ARTICLES

PORTABLE RECIPROCITY: RETHINKING THE INTERNATIONAL REACH OF SECURITIES REGULATION

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I. INTRODUCTION

On June 18, 1997, the Securities and Exchange Commission ("SEC") issued a cease-and-desist order against GFL Ultra Fund Ltd., a British Virgin Islands investment company, for violating Regulation S of the Securities Act of 1933, which governs the offering of securities outside the United States.[1] Incorporated in 1994, GFL Ultra specialized in purchasing offshore securities sold through Regulation S offerings, often at discounts of fifteen to twenty percent of their U.S. secondary market price.[2] GFL Ultra would hedge its offshore securities position through short sales of the issuers' securities in the United States.[3] After a mandatory waiting period of forty days under Regulation S, GFL Ultra then covered its short positions with the Regulation S stock. Because of the initial discount on the Regulation S shares, GFL Ultra almost always made a profit from its transactions.[4] In less than two years, GFL Ultra engaged in ninety Regulation S deals involving forty-seven issuers.[5] The SEC held that GFL Ultra was a statutory "underwriter" subject to Section 5 of the Securities Act's registration requirements because its transactions provided investors with an

1. *See* In re GFL Ultra Fund Ltd., Securities Act Release No. 7423, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,949 at 89,752 (June 18, 1997) [hereinafter GFL Ultra Fund].

2. *See id.* at 89,753.

3. Through short sales, investors may sell securities they do not own in the market. Mechanically, investors first borrow stock from willing broker-dealers. Then, the investors sell the borrowed stock in the marketplace. Later, investors must replace the borrowed stock either through purchases of the stock on the open market or, as in the GFL Ultra scenario, through Regulation S stock purchased earlier once the stock becomes eligible for trades in the United States.

4. *See* GFL Ultra Fund, *supra* note 1, at 89,753 & n.5 (indicating the total profit to GFL Ultra was more than $840,000).

5. *See id.* at 89,753.

easy way to purchase securities outside the U.S. regulatory regime for eventual introduction into U.S. capital markets.[6]

In GFL Ultra, the SEC attempted to close a loophole in Regulation S that provided issuers and investors a mechanism to avoid compliance with the U.S. securities registration requirements while selling securities into the United States.[7] Several commentators warn of the dangers of this type of transaction.[8] The argument is that without the benefit of U.S. regulatory protections, investors are at a greater risk of fraud. Confidence in U.S. capital markets may falter, leading to a loss in capital market liquidity. Such arguments assume that American investors are unable to discount for the loss of the protection provided by U.S. securities laws and that U.S. regulation acts as a valuable form of investor protection. These same assumptions may be used to justify extending the reach of the U.S. regime extraterritorially to transactions taking place in other jurisdictions that may have some indirect impact on U.S. markets or investors.[9]

The debate over the regulation of global capital markets continues to grow in importance as internationalization of capital markets continues at a dramatic pace. The move to a global market raises many challenges and potential problems.[10] Through decreased communication costs and im-

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6. *See id.* at 89,754 to 89,755. Section 2(11) of the Securities Act of 1933 ("Securities Act") defines "underwriter" in part as "'any person who has purchased from an issuer with a view to . . . the distribution of any security.'" *Id.* (quoting 15 U.S.C. §77b (11) (1994)). Once a statutory underwriter is involved in a transaction, Section 4(1)'s exemption from Section 5's registration requirements no longer applies. *See* 15 U.S.C. § 77d (1994).

7. The SEC closed the loophole for good when it promulgated reforms to Regulation S in early 1998. *See* Offshore Offers and Sales (Regulation S), Securities Act Release No. 7505, Fed. Sec. L. Rep. (CCH) ¶ 86,006, at 80,156 (Feb. 17, 1998) (to be codified at 17 C.F.R. pts. 230, 249) [hereinafter Securities Act Release No. 7505]. The reforms, among other things, treat all equity securities issued by a U.S. company as "restricted" for a period of one year after the close of the Regulation S offering. Such restricted securities may not be resold into the United States other than through a valid exemption from the Securities Act's registration requirements, such as under Rule 144 or 144A of the Securities Act. *See* 17 C.F.R. § 230.905 (1998).

8. *See* Josh Futterman, Note, *Evasion and Flowback in the Regulation S Era: Strengthening U.S. Investor Protection While Promoting U.S. Corporate Offshore Offerings*, 18 FORDHAM INT'L L.J. 806 (1995); Julie L. Kaplan, Comment, *"Pushing the Envelope" of the Regulation S Safe Harbors*, 44 AM. U. L. REV. 2495 (1995).

9. For example, Rule 10b-5 antifraud liability under the Securities Exchange Act of 1934 ("Exchange Act") is sometimes applied abroad where securities transactions have some "effect" on U.S. markets. *See infra* text accompanying notes 47-51.

10. Aggregate trading in U.S. stocks by foreign investors reached $417 billion in 1990 compared to $75 billion in 1980. In 1992, U.S. investors purchased and sold $290 billion in foreign equity. *See* Philip R. Wolf, *International Securities Fraud: Extraterritorial Subject Matter Jurisdiction*, 8 N.Y. INT'L L. REV. 1, 1 (1995). *See also* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997) (examining the need for apportionment of regulatory authority among countries for transnational transactions) [hereinafter Fox, *Who Should Regulate Whom*]; Merritt B. Fox, The Political Economy of

proved international financial connections, investors and issuers are able to shift capital quickly from one country to another.

In a world where both investor capital and issuer demand for capital are mobile, countries compete to attract market participants. An increase in the number of market participants adopting a particular country's regulatory regime leads to more tax revenue,[11] a greater willinguess by issuers to access the country's capital markets, and a stronger incentive for companies to invest resources in the country to raise awareness among market players and obtain political clout.[12]

Like domestic regulatory competition among states within the United States, regulatory competition among countries may theoretically result in either a race-to-the-bottom or a race-to-the-top.[13] Where different types of investors and issuers exist, however, regulatory competition is likely to lead to neither race but rather to a separation among the regulatory regimes of different countries.[14] Some countries may cater to high quality issuers, supplying strong antifraud protections and requiring significant disclosure. Other countries may cater to lower quality issuers, providing a quick and relatively inexpensive means to raise capital. As countries seek to establish a niche for themselves in the international competition for securities issues, a spectrum of regulations may emerge. Investors, in turn, will discount the price they are willing to pay for securities based on the regime under which the securities are issued or traded. Investors, for example, who believe the U.S. system of regulation is the most stringent and protective of investors will pay more for securities governed by U.S. law.

Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities (1997) (unpublished manuscript on file with authors) (advocating an issuer nationality approach to securities regulation); Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 AM. ECON. REV. 222 (1991) (examining incomplete diversification of investor portfolios with greater emphasis on domestic securities than international capital markets).

11. For example, countries may force users of their regulatory regime and enforcement apparatus to pay a fee.

12. *See* Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855, 1861 (1997) [hereinafter Choi & Guzman, *National Laws*]. *See also* Howell E. Jackson, A Concept of the Selective Incorporation of Foreign Legal Systems to Promote Nepal as an International Financial Services Center 2 (Sept. 8, 1997) (unpublished manuscript on file with authors) (explaining why Nepal wants to attract international financial activity).

13. *See* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

14. *See* Choi & Guzman, *National Laws*, *supra* note 12, at 1874-82.

In earlier work we pointed out that the reach of American securities laws is overbroad[15] and we developed a theoretical framework in which to analyze the impact of various jurisdictional rules on global securities markets.[16]

This Article offers a detailed discussion of a proposal that was first discussed in our *Dangerous Extraterritoriality* article.[17] The proposal is what we term "portable reciprocity" and recommends a regulatory regime that focuses on regulatory competition and gives issuers and investors the ability to choose the law that governs their transactions.

Countries already enter into what we call "normal" reciprocity agreements with one another. Under a normal reciprocity regime, a country may allow a foreign issuer to sell securities within its domestic jurisdiction while complying only with the regulations of the issuer's own jurisdiction.[18] Normal reciprocity is advantageous for issuers because it decreases the cost of selling securities abroad; by satisfying one country's laws, an issuer is able to sell in both countries. Normal reciprocity also increases the regulatory choices to investors who are unable to shift capital abroad. By raising capital mobility in this way, normal reciprocity increases regulatory competition.

Portable reciprocity goes one step further. Under portable reciprocity, issuers may select the law of any participating country regardless of the physical location of the securities transaction. Indeed, investors and issuers have the option of opting out of any regulatory regime, perhaps substituting private contractual protections.[19] In this sense, portable reciprocity encompasses freedom of contract. It also works to delink the choice of regulatory regime from the choice of capital market. For example, U.S. issuers may have access to the New York Stock Exchange ("NYSE") under a portable reciprocity regime while complying with any participating country's securities laws. Once a regime is chosen, compliance with that

15. *See* Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Laws*, 17 NW. J. INT'L L. & BUS. 207 (1996) [hereinafter Choi & Guzman, *Dangerous Extraterritoriality*].

16. *See* Choi & Guzman, *National Laws*, *supra* note 12.

17. *See* Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 15, at 231-33 (setting out the basis contours of portable reciprocity).

18. *See* Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 6902, Exchange Act Release No. 29,354, 56 Fed. Reg. 30,006 (July 1, 1991) (to be codified at 17 C.F.R. pts. 200, 201, 210, 229, 230, 239, 240, 249, 260 & 269) [hereinafter Multijurisdictional Disclosure].

19. Regulatory regimes provide protections unavailable through private contract, including public enforcement and monitoring, criminal sanctions, and scale economies.

regime is sufficient to allow trading in, and sales to citizens of, all participating countries. A Japanese company, for example, could choose German law to cover its securities offerings within the United States and all other participating jurisdictions.

Part II of this Article discusses the current regulation of international securities markets and analyzes the regulatory competition among countries. Part III presents the argumeut for a portable reciprocity regime by examining its advantages and disadvantages compared to the current regimes. Part IV demonstrates that portable reciprocity furthers the goals of securities regulation. Part V compares portable reciprocity to alternative international securities regulatory schemes and discusses why portable reciprocity is a preferable choice.

II. THE CURRENT U.S. SECURITIES REGIME

All countries with substantive securities laws apply them, at the very least, within their own territory. The laws of the United States are designed primarily to apply within the United States, just as the laws of Australia are targeted primarily to events occurring within Australia. However, countries sometimes seek to extend the reach of their laws beyond their borders to people or assets in other jurisdictions. Germany, for example, may seek to apply its laws extraterritorially to transactions that take place in Russia but that impact German markets or investors. Before presenting the portable reciprocity approach to international securities regulation, an overview of the American domestic securities regime and its extraterritorial application will help establish a benchmark with which to assess the impact of portable reciprocity.[20]

Transactions implicating the extraterritorial elements of existing U.S. securities law are commonplace and can take a variety of forms. This Article focuses on two of the more important areas: (1) the issuance of securities internationally under the Securities Act of 1933 ("Securities Act") and (2) the international application of Rule 10b-5's antifraud rule of the Securities Exchange Act of 1934 ("Exchange Act").[21]

20. Resources discussing U.S. securities regulation are plentiful and we simply mention a few. *See, e.g.*, RICHARD W. JENNINGS, HAROLD MARSH, JR. & JOHN C. COFFEE, SECURITIES REGULATION (1992); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION (1995); Don Berger, *Offshore Distribution of Securities: The Impact of Regulation S*, 3 TRANSNAT'L LAW. 575 (1990); Samuel Wolff, *Offshore Distributions Under the Securities Act of 1993: An Analysis of Regulation S*, 23 LAW & POL'Y INT'L BUS. 101 (1992); John R. Coogan & Thomas C. Kimbrough, *Regulation S Safe Harbors for Offshore Offers, Sales and Resales*, INSIGHTS, Aug. 1990, at 3.

21. Rule 15a-6 of the Exchange Act covers the extension of broker-dealer registration requirements to foreign brokers and dealers. *See* 17 C.F.R. § 240.15a-6 (1998). The extraterritoriality of Rule 15a-6's application is beyond the scope of this Article.

A. THE REACH OF THE SECURITIES ACT

Section 5 of the Securities Act forms the lynchpin of the Act, covering all offers and sales of securities. Under Section 5, an issuer must file a registration statement containing numerous disclosure items relating to the issuer and the securities transaction and, under certain circumstances,[22] distribute a prospectus containing a portion of this information to investors before sales are allowed.[23] Most nonissuer sales of securities, however, are exempt from Section 5 under Section 4(1) of the Securities Act.[24] As a result, the primary impact of the Securities Act is to regulate sales of securities by issuers.[25] For issuers, the Securities Act takes a broad reach. By its terms, Section 5 covers all offers and sales of securities that make use of "any means or instruments of transportation or communication in interstate commerce."[26] The definition of interstate commerce provided in Section 2(7) of the Securities Act[27] includes transportation or communication "between any foreign country and any State, Territory, or the District of Columbia."[28] Taken literally, this provision extends American jurisdiction over all offerings anywhere in the world that have some connection, no matter how remote, with the United States. For example, transactions that make use of telephone calls to the United States either in the selling of securities or in the preparation for the sale may fall under Section 5's literal jurisdiction.

Despite the expansive coverage the Securities Act takes on its face, the SEC has not sought to push the jurisdictional limits of Section 5, choosing instead to adopt a more restrained approach through Regulation S.[29] Enacted after a period of confusion and uncertainty that ran from 1964

22. For example, a Section 10(a) prospectus must accompany or precede any additional written materials sent to potential investors after the effective date of the registration statement. *See* 15 U.S.C. § 77e(b)(2) (1994).

23. *See id.* § 77e. Section 5 contains numerous other requirements relating to the registration process and the delivery of the prospectus to investors.

24. Section 4(1) exempts all "transactions by any person other than an issuer, underwriter, or dealer" from the registration requirements of Section 5. *Id.* § 77d(1).

25. Because anyone selling for a control person is considered an underwriter under Section 2(11) of the Securities Act, control persons generally are prohibited from using Section 4(1)'s exemption from Section 5. *See id.* § 77b(11). As a result, control persons must find some other exemption to Section 5 or else have their securities registered by the issuer.

26. *Id.* § 77e. Regulation S provides guidance on what securities transactions outside the United States may be subject to Section 5. *See* 17 C.F. R. §§ 230.901-.904 (1998).

27. 15 U.S.C. § 77b(7) (1994).

28. *Id.* The application of Regulation S, therefore, turns on whether a transaction is deemed to occur outside the United States.

29. *See* 17 C.F.R. §§ 230.901-.904. For more detailed discussion of Regulation S and related securities regulations, see Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 15; Guy P.

to 1990,[30] Rules 901 through 905 of the Securities Act form the body of Regulation S and take a primarily territorial approach to jurisdiction. Under Regulation S, issues made "outside" the United States are exempt from the registration requirements of Section 5.[31] In particular, the regulation establishes two safe harbors from Section 5. The issuer safe harbor under Rule 903 requires that the offer or sale be made in an offshore transaction, that there be no directed selling efforts within the United States and that issuers satisfy certain other requirements based on the likelihood that the securities will "flow back" into the United States.[32] Rule 904 provides a safe harbor for the purpose of the resale of securities by individuals "other

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Lander, *Regulation S—Securities Offerings Outside the United States*, 21 N.C. J. INT'L L. & COM. REG. 339, 341 (1996); Marc I. Steinberg & Daryl L. Lansdale, Jr., *Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market*, 29 INT'L LAW. 43 (1995); Kellye Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927 (1994); Samuel Wolff, *Recent Developments in International Securities Regulation*, 23 DENV. J. INT'L L. & POL'Y 347 (1995).

30. This confusion was caused by Securities Release No. 4708, which attempted to limit the reach of American law by exempting offerings made in a manner reasonably designed to preclude distribution or redistribution in the United States or to U.S. nationals from Section 5's registration requirements. *See* Registration of Foreign Offerings by Domestic Users, Release Nos. 33-4708 and 34-7366, Fed. Sec. L. Rep. (CCH) ¶ 1361, at 2123 (July 9, 1964). In the wake of Release No. 4708 came a large number of no-action letters that failed to shape the policy. "[M]ost companies were compelled to seek an individualized determination by the Commission's staff that their particular offerings would not be deemed to occur in the United States." Testy, *supra* note 29, at 939. One consequence of the law prior to Regulation S was that American investors found it difficult to invest in offerings made by foreign issuers (who were not discussed in Release No. 4708 and whose status was uncertain). These issuers feared that the presence of an American investor would trigger a registration requirement in the United States. *See id.* In February 1998, the SEC promulgated reforms to Regulation S to restrict the ability of purchasers of Regulation S securities to resell the securities back into the United States. *See* Securities Act Release No. 7505, *supra* note 7, at 80,156.

31. 17 C.F.R. § 230.901. All transactions exempt under Regulation S must satisfy two basic requirements. First, a transaction occurs outside the United States only if "the offer or sale is made in an offshore transaction." *Id.* §§ 230.903(a), .904(a). The definition of "offshore transaction" requires that the offer not be made to a person inside the United States, that either the buyer is outside the United States at the time of sale (or the seller reasonably believes the buyer is outside the United States) or the transaction is "executed in, on or through a physical trading floor of an established foreign securities exchange that is located outside the United States" (for Rule 903), or that the transaction is "executed in, on or through the facilities of a designated offshore securities market" and that the seller does not know that the transaction has been prearranged with a buyer in the United States. *Id.* § 230.902(i).

The second basic requirement of Regulation S is that sellers cannot make any "directed selling efforts" within the United States. *Id.* §§ 230.903(b), .904(b). The definition of directed selling efforts "means any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered." *Id.* § 230.902(b). Although the offer and sale portion of the transaction may take place outside U.S. territorial borders, other preliminary steps may actually occur within the United States.

32. The issuer safe harbor is the core of Regulation S and is set forth in Rule 903. *See id.* § 230.903. For a more detailed discussion of the requirements of Rule 903, see Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 15, at 211-15.

than the issuer, a distributor, any of their respective affiliates . . . or any person acting on behalf of any of the foregoing."[33] An offer or sale that satisfies either Rule 903 or 904 is deemed to occur "outside" the United States for the purposes of Rule 901 and, therefore, is exempt from Section 5.[34]

B. THE REACH OF THE ANTIFRAUD RULES

Regulation S grants issuers of securities in foreign markets some measure of protection from the Securities Act's registration requirements. With this exemption also comes relief from the transaction-specific antifraud rules, which apply to the public offering documents. Section 11 liability,[35] applicable only to fraud in the registration statement, no longer applies to transactions exempt under Regulation S. Similarly, Section 12(a)(2),[36] covering only prospectuses pursuant to a public offering,[37] may also lack force.

At least one antifraud provision, however, may still apply. Rule 10b-5 under Section 10(b) of the Exchange Act covers all transactions "in connection with the purchase or sale of any security."[38] Where other transactions exempt from Section 5—including intrastate offerings and private placements—also avoid Section 11 and Section 12(a)(2) liability, they still remain subject to Rule 10b-5. The question remains, therefore, as to how far the reach of Rule 10b-5 extends to cover overseas transactions.

As is the case for the Securities Act's registration requirements under Section 5, the Exchange Act restricts the reach of Section 10(b) and Rule 10b-5 only through its requirement that there be some use of interstate commerce.[39] The exact extent of this reach, however, is uncertain. Section 10(b) of the Exchange Act only makes it unlawful to employ "any manipu-

33. 17 C.F.R. § 230.904.

34. Foreign issuers in particular care about escaping the financial disclosure items of Section 5's registration statement that relate to accounting disclosures pursuant to the generally accepted accounting principles (GAAP). *See, e.g.*, Nicholas G. Demmo, Comment, *U.S. Securities Regulation: The Need for Modification to Keep Pace with Globalization*, 17 U. PA. J. INT'L ECON. L. 691, 693 (1996).

35. 15 U.S.C. § 77l(a)(2) (1994).

36. *Id.* § 77k.

37. *See* Gustafson v. Alloyd Co., 513 U.S. 561 (1995). *Gustafson* left open the issue of what is a "public offering" for purposes of defining a "prospectus" and restricting the application of Section 12(a)(2) antifraud liability. Justice Ginsburg, in dissent, notes that "public offering" meant not only Section 5 registered offerings but also "transactions that would have been registered had the securities involved not qualified for exemption under § 3." *Id.* at 596 & n.1 (Ginsburg, J., dissenting).

38. 17 C.F.R. § 240.10b-5 (1998). In 1948, the Commission adopted Rule 10b-5, which provides an enforcement mechanism for Section 10(b).

39. *See id.*

lative or deceptive device or contrivance" when using "any means or instrumentality of interstate commerce or of the mails" for purchasing or selling securities.[40] Section 3(a)(17) of the Exchange Act, in turn, defines interstate commerce as "trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof."[41] Section 30(b) of the Exchange Act exempts "any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe."[42] Unlike Regulation S, however, the SEC has not clarified the reach of Rule 10b-5 outside the United States. Instead, Section 10(b)'s scope has been left to the courts, which have grappled with the issue of extraterritoriality on a case-by-case basis.[43]

Today, the question remains: To what extent can American laws govern activity that takes place outside U.S. borders? Courts have applied two tests to answer this question—the conduct test and the effects test.[44]

First, under the conduct test, jurisdiction is conferred on events based on their location. In the case of securities, such a rule would allow the issuer and investor to avoid the jurisdiction of any country simply by moving their transaction abroad. The rule of territorialism is the simplest of the possible jurisdictional rules, because it partitions the world neatly into separate legal regimes. Every country legislates with respect to its own geographic territory and imposes its own rules.[45]

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40. 15 U.S.C. § 78j(b) (1994).

41. *Id.* § 78c(a)(17).

42. *Id.* § 78dd(b).

43. *See, e.g.*, MCG, Inc. v. Great Western Energy Corp., 896 F.2d 170 (5th Cir. 1990); Zoelsch v. Arthur Andersen & Co., 824 F.2d 27 (D.C. Cir. 1987); Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc., 592 F. 2d 409 (8th Cir. 1979); Des Brisay v. Goldfield Corp., 549 F.2d 133 (9th Cir. 1977); SEC v. Kasser, 548 F.2d 109 (3d Cir. 1977); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968).

44. Additionally, the RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES (1987) provides guidance on extraterritoriality. *See also* Gary B. Born, *A Reappraisal of the Extraterritorial Reach of U.S. Law*, 24 LAW & POL'Y INT'L BUS. 1, 37 (1992) (analyzing the Restatement).

45. The principle of territoriality was bluntly expressed by the Supreme Court in *American Banana Co. v. United Fruit Co.*, 213 U.S. 347 (1909), a case in which an American plaintiff sought damages in an antitrust claim against an American defendant for actions alleged to have occurred in Costa Rica. *See id.* at 354-55. For the Court, Justice Holmes held that American courts lacked jurisdiction over the dispute, stating that "the character of an act as lawful or unlawful must be determined wholly be the law of the country where the act is done." *Id.* at 356. This rule is known as the conduct test, because jurisdiction is exercised based on the location of the parties' conduct.

One difficulty with the conduct test is defining what actions count as "conduct" for the purposes of determining territoriality. In a securities transaction, for example, many actions may precede to the ultimate transaction. Telephone calls may cross jurisdictional boundaries, attorneys may conduct cross-border investigations, and funds may flow internationally. A workable conduct test must specify the amount and type of conduct that is necessary to trigger jurisdiction. U.S. circuit courts are split on this question.[46] Where significant conduct occurs in more than one jurisdiction, conflict may exist between two jurisdictions applying a conduct-based rule of territoriality. Two countries, for example, may have enough activity within their borders to trigger conduct-based jurisdiction. This is particularly true for transactions involving securities, an essentially intangible product. Offers and sales of securities may occur simultaneously across the borders of two countries; a seller located in the United States, for example, may telephone buyers located in Sweden to complete a sales transaction. Furthermore, the conduct test provides little guidance to the parties to a transaction regarding which acts are central to the transaction and which are merely preparatory.

The second test used by courts is termed the effects test. This is a less territorialist approach adopted by many countries, including most notably the United States.[47] Within the United States, the seminal case dealing with antifraud securities regulation is *Schoenbaum v. Firstbrook*.[48] In that case, an American plaintiff and shareholder of Banff Oil Ltd., a Canadian corporation, alleged a violation of Section 10(b) of the Exchange Act claiming that the company's controlling shareholders had arranged to purchase shares from the corporation for a price below fair market value.[49] Despite the fact that the transaction took place entirely within Canada, the court held that "the district court has subject matter jurisdiction over violations of the Securities Exchange Act although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors."[50] The *Schoenbaum* court argued that the sale of undervalued stock

46. *See* Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 15, at 217.

47. *See, e.g.*, Offshore Offers and Sales, Securities Act Release No. 6779, 53 Fed. Reg. 22,661, 22,662 (June 17, 1988); John C. Maguire, *Regulatory Conflicts: International Tender and Exchange Offers in the 1990s*, 19 PEPP. L. REV. 939, 949 (1992).

48. 405 F.2d 200 (2d Cir. 1968).

49. Specifically, the plaintiff alleged that the insiders had purchased the shares based on information not yet disclosed to the public.

50. *Schoenbaum*, 405 F.2d at 208.

in Canada would unduly depress stock listed on the American Exchange, thereby generating enough effect on the U.S. market to justify U.S. jurisdiction.[51]

III. PORTABLE RECIPROCITY

A. REGULATORY DIVERSITY

Most of the efforts made through Regulation S and the extraterritorial application of Rule 10b-5 to deal with the increasing internationalization of the securities markets have been misguided. In particular, efforts on the part of American regulators to extend their jurisdiction beyond the borders of the United States fail to regulate the securities market effectively and are subject to much uncertainty in application. Even strict territorial notions of jurisdiction fail to maximize the potential benefits from regulatory competition.

When the United States seeks to regulate foreign activities that may impact U.S. securities markets, several problems arise. First, to the extent foreign-based parties seek to avoid U.S. laws, American regulatory authorities must nevertheless find a means of serving process to them. Even if U.S. regulatory authorities were able to obtain judgment against the parties, they would run into problems enforcing such judgments outside the United States.

Second, to the extent the United States seeks to regulate investment activity abroad, it cannot help but interfere with the regulatory systems of other countries. At the very least, U.S. interference may generate confusion and multiply the costs to investors and issuers. It is also likely to generate tension between the United States and other countries. Moreover, other countries may retaliate, seeking to regulate activities of U.S. parties that impact their countries.

Third, efforts to regulate all transactions that impact the American market regardless of where they occur potentially lead to a policy subject-

51. Note, however, that though *Schoenbaum* is cited as an example of the effects test, the court did not state that an effect on American investors alone was a sufficient basis for jurisdiction. Rather, the court suggested that a listing on a U.S. exchange is an important element in generating sufficient effect on the U.S. capital markets to justify jurisdiction. Nevertheless, the principle of *Schoenbaum*'s effects test has been followed in several other cases. *See, e.g.*, SEC v. Unifund SAL, 910 F.2d 1028, 1033 (2d Cir. 1990) (stating that trading "on the basis of inside information, options of a United States corporation listed exclusively on a United States stock exchange . . . created the near certainty that United States shareholders . . . would be adversely affected"); Des Brisay v. The Goldfield Corp., 549 F.2d 133, 136 (9th Cir. 1977) ("[T]he transaction in question . . . involved the improper use of securities . . . on a national exchange and adversely affected not only the plaintiffs but also the American market . . . .").

ing any securities transaction in the world to U.S. law. Even transactions with no apparent connection to the United States may be required to comply with American law if American investors participate. In a global capital market, this represents an extreme extensiou of the laws of the United States. The problem is dramatically demonstrated by what is sure to become an important venue for trading in securities, the Internet. Although the position of the United States toward trading on the Internet is still being developed, its current jurisdictional approach is expansive. The United States appears to believe that its jurisdiction should be asserted over any offer made on the Internet that is transmitted to the United States.[52] Given that the offeror does not control the location of those who visit the offeror's web pages, any Internet offering may become subject to the laws of the United States, regardless of the offeror's intent.

Likewise, efforts on the part of countries to construct workable international cooperation in securities regulation, although fine in theory, are most likely to fail. In theory, countries may design efficient securities regulations through international cooperation that would be enforced globally. Parties engaging in securities fraud, for example, would find it difficult to escape enforcement under a perfect global regulatory regime. In practice, of course, the existing global regnlatory regime is far from perfect. Although the SEC has met with some success in gaining cooperation from other countries regarding insider trading laws, international cooperation remains limited.[53] Despite the facial success of the SEC's efforts, agreements between countries are often difficult and time consuming to obtain.[54] Moreover, once agreements are signed, couutries must expend resources monitoring compliance. For example, initial evidence on the insider trading laws instituted in Japan and Switzerland demonstrate less than vigorous enforcement.[55] Over time, national regulatory bodies may take over the agreement, adding provisions and

52. *See, e.g.*, John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1227-32 (1997) [hereinafter *Brave New World*].

53. On the one hand, the SEC obtained the cooperation of a number of countries in instituting insider trading laws during the 1980s and early 1990s. *See* James A. Kehoe, *Exporting Insider Trading Laws: The Enforcement of U.S. Insider Trading Laws Internationally*, 9 EMORY INT'L L. REV. 345 (1995). The SEC also obtained understandings from several countries for assistance in enforcement of insider trading prohibitions. *See* Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation*, 4 TRANSNAT'L L. & CONTEMP. PROBS. 69, 86-87 (1994); Kehoe, *supra*, at 359-62.

54. *See* Choi & Guzman, *National Laws*, *supra* note 12, at 1890-92.

55. *See Tokyo Exchange Puts Out Insider-Trading Warning*, WALL ST. J., June 18, 1987, at 45 ("While insider trading in a broad sense is illegal under Japanese law, regulations and enforcement mechanisms lag behind those of other countries.").

increasing the complexity of the regime to enhance the importance of the regulatory agencies.

A better system would encourage regulatory competition among different regimes, which would provide choice to issuers and investors in how they should be regulated. Issuers would have an incentive to opt into a regulatory regime because they benefit from some amount of securities regulation. To the extent investors are less fearful of fraud, for example, investors will be willing to pay more for an issuer's securities. Of course, issuers and investors as a group will not value all forms of regulation. Regulations impose a cost on issuers. For example, stringent mandatory disclosure requirements that force issuers to update their financial statements hourly would impose large administrative costs. As a result, marginal issuers will choose other means of raising capital and investors as a group may expect to receive a lower return on their investment. Therefore, for particular investors and issuers an optimal level of securities regulation exists. Investors and issuers will value all regulations whose value in terms of reducing informational asymmetries exceeds the expense such regulations impose on issuers.

Some commentators have expressed concern that allowing firms to select the applicable regime will lead to a harmful "race-to-the-bottom" as national governments adopt regulations that appeal to the interests of managers rather than those of shareholders.[56] As a theoretical matter, in a world in which all issuers and all investors are the same (meaning that all issuers present the same risk to investors and all investors have the same attitude toward risk), there can exist either a race-to-the-top or a race-to-the-bottom.[57]

Issuers and investors, however, are not all the same. Investors possess varying degrees of sophistication, access to information, and liquidity. Issuers may vary in the cost they must bear to comply with a securities regime and the constraints imposed by other areas of law and contract. The managers of issuers also vary in the incentives they face to behave in their private interest at the expense of the interests of shareholders. Some man-

56. *See, e.g.*, Fox, *Who Should Regulate Whom*, *supra* note 10, at 2503 n.5 (arguing that giving issuers freedom to determine the jurisdiction that will govern disclosure would be "undesirable").

57. *See* Bebchuk, *supra* note 13, at 1435; Winter, *supra* note 13. With respect to state competition for corporate charters, substantial evidence exists that there is a race-to-the-top. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2383-88 (1998) (providing evidence of a race-to-the-top in state corporate law competition). To the extent a race-to-the-top would occur in international competition for securities market participants, our arguments for portable reciprocity as a means of accelerating competition between regulatory regimes are strengthened.

agers, for example, may have differences in their preferences for, and opportunities to engage in, insider trading.

In such a world, different issuers and investors will prefer different regimes. If there is sufficient capital mobility, competition for issues is likely to lead to more than one regime. Countries will find themselves unable to attract all types of issuers and investors, because these securities market participants will not all seek the same regulatory regime. In response, countries will target only a part of the overall market. For example, one country may adopt strict laws and appeal to those issuers that face relatively low costs of disclosure and whose managers do not wish to engage in insider trading or other prohibited activities. Another country might adopt very permissive laws in order to attract low quality issues. These issues would be those that face relatively higher costs of disclosure and that anticipate undertaking activities prohibited in other jurisdictions.[58] Because managers will sort themselves based on regulatory regimes, shareholders will be better able to identify instances where the managers are seeking their own objectives rather than those of shareholders.

Investors will also be able to select the regimes under which they are prepared to invest. For example, a conservative investor who is prepared to accept a lower return in exchange for the protection of strict securities laws would invest in the first regime. On the other hand, an investor who seeks high returns or is otherwise prepared to accept the risks of the second regime will choose to invest there. Many investors will wish to hold a diversified portfolio containing securities regulated by various regimes. The returns on investment in the different regimes will adjust such that the supply of issues is equal to the demand under each regime.

At a minimum, to generate meaningful competition among countries and a value-maximizing separation between different regulatory regimes, issuers and investors must possess the ability to exit any particular regime and select the regulations of an alternative jurisdiction at both low cost and with ex ante certainty. One method of generating such opt-out ability is to strictly apply individual country laws along jurisdictional boundaries. For example, countries could apply a narrowly-based conduct test to determine jurisdiction, enforcing domestic regulations only where the actual transaction is executed on an exchange or through a marketmaker physically located in the jurisdiction.[59] Such a territorial regime would provide issuers and investors with an easy

58. A detailed discussion of how such a diversity of regimes may come about is presented in Choi & Guzman, *National Laws*, *supra* note 12, at 1874-82.

59. *See* Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 15, *passim* (arguing that a clearly defined, territorial notion of jurisdiction will enhance regulatory competition).

means of selecting between different regulatory regimes simply through their selection of an exchange or marketmaker.

Although it has some merit, the strict territorial approach to jurisdiction is not the most efficient means of generating regulatory competition. In fact, maintaining strict territorial boundaries for determining which securities regulations should apply is becoming increasingly anachronistic given the fluid international nature of most capital markets. As well, the territorial approach to jurisdiction ties together two separate aspects of value for investors—the capital located in the country and the particular regulatory regime of the country. Portable reciprocity is able to separate investment decisions made on the basis of particular capital markets from the regulatory protections present in such markets, thereby increasing regulatory competition.

In light of the beneficial impact of regulatory competition among countries, we propose to increase the amount of competition through a portable reciprocity system of regulation. Under portable reciprocity, participating countries would allow issuers to select the securities regime under which transactions of their securities would be governed. Once selected, one set of securities laws would govern all aspects of the issuance and trading of the company's securities, regardless of the jurisdiction in which the actual transactions take place.

B. NORMAL RECIPROCITY

One existing approach to the international regulation of securities is what we term "normal" reciprocity agreements.[60] The United States, for example, has a reciprocity agreement with Canada called the Multijurisdictional Disclosure System ("MJDS").[61] Under this agreement, Canadian issuers that comply with Canada's registration requirements may sell their securities in the United States without having to comply with the Securities Act's registration requirements.

More generally, under normal reciprocity, countries agree to honor one another's laws with respect to certain specified transactions. Suppose, for example, that two countries called A and B are party to a reciprocity agreement. Transacting parties from country A can conduct certain transactions—

60. These agreements are usually simply called reciprocity agreements. We refer to them as "normal" reciprocity to distinguish them from "portable" reciprocity.

61. The Multijurisdictional Disclosure System was established in 1991. Under the MJDS, Canadian issuers may issue securities in the United States while complying only with Canadian registration and disclosure requirements so long as their financial statements conform to U.S. generally accepted accounting principles. However, even under the MJDS, Canadian issuers in the United States are still subject to antifraud laws. *See* Multijurisdictional Disclosure, *supra* note 18.

depending on the specifics of the agreement—within country B without any additional compliance with country B's laws. Normal reciprocity allows some portability of national laws. In particular, parties are freed from having to learn and comply with a new set of laws when they enter a new jurisdiction. Rather, parties may continue to follow their own domestic laws regardless of the jurisdiction in which transactions take place.[62]

Normal reciprocity has the potential to increase the pressure of regulatory competition among countries. For example, consider the current regime in the United States. In the absence of a reciprocity agreement, an issuer that wishes to sell securities in the United States must comply with the requirements of the Securities Act and Exchange Act. In deciding whether to enter the American market, issuers must take into account both the nature of U.S. capital markets and the securities regime. Some issuers may choose to issue within the United States to have access to the capital available in the large and liquid American market, even if the laws of the United States are not favorable. In other words, the United States can attract issuers even if its regime is suboptimal, because it is such an important market. Therefore, there is relatively little pressure on the regulatory authority to adopt more efficient securities laws.

Assume that the United States has a reciprocity agreement with Canada. Under the agreement, Canadian-based issuers may sell in the United States without complying with American securities laws as long as they meet the requirements of Canadian laws. Put another way, Canadian issuers selling in the United States can choose to sell in the United States without following American law.[63] Normal reciprocity increases the ability of issuers to select a particular regime's capital market without also having to choose the regime's regulatory system. In particular, under a normal reciprocity agreement, issuers may choose to enter into a participating country's securities market while complying only with their home securities regime. Alternatively, if the issuer prefers the foreign jurisdiction's regime, the issue may choose to go to the foreign jurisdiction and comply with its securities regulation.

Therefore, to a limited extent, a normal reciprocity agreement between two countries separates the choice of a capital market in which to issue securities and the choice of a securities regime. Canadian issuers need not avoid American capital markets simply because they dislike the American securities

62. Normal reciprocity may be found in many areas of the law outside the securities context. For example, many countries will honor the driver's licenses of other countries. Either the actual driver's license is accepted or individuals may obtain a visitor license by showing their foreign license without having to comply with local testing requirements. Likewise, most countries will accept as valid a marriage license issued by another country.

63. U.S. antifraud laws, however, continue to apply under the MJDS. *See supra* note 61.

regulatory regime. Avoiding a securities regime no longer requires giving up the advantages present in a country's capital markets, including liquidity and publicity among consumers in the particular market.[64] As a result, countries party to a normal reciprocity agreement may experience greater pressure to design their regulatory regimes to accommodate the interests and preferences of both issuers and investors.

This theoretical impact of reciprocity agreements on regulatory competition, although present in theory, is small in practice for at least two reasons. First, countries typically consider such agreements only when the laws of the signatories are extremely similar.[65] The reciprocity agreement between Canada and the United States, for example, exists only because the laws of the two countries offer virtually equivalent protections.[66] Commentators often justify normal reciprocity agreements on the grounds that they serve as mechanisms to reduce the reporting requirements of firms that have already reported within a system offering equivalent information.[67] Second, regulators have traditionally feared that allowing securities to be traded within their country but under the laws of a foreigu regime would canse confusion among domestic investors. This concern typically reduces the interest of regulators in reciprocity arrangements, which minimizes the number of such agreements and their impact on regulatory competition.

Despite its potential to increase regulatory competition, therefore, normal reciprocity has had very little impact on regulatory decisions. Moreover, even if normal reciprocity agreements were sigued in greater numbers and among countries with different securities regimes, the effect on regulatory competition would still be limited. Issuers seeking to issue in their domestic jurisdiction, for example, could not apply the laws of a foreign jurisdiction even if a normal reciprocity regime were in place. Normal reciprocity only allows an issuer to

64. *See* Choi & Guzman, *National Laws*, *supra* note 12, at 1861 (explaining why countries might compete to attract securities issues).

65. *See, e.g.*, Manning Gilbert Warren III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L.J. 185, 192 (1990) (defining reciprocity as follows: "[I]f one jurisdiction has enacted a regime that follows the same general regulatory principles as another, then each would accept adherence to the other's rules as sufficient in its own jurisdiction.").

66. "The agreement rested on the premise that Canadian and U.S. accounting, disclosure, supervisory, and enforcement standards are so similar that each country's documents can be used in the other country without harm to investors." David S. Ruder, *Reconciling U.S. Disclosure Practices with International Accounting and Disclosure Standards*, 17 NW. J. INT'L L. & BUS. 1, 11 (1996).

67. *See* International Tender and Exchange Offers, Securities Act Release No. 6897, Exchange Act Release No. 29,275 [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,803, at 81,741, 81,741 to 81,746 (June 5, 1991) (stating that the commission intends to develop reciprocity agreements with other countries that offer protections similar to those of the United States).

carry a domestic regime abroad as the issuer seeks capital in other countries. It does not allow a domestic firm to "import" another country's laws. For example, under the MJDS, U.S. issuers are still tied to U.S. securities laws. Indeed, the impact of the MJDS is further reduced by the fact that Canadian issuers in the United States remain subject to American antifraud laws.[68] Normal reciprocity, therefore, does not maximize the potential for regulatory competition.

C. PORTABLE RECIPROCITY

Portable reciprocity extends the concept of reciprocity to include multiple countries, diverse regulations, and greater issuer choice.[69] Rather than simply allowing issuers to engage in transactions abroad on the basis of compliance with the requirements of their home jurisdiction, portable reciprocity allows issuers to choose any of the regimes of participating countries regardless of where the securities are issued. The choice is available even though the participating countries may have radically different regulatory requirements. Portable reciprocity rejects territorial notions of jurisdiction and allows securities market participants to choose the most appropriate regulatory regime for themselves. By rejecting territorial-based jurisdiction, portable reciprocity essentially allows securities market participants to determine the jurisdictional reach of different countries' regimes.

This Section first describes portable reciprocity and its advantages. It then considers the impact of a portable reciprocity regime on regulatory competition. Finally, it discusses potential problems with a portable reciprocity regime and how those problems might be handled.

68. *See* Multijurisdictional Disclosure, *supra* note 18.

69. Although we are likely the first to propose such an expansive approach to reciprocity, others have called for changes in favor of greater reciprocity. *See* Edward F. Greene, Daniel A. Braverman & Sebastian R. Sperber, *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 BUS. LAW. 413, 433-38 (1995) (arguing for greater deference within the United States to the home-country disclosure provisions of foreign issuers meeting certain size and market-following requirements, so long as the disclosure provisions function in a manner comparable to U.S. regulations). Related to reciprocity are proposals to allow certain well-followed foreign companies to issue in the United States under Section 5 while complying with only their own country's financial accounting standards. *See* James L. Cochrane, *Are U.S. Regulatory Requirements For Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58, S63 (1994) (summarizing NYSE proposal to allow "world-class" foreign companies to issue without compliance to generally accepted accounting principles so long as a written explanation describing material differences in accounting practices is supplied).

1. *Portable Reciprocity Explained*

Portable reciprocity is conceptually quite simple. Under a portable reciprocity regime, an issuer of securities may select the regulatory regime that will govern its securities. Once the regime is selected and the issuer has complied with its requirements, securities transactions may commence.[70] Transactions may take place iu any location. The firm, therefore, is able to select a regime and have the regime "travel" with the securities it issues. For this reason, we have termed the regime "portable" reciprocity.

To illustrate how portable reciprocity would change an issuer's options, consider a hypothetical, large, U.S.-based multinational firm called Multitech. Under a portable reciprocity regime, Multitech would be able to duplicate the results of a normal reciprocity regime. It could sell securities in Canada while complying only with U.S. securities laws. However, under a portable reciprocity regime, Multitech could also select from a number of different securities regimes to govern its securities—something it cannot do under normal reciprocity. Multitech could choose to apply the laws of France to a securities offering in the United States. The choice of regime is entirely up to the firm. Furthermore, Multitech's transactions could take place anywhere within participating countries, such as Singapore, Germany, and Mexico. Any combination of issuer nationality, investor nationality, regime choice, and transaction location are permissible under a portable reciprocity regime.

Portable reciprocity offers a host of advantages over the existing American system. It increases the range of investment choices available to investors in any one country. For example, under the current U.S. regime, issuers can ouly gain access to capital in the United States by complying with the American securities regime. Many foreign issuers, in fact, purposefully exclude U.S.-based investors to avoid the application of U.S. securities laws.[71] The current regime, therefore, restricts the flow of capital. American investors are not permitted to invest in some foreign ventures they believe will be profitable, and foreign issuers can only gain access to

70. Default rules would be required should an issuer fail to select a regime. Existing jurisdictional rules, for example, could serve as default rules.

71. *See* Laurie P. Cohen, *Goldsmith Is Shunning U.S. News Media, Seeking to Keep B.A.T Bid From Snags*, WALL ST. J., July 18, 1989, at B6 (reporting that Sir James Goldsmith, in his bid to acquire B.A.T. Industries PLC, a British corporation, intended to exclude both the U.S. media and investors from his bid to avoid the American securities regulatory regime). *See also* MCG, Inc. v. Great Western Energy Corp., 896 F.2d 170, 172 (5th Cir. 1990); Consolidated Gold Fields PLC v. Minorco, 871 F.2d 252, 256 (2nd Cir. 1989).

the capital in the United States if they pay the cost of complying with American laws.

Portable reciprocity increases the regulatory pressure on regulators of participating countries much more than normal reciprocity agreements. For example, unlike a normal reciprocity arrangement, portable reciprocity allows U.S. issuers to offer securities in the United States under the laws of any participating country. The choice of capital markets and the choice of governing law, therefore, are fully separate under the portable reciprocity regime. The increased regulatory mobility that portable reciprocity grants issuers and investors, in turn, affects the incentives of domestic lawmakers to fashion regimes designed to maximize the welfare of securities market participants. First, regulators themselves benefit when many issuers and investors choose to be governed by their regulations. The regulators benefit from the increased size and importance of their own agencies.[72] They may also charge fees to issuers that use the jurisdiction's regulatory apparatus.

Second, issuers that select a particular country's regulatory regime are more likely to issue securities within that country, which increases the volume of securities transactions. For one reason, issuers are guaranteed that investors within the country are familiar with the regime. Also, enforcement is easier within the country. Finally, the infrastructure of the country is geared to its own regime. Although portable reciprocity allows issuers to select a regime from any number of different countries, issuers nevertheless are likely to gravitate to the capital markets of the country whose regime they select. Therefore, the securities volume a particular country receives depends in part on its securities regime.

Third, countries benefit from economies of scale as issuers in other countries choose to apply their securities regime. The country's enforcement body, for example, may enjoy scale advantages as it regulates more transactions. Likewise, private market participants may enjoy scale advantages. Underwriters, for example, may invest in learning only a few countries' regulatory procedures and may find it valuable to apply the same laws to multiple transactions.

Issuers and investors seek out the most efficient regimes for their transactions. Therefore, countries have an incentive to provide such regimes to expand or maintain their financial centers. The resulting regulatory competition improves the efficiency of transactions in a world of heterogeneous issuers and investors, and leads to a separation among

72. For a more detailed discussion, see Choi & Guzman, *National Laws*, *supra* note 12, at 1861.

securities regulatory regimes.[73] By selecting from among these diverse regimes, issuers may not only choose the law under which they agree to operate but also may provide the market with a signal regarding their own quality. When a firm issues in a high quality regime, investors know there is relatively little risk even without examining the disclosures made under that regime. Therefore, the advantages of disclosure are supplemented by the signal provided by the regime choice. This form of signaling exists on the London Stock Exchange. European firms often choose to comply with the disclosure requirements of British securities laws even though it would be permissible to comply with the weaker requirements of their home countries.[74] The signal provided to the market by the selection of a regime would allow more accurate pricing of the security which, in turn, would lead to a more efficient allocation of capital and less risk for the investor.

Finally, portable reciprocity eliminates any disadvantage faced by American firms that currently must comply with one of the most rigorous and expensive regimes in the world.[75] Portable reciprocity treats all firms equally, regardless of their nationality. Every firm can choose from the available national regimes. American firms that are better off under the laws of Singapore, for example, may select those laws for their offering.

2. *Information Overload*

One criticism of normal reciprocity regimes is that they increase confusion among investors. Afraid of a potential "Tower of Babel," some argue that normal reciprocity will result in securities trading under many different regimes and lead to great confusion among investors.[76] Portable reciprocity multiplies the potential number of regimes investors must track. Not only must investors in the United States, for example, worry about foreign companies subject to

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73. In the alternative, if a race-to-the-top arises through regulatory competition, portable reciprocity will magnify the benefits from such a race.

74. *See* G.K. Meek & S.J. Gray, *Globalization of Stock Markets and Foreign Listing Requirements: Voluntary Disclosures by Continental European Companies Listed on the London Stock Exchange*, 20 J. INT'L BUS. STUD. 315 (1989); HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 314 (3d ed. 1995).

75. *See, e.g.*, Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 FORDHAM INT'L L.J. S77, S88 (1994) ("Substantial differentials in disclosure policies, accounting principles, or auditing standards could leave U.S. firms at a competitive disadvantage by disclosing more than their competitors, as well as at a significant cost disadvantage.").

76. Breeden characterized the potential investor confusion as follows:

> [I]f the SEC were to adopt a system of home country exemptions, then U.S. investors would be confronted even today with financial statements prepared under at least forty different sets of accounting principles. That approach actually has been tried in the past, and the results are chronicled in the Bible in the story of the Tower of Babel.

Id.

foreign securities laws, but they must also discern what regime *domestic* companies follow under portable reciprocity. At the very least, investors face additional research costs in determining the value of different legal regimes.

The informational problem, however, is neither large in magnitude nor universal for several reasons. First, investors who seek to ascertain the value of a security already must contend with a myriad of factors that its value, such as the systematic risk of the security, the management of the underlying corporation, and the nature of the corporation's business. Gone are the days when companies issued common stock of a single class. Companies have much more complex capital structures, including debt instruments, warrants, and other derivatives.[77] Valuing a security, even under the current securities regulatory regime, is a complex undertaking. Pricing the value of a regulatory regime on top of these myriad factors adds only incrementally to the cost of determining a security's value.

For companies with the necessary size to seek capital internationally, many investment analysts will follow information relevant to the companies' securities and incorporate such information into the secondary market prices.[78] In addition to the incorporation of information about macroeconomic conditions, industry conditions, firm management, firm capital structure, and many other factors, the market will take into account the value of the securities laws.[79] If the laws serve to protect investors at low cost to the firm, this will be reflected in a higher market price. On the other hand, if the laws provide opportunity for managers to extract value from the firm, this will be reflected in lower prices for the traded securities. Therefore, even unsophisticated investors or those lacking information will rely on the securities price to reflect such information.

Second, in any given country, only a limited number of different regimes may exist in practice. Due to the transaction costs of investing abroad, domestic investors may form the largest body of investors within the country's capital markets. These investors may have the resources to learn about and follow the securities regimes of only a limited number of jurisdictions. Securities gov-

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77. For an early discussion of the impact of derivatives on the valuation of corporate instruments, see Note, *Investor Liability: Financial Innovations in the Regulatory State and the Coming Revolution in Corporate Law*, 107 HARV. L. REV. 1941 (1994).

78. *See* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554-65 (1984) (providing a definition of efficient capital markets).

79. *See, e.g.*, Joseph Grundfest, *Zen and the Art of Securities Regulation, in* MODERNIZING U.S. SECURITIES REGULATIONS: ECONOMIC AND LEGAL PERSPECTIVES 6 (Kenneth Lehu & Robert Kamphuis eds., 1992); J. William Hicks, *Securities Regulation: Challenges in the Decades Ahead*, 68 IND. L.J. 791, 794 (1993); Demmo, *supra* note 34, at 691-92 (1996) (notiug that in 1990, institutional investors held 53% of the value of publicly traded U.S. equity; and accounted for over 70% of the volume).

erned by regimes not followed by investors within the country will encounter a steep discount. To the extent investors are familiar with a preferred set of regimes, informational overload is reduced. Domestic investors are likely to gravitate to their country's own securities regime. Since the domestic regime is well-known to domestic market participants, their information cost in determining the value of regulatory protections for particular securities is reduced. Unlike in the current regime, investors may also gravitate toward other well-known securities regulatory systems.

Third, markets may react to the presence of different regimes through easy-to-distinguish symbols or identifiers. Issuers selecting a relatively investor-protection oriented regime, for example, will have an incentive to advertise their selection to the market to signal the value of their offerings. Lawmakers can assist this identification effort through minimal regulations to protect investors. Domestic lawmakers, for example, may place a duty on broker-dealers to notify investors of the law governing transactions in a particular company's securities. Lawmakers may also force companies to announce clearly their selected regime on all disclosure documents and to local exchanges. To function well, portable reciprocity requires that investors know which securities regime the issuer chose. Regulations requiring clarity and emphasis on the chosen regulatory regime can reduce investor confusion caused by investors' mistaken beliefs about the choice of regime.

Fourth, intermediaries may help provide investors with information on the regulatory status of different securities and issuers. The role of intermediaries in the market is currently much more important than it was even a few years ago.[80] As the securities market becomes more complex, more investors recognize that intermediaries provide a valuable service. The presence of intermediaries increases the proportion of sophisticated investors in the market and reduces the risk of confusion.

Fifth, as electronic trading of securities becomes more popular and more commonplace, whether through conventional methods or more modern ones such as the Internet, it may become more difficult to identify the location of a transaction. Investors may not be able to automatically determine the securities regime of a particular security simply by looking at the identity of the exchange

80. In recent years, institutional investors have risen in prominence and in the amount of total investment funds under their control. *See* John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 847-48 (1994) (noting that the holdings of institutional investors has grown from 23% of all stock outstanding in the United States in 1955 to 38% in 1981, and to 53.3% in 1990); Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 657-58 (1995) (noting that institutions own half the equity in the United States and are responsible for 60% to 80% of the trading volume in the NYSE).

on which it is traded. Indeed, investors may access the securities of many different countries almost instantaneously. In such a world, portable reciprocity may not materially add to investor confusion.

Finally, with respect to the truly unsophisticated investor trading in securities of a company where no efficient price mechanism exists and no intermediaries operate to protect investors, one should not exaggerate the protections afforded by the existing U.S. regulatory regime. Issuers in the United States must comply with compulsory disclosure requirements, but they are not required to limit themselves to high value or low risk issues. To the extent unsophisticated investors either do not read mandated disclosure items or are unable to analyze the value of such disclosure, the U.S. securities protections are limited. Shifting to a portable reciprocity system would not adversely affect such investors and would afford greater choice for the more sophisticated market participants.

3. *Enforcement*

In this section, we discuss how an effective enforcement regime can be established. To be effective, a portable reciprocity regime must include mechanisms to enforce the laws of one country in the territory of another. For example, suppose that Multitech, an American company, issues common stock in Japan under British securities laws. For British securities laws to protect investors who purchase Multitech securities in Japan, there must be some means of enforcing the investors' British securities rights at reasonable cost.

Before proceeding, however, it is important to note that the need for effective enforcement is not solely the problem of portable reciprocity.[81] Rather, it is the result of the transnational nature of an international sale of securities. Even in a world without portable reciprocity, investors engaging in international capital transactions face the risk and additional cost of enforcing their securities rights abroad. This problem is not eliminated by expanding the reach of the laws of the investor's home country. Even with expansive jurisdiction, and even if a judgment is granted in favor of an investor, enforcement of the judgment remains necessary. Such enforcement may require foreigu legal action if there are few assets in the investor's home country.[82]

81. Efforts are underway to make international enforcement more effective. For example, Congress passed the International Securities Enforcement Cooperation Act of 1990 (ISECA), Pub. L. No. 101-550, 104 Stat. 2713 (codified as amended in scattered sections of 15 U.S.C.).

82. The enforcement problem under existing American law is compounded by the fact that, to the extent the law imposes inappropriate levels of regulation, the market will seek to structure transactions that are outside the reach of American authorities. *See, e.g., Brave New World, supra* note 52, at

We begin by considering the forum in which a claim should be adjudicated. Portable reciprocity dictates that the parties should be entitled to choose the applicable law through their selection of the regime. As a general matter, however, the choice of forum is distinct from the choice of law. Nevertheless, the default forum for the adjudication of disputes should be the courts of the country whose law is chosen under portable reciprocity.[83] Note that the discussion that follows outlines a choice of forum rule that can be altered by issuers. For the same reasons contractual freedom in the choice of law should exist, parties should be free to select a forum. The discussion also outlines some of the principal concerns that issuers and investors have when they choose a forum.

At least four potential fora exist for the litigation of disputes: the *trading* jurisdiction, where the actual securities transaction takes place; the *regime* jurisdiction, where the securities regulations are promulgated; the *issuer* jurisdiction, where the issuer resides; and the *investor* jurisdiction, where the investor resides. In a purely domestic regulatory regime, the question of which forum to choose does not arise because the home country encompasses each of the possibilities. In the U.S. market, for example, American investors may file suit against domestic companies alleging a violation of U.S. securities laws. In a portable reciprocity regime, however, the four options may represent four different jurisdictions.

Consider the issuer jurisdiction, the home of the issuing company.[84] This forum provides the most convenient location for investors to attach the assets of the issuing company as well as impose liability on individual company defendants. If a judgment is handed down by the court of the home jurisdiction, the judgment is immediately enforceable against the assets of the company. Therefore, the issuer jurisdiction presents the forum with the lowest enforcement costs against issuers. The issuer jurisdiction also makes it possible for investors valuing a security to turn to a single reference jurisdiction for their valuation, regardless of the location of the transaction or of the investors.

The issuer jurisdiction, however, has several problems. Under portable reciprocity, issuers from several countries may apply the laws of a particular regime. Investors holding a portfolio of securities governed by

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1228-30 (discussing how a foreign market for U.S. stocks could arise that would be beyond the ability of American authorities to enforce U.S. law).

83. International arbitration is an appealing mechanism through which to enforce a portable reciprocity regime. We discuss the advantages and disadvantages of such a system in Part III.B.3.

84. One possible definition of the issuer jurisdiction would be the jurisdiction in which the issuing company conducts its principal place of business. Alternatively, the definition could focus on the issuer's country of incorporation.

the laws of a single regime may need to turn to a number of different jurisdictions, depending on where issuers are located, to enforce their securities rights. For example, an investor in the United States who wants the protection of American law and who does not want to have to pursue remedies abroad can only invest in securities issued under the American regime *and* issued by American firms. In valuing the protection of a securities regime, investors must also account for the location of issuers. This increases the investors' cost of valuing a particular regime's protections. Where the issuer jurisdiction differs from the regime jurisdiction, courts in the issuer jurisdiction may also lack the expertise to analyze and interpret the laws of the regime jurisdiction.[85] Furthermore, even if the issuer jurisdiction were able to enforce the laws of the regime jurisdiction, the development of the law around a particular securities regime would be retarded and inconsistent. Where different regimes apply their own precedents, for example, a multitude of different subsets of the chosen securities regime's laws would arise.

Consider the merits of the investor jurisdiction. The investor jurisdiction presents the most convenient location for investors to file suit for securities fraud or other violations of the chosen regime's regulatory requirements. Because investors may be located in several different locations, however, the forum will vary depending on the parties to a transaction. This increases the amount of information required to value different securities. To the extent that the rules of procedure vary from forum to forum, for example, the value of the protections offered by the chosen securities law may vary based on the country of the investor. Courts also may interpret the laws of a particular regime inconsistently, making the protections afforded to investors further dependent on their nationality.[86] The development of precedent in the regime jurisdiction may be retarded and courts in the investors' jurisdiction may lack the expertise to competently analyze the regime jurisdiction's laws. Finally, investors may find it difficult to enforce judgments against issuers when there are no assets within the jurisdiction.

Consider next the trading jurisdiction. The trading jurisdiction may contain the most information relevant to the transaction at issue,[87] which may

85. Differences in language, legal traditions, and substantive law, for example, could make it extremely difficult for the judges of one country to decide cases based on the laws of another.

86. Class actions also may become more difficult or even impossible where investors are located across multiple jurisdictions under an investor jurisdiction choice of forum approach.

87. In practice, the trading jurisdiction cannot be counted on to have even this advantage. Once the transaction is completed, all relevant documents may leave the trading jurisdiction and be kept instead in the home country of the issuer. Thus, the issuer jurisdiction and the regime jurisdiction (where the issuer will file any documents required to comply with the securities laws) may well have more relevant information than the trading jurisdiction.

make the trading jurisdiction a relatively low cost forum. Nevertheless, technological advances have reduced many of the trading jurisdiction's advantages as the primary venue for enforcement. For example, information on actual transactions can easily be obtained and transmitted through global communications to any other jurisdiction around the world.[88] The trading jurisdiction also poses problems similar to the issuer and investor jurisdictions. Because a company's securities may potentially trade across several different jurisdictions, interpretation and application of the regime jurisdiction's laws may vary based on the particular trading jurisdiction. Over time several different subsegments of precedent based on each particular trading jurisdiction may arise. In addition, an issuer may engage in a wrongful act that impacts trades across many jurisdictions. Focusing on the trading jurisdiction, therefore, may lead to scattered and inconsistent enforcement.

Finally, consider the regime jurisdiction. The regime jurisdiction provides the most stable location for enforcement of the securities regulatory regime. Regime jurisdiction regulators have the most expertise and incentive to develop regulations to maximize welfare both in terms of the substantive law and enforcement. To the extent enforcement occurs efficiently and effectively, the regime's laws are given higher value by both issuers and investors who find the regime more attractive for future issues. Also, the more parties choose to use a given regime's laws, the more likely they are to issue securities within the borders of the regime country. This is so because investors located in the regime country understand the regime's own regulations better. Moreover, enforcement may occur more vigorously in the regime jurisdiction because it is upholding its own laws, which has a positive effect on the country's legal system generally. An additional advantage of the regime jurisdiction is that it provides investors and issuers with a single forum in which to value the securities. The nationality and location of the issuer and investors are not necessary to assess the value of the securities regime.[89]

In addition to resolving many of the problems present in the alternative enforcement jurisdictions, the regime jurisdiction avoids the need for the courts of several countries to review a single set of facts. Suppose, for example, that the issue of a security leads to the filing of lawsuits by many investors. If either the trading jurisdiction or the investor jurisdiction act as the jurisdiction for enforcement purposes, multiple proceedings may be required to resolve a dispute arising from a single set of facts.

88. The same technological advances also mean that transactions can take place in countries in which the traditional informational advantage of the trading jurisdiction is absent.

89. Of course, it may be necessary to know whether or not the home country of the issuer (or other countries in which the issuer has assets) will honor a judgment from the regime jurisdiction.

This Article recommends that the regime jurisdiction be designated as the default enforcement jurisdiction in a portable reciprocity system. Parties seeking to enforce French law, for instance, may turn to French courts for enforcement. French securities regulators likewise may be responsible for the public enforcement of French securities laws where applied in foreign jurisdictions.

Parties should be allowed to opt out of the default regime jurisdiction by so specifying when the transaction takes place. In practice, however, because of the regime jurisdiction's advantages in providing accurate, easily valued, and consistent execution of the regime's securities laws, most parties are likely to select the enforcement jurisdiction.

Some may argue that an enforcement mechanism based on the regime jurisdiction is unworkable to the extent that assets, litigants, and information on events at issue are all located abroad. Where a German company selects the laws of the United States for its securities transactions, for example, investors located in Mexico may not have the ability to travel to an American court to obtain a judgment and enforce it against assets located in Germany. There are several responses to this criticism.

First, these concerns are not unique to portable reciprocity. As discussed in Part II, both Regulation S and the Exchange Act's antifraud rules contemplate application of U.S. laws abroad where American interests are at stake. Consider the previous example. A German company issues its securities in the United States subject to American law. A Mexican citizen who purchases those securities must turn to the courts of the United States to seek judgment for any wrongdoing by the company and may then have to turn to Germany to enforce the judgment. This example shows the difficulties of enforcement present under existing law. Indeed, they are unavoidable in a global market. With interconnected financial markets and communications media, it is difficult to maintain a purely geographical notion of jurisdiction with respect to capital markets.

Second, although it is true that forcing litigants to enforce their securities rights in a foreign jurisdiction and collect information located abroad increases the cost of enforcement, modern communications reduces the cost of obtaining information internationally. Similarly, international travel is also much more frequent today than in the past, further reducing the marginal cost of international transactions.

Issuers and investors will take these costs into account when selecting a regulatory regime. In practical terms, companies will only choose a securities regime where information and travel costs are not excessive. Regimes that entail high transaction costs for enforcement will be valued less by investors. If there is an inexpensive way for issuers to reduce the cost of enforcement, they will do so to attract investors.

This implies that investors will have a natural advantage when purchasing securities governed by their own regime's regulations. Portable reciprocity thus will not result in perfect competition among regulatory regimes, but it will enhance the possibility of competition. Even though regimes will enjoy some home field advantage with respect to their own issuers and investors, issuers and investors will still switch to other regimes that provide significantly more valuable regulations.[90]

Third, the assets of issuers may be reached through treaty agreements. Under a portable reciprocity treaty, different countries may agree to honor securities judgments rendered against companies that voluntarily accept the regime of another country. The portable reciprocity arrangement may break down, however, where countries refuse to honor different country judgments against the issuer. Issuers may select the regime of a particularly stringent jurisdiction while hiding their assets behind a jurisdiction unwilling to honor judgments of another country.[91] Where issuers engage in such opportunistic behavior, however, investors will reduce their valuation of the issuers' securities. Not only wonld investors not give the issuer credit for undergoing the scrutiny of a stringent securities regulatory regime, but investors also would take the issuer's attempt to protect its assets from judgment as a signal that the issuer is most likely going to engage in fraud.[92]

Issuers will therefore have incentive to expose themselves to potential judgments as a means of bonding themselves to the particular securities regulatory regime they select. For example, issuers that choose to be governed by the German securities regime will have incentive to place assets within the reach of German courts to bond themselves to the regime.[93]

90. One possible effect of this "home field advantage" is that issuers may choose to issue their securities under the laws of more than one country. If compliance with a country's regime is sufficiently inexpensive, then issuers may choose to comply even though they are already in compliance with a different regime. By doing so, they reduce the cost of investment for potential investors from that country and, accordingly, make it easier to sell the issue.

91. For example, suppose the U.S. regime is considered extremely pro investor and provides stringent market protections. An opportunistic issuer may select the U.S. regime under a portable reciprocity arrangement but keep the majority of its assets located in jurisdictions where U.S. enforcement may be difficult.

92. Note that this problem can also exist under the current regime. For example, an issuing firm that must comply with the securities laws of the United States can locate assets in a jurisdiction that does not honor American judgments.

93. In some cases, such bonding strategies will clearly be inefficient. The fact that a country has the best securities regime for a particular issue does not imply that it is the most desirable location for

Where enforcement occurs through the regime jurisdiction's own regulatory apparatus, an additional problem exists. To the extent taxpayers of the regime country pay for much of the judicial apparatus, foreign users of the home securities regime are subsidized in their use of the regime country's laws and courts. For example, suppose that Singapore establishes a securities regime that companies decide to employ across the world. A Russian issuer selling securities in the Netherlands but choosing Singapore's securities regime would then rely in part on Singapore's judicial apparatus for private litigants to enforce their rights. In addition, investors would rely on Singapore's public enforcement apparatus. Singapore, however, may not wish to pay for either the judicial apparatus costs or the public enforcement costs for securities transactions that occur almost completely in foreign jurisdictions. Several straightforward solutions exist to this problem.

First, enforcement officials from the regime jurisdiction may welcome foreign companies adopting their enforcement regime for use in foreign jurisdictions. The more companies that adopt a particular country's regime, the more likely it is that the companies themselves will choose to invest resources in the regime as a means of bonding to the regime's enforcement. Therefore, expanded securities regulation may serve as a means of obtaining international investment in a regime jurisdiction country.

Second, companies adopting a particular regime's regulatory apparatus have a greater incentive to issue securities within the jurisdiction's capital markets. Because investors in the regime jurisdiction know the regime's own securities laws well, the costs of issuing under the regime's laws are cheaper within the regime jurisdiction. Operating a value maximizing securities regime, therefore, increases the securities volume in a regime jurisdiction.

Third, the officials who manage the regulatory regime in a country have a strong stake in increasing volume and are unlikely to object to increased use of national laws. For example, greater volume leads to increased prestige and power for those who administer the American regime. The interests of individual officials operate as a strong counterbalance to any concern that local laws are being applied to "foreign" transactions.

Finally, enforcement officials in a regime jurisdiction can charge a fee to issuers seeking to avail themselves of the regime's securities apparatus and enforcement resources. The cost of enforeement can easily be internalized by the issuers.

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investment. Where such bonding is inefficient, however, the market will discourage it and more efficient alternatives such as arbitration will be pursued.

This discussion has focused on enforcement through national court systems. However, parties should be permitted to opt out of the regime jurisdiction. The regime jurisdiction is the most favorable default rule, but the details of a specific transaction may require a different forum in which to adjudicate.

4. *Path Dependence—Excessive Inertia*

For issuers, investors, and financial intermediaries, learning the regulations of a particular regime is costly. Because securities regulation is a dynamic field, capital market participants must expend considerable resources to keep up with developments in particular regimes. Rather than shoulder the costs of keeping abreast of every regime, capital market participants may learn the regulations of only a few different countries. Therefore, portable reciprocity may result in only a few different operative regimes in the world.

Small countries in particular may find that opening their countries to a portable reciprocity regime would result in the demise of their own domestic regulatory system. To the extent the country's domestic market is relatively small, few investors within the international marketplace may know about the regulatory system. Companies may induce investors, particularly those from other countries, to invest in their securities only if they adopt the securities regulatory regime of another country.

The resulting small number of regimes in turn may develop excess inertia and stop evolving to meet the needs of issuers. Because investors have already spent resources to learn about a few countries' regimes, they may be reluctant to switch to other regimes. Even regimes that increase the value to issuers and investors may not gain converts if the cost of learning about the regime is high.

For several reasons, however, excessive inertia is unlikely to occur. First, legal intermediaries can specialize in learning the laws of different countries and provide issuers with a menu of different legal options. Small investors may not find it worthwhile to employ these legal intermediaries. However, large institutional investors are likely to find it cost-effective.

Second, smaller countries may choose not to develop completely different regimes from larger country regimes, but rather design regimes that are incrementally different in clear and easy to understand ways. Some smaller countries, for example, may adopt the U.S. regime in whole but remove insider trading prohibitions. Because the rest of the small country's regime would be the same as the U.S. regime, the costs of learning about the new regime are reduced.[94]

5. *Overlapping Regulations*

Securities regulation does not exist in isolation. Rather, the securities regime of a particular country may operate in conjunction with other bodies of law, including the country's criminal, corporate, and antitrust laws. Opponents of portable reciprocity may argue that allowing issuers and investors to pick and choose their securities regulatory regime results in significant coordination problems with other aspects of law that govern corporations and investment vehicles. For example, the U.S. securities regime regulates not ouly the public offering of securities but also the proxy voting process.[95] Companies may avoid the U.S. regulatory regime not because they fail to value its investor protections but because they dislike the U.S. proxy regulations. Alternatively, an American corporation may decide not to select another country's securities laws because they are mismatched and negatively impact other U.S. laws applicable to the corporation.

Several responses are possible to the coordination problem of overlapping regulations. First, countries entering into a portable reciprocity arrangement may specify that only certain functional aspects of their regulatory regime are portable. For example, the U.S. securities regime is quite broad. Regulators may agree to allow portable reciprocity only for those provisions that govern the primary issuance of securities into a market. By focusing on functional aspects, countries participating in a portable reciprocity regime may increase the ability of issuers and investors to compare different regimes and make choices based on desired provisions. Nevertheless, even where portable reciprocity focuses on functional provisions of regulation, some coordination problems may still exist. For example, securities and bankruptcy law intersect when dealing with the disclosure of new securities issued to participants to a reorganization.[96] Companies opting out of the U.S. regime, therefore, negatively impact the ability of reorganization participants to value and obtain information on their rights.

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94. At the turn of the century, for example, Delaware courts adopted precedents from New Jersey's state courts in interpreting Delaware's state corporate law, providing Delaware with an instant reservoir of expertise and experience. *See* Wilmington City Ry. Co. v. People's Ry. Co., 47 A.2d 245, 251 (Del. 1900).

95. The federal proxy regulations are contained in Section 14(a) of the Exchange Act, as well as in Rules 14a-1 through 14a-15 of the same Act. *See* 17 C.F.R. §§ 240.14a-1 to .14a-15 (1998).

96. *See* Richard E. Mendales, *We Can Work it Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1211 (1994).

Where coordination problems reduce the value of other regulations designed to benefit market participants, the amount of mobility brought on by portable reciprocity is reduced. Issuers may choose to remain with a particular country's securities regime becanse the regime meshes well with another regulatory regime that the issuer values.[97] Even where mobility is reduced, however, portable reciprocity still offers some advantages. For example, certain subsets of countries may possess similar legal systems. Importing the securities regulatory protections from one country to another within this subset may still be possible under portable reciprocity.

Second, lawmakers may react to the presence of overlapping regulation desigued to benefit market participants through expanded portable reciprocity. Not only slionld market participants be able to select which securities regulatory regime should apply to their transactions, but it may be desirable to give them their choice of law in other areas of public regulation designed for the benefit of market participants. For example, corporations already may select their form of state corporate law within the United States,[98] and several commentators support offering firms the ability to choose bankruptcy law contractually.[99] To the extent these discrete bodies of law are designed primarily for the benefit of the market participants themselves, similar arguments exist to allow international regulatory competition. Market participants may then decide for themselves the value (or lack of value) they receive from choosing different overlapping regulations from the same country.

On the other hand, where coordination problems reduce the value of other regulations designed for the benefit of third-party nonmarket participants, portable reciprocity may undermine these other bodies of regulation. For example, companies may opt out of a particular regime by choosing an alternative regulatory system not because the alternative maximizes investor welfare but to reduce the effectiveness of third-party regulations. For example, securities regulations in a particnlar country may generate a wealth of corporate information the country may then use in its environmental liability enforcement for the benefit of all its citizens. To prevent portable reciprocity from undermining such third-party protections, countries may wish to tie the choice of a particular securities regime with other regulations that depend on the securities regime's provisions.

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97. For example, the issuer may value a country's bankruptcy regime and prefer to remain with its securities regulatory regime though it may not necessarily place a high value on the securities regime.

98. *See* Bebchuk, *supra* note 13, at 1435-39.

99. *See* Allan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127 (1997); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992).

D. COMPANY REGISTRATION AND PORTABLE RECIPROCITY

Most of the world's securities regimes are transaction-focused. Under a transaction-based system, individual transactions of securities rather than the issuers themselves form the focal point of regulation. For example, regulatory requirements to disclose information in the United States occur when an issuer chooses to sell securities to the public. For such transactions, Section 5 of the Securities Act imposes duties on the issuer and underwriters assisting the issuer to construct a registration statement and include detailed information on the issuer's business and plans for the offering proceeds.[100]

Portable reciprocity readily applies to the current transaction-based mode of securities regulation that predominates today's regulatory world. In transaction-based domestic regimes, portable reciprocity would allow issuers to choose the laws that best apply to each separate transaction. For example, Multitech could choose to have American securities laws apply to a 1996 offering but switch to German law for its 1997 offering. This flexibility, however, may increase the informational overload problem. Investors may be faced with multiple regulatory regimes for the same issuer, causing some chance of confusion among regimes.

Issuers will have an incentive to avoid confusion by maintaining a single regulatory regime. However, this reduces the ability of issuers with multiple offerings of securities to switch to a new regime. A U.S. issuer, for example, that already has issued siguificant amounts of securities into the United States becomes bound to the U.S. periodic reporting requirements. The same issuer, even under a portable reciprocity regime, may find it difficult to switch to issuing securities under French law inside the United States under a transaction-based approach. Although the issuer's current and subsequent offerings may be governed by French law, the issuer's past offering would be under U.S. law and the issuer would still have to meet the U.S. periodic reporting requirements as a result.[101]

The magnitude of these problems is difficult to know without empirical evidence. It should be noted, however, that the issuer will internalize

100. *See* 15 U.S.C. § 77e (1994).

101. A portable reciprocity regime could also allow issuers to switch regimes after their securities are issued. Care must be taken, however, to ensure that the risk of a regime switch does not undermine investor confidence in the protections afforded by the chosen regime. One way to address the risk of an ex post regime switch would be to require the approval of existing holders of securities prior to the switch. Such regime switches should be governed by the law of the regime jurisdiction. In this way, investors can assess the risk that the issuer will change regimes, and the market can price the security appropriately.

these costs and, if they are significant, the issuer can simply issue all stock under the laws of a single country. Although this strategy would reduce the benefits available from a more carefully tailored matching of individual issues with optimal regimes, it would still represent an improvement over the status quo because, even though the issuer must make a once and for all choice, the issuer can at least choose the regime that is most appropriate. In the United States today, on the other hand, issuers are not able to avoid the American regime at all and, in addition, may be subject to multiple regimes when issuing securities abroad.[102]

An alternative solution to the problem is to move to a company registration approach.[103] Under a company registration regime, issuers and not transactions are the primary focus of regulation. Rather than treat the sale of securities as a triggering event for regulation, a company registration system simply reqnires the issuer to disclose periodically business and financial information to the market. Once registered, all securities of the company may be freely traded by investors in the market.[104]

The company registration system has even greater importance in a portable reciprocity regime. Under portable reciprocity, a company may select one country's regime to govern all securities transactions and disclosures. With company registration, investors may easily determine which regime governs a particular company. A company may be governed by at most one regime, so the investor need not track multiple regimes. The company registration system also makes it easier for a company to switch to a different regime. Because the issuer shifts all disclosnres to the new

102. One possible solution to the problem of issuers committing to a single regime would be to allow "midstream" changes of regimes. An issuer could change the regime under which the issuer's securities are traded, including those already issued. A rule of this sort, however, would encounter many problems, including protecting existing investors from such a regime change. *See supra* note 101.

103. The SEC is working on a proposal to introduce company registration into the U.S. market in a limited manner. *See* Securities and Exchange Commission, Report of the Advisory Committee on the Capital Formation and Regulatory Processes No. 1726, Fed. Sec. L. Rep. (CCH) (Aug. 5, 1996) <http://www.sec.gov/rules/concept/33-7314.5xt>. *See also* Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 567 (1997) (critiquing the SEC's company registration proposal).

104. In the purely domestic situation, the company registration system has many advantages over the transaction-based approach. Especially for companies that operate in an efficient market, it is unclear why securities transactions should serve as the focus for regulation. All investors care about a sale of securities, not just those purchasing a particular batch of securities from the issuer. The issuance of securities provides information on the issuer's prospects as well as management's own valuation of the issuer's securities to all investors. Likewise, to the extent the company has publicly available information, there is no reason to restrict the trade of particular subsets of the company's securities. All securities holders benefit from the information contained in the efficient market.

regime, the confusion costs of the switch are minimized, which reduces the cost to switch.[105]

E. PRIVATE CONTRACTUAL ARRANGEMENTS

The increased international mobility of capital presents a profound challenge to traditional notions of regulation. The possibility of multinational fraud poses substantial detection and enforcement problems for individual country regulators. Aside from the actions and decisions of regulators, however, securities markets themselves are evolving to meet the challenges of the global marketplace. Portable reciprocity provides a means to reach a healthy mix of government regulation and private market responses to internalization. This section first discusses possible private market responses and then analyzes the interaction of portable reciprocity with these responses.

Several market responses to internationalization are possible. First, in an effort to make their securities more appealing to investors, issuers may offer assurances through contract as to the truthfulness of their offerings. Through warranties, for example, an issuer may guarantee the value of its securities and alleviate fears among investors that the issuer is overstating its value to obtain higher offering proceeds.[106] To the extent the issuer's own legal system is effective, investors may rely on these warranties and not discount ex ante for the risk of fraud. A portable reciprocity system grounded on assumptions that investors and issuers will select protections to maximize their joint welfare should allow issuers and investors to opt out of public securities regulations and implement warranties instead. Nevertheless, the private warranty system operating on its own has several problems.

First, unlike public regulatory requirements, private contract obligations must be negotiated and drafted by private parties. Although issuers may engage in a warranty contract with private investors during an offering, the issuer may choose not to do so because of the added costs of negotiation and drafting. Thus, even if existing forms are suboptimal, they may be adopted in order to avoid the cost of drafting new terms. The re-

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105. The regulation of a switch from one jurisdiction to another under a company registration regime, like under a transaction-based regime, must be done with care. *See supra* note 101.

106. *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE. L.J. 1297, 1303-09 (1981); Michael Spence, *Consumer Misperceptions, Product Failure and Producer Liability*, 44 REV. ECON. STUD. 561, 569-71 (1977).

sulting inertia of standard form contracts may exceed the efficient level, because parties considering the use of custom terms will take into account only the benefit of those terms to themselves and not to other future users. Charging a fee for the use of contractual terms does not solve the problem because the fee could easily be avoided by making minor changes to the terms.[107] On the other hand, there may be too great an incentive to abandon an existing term to the extent contracting parties ignore the positive externality to others from maintaining a standard set of terms.[108] Put simply, the creation of governing terms for securities law has features of a public good—introducing a market failure that can be corrected by appropriate government intervention.

New terms may also suffer from uncertainty with respect to their likely application by courts. National regulations have a large advantage over private contracts in this respect, because legislatures are better able to guide court decisions through statute than private parties are able to do through contract. A legislature, for example, is able to direct courts to craft exceptions to existing legal doctrines where necessary to support a particular regulatory regime.

Regulations adopted and maintained by a public regulatory body may be both easier to adopt and change over time. Regulators can incorporate the entire benefit to all parties who use the regulations when designing them.[109] Likewise, regulators act as a centralized decisionmaking body in changing the regulations over time.[110]

Second, issuers may be able to make a more credible commitment to remaining truthful by using public regulations rather than private contracts. Through public enforcement, issuers are able to ensure that if they do engage in fraud in cases where private parties lack the incentive to enforce private liability, public enforcement officials nevertheless can uphold the securities regime. Public enforcement may also result in criminal penalties, which private contracting parties cannot provide. Through public

107. A good discussion of this problem can be found in Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1479-80 (1997).

108. *See* Michael Klausner, *Corporations, Corporate Law and Networks of Contracts*, 81 VA. L. REV. 757 *passim* (1995).

109. One possibility would be to allow issuers to choose for themselves what enforcement penalties should apply to them in case of fraud—a notion termed "self-tailored liability." *See* Choi, *supra* note 103 (defining and arguing for a self-tailored liability system).

110. This is subject to the caveat that regulators may be captured by special interests or seek their own objectives in the making of policy.

regulation, therefore, issuers are better able to commit credibly to remaining truthful in their securities disclosures.[111]

Finally, many market transactions do not directly involve the issuer. For example, when one investor purchases the issuer's securities from another investor in a secondary market transaction, the issuer is a not a direct market participant. In such transactions, the issuer is unable to warrant directly the truthfulness of information or the absence of market manipulation. However, issuers have an interest in assuring all secondary market investors that information is truthful and that investors are not subject to a substantial risk of market manipulation. Without this assurance, investors may reduce their valuation of the issuer's securities based on the risk of fraud and market manipulation. Through adoption of a regulatory regime that punishes fraud and market manipulation on the part of investors and other parties, the issuer is able to commit credibly to such an assurance to investors.

IV. PORTABLE RECIPROCITY AND THE GOALS OF SECURITIES LAWS

A. INVESTOR PROTECTION

One of the most cited and intuitive goals of the securities laws is the protection of investors.[112] In the United States, for example, the Securities Act was enacted in large part due to the concern that individual investors were unfairly robbed of their investments during the stock market collapse of 1929.[113] Underlying the notion of investor protection is the assumption

111. Whether criminal sanctions are optimal in the securities context is open to debate. *See, e.g.*, Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232 (1985).

112. The SEC itself viewed investor protection as its principal function for many years. "[T]he Commission has traditionally taken the position that the registration requirements of Section 5 of the Act are primarily intended to protect American investors." Registration of Foreign Offerings by Domestic Issuers Exchange Act, Release Nos. 33-4708, and 34-7366, Fed. Sec. L. Rep. (CCH) ¶ 1362, at 2124 (July 9, 1964). Although the SEC has formally stated that investor protection is no longer its main goal, the current rules retain the characteristics of an investor protection approach. This is evidenced by comparing the rules today and the language included in the release quoted above:

> [I]t is immaterial whether the offering originates from within or outside the United States, whether domestic or foreign broker-dealers are involved and whether the actual mechanics of distribution are effected within the United States, so long as the offering is made under circumstances reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States.

Id.

113. *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 3-5 (2d ed. 1997).

that investors are unable to protect themselves. Investors may lack the resources to request information from issuers and analyze this information on their own. Investors may also act irrationally and make poor investment choices. Securities regulation, therefore, may play a role in forcing companies to provide information truthfully to investors.[114] Increased regulation, however, need not lead to an increase in investor welfare. Compliance costs are not trivial in the United States,[115] and more regulations inevitably increase the costs of compliance. If, at the margin, the costs of compliance exceed the benefits to investors, it becomes more costly to invest, and the return on investment is reduced. If taken too far, regulations justified as protective of investors may actually harm them.

As discussed earlier, portable reciprocity does introduce an additional dimension to the choice of investments. To invest wisely, one must identify the regime under which securities trade. Unsophisticated investors may not take the time to determine the particular regulatory regime. Moreover, naive investors (even with information on the regulatory regime) may not incorporate the value of the regime adequately into the securities. However, the risk of confusion may not be large. Even today, the proportion of unsophisticated investors is dropping as institutional investors rise in their market holdings.[116] The use of stringent regulatory controls to protect the unsophisticated investors necessarily imposes higher costs on issuers, thereby reducing the return to all other investors. As more investors seek to invest through the more sophisticated institutional investors, it becomes less clear whether the protection of the unsophisticated investor is worthwhile, particularly if such protections slow the transition toward institutional investors. For companies whose securities trade in an efficient market, unsophisticated investors may also rely on the market price to incorporate the value of the chosen securities regime.

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114. *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722 (1984). *But see* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-74 (1984). Indeed, without truthful information disclosure, the securities market faces a lemon problem. *See* George A. Akerloff, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970). To the extent investors are unable to distinguish between fraudulent and truthful companies, and pay both the same amount as a result, more fraudulent companies will enter the market and truthful companies will exit.

115. The cost of a common stock offering is estimated to be between 1.5% and 2% of the proceeds. *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 339 (1989). *See also* Fox, *Who Should Regulate Whom*, *supra* note 10, at 2501 n.3 (calculating the cost of compliance with the U.S. regime to be approximately $1.6 billion in 1987 based on the 2% estimate of Loss and Seligman).

116. *See supra* note 80.

Furthermore, investors can voluntarily restrict their investments to securities issued under U.S. laws at no cost. If nothing else, these investors may benefit from the fact that only those issuers that prefer the American regime will choose it. Because American securities laws are very strict, investors may enjoy a self-selection benefit: Only high quality issuers seeking to distinguish themselves from lower quality issuers will choose American securities laws.

At the very least, portable reciprocity should be allowed for more sophisticated investors and for larger companies with siguificant investment analyst followings. Sophisticated investors are able to fend for themselves, and unsophisticated investors are protected through the efficient market for securities of larger, well-followed companies. Already, Regulation D and Rule 144A of the Securities Act embody some notions of portable reciprocity for companies. Through Rule 506 of Regulation D, for example, companies (including foreigu issuers) may sell securities in the United States to accredited investors and a limited number of non-accredited, sophisticated investors.[117] Purchasers of Rule 506 securities may then use Rule 144A to resell the securities immediately into a liquid secondary market comprised of certain large financial institutions known as "qualified institutional buyers."[118]

Regulation D and Rule 144A, however, are imperfect substitutes for a true portable reciprocity regime. Under Regulation D, issuers must still provide some limited disclosure following U.S. laws and face limitations on their ability to engage in general solicitation for investors.[119] Rule 144A also does not apply to securities that are of the same class as securities listed on an exchange or quoted on a U.S. automated iuter-dealer quotation system, such as NASDAQ.[120] Moreover, Rule 144A excludes all but the largest and most sophisticated financial institutional investors.[121] A much greater range of investors would benefit from regulatory competition. Portable reciprocity provides more regulatory options, particularly where the issuer trades in an efficient market and unsophisticated investors rely on the stock market price to incorporate information on the chosen securities regulatory regime. At a minimum, therefore, all Form S-3 com-

117. *See* 17 C.F.R. § 230.506 (1998).

118. *See id.* § 230.144A. Rule 144A(a)(1) defines "qualified institutional buyers" to include, among others, insurance companies, investment companies, and banks with a certain net amount of securities owned and invested. *See id.* § 230.144A(a)(1).

119. *See id.* § 230.502(b), (c).

120. *See id.* § 230.144A(d)(3)(i).

121. *See id.* § 230.144A(a)(1).

panies[122] should be allowed to engage in portable reciprocity regardless of the range of sophistication among potential investors.[123]

B. MARKET PROTECTION

Another goal of securities regulation is the protection of the capital market. The SEC has publicly stated that it considers the protection of the capital market as its primary mission.[124] If the market is sound and if securities are permitted into the market only when they satisfy relevant disclosure requirements, investors can invest with confidence. Through liquid capital markets, companies are able to raise funds to engage in positive net present value investment projects to the benefit of the companies and to the country itself. Well-functioning capital markets also ensure that investment funds are allocated to those investment projects with the highest net present value. Where two projects compete for investment funds and one project promises a return of $1 million while the other project promises a $2 million return, a well-functioning capital market will ensure that investors will first place their funds in the $2 million return project.

Confidence in a nation's capital market may decline if fraudulent companies are allowed to issue securities in the market or traders are allowed to engage in manipulative practices. To the extent either occurs, investors may withdraw from the market, which decreases market liquidity and raises the cost of capital. For example, if investors are unable to distinguish high quality issues from low quality issues due to a lack of disclosure or unduly weak insider trading laws, investors may discount the price of all issues. This may drive leading high quality issues to more favorable regimes that allow them to distinguish themselves from the low quality issues. The result may be a higher selling price.

Too much regulation can hurt the capital markets as easily as too little regulation. To the extent issuers are forced to engage in extremely costly disclosure, issuers may either exit the capital markets or raise the price of

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122. *See id.* § 239.13 (defining the requirements for U.S. or foreign firms to be considered Form S-3 companies).

123. In a market that is not efficient, some mandatory regulatory protections may be appropriate. This is not an issue among industrialized countries that have quite efficient markets, but is relevant to many developing countries and "emerging economies." *See* Andrew T. Guzman, *Regulating Capital Markets in Developing Countries*, 39 VA. J. INT'L L. (forthcoming 1999).

124. *See* Offshore Offers and Sales, Securities Act Release No. 33,6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524, at 80,665 (April 24, 1990); Arbie R. Thalacker, *Reproposed Regulation S*, 683 PLI/CORP. 799, 805 (1990); Steinberg & Lansdale, *supra* note 29, at 47.

their securities. Either action reduces the return investors receive from entering the capital markets.[125]

Portable reciprocity supports the goal of capital market protection in at least two ways. First, portable reciprocity allows issuers and investors to avoid overly burdensome regulations while still trading in the capital markets of the country promulgating the burdensome regulations. For example, issuers wary of complying with U.S. securities regulations may still issue securities in the NYSE under a portable reciprocity system. Second, to the extent issuers select regimes that maximize the joint welfare of issuers and investors, portable reciprocity aids investor confidence. Greater investor confidence increases the securities volume and liquidity of a country's capital markets. For example, investors may fear trading in a small country's market due to its weak regulatory regime. Under portable reciprocity, however, an issuer may select a more stringent regime to govern the issuer's transactions around the world to induce investors to trade in even the small country's capital markets.

V. ALTERNATIVES TO PORTABLE RECIPROCITY

A. EXCHANGE-BASED REGULATION

Private self-regulation through exchanges represents an alternative mechanism through which the market may adapt to the globalization of capital markets.[126] Exchanges generate profits through either fees paid by companies trading on the exchange or through commissions paid for transactions that take place on the exchange. The amount of profit to exchanges increases with greater securities volume. Exchanges may attract both issuers and investors by designing internal regulations that maximize the surplus of both groups. Competition between exchanges increases the need to cater to issuers and investors. Investors may then value securities trading on particular exchanges based on the amount of self-regulation within the exchange itself.[127]

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125. In countries where investors are not internationally mobile, domestic liquid capital markets provide individuals a means of saving their wealth over time in exchange for some investment return. Because investors are unable to shift funds abroad to other capital markets, investors lose an important means of engaging in savings where the domestic capital markets are weak.

126. *See* Mahoney, *supra* note 107, at 1453. *See also* George J. Benston, *Regulation of Stock Trading: Private Exchanges vs. Government Agencies*, 83 VA. L. REV. 1501 (1997) (commenting on Mahoney); Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509 (1997) (same).

127. Several commentators have written on whether competition for trading volume provides exchanges with incentives to implement socially beneficial rules. *See* Daniel R. Fischel, *Organized Ex-*

Already, exchanges impose a number of different requirements on their broker-dealer members, as well as on companies listed on the exchange. The NYSE, for example, requires its listed companies to disclose certain material information to the exchange.[128] Where public regulation breaks down, exchanges may fill the void. Moreover, with the rise of Internet communications and other forms of low-cost transmission technology, competition between exchanges is likely to increase.

The argument in favor of exchange-based regulation is premised, like portable reciprocity, on the benefits of regulatory competition. Many of the arguments we advance in this Article and in earlier writings,[129] therefore, could be applied to a system of exchange-based regulation. Though not discussed in the existing literature, an exchange-based approach would likely lead to a diversity of regulatory regimes with many of the same informational benefits as portable reciprocity.

An initial problem, however, with an exchange-based system is that it cannot succeed unless exchanges can compete across national borders. Because most countries have a single dominant exchange, competition would exist only if the exchanges of different countries can compete.[130] If issuers are able to choose any exchange, the regime begins to resemble portable reciprocity in the sense that any issuer can trade in any country and sell to any investor, regardless of nationality.

Assuming that issuers can choose from a wide variety of regimes, one cost of an exchange-based regime is that transactions must be structured to

changes and the Regulation of Dual Class Common Stock, 54 U. CHI. L. REV. 119, 123 (1987) ("[E]xchanges face the same incentives to provide high-quality products . . . as any other business. Just as a manufacturer of automobiles has strong incentives to make a product that consumers want in order to maximize its profitability, an exchange has incentives to design transactional and ancillary services that investors prefer."). Fischel also argues that exchange competition would not result in a race-to-the-bottom between excbanges. *See id.* at 129 ("If an exchange allows managers of some firms to exploit investors, investors will lose confidence in the exchange, as a whole, causing *all* firms on the exchange to face higher costs of capital."). *See also* Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 934-35 (1994) ("One clear advantage of securities laws promulgated by an exchange over those promulgated by the SEC is that the latter, as a monopoly, has fewer incentives to innovate and no incentives to customize its legal rules to meet the individualized needs of particular market participants."). *But see* Stephen Craig Pirrong, *The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation*, 38 J.L. & ECON. 141 (1995) (arguing that exchange competition ignores the benefit to inframarginal customers and third parties that rely on accurate securities prices).

128. *See* N.Y. STOCK EXCH. LISTED CO. MANUAL ¶ 202.05, *reprinted in* 3 Fed. Sec. L. Rep. (CCH) ¶ 23,519.

129. *See* Choi & Guzman, *National Laws*, *supra* note 12; Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 15.

130. *See* Kahan, *supra* note 126, at 1515.

take place on a particular exchange in order to take advantage of the exchange's rules. Under portable reciprocity such structuring is unnecessary. The choice of regime and the site of the transaction are independent decisions, each of which can be made to maximize the value of the transaction.

Other concerns about exchange-based regulation are identical to reservations already discussed in the context of a regime based exclusively on private contracts. These include the inability of exchanges to provide for criminal enforcement and perhaps certain forms of civil enforcement (such as punitive damages),[131] and the uncertainty with respect to enforcement by the courts.

A final difficulty with exchange-based regulation is the inability of exchanges to regulate investors. As Professor Marcel Kahan has written, "The basis . . . on which the exchange could pass regulations that bind investors at large—such as disclosure requirements for large shareholders, margin rules, or rules against stock price manipulation—is not evident."[132] Within a portable reciprocity regime, on the other hand, national regimes could regulate investor activities relating to an electing company's securities.

Ultimately, allowing securities market participants the choice between adopting either exchange-based or regime-based investor protection is desirable. Portable reciprocity makes this choice available. Under portable reciprocity, issuers that believe a particular exchange provides effective and low-cost protections may simply opt out of all public regimes. Indeed, nothing within a portable reciprocity regime stops an issuer from selecting from a variety of private market-based investor protections, such as exchange listing requirements and third-party certification intermediaries, in *addition* to a public regime to provide their optimal level of protection. Where different sources of investor protection have a comparative advantage in providing certain types of protection, some reliance on these different sources enhances investor welfare.

B. STATE-BASED REGULATION

An additional proposal put forth by Professor Roberta Romano and premised on the benefits of regulatory competition is to provide individual states with the power to establish exclusive securities regulatory regimes within the United States.[133] Under Romano's proposal, issuers would

131. *See id.* at 1517 & n.43.
132. *Id.* at 1516.
133. *See* Romano, *supra* note 57.

choose the state under which their securities transactions would be governed, much as they currently have a choice in selecting a state corporate law regime. As proposed, this idea is virtually identical to the proposal of portable reciprocity.[134] Two significant differences remain. Under the state-based approach the applicable securities regime belongs to the state of incorporation. In contrast, portable reciprocity allows the issuer to choose the applicable regime. The advantage of allowing choice is that firms can then choose their place of incorporation on other efficiency-based grounds without committing themselves to a particular securities regime. In addition, it would not require a firm to commit once and for all to a particular securities regime. Firms can change over time and portable reciprocity would allow them to select the best regime for each issue of securities.[135]

The proposals also differ in the market they address. Portable reciprocity addresses the challenge of the globalization of securities markets, whereas a state-based approach considers primarily domestic U.S. issues. When the state-based approach does turn to international issues, it advocates a policy that is strikingly close to portable reciprocity by essentially allowing a foreign issuer to choose its "securities domicile" for U.S. trading purposes.[136]

C. ISSUER NATIONALITY

At least one commentator supports a proposal for the regulation of international securities markets that is radically different from the proposal presented in this Article. Professor Merritt Fox describes his position as follows:

> [I]ncreasing internationalization of portfolios should not obscure the fact that . . . it is still in the best interests of the United States and of the global economy as a whole for disclosure regulation to be undertaken at the national level and for the United States to apply its regime only to those issuers that have their economic center of gravity in the United States.[137]

Fox believes that regulatory competition will lead to a race-to-the-bottom with undesirably low levels of mandatory disclosure. He claims

134. The theoretical basis for state-based regulation is a traditional race-to-the-top argument, making the underlying theory of state-based competition different than that of portable reciprocity, which relies on diverse regulatory regimes.

135. Nevertheless, firms may voluutarily stick to one regime; alternatively in a company registration system, firms would only be able to choose one regime for all their transactions. *See supra* Part III.D (discussing company registration).

136. *See* Romano, *supra* note 57, at 2418-27.

137. Fox, *Who Should Regulate Whom*, *supra* note 10, at 2506.

that an approach termed the "issuer-nationality" approach would lead to better global securities regulations by eliminating regulatory competition and providing each country a well-defined regulatory monopoly over their subset of issuers.[138]

One problem with this race-to-the-bottom argument is that it iguores not only the possibility of a race-to-the-top, but also the possibility that a diverse set of national regulations will arise and issuers will choose from this set of possible regimes.[139] Where managers seek to maximize firm value, competition for issuers and investors leads to a race-to-the-top. Under more complex and realistic assumptions that allow issuers and investors to vary in their preferences for different securities regimes, a diverse set of regimes is likely. In a world where countries offer different types of regimes, investors would gain much information from the type of regime different issuers select.[140]

Even if one were to accept the assumption that a race-to-the-bottom is likely, the issuer nationality solution may do more harm than the problem it seeks to address. Issuer nationality undermines international capital mobility. Although it remains true that investors from any country can purchase the issue, there is no reason to think that the required level of disclosure is the most efficient level for the firm or for the investor. Consider, for example, a firm that presents investors with a very high quality offering but happens to be in a country that has a relatively low level of mandatory disclosure. If the issuer could choose to comply with the laws of any regime, the issuer would be able to choose a very strict regime, thereby demonstrating the quality of the issue and increasing the price of the security. Mobility would allow the issuer to identify the quality of its issue with greater precision, which leads to more accurate pricing and greater efficiency.[141] This increased precision would also benefit investors who could price the issuer with greater accuracy, reducing the associated risk.

An additional problem with the issuer nationality option is that it removes *all* competition among regimes. Once guaranteed a monopoly of

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138. Fox writes:

> This approach assigns to each country regulatory authority over the issuers whose disclosure behavior most affects its welfare. Global welfare will be maximized because each issuer will be regulated by the country that will benefit most by getting the level of required disclosure right. A switch to the issuer-nationality approach will also prevent a kind of regulatory competition that could lead to suboptimally low disclosure levels required by all countries.

Id. at 2628-29.

139. *See* Choi & Guzman, *National Laws*, *supra* note 12; *supra* Part III.A.

140. *See* Choi & Guzman, *National Laws*, *supra* note 12, at 1874-83.

141. *See supra* text accompanying notes 56-59.

regulation, regulatory agencies may cater to special interest groups to gain monetary reward[142] or may institute regulations of ever-increasing complexity to increase their own size and importance. National regulators would face little incentive to adopt efficient regulations and have considerable incentive to overregulate.

VI. CONCLUSION

Portable reciprocity in concept is simple. Under a portable reciprocity approach to securities regulations, individual issuers have the choice of several different countries' regulatory regimes with which to comply. At first glance, commentators may criticize such a system as inviting investor confusion and a race-to-the-bottom among different countries. Investors may fail to realize that securities trading in a particular capital market are governed by another jurisdiction's laws. Countries competing for issuers to select their body of law likewise may adopt laws geared to opportunistic managers rather than designed to maximize social value in the capital markets.

In response, we have argued first that regnlatory competition among countries will benefit investors and capital markets. Although under certain rigid assumptions countries may engage in either a race-to-the-bottom or race-to-the-top, under the more realistic assumption that the world is populated by different issuers, managers, investors, and financial intermediaries, all with different preferences and levels of financial sophistication, regulatory competition will result in a separation between countries in their type of securities regulatory regime. Some regimes, for example, will cater to managers seeking to act opportunistically. Other regimes will cater to issuers seeking to signal credibly to investors that they will not engage in such opportunistic behavior. Given this separation in types of regimes, companies will identify themselves based on their preferred regimes. Rational investors with information on these different types of regimes will then discount the price they are willing to pay for securities based on the increased risk of fraud and other opportunistic behavior. Through regulatory competition, investors will be able to obtain information on different types of companies based on the regime the companies choose.

Portable reciprocity provides one means of increasing the intensity of regnlatory competition between nations. Under an ideal portable reciprocity system among countries, issuers can delink the choice of regulatory regime under which to be governed and the choice of location in which to sell their securities. Issuers that desire access to capital held in the United States but that

142. For a critique generally of the SEC as a regulatory agency and the dangers of regulatory obsolescence, see Macey, *supra* note 127.

do not wish to comply with U.S. securities regulations may do so under portable reciprocity. Investors within the United States then have the opportunity to purchase the issuer's securities. To the extent the issuer selects a regime with, for example, less stringent antifraud protections, issuers will discount the value of the securities accordingly.

Although problems exist with obtaining portable reciprocity agreements and implementing enforcement across several different countries, portable reciprocity represents the best solution to the challenges of the international securities market. Short of completely cutting off access to the world capital markets, individual countries must devise systems to deal with the flow of investor and issuer transactions across different countries. Competition provides regulators with good incentives to maximize the welfare of all securities market participants. Moreover, portable reciprocity complements emerging private market mechanisms to deter fraud. Exchanges, for example, may take part in greater self-regulation. Third-party certification intermediaries may also play a greater role in international securities transactions. Where such private market mechanisms work well, issuers and investors may choose regimes with relatively weak securities regulatory regimes. On the other hand, where private market systems work poorly, portable reciprocity allows market participants to find more stringent regulatory solutions that best fit their situations.