Act was arbitrable, provided that it arose from an "international" transaction.[149] More recently, the Court reversed the basic rule and held that claims under the Securities Exchange Act -- both domestic and international -- are arbitrable.[150] In so doing, the Court has been giving the Acts a flavor of private law.

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[146] Stephen J. Choi and Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation,* SO. CAL. L. REV. (forthcoming 1998); Robert W. Hillman, *Cross-Border Investment, Conflict of Laws, and the Privatization of Securities Law,* 55:4 L & CONTEMP. PROB. 331 (Autumn 1992). Hillman's proposal is limited to private placements, though. These transactions don't always warrant invoking the protecting umbrella of the Securities Acts, as was acknowledged by the Supreme Court in *Gustafson v. Alloyd, Inc.* 115 S. Ct. 1061 (1995).

[147] Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation,* Working Paper, Yale Law School (1997).

[148] *Wilco v. Swan,* 346 U.S. 427 (1953).

[149] *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974).

[150] *Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220 (1987).

In sum, the fact that corporate law and securities law cannot precisely be defined as “private” or “public” is hardly surprising. In light of their common source -- having branched out from early company law -- and their mutual interpenetration today in terms of subject matter, such an effort is bound to be imprecise. But the wide areas of penumbra in each field should not obstruct the observation that these fields have a solid, determinable core of private law and public law character, respectively.

IV. Roadblocks on the Way to Convergence

Building on the previous parts, this part analyzes the implications on international regulatory cooperation and harmonization borne by the interdependence of corporate law and securities regulation and their character as private and public laws. I will argue that in relative terms, securities regulation regimes should lend themselves more readily to harmonization and cooperation compared with similar efforts with regard to corporate governance regimes. At the same time, however, the tight relations between securities and corporate laws imply that regulatory convergence and cooperation in securities regulation is likely to face more roadblocks compared with other regulatory areas. For reasons that were briefly explored above, rules and structures of corporate governance are more likely to exhibit rigidities and inertia. Consequently, they impede convergence in securities regulation as well.

For the sake of clarity, the following discussion separates between the influence of comparative corporate governance aspects and those of the public/private distinction. It should be borne in mind, though, that the two sets of aspects are intertwined and mutually reinforce one another.

A. Implications of Comparative Corporate Governance

Part III.A has shown that the distinction between corporate law and securities regulation may be tenuous and that the distinction line may be hard to discern but that both are very stable, compelling, and refuse to go away. Earlier we have seen that a movement is currently under way toward global harmonization of disclosure regimes under a “one size fits all” philosophy. Regionally in the European Union, there is a movement toward broader harmonization of entire securities regulation regimes. At the same time, however, efforts to harmonize corporate laws have so far all fallen through. Our present understanding of corporate governance legitimizes or at least acknowledges diversity. Where appropriate, foreign corporate governance systems may be deemed a model for imitation even if not a source for direct importation of structural transplants. Could these trends be reconciled? My answer is a qualified “No.”

While securities regulation and corporate law are distinct legal fields in certain aspects, they are also deeply integrated with one another. Ideally, securities regulation represents government intervention in corporate practices to the extent that public investors are involved; but as we have seen, at least in the United States it bears directly and significantly on corporate governance as well. Together, corporate law and securities regulation constitute a single legal regime for incorporated investment and business. In a healthy and functioning legal system, therefore, they must be balanced and coherent with each other.

By saying that corporate law and securities regulation are “balanced and coherent” I mean to say that in a normal national legal regime, there has to be a good fit between the two fields. Deficiencies in one field -- for the present purposes, corporate law -- may be, and often are, filled out or corrected by provisions in the securities laws. Corporate law tends to be a deficient component mostly because it is often less attuned to the special features of public trading of securities. Because corporate law usually precedes securities law, it may exhibit traditional features that are less appropriate for modern securities trading, such as liability formulas for securities fraud that require actual reliance, etc. Being largely enabling by nature, corporate law may become suboptimal where mandatory rules are called for, e.g., where information asymmetries are involved or where structural features of the corporation preclude effective and efficient bargaining.[151] Finally, where, as the case is in the United States, corporate law is largely in the province of the states, federal intervention in matters of corporate governance could be effected through the Securities Acts.

Company law does not have to be completely dysfunctional to warrant supplementing it through securities law. When a company does not have a large number of shareholders publicly trading their shares company law can do very well on its own, sometimes distinguishing between closely held corporations and larger ones. This is the case in Germany, where there are two separate statutes for the corporate forms. It is mainly the element of public trading which gives rise to the need for regulation, together with the regulation of markets (stock exchanges) and intermediaries.

Note that the claim just made about balance and coherence is independent of the premise one may hold with regard to the causes and sources of legislation. Under a public interest view of legislation, laws are enacted by a benevolent legislature or administration

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[151] In such cases, direct amendment of corporate laws may be an alternative, of course, but if problems were limited to publicly traded companies, it could be preferable to leave corporate law intact and intervene through the securities laws.

in order to further the public good, increase national social welfare, etc. In unitary states the locus for intervention equally could be found either in the country's corporations law or in its securities law. But the two instruments must work in harmony in order to further the legislative purpose. This should also be true in federal states where authority over corporate laws and securities laws is split between the national government and the sub-states. There, national legislation and rule making are supposed to remedy deficiencies in the legal regime promulgated by the sub-states.

The competing view, ironically called "public choice", in fact holds that legal regimes tend to serve the goals of private interest groups. Compared with the general public, those groups suffer less from collective action problems and can thus further their interests more effectively through lobbying and less legitimate methods. Government agencies under this view are less attuned to the public interest but rather to self-aggrandizement, accumulation of power, empire building, and so forth. That view has been applied in the financial regulation area as well. For example, scholars argue that the SEC had initially acted to make insider trading illegal and subsequently pursued violators in order to enhance its public stature and power, or to serve the interests of intermediaries.[152] Recently, public choice was also applied to international securities regulation.[153]

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[152] David D. Haddock and Jonathan R. Macey, *Regulation on Demand: A Private Interest Model with an Application to Insider Trading Regulation,* 30 J. L. & ECON. 311 (1987); JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS AND POLICY (1991).

[153] Enrico Colombatto and Jonathan R. Macey, *A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 CARDOZO L. REV . 925 (1996).

For the present purpose this does not matter, however. Under a public interest view of the law, company law and securities regulation would be balanced and coherent, together serving the public at large and protecting public investors to the extent needed to maximize social welfare. Under the opposite, public choice view, company law and securities regulation would be balanced and coherent too, but this time in a way that would further the interests of small business groups and of bureaucrats and politicians. Had it not been so, public choice theory would not have had much of a claim.[154] Thus, a "balanced and coherent" legal system need not be a perfect one -- indeed, it would rarely be one; it just has to be consistent within itself which is something we can generally assume.

1. Disclosure Regulation

Consider disclosure regulation. One can point at three different factors influencing a perceived need for a mandatory disclosure regime. The first factor is oriented towards the need of a well functioning stock market. The standard justification for mandatory disclosure is the need to provide investors with the information necessary for making an informed investment decision. The economies of producing this information are such that

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[154] The only interesting case would happen if one believed that one legal field were more susceptible to public choice problems whereas the other field were not. Developing this point exceeds the scope of this Article. Relatedly, scholars debate which government level may be more susceptible or resilient to public choice problems -- the federal or the state -- with regard to corporate laws. *See* Bebchuk, *supra* note 97; Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes,* 61 FORDHAM L. REV. 843 (1993).

it is more efficient to impose a mandatory disclosure duty on the issuer rather than have all market participants (under-)produce it.[155]

Rarely, however, does this reasoning stand alone as the only content of "investor protection" and hence, as the basis for mandatory disclosure. Almost generally it is tightly coupled with Brandeis's "electric light policeman" element, namely, the idea that disclosure has a prophylactic effect in preventing outreaches by the management and controlling shareholders. In modern economic parlance this is the agency problem justification for mandatory disclosure, which is conceptually different than the one based on information economies.[156] Aimed against the agency problem, mandatory disclosure goes down to the root of corporate governance which, the reader may recall, is designed to overcome this very problem. Indeed, disclosure duties under the Securities Acts constitute a major part of what Dean Seligman calls "the new corporate law".[157]

Now, recent studies of comparative corporate governance have shown that there could be more that one way for mitigating the agency problem in large corporations. Stricter fiduciary duties coupled with an effective enforcement infrastructure (courts, etc.) could be one way. Large blockholdings which increase the value of monitoring could be

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[155] John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System,* 70 VA. L. REV. 717 (1984). This is not the only justification, let alone opinion, with respect to mandatory disclosure. Some scholars see it as an efficient arrangement for positive externalities among issuers. EASTERBROOK AND FISCHEL, *supra* note 142, ch. 6. For more (different) views, *see*, e.g., ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW ch. 6 (1993); George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934,* 63 AM. ECON. REV. 132 (1973).

[156] For a view based on this aspect, *see* Mahoney, *supra* note 71.

[157] Seligman, *supra* note 94.

another, at least vis-a-vis the management. Structural arrangements such as commulative voting could be yet another way, where the legal infrastructure is unreliable and large blockholders are not trustworthy. To this menu stricter disclosure duties may be added as another option.

These strategies for mitigating the agency problems are partial substitutes. A corporate governance system (i.e., a combination of legal regimes and actual stockholding structures) with large blockholders and relatively weak disclosure duties imposed on the issuer may be roughly equivalent -- agency problem-wise -- to a system with dispersed ownership and stricter disclosure duties. To take another example, a country may believe that it is beneficial to reduce tensions between companies and their employees. One way to achieve this goal would be formally to adjust the board of directors and establish co-determination, as the case is in Germany. Another would be to staff the board with a large number of former employees as is commonly done in Japan. Finally, the law may provide employees with large amounts of information through the disclosure system -- something which might ease their suspiciousness toward the management. One may believe that this is the case in the Untied States.[158]

To a certain extent, a high level of disclosure could prove detrimental to the working and effectiveness of alternative systems of corporate governance. An example from the American market is the 1992 reform in the proxy rules. Briefly, the proxy rules -

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[158] I do not claim that the United States shares with Germany and Japan their values regarding employees' rights nor that the three alternatives mentioned are equivalent; only that some of the effects of co-determination and its like could be achieved in other ways, albeit partially.

- as originally conceived by the SEC -- were intended to protect public investors by imposing a requirement for a prospectus whenever shareholders were communicating with respect to voting. The idea was to formalize the process of proxy solicitation and to provide shareholders with the standard disclosure deemed sufficient for an informed decision. With the emergence of large institutional investors, it turned out that the proxy rules, as they were interpreted and implemented by the SEC, were impeding active monitoring by them.[159] What might have been warranted in the context of numerous public shareholders proved counterproductive to institutional monitoring -- and, eventually, to public shareholders -- because it meant that every communication among institutional investors could be claimed to be subject to a prospectus requirement and expose institutional investors to litigation. The SEC responded accordingly and adjusted the proxy rules to fit the new reality.[160]

Note that the claim just made is independent of another possible claim that sometimes, there could be "too much" disclosure. Cases where it has been argued that disclosure requirements are actually destructive to issuers include reporting of results with a line-of-business breakdown and, more recently, of exposure to market risk.[161] The claim here is only that a disclosure regime which is theoretically appropriate for a market

[159] *See* John Pound, *Proxy Voting and the SEC: The Case for Deregulation*, 26 J. FIN. ECON. (1991); Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

[160] SEC, *supra* note 102.

[161] On line-of-business reporting *see* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOKLYN L. REV. 763, 792-98 (1995). On exposure-to-risk disclosure *see* Merton H. Miller and Christopher L. Culp, *The SEC's Costly Disclosure Rules*, Wall Street Journal, 25 April 1996, p. A14.

with widely dispersed ownership could be too burdensome for a corporate governance system with large blockholders.

2. Insider Trading

The same theme can be pursued with regard to insider trading -- a major element in many securities regulation regimes. Insider trading is an illusive conduct. While the core nature of it may be intuitively clear, its perimeter is not.[162] Worse yet, in the United States a debate has been going for over three decades on whether insider trading should be prohibited or regulated in the first place, notwithstanding the legal ban on it.[163] I do not wish to settle that debate here as I believe it may very well be unsettleable. Our current understanding of the effects of insider trading in light of recent economic analyses is such that regulation of insider trading has an element of choice to it. By "choice" I mean that regulating insider trading would be an imposition of certain previously held beliefs and values with regard to that conduct as opposed to an imposition of one efficient regime by the law.

Like the case of disclosure regulation, one can identify two separate rationales for the prohibition on insider trading. These rationales are derived from two possible harms

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[162] The literature on insider trading is too voluminous to cover here. For a good recent discussion of the borderlines of insider trading and their underlying theories, *see* Roberta Karmel, *Outsider Trading on Confidential Information -- A Breach in Search of a Duty,* working paper (1996).

[163] For major contributions, *see* Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws,* 93 HARV. L. REV. 322 (1979); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information,* 1981 S. CT. REV. 309; Dennis Carlton and Daniel R. Fischel, *The Regulation of Insider Trading,* 35 STAN. L. REV. 857 (1983); DONALD C. LANGEVOORT, INSIDER TRADING REGULATION (1991); HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

allegedly caused by insider trading. The first rationale is market oriented and under it insider trading may be deemed an "offense against the market" -- something which compromises "market integrity." Under this rubric the debate is framed as whether insider trading impedes the functioning of the market as a price discovery mechanism intended to provide updated and reliable prices.

Proponents of insider trading argue that insider trading does not harm anybody since all market participants are aware of the potential of them trading with an insider and hedge accordingly.[164] Moreover, these scholars further claim that insider trading improves market functioning by helping it to move toward the price reflecting the new information. These arguments are subject to the general critique that insider trading is a second best to direct and prompt disclosure of information.[165] Moreover, economic models give reason to believe that only large market players can hedge against insider trading and that the gains from informed trading come at the expense of small individual traders.[166]

The other view of insider trading sees it as an "offense against the corporation."[167] Under this view, insider trading is an issue of corporate governance. Proponents of insider

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[164] *See*, e.g., Carlton and Fischel, *supra* note 163; MANNE, *supra* note 163.

[165] Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L. J. 628.

[166] *See* Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L. L. (forthcoming 1998).

[167] This view is the one that underlies the current Supreme Court jurisprudence regarding the liability theory for insider trading -- the Fiduciary Theory. *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983). By endorsing the requirement for pre-existing relationships of trust and confidence, the Court rejected the Equal Access Theory -- a theory that would require general parity of information among market participants. Since it focuses on market participants in general as those

trading consider it to be an efficient form of executive compensation and a mechanism for encouraging managers to assume risks.[168] The opponents' response is that insider trading is an inefficient form of executive compensation because it obscured from the market and, thus, cannot be evaluated correctly.[169] Moreover, argue the opponents, managers preferring their private interests over the company's would manage it sub-optimally or exploit it to their benefit.[170] More recent economic models of the impact of insider trading rules on the corporation reach a mixed answer: allowing insider trading could sometimes prove beneficial to the firm while in other circumstances it may not.[171]

Importantly, every discussion of insider trading has a very strong aspect of fairness. The ethical argument against insider trading holds that "it's just not fair",[172]

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potentially harmed it may interpreted as reflecting the offense-against-the-market view of insider trading. For a critical discussion, *see* CLARK, *supra* note 86, ch. 8. If this is a correct interpretation of American liability theory of insider trading, then they may be inconsistent with the current American jurisprudence regarding extraterritorial application of the Securities Acts. There, the underlying reasoning for asserting jurisdiction is an effect on the *market*. *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir. 1968),*Cert. denied sub nom. Manley v. Schoenbaum*, 395 U.S. 906 (1969). *See* Langevoort, *supra* note 21.

[168] Carlton and Fischel, *supra* note 163.

[169] CLARK, *supra* note 86, AT 274-275; James D. Cox, *Rethinking US Securities Laws in the Shadow of International Regulatory Competition,* 55:4 L. & CONTEMP. PROB. 157 (Autumn 1992).

[170] *See,* e.g., CLARK, *supra* note 86, ch. 8; Easterbrook *supra* note 163 (insider trading decreases incentives to disclose and produce information); Cox, *A Critical Response to the "Chicago School",* supra note 165 (transparency of management compensation justifies insider trading regulation); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation,* 80 MICH. L. REV. 1051 (1982) (insider trading obstructs the orderly flow of information in the firm); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts,* 68 VA L. REV. 117 (1982).

[171] Lucian A. Bebchuk and Chaim Fershtman: *Insider Trading and the Managerial Choice among Risky Investment Projects,* 29 J. FIN. & QUAN. ANAL. 1 (1994); *The Effect of Insider Trading on Insiders' Efforts in Good and Bad Times*, 9 EUR. J. POL. ECON. 469 (1993); *The Effect of Insider Trading on Insiders' Reaction to Opportunities to "Waste" Corporate Value,* Discussion Paper No. 76, Program in Law and Economics, Harvard Law School (1990); Michael Manove, *The Harm from Insider Trading and Informed Speculation*, 104 Q. J. Econ. 823 (1989).

[172] *See, e.g.,* Kim L. Scheppele, *It's Just Not Right: The Ethics of Insider Trading* 56 L. & CONTEMP. PROB. 123 (Summer 1993).

reflecting fundamental concepts of justice and of the right distribution of wealth.[173] As such, it explains the public interest in insider trading scandals and the fervor with which "American jurisprudence abhors insider trading."[174] Public opinion that despises insider trading in turn drives politicians to respond by enacting anti insider trading measures, using the most expressive language to describe insiders as "thieves".[175]

Concentrating for a moment on insider trading as an offense against the corporation, countries may have different takes as to the desirability of prohibiting this conduct. First, in a country where insider trading is not deemed by the public to be morally sinful, engaging in insider trading could constitute an implicit part of compensation packages for management. Investors in such a country could believe that it is efficient to do so in light of certain economic models. However, they may also acknowledge that such extraction of private benefits is inefficient per se but also very

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[173] James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading,* 80 CAL. L. REV. 1413 (1992).

[174] Cox, *A Critical Response to the "Chicago School,"* supra note 165, at 628 ("American jurisprudence abhors insider trading with a fervor reserved for those who scoff at motherhood, apple pie, and baseball").

[175] "I concur wholeheartedly with John Fedders, the Director of the SEC's Division of enforcement, that insider traders are thieves." Senator Alphonse D'Amato (R., NY), then chairman of the Senate Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs. Hearing before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs. H.R. 559, 98th Cong., 2d Sess., at 1 (April 3, 1984).

A fine analysis of the interaction between politics and corporate governance and corporate law is provided by MARK J. ROE, STRONG MANAGERS, WEAK OWNERS -- THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994) (arguing that political response to public distrust in capital concentration has shaped the present American model of separation between ownership and control).

difficult to monitor and detect. They could thus prefer to deny insiders other, more observable, perks.[176]

But the problem is broader. Countries that do see insider trading as a modern form of sin, such as the United States, may still suffer from overzealous prohibition of that conduct in certain circumstances. Where corporate governance systems feature large blockholdings, such large stockholders would usually possess knowledge about the company beyond the level of publicly available information. Indeed, this is the very promise of institutional investors -- that they would have increased incentives to monitor and collect information about their portfolio companies. But such an increased level of knowledge may prove a double-edged sword. Should an institutional investors buy or sell securities of a portfolio company while in possession of non-public information, it may run afoul of the prohibition on insider trading[177] given its large blockholding which might deem it an insider.[178]

The fear from getting entangled in illegal insider trading is also one of the reasons why institutional investors in the United States avoid nominating directors in their

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[176] *See,* generally, Fox, *Insider Trading in a Globalizing Market, supra* note 21.

[177] The provision most likely to be breached is the prohibition on short-swing transactions under Section 16(b) of the Exchange Act. Such short-swing transaction may take place inadvertently, e.g., when a large institutional investors with an indexing investment policy readjusts its portfolio or uses program trading to hedge against market volatility. Of course, trading algorithms in both cases could be adapted to avoid short-swing transactions, but such a rigidity would be a cost on the institutional investor which is exactly the point claimed in the text.

[178] *See* Coffee, *supra* note 56, at 1330 (1991); John C. Coffee, *The SEC and the Institutional Investor: A half-time Report,* 15 CARDOZO L. REV. 837 (1994).

portfolio companies.[179] By doing so, they diminish their potential contribution as effective monitors toward mitigating the agency problem in the firm. Structural solutions, such as “Chinese walls” can be put in place but they too have their costs and, apparently, institutional investors do not see them as a complete solution.

Analyzing the problem from a clean slate, i.e., without a presumption that insider trading is unacceptable in principle, the tradeoff here is straightforward: in exchange for monitoring services by institutional investors public investors may want to allow them to engage in some level of insider trading. The company, in turn, may enter into such a contract on behalf of public investors.[180] Such an arrangement may be appealing to developing countries. It has been argued that developing nations should increase foreign investment flows into their economies by focusing on encouraging relational investment, as a substitute for foreign direct investment, foreign debt, and portfolio investment.[181] In such cases, institutional investors may be a promising solution to corporate governance

[179] *See* Coffee, *supra* note 56; George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation,* 1989 WIS. L. REV. 881, 916. *See,* generally, Ronald J. Gilson and Reinier H, Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors,* 43 STAN L. REV. 863 (1991). Other reasons for not nominating directors is the fear from being sued for alleged directorial malpractice.

[180] *See* Stephen Thurber, Note, *The Insider Trading Compensation Contract as an Inducement to Monitoring by the Institutional Investor*, 1 GEO. MASON L. REV. 119 (1994)(arguing that institutional investors’ incentive structure can be improved by permitting them to exchange monitoring services for rights to engage in insider trading).

[181] *See,* e.g., Enrique R. Carrasco and Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis,* 34 COLUM J. TRANSNAT’T L. 539 (1996).

problems where stock markets are under-developed.[182] Independently, those countries could still ban insider trading by individual insiders.

3. Harmonization

The Article is now in a position to tie some ribbons from several parts of the discussion. Securities regulation is tightly connected to and directly influenced by the prevailing corporate governance system prevailing in each country, i.e., the legal regime as set by corporate law and actual governance structures. Corporate law and corporate governance exhibit features of adaptability to national economic, political, and cultural circumstances and in general exhibit considerable path dependency. National corporate laws also prove fairly resilient to harmonization efforts which would move them away from their beaten path. In light of all this, what could be the logic behind the movement to harmonize securities laws, and particularly disclosure rules? And what are their prospects to succeed? In what follows, I offer some speculations.

One possibility is that the IASC accountants conducting the IAS project and the scores of securities regulators in IOSCO who are to endorse it are aware of the full implications -- in truth, complications -- of their project in terms of corporate governance. In pursuing their harmonization project, therefore, they in fact intend to advance an agenda on corporate governance as well, mainly for mitigating the agency problem through increased disclosure. Nothing in the public materials of IOSCO or IASC suggests

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[182] Carrasco and Thomas, *id. See* also MITSUHIRO FUKAO, FINANCIAL INTEGRATION, CORPORATE GOVERNANCE, AND THE PERFORMANCE OF MULTINATIONAL COMPANIES (1995).

that this is the case,[183] and a hidden agenda of such a scale is somewhat unlikely and would also be unethical.

If this were the case, however, then the project would be an uphill battle against highly powerful forces. Corporate governance systems have enormous inertia. Not only that it is difficult to reform or harmonize them directly, they are also likely to interject rigidities into the harmonization project of securities regulation regime. Regulators would thus find it difficult to implement the harmonized framework. Even more likely, compliance with the harmonized rules could be lower than expected, and so forth.

At the same time, however, this possibility should not be completely ruled out. One could conjecture that some securities regulators may be interested in revamping corporate governance regimes in their countries and would like to use securities regulation as a vehicle for this purpose. After all, the SEC has been penetrating the states' company law turf for years, and other regulators may have similar agendas. Some degree of regulatory power seeking is also not unthinkable. But it should be re-emphasized here that whether such an agenda is motivated by public interest or public choice causes is an independent issue.

A second possibility is that IOSCO members are blissfully unaware of the corporate governance implications of their disclosure harmonization project. This would require a strong assumption ascribing considerable naivete to these regulators. Under this

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[183] *See* INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, COMPARATIVE ANALYSIS OF DISCLOSURE REGIMES (1993).

scenario, the “one-size-fits-all” philosophy championed by IASC is simply wrong -- a fact which would render the project severely misguided. This conjecture is supported by the fact that available materials from IASC and IOSCO fail to provide a thorough analysis of corporate governance aspects. Although such a possibility might seem remote, I believe it too cannot be ruled out completely.

Should this be the case and should IOSCO end up endorsing IASC’s standards, the consequences may be similar to the previous scenario. When these rules reach their implementation phase they will encounter strong resistance on the ground. Standards that do not fit local corporate governance systems are likely to be breached, watered down, or simply ignored. In any event, they will require much more determination and regulatory resources to be effectively implemented and enforced. In the extreme, they might even harm reporting companies if the duties imposed by them were to erode beneficial corporate governance features.

Finally, the current IASC/IOSCO project may be beside the point, i.e., it may purport to impose a regime that has no effect on corporate governance. At present, the project concentrates on financial reporting which might be deemed relatively less relevant to corporate governance, compared with non-financial reporting. Such a project would have substantial merits nonetheless. Inasmuch as it is a focal point solution to a coordination problem of choosing one standard from a menu of several possible ones, then it can bring about considerable savings in transaction costs of preparing multiple statements or reconciling with foreign GAAP. Alternatively, but still with little relevance to corporate governance, the project could constitute an effort on behalf of advanced markets, notably the American one,[184] to use IOSCO as a leverage mechanism for imposing uniform disclosure rules such that its hegemonic leadership would not be eroded. I give this scenario a high probability.[185]

Similar conjectures may be put forward as to insider trading, but will be presented here only briefly. Currently, developing countries seem to be signing on to the ban on insider trading in the framework of IOSCO. It is not clear, however, whether they have gone through the calculus set forth above. Maybe they are doing so because they perceive insider trading as an offense against the market and the harm it causes as greater than its putative benefits if it were allowed to institutional investors. One can doubt it. Although I believe that insider trading should generally be banned -- mainly due to its adverse effects on the market -- it seems that what is taking place in IOSCO is largely in response to American hegemonic pressures, this time stemming mainly from ideology.[186] In this regard, it should be repeated that a limited permission for institutional investors to trade on non-public information is not equivalent to a sweeping permission for everybody to do so.

In any event, it is evident that the discussion of harmonization of securities regulation regimes has so far been devoid of a thorough analysis of its corporate

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[184] The title to the SEC's report to Congress on the progress of the IASC/IOSCO project, *supra* note 13, is telling: "Report on Promoting Global Preeminence of American Securities Markets".

[185] For a basic game theoretic analysis of the scenarios mentioned in the text *see* Amir N. Licht, *Games Commissions Play: 2x2 Games of International Securities Regulation,* Working Paper No. 223, John M. Olin Center on Law, Economics, and Business, Harvard Law School, at 25 (1997).

[186] *See* Licht, *id.* at 46.

governance implications. It would seem beneficial to add this dimension as a major consideration of harmonization projects of this sort. One may think of a “corporate governance impact analysis” -- akin to an environmental impact analysis -- as something that securities regulators may be required to take into account as part of the regulatory process. Such an analysis would specify how the harmonized measure would fit into the larger system of securities regulation and company law while having regard to the prevailing structures of corporate governance.

Another conclusion from the analysis is that caution is warranted if -- in an environment of regulatory competition -- company law and securities law were allowed to be uncoupled. In other words, where entrepreneurs and investors would be able to “mix and match” their favored regimes of company law and securities law. Proposals in this spirit have recently been put forward, calling for establishing free regulatory competition in securities regulation, both domestically in the United States[187] and internationally.[188]

Should such a system be established, the assumption that company and securities laws are balanced and coherent may lose its basis. This might open new opportunities for the agency problem by creating loopholes that are not governed by either regime. It is difficult to estimate the severity of the problem both as a theoretical and as a practical

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[187] Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation,* Working Paper (1997) (advocating state competition in securities regulation, without federal preemption, in a fashion similar to state competition in corporate law).

[188] Choi and Guzman, *supra* note 146 (advocating international competition in securities regulation to be available irrespective of the company’s country of origin). But *see* Darrel Hall, Note, *No Way Out: An Argument Against Permitting Parties to Opt Out of U.S. Securities Laws in International Transactions,* 97 Colum. L. Rev. 57 (1997).

matter. But legislators and regulators should be aware of the potential danger and might want to form a policy on it in advance. It would seem beneficial, for instance, to include a corporate governance impact analysis in any regulatory reform which endorses regulatory competition as part of its internationalization strategy. Similarly, regulators could limit the set of securities regulation regimes that would be available to their regulatees -- something along the idea of "opting out is possible but only to an equivalent or a higher league."[189]

4. Corporate Governance as a Normative Basis of Securities Regulation

The internationalization of securities markets -- e.g., through foreign listing and cross-border trading -- creates a world of interacting securities markets. In such a world, securities regulation regimes also interact. Where investors price securities in light of several applicable legal regimes, one regime could enhance, as well as erode, the value that another regime confers upon the security.[190] The question left open is what normative basis should investors use for passing a judgment on the effect one regime could exert on the other, i.e., whether the former would enhance or rather erode the value created by the latter. Such a theory would primarily serve investors in pricing the foreign-listed or cross-traded security. Consequently, it could serve as a guide for regulators as to what to expect

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[189] *Cf.*, in a context of market intermediaries regulation, Howell Jackson, *The Selective Incorporation of Foreign Legal Systems: A Concept Paper on Nepalese Financial Reform*, Working Paper, Harvard Law School (1997).

[190] *See* Licht, *supra* note 166.

when their system is about to interact with foreign one, e.g., when a security is cross-listed or cross-traded to or from their jurisdiction.

In light of the analysis in this Article, comparative corporate governance emerges as the primary candidate for such a normative basis. When a foreign securities regulation regime interacts with a domestic one the question should be In what corporate governance system was the foreign regime promulgated? What deficiencies is it purported to remedy? More generally, how does it complement and is being complemented by that corporate governance system? The notion that corporate governance and securities laws fit together to create a balanced and coherent system is reflected here again from an external point of view -- that of foreign regulators.[191]

If the foreign securities law purported to remedy problems that are also common in the domestic market then its effect could be either positive or nil. For example, if management in both countries is perceived as prone to outreach by awarding itself excessive compensation, a rule which required disclosure of top officers' compensation schemes would be deemed beneficial in both countries. It could be the case, however, that the effect of such a rule would be negative. Consider a domestic market where the setting of executive compensation is dominated by conventions and traditions which put an effective cap on it but also make its disclosure a matter of great embarrassment. Here, the

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[191] To be sure, the legal regime affecting a security comprises of more that just securities and company laws. Other laws, e.g., tax law, civil procedure, and criminal law may also be relevant in assessing the total effect of the legal system on the security's value. Those laws, however, are much more peripheral compared with securities and company law (coupled with the prevailing corporate governance structure) so their marginal effect on security prices is lower.

foreign disclosure rule might have a negative effect on managers without having the redeeming virtue of constraining management excesses.

Diametrically, in a regulatory "mix and match" environment hypothesized in the preceding sub-part, gaps may emerge which may cause a decrease in security value. For example, consider a company from the foreign market that opts out of its securities regulation regime and into the domestic one. The conventions and traditions that were the basis for the domestic regime bear no relevance to the foreign management which is oblivious to them. The likelihood of excessive management compensation would thus rise somewhat and stock value would decrease accordingly.

A corporate governance impact analysis of the kind suggested above should be useful in this context. Although security prices are believed to reflect all publicly available information, there is reason to believe that they do not do a perfect job in pricing the effect of foreign legal systems.[192] In spelling out the corporate governance premises underlying the securities regulation regime, such an analysis may prove helpful in identifying potential points of friction, i.e., cases where applying a foreign regime -- in addition or in lieu of the domestic one -- might engender problems in terms of corporate governance.[193]

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[192] For a discussion, *see* Licht, *supra* note 166.

[193] Recently, James Fanto made a somewhat similar proposal with respect to cultural differences among countries affecting corporate governance. James A. Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 NW. J. INT'L L. & BUS. 119 (1996). His proposal is more problematic than the one put forward here because cultural differences are much more difficult to spell out in a determinable fashion. Moreover, under Fanto's proposal issuers would disclose to foreign investors their own cultural peculiarities. It is doubtful whether

B. Implications of the Public/Private Distinction

The now standard story about the causes of path dependence in corporate governance systems is mainly about political economy with some cultural garnish. It recounts how historical and political forces, coupled with popular cultural tendencies, and operating in particular economic circumstances, shaped the laws affecting corporate governance and broke the path for their future development. This part adds another dimension to the story of path dependence by looking at the implications of the public/private distinction. It then explains the differences between corporate governance and securities regulation in what regards harmonization and regulatory cooperation -- why harmonization of company laws has mostly proven stillborn while that of securities laws proceeds apace.

Company law and securities regulation can be described as the private law and public law components of one legal field. To be sure, the public/private distinction -- both in general and with respect the corporation in particular -- could be shown to be completely malleable, endlessly flippable,[194] and so forth. Nevertheless, it resurrects after every attack. Company law has some basic features of private law while securities regulation retains the character of public law. At the very least, this means that these distinctions may have an instrumental value as tools in predicting and explaining legal phenomena.

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this is a feasible requirement. Such peculiarities may be of a relative nature and issuers (and the people preparing the disclosures for them) may themselves be biased by them and thus unaware of their full extent. Here, international markets may do better in analyzing the problem.

1. Structural Aspects

One reason why securities laws can more easily be harmonized stems from the structural differences between private and public law. Recall that company law, like all private law, is enacted by the primary legislative body -- the parliament or its equivalent. It is then administered by the courts on a case by case basis. In securities law, only the primary principles of it are enshrined in primary legislation. As in other fields of public law, these principles are then fleshed out by a regulatory agency. This structural difference means that there is "someone in charge" -- an entity which can serve a point of contact for addressing foreign concerns and for cooperation.

Parliaments as such cannot meet, negotiate, or harmonize their laws. Members of parliaments may, of course, meet and exchange views but this remains only at the personal level with no effect on their institution. A state can in principle communicate its concerns with another state's laws but the process is cumbersome and never involves the parliaments directly. Regulators can and do meet, they discuss regulatory policies, and, most importantly, they negotiate, albeit in a different way than states.[195] In the field of securities regulation there exists an extensive regulatory network spanning the entire

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[194] *Cf.* Horwitz, *supra* note 131, at 176.

[195] For a discussion of regulatory networks in general, *see* Anne-Marie Slaughter, *The Real New World Order*, 76 FOREIGN AFFAIRS 183, at 189 *et seq.* (1997). *See* also Sol Picciotto, *Networks in International Economic Integration: Fragmented States and the Dilemmas of Neo-Liberalism,* 17 NW. J. INT'L L. & BUS. 1014 (1997).

globe. The most prominent institution is IOSCO, with some 135 members in 1996.[196] Securities regulators in the EU also meet regularly, both formally and informally, to discuss common problem.[197] Finally, a thickening network of bilateral Memoranda of Understanding (MOUs) is developing between securities regulators in various countries around the world.[198]

Why would securities regulators *want* to meet, cooperate, and harmonize their regulations is a question which exceeds the scope of this Article.[199] As securities markets become more internationalized, regulators may more frequently encounter problems involving foreign elements. One could thus conjecture that as a consequence, they would be more willing to engage in dialogue and cooperation with their foreign counterparts in order to ensure the effectiveness of their performance at home. The point advanced here is that as a structural matter, securities regulators are better equipped to do so compared with the institutions that are in charge of company law.

2. Substantive Aspects

A second reason why securities laws may be more susceptible to cooperation and harmonization than company law stems from their different substantive status as public

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[196] INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, ANNUAL REPORT 1996, at 1. The report also provides an overview of IOSCO's activities. *See* also A.A. Sommer, Jr., *IOSCO: Its Mission and Achievement*, 17 NW. J. INT'L L. & BUS. 15 (1996).

[197] Licht, *Supra* note 17, at 36-37.

[198] An updated list of MOUs in force can be found in IOSCO's web page at <http://www.iosco.org>. For an overview of the MOU phenomenon from an American perspective, *see* Mann, Mari, and Lavdas, *International Agreements*, *supra* note 25. *See* also Trachtman, *supra* note 24.

[199] For a discussion, *see* Licht, *supra* note 185.

and private law, respectively. A simplistic view would hold that company law, as a part of private law, deals with horizontal relationships among entrepreneurs, investors, and other factors providers -- most importantly workers. This is the standard nexus-of-contracts model of the corporation. Securities regulation, on the other hand, is more of a technical service provided by the government to ensure and facilitate an orderly working of securities markets. It is also limited to the relationship between suppliers and consumers of capital as opposed to other factor providers. Securities regulation thus represents a vertical intervention in but a partial section of the nexus of horizontal relationships governed by company law. To be over-simplistic, company law belongs to the people whereas securities regulation belongs to the government.

Why the above description is over-simplistic (some would say plainly wrong) has been explained above.[200] But the fact remains that the same countries that are reluctant to reform their company laws so as to converge them toward a harmonized model express readiness substantially to revamp their securities regulation regimes toward that end. It seems that states are more willing to cede ground in what belongs to the government but not in what belongs to the people. It thus turns out that even if the public/private distinction has a dubious analytical basis it can nonetheless serve as a strong heuristic model for the dynamics in the field.

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[200] *See supra* text to note 135 *et seq.*

A somewhat similar argument has been recently put forward with respect to core private law in Europe, where the public/private distinction retains a lot of bite. In a thoughtful article,[201] Daniela Caruso argues that a state's control over its private law is laden with ideological significance and tied historically to the very notion of sovereignty.[202] She further observes:

> "In spite of Europe's transformation, the core of Member State private law remains guarded in the jealous hands of national institutions, and these institutions are quite conscious of their 'national' character. Furthermore, in spite of the effort to harmonise the black-letter law of the different legal systems and -- where possible -- to bring them into complete uniformity, the procedural rules and judicial remedies of each state retain diverse national features...
>
> Because of the lasting centrality of civil codes in most Member States' self-perception, control over civil adjudication may be the one national border that Brussels does not, and indeed must not, cross. In the legal culture of Europe, private law is perceived as and may actually function as a bulwark against the flood of European regulation, a sort of antidote to the dilution of regional identities."[203]

Caruso's argument can be directly extended beyond the inner core of private law to company law as well. The arguments advanced by European national courts and

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[201] Daniela Caruso, *The Missing View of the Cathedral: The Private Law Paradigm of European Legal Integration*, 3 EUR. L. J. 3 (1997).

[202] *Id.*, at 5.

[203] *Id.*, at 4.

lawyers against harmonizing private law are mostly doctrinal. They claim that such interference would breach the internal doctrinal coherence of the civil codes. From this aspect, company laws cannot generally claim for the same degree of doctrinal sophistication and coherence. Furthermore, from a doctrinal perspective, company law may be more amenable to changes compared with the core Civil Law. This is due to its classification as commercial law which has its origins in the ancient Law Merchant. That field traditionally has been more flexible.

The evidence so far does not show such flexibility, however. With the rise of the subsidiarity principle in the EU and in light of its forthcoming enlargements, one may assume that company law in the European Union will remain country specific.[204] More member states (particularly East European ones) mean higher diversity, and subsidiarity means more deference to national and local preferences. The recent developments with regard to the Draft Fifth Directive on company law will most likely lead to its final abandonment, and prospects of the European Company status may not be too rosy either. At the same time, the European Union has succeeded in harmonizing large parts of securities laws. This evidence calls for a deeper, more substantive explanation.

In truth, the codes of private law represent a large-scale national bargain struck generations ago among a wide array of social constituencies. They are politically,

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[204] *See* Erik Berglof, *Corporate Governance*, in THE EUROPEAN EQUITY MARKETS 149, 166 (Benn Steil, ed., 1996).

socially, and culturally in equilibrium as much as they are doctrinally so.[205] This is what ties them to the "very notion of sovereignty." In this substantive respect, company law is on equal footing with the very core of private law. It too represents a delicate bargain struck among a large number of different constituencies in light of historical, political, and economic realities -- all of which are very national. As such, we would expect it to be as resilient as regular private law to harmonization efforts as indeed shown by the evidence from the European Union.

Note how close the argument is to the argument about path dependence. Both arguments seek to explain the stability of corporate governance systems by turning to factors which are external to the boundaries of the corporation, strictly defined: history, politics, etc. The argument about the public/private distinction indeed can be interpreted as a transformation of the basic path dependence argument into more legalistic terms. While this has a grain of truth to it, the two arguments are not completely overlapping.

First, the public law/private law distinction can reinforce the effect of those factors which give rise to path dependence, thereby deepening the path. This would happen wherever the distinction has a bite; and in Civil Law countries it has a lot of bite. In continental Europe, for example, path dependence of corporate governance systems may be also stemming from, or at least exacerbated by the nature of company law as private law. In common law countries, where the public law/private law does not enjoy

[205] Who gets the upper hand in that bargian is a separate question which needs not be resolved here. Legal interpretation of the codes, however, has been constantly used to readjust the implicit bargain so as to adopt to new economic and political realities.

the same status, that quality of company law by itself would tend to have a smaller effect. One should not dismiss the distinction as irrelevant, though, since the underlying public/private distinction *is* known and influential, at least in the United States.

The somewhat archaic practice of classification of legal systems has recently gained new vitality with the work of La Porta *et al.*[206] They argue that Civil Law countries -- most notably those belonging to the French law family -- have inferior business laws compared with common law countries, as judged by a wide array of factors. But their argument is only static in the sense that it is limited to a description of a current situation. In light of the debate about the "end of history in corporate law"[207] one may be interested in the dynamic aspect as well.

Under the reasoning presented here, the legal tradition to which countries belong may not only influence the static picture of corporate governance systems that these countries have. It may also influence its dynamic picture in what regards the speed and nature of adaptations. Specifically, one can thus hypothesize that the characterization of a country's legal system as a Civil Law one and the classification of a legal field as private law would have a negative effect on the speed and scope of adaptations in its corporate governance system. In this respect, it is interesting to note that the country which most

[206] Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Schleifer, and Robert W. Vishny, *Legal Determinants of External Finance,* 52 J. FIN. 1131 (1997).

[207] Hansmann and Kraakman, *supra* note 68.

staunchly objected to the Draft Fifth Directive and to the European Company Regulation is the United Kingdom -- the origin of the common law. This objection, however, was in response to efforts on behalf of continental European countries to fixate their own corporate governance systems through EU mechanisms, perhaps in order to shield them from erosion.[208]

Second, the argument advanced here is broader than the standard path dependence story in that it relates to both corporate governance and securities regulation and to the relations between them. The upshot of the argument is that national company laws and corporate governance systems in general will introduce an *additional* drag -- or rigidities -- into harmonization efforts of securities regulation regimes. This is because they are so closely connected with the latter and because they are private in nature.

Finally, the argument is narrower than the general scope of the path dependence argument. It applies more forcefully to concerted reforms in corporate governance attempted by harmonization initiatives and the like. It is in these instances that countries may entrench in their private law positions in response to perceived encroachments from the outside. Since Japan and the United States, for example, were not part of such an initiative, the present argument cannot not be directly applied to them.

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[208] An empirical testing of the hypothesis would look for actual changes in corporate governance systems over time and would (in this case, rightly) ignore the identity of political players.

The argument would similarly be less applicable with respect to changes induced by global competitive pressures in capital markets, product markets, or labor markets.[209] Changes of this kind may induce adaptations in the private spheres of the law as much as they may induce regulatory response (although it is difficult to make categorical statements that are so general). Therefore, the public law/private law argument has little to say about Japan and why it may or may not retain its unique *keiretsu* structure in response to erosion in lifetime employment,[210] or about the prospects of institutional investors in the United States acquiring a status akin to the German *hausbank*'s.

V. Conclusion

International diversity and convergence have been primarily a topic for debate with respect to corporate law and corporate governance. This Article extends the debate to securities regulation in a way which connects it to corporate governance and these two fields, in turn, to some fundamental concepts of legal theory -- the concepts of public and private law. After an overview of recent international trends in corporate governance and securities regulation, the Article proceeds to analyze the relations between corporate law and securities regulation. The two fields are distinctive and different but a large overlap exists between them. A better view would thus see them as two integrated components of one larger field. Corporate law and securities regulation can also be classified as private

[209] *See* Kraakman and Hansmann, *supra* note 68; Gilson, *supra* note 66.

[210] *See* Ronald J. Gilson and Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, Working Paper No. 126, Center for Law and Economics Studies, Columbia University School of Law (1997).

law and public law, respectively. The distinction between them as such -- although no clearer than the former -- correlates with it.

Building on these observations, the Article proceeds to point out at some roadblocks on the way to international convergence, primarily of national securities regulation regimes and also of corporate governance systems. First, it demonstrates how the inertia and relative stability of corporate governance systems -- today understood in terms of path dependence -- may interject similar element into processes of international convergence in securities regulation. In particular, the Article argues that the project currently under way under the auspices of IASC and IOSCO does not demonstrate sufficient awareness to these aspects. This may put a question mark over the project and its prospects for success. More generally, the Article urges regulators to conduct a corporate governance impact assessment on a general basis.

Turning to the public law/private law distinction, the Article shows how it may further exacerbate path dependence dynamics where the distinction carries legal weight as in many Civil Law countries. The special status of private law in these countries may render company law more resilient to convergence through harmonization by dint of this status. Fields of public law, including securities regulation, are less susceptible to this type of problem. Evidence from the European Union during the last three decades about initiatives to harmonize securities law and (unsuccessfully) to harmonize company laws are consistent with this argument.