Foreign Listings and the Preeminence of U.S. Securities Exchanges: Should the SEC Recognize Foreign Accounting Standards?

Michael A. Schneider

On October 5, 1993, after three years of stalemated negotiations and mixed international press,[1] the German automaker Daimler-Benz made history by listing its common stock for trading on the New York Stock Exchange (NYSE).[2] The event marked not only the first German company to list shares on a U.S. securities exchange, but also the last major industrial country to have a company listed on a U.S. securities exchange.[3] These two milestones have sparked renewed debate in the United States over the ability of the U.S. national securities exchanges[4] to attract foreign securities listings.[5]

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1. *See* Barry Riley, *Feeling of Betrayal in Corporate Germany*, FIN. TIMES, Sept. 22, 1993, at 27 (describing the listing of Daimler-Benz on the NYSE: "[f]or the German corporate establishment this has been quite a snub") *and* Anita Raghavan & Michael R. Sesit, *Financial Boom: Foreign Firms Raise More and More Money in the U.S. Markets*, WALL ST. J., Oct. 5, 1993, at A1 (stating that the Daimler-Benz decision to list on the NYSE represents a "fundamental shift in the way U.S. financial markets are viewed abroad").

2. Richard C. Breeden, then-Chairman of the Securities and Exchange Commission, announced that the listing of Daimler-Benz on the NYSE marked a "new beginning in the world of corporate finance." Richard C. Breeden, Remarks Regarding the Listing of Shares of Daimler-Benz in the U.S. Securities Market 1 (March 30, 1993) (transcript on file with the *Minnesota Journal of Global Trade*). Chairman Breeden further characterized the listing as a "win" for both Daimler-Benz and investors in the United States and worldwide. *Id.*

3. *See* SECURITIES AND EXCHANGE COMMISSION, PARTICIPATION OF FOREIGN ISSUERS IN THE UNITED STATES SECURITIES MARKET (May 20, 1993) (on file with the *Minnesota Journal of Global Trade*); Breeden, *supra* note 2, at 3; David Duffy & Lachlan Murray, *The Whooing of American Investors*, WALL ST. J., Feb. 25, 1994, at A14 (Mr. Duffy is chairman of a public relations firm that specializes in cross-border investor relations).

4. "U.S. national securities exchanges" or "U.S. national exchanges," as used in this Note, refer to the three securities exchanges in the United States that offer foreign securities for trading: the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers Automated Quotation (NASDAQ) system. Although NASDAQ is not an exchange per se, see *infra* note 13, it is included because of the SEC's 1983 ruling that NASDAQ is the functional equivalent of an exchange for the

The ability to attract foreign listings is crucial to the continued preeminence of the U.S. national exchanges. Foreign companies now represent the largest growth opportunity for the U.S. national exchanges.[6] For instance, over 3,000 worldwide privately-held companies currently meet the listing standards of the NYSE alone.[7] As the "globalization" of capital markets[8] con-

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purposes of registration and reporting under the Securities Exchange Act of 1934. *See infra* note 49. *See also infra* note 48 (listing the "true" national securities exchanges located in the United States).

These three U.S. national exchanges co-exist with regional exchanges that do not offer foreign listings, and the U.S. "pink-sheet" market which is an over-the-counter securities market that does trade foreign securities. *See infra* note 13.

5. *Compare* William Freund, *That Trade Obstacle, The SEC*, WALL ST. J., Aug. 6, 1993, at A6 (arguing that "America's anachronistic accounting standards . . . will do irreversible harm to the U.S. as the world's dominant financial center") *and* William J. Baumol & Burton G. Malkiel, *Redundant Regulation of Foreign Security Trading and U.S. Competitiveness*, *in* MODERNIZING U.S. SECURITIES REGULATION 39, 51 (Kenneth Lehn & Robert Kamphuis eds., 1992) (concluding that "[i]t is difficult to defend a regulatory policy that prevents [U.S. exchanges] from competing effectively in making markets in foreign securities") *with* Mary Schapiro, *The SEC's Open Door Policy*, WALL ST. J., Sept. 23, 1993, at A17 (arguing that the United States "compares favorably" to other worldwide markets in the number of foreign listings and the recent trend is even more illustrative of its competitiveness).

6. *See* Franklin R. Edwards, *Listing of Foreign Securities on U.S. Exchanges*, *in* MODERNIZING U.S. SECURITIES REGULATION 57, 58 (Kenneth Lehn & Robert Kamphuis eds., 1992).

7. Letter from Dr. William C. Freund, former chief economist of the NYSE and current Professor of Economics and Director of the Center for the Study of Equity Markets at Pace University, to Mary L. Schapiro, SEC Commissioner (Sept. 27, 1993) (on file with the *Minnesota Journal of Global Trade*). The potential opportunity in the foreign listings market is staggering considering that the NYSE now lists only about 2,100 companies. *Major Issues Facing the Financial Markets: Testimony Before the Securities Subcomm. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 3 (1993) [hereinafter *Hearings*] (testimony of William H. Donaldson, Chairman and Chief Executive Officer, New York Stock Exchange) (on file with the *Minnesota Journal of Global Trade*). Thousands more privately-held foreign companies would meet the less rigorous listing standards of the NASDAQ and AMEX. *See* Letter from Dr. William C. Freund to Mary L. Schapiro, *supra*.

8. The globalization of securities markets has been primarily driven by five forces. *See* Joseph Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. FIN. SERVICES RES. 349 (1990). The first and the most significant force driving transnational capital flows is pure economics. *Id.* at 361. Differences in national savings rates, investment opportunities, and trade imbalances encourage the flow of capital in the world. *Id.* Second, increases in computer and telecommunications technology have fueled a worldwide network of brokers, dealers, and investors with powerful capabilities to conduct large transactions instantaneously. *Id.* at 361-62. Third, the increasing emphasis on global diversification has increased the demand for foreign securities and investments as

tinues at a record pace,[9] the U.S. national exchanges must transform themselves into *transnational* securities exchanges by offering large numbers of foreign listings.[10] Unless they do so, the U.S. national exchanges risk being relegated to the status of "regional" exchanges which offer only domestic securities.[11]

Advocates of reform argue, however, that the U.S. national exchanges are unable to effectively compete for foreign listings. The chief impediment cited is the requirement that foreign companies comply with U.S. generally accepted accounting principles (GAAP) in order to list on a U.S. national securities exchange.[12] By contrast, other major foreign securities markets

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investors seek to diversify across economies. *Id.* at 362-63. Fourth, the explosive growth of derivative securities has increased demand of foreign securities, as investors use options, futures, and indices to diversify and speculate across economies. *Id.* at 364. Fifth, regulatory barriers continue to fall in all major markets. *Id.* at 364-65. Worldwide deregulation facilitates international securities trade by lowering costs and easing access to foreign capital markets. *Id.* The United Kingdom, Japan, and the United States have all eased regulatory requirements in an attempt to provide the most liquid, least regulatory, and lowest cost market in which to raise capital and trade securities. *Id.*

9. In 1992, U.S. investors purchased a record $51.5 billion in foreign debt and equity, up from a previous record of $47 billion in 1991. *U.S. Investors Bought Record Amount Of Foreign Securities In 1992, SIA Says*, 25 SEC. REG. & L. REP. (BNA) 671 (May 7, 1993) (citing the Securities Industry Association). U.S. investors acquired a net $32.1 billion of foreign equities in 1992, comprised mainly of $18 billion in European securities and $8.9 billion in Asian securities. *Id.*

The record pace continued in 1993. During the first half of 1993, investors purchased a net $21.7 billion of foreign equities, an amount roughly double the amount purchased during the first half of 1992. *Americans Snap Up Securities Overseas at Record Pace*, WALL ST. J., Oct. 10, 1993, at C1 (citing the Securities Industry Association). U.S. investors also purchased a record $27.3 billion of foreign bonds in the first half of 1993 which is more than the total amount purchased during all of 1992. *Id. See also* Edwards, *supra* note 6, at 58-59 (discussing the growth of foreign securities trading throughout the 1980s).

10. Duffy & Murray, *supra* note 3, at A14; *see* Edwards, *supra* note 6, at 58-59.

11. *Hearings*, *supra* note 7, at 12 (testimony of William H. Donaldson, Chairman and Chief Executive Office, New York Stock Exchange).

12. JAMES L. COCHRANE, ASSESSING AND EVALUATING THE CURRENT DIRECTIONS OF TRANSNATIONAL LISTINGS 8-9 (New York Stock Exchange Working Paper 93-03, 1993); Joseph McLaughlin, *Listing Foreign Stocks On U.S. Exchanges: Time To Confront Reconciliation?*, 24 REV. SEC. & COMMODITIES REG. 91, 91 (1991); *see also* Freund, *supra* note 5, at A6 (arguing that "if the SEC continues to insist that foreign firms abide by America's anachronistic accounting standards, it will do harm to the U.S. as the world's financial center"). Dr. Freund cites numerous reasons in support of relaxing the SEC rules that require foreign firms to comply with U.S. GAAP standards. First, U.S. investors already circumvent the paternalistic mission of the SEC by purchasing foreign securities. *Id.* Second, studies indicate that European and Asian markets

do not require foreign companies to comply with their domestic accounting standards, nor does the U.S. "pink-sheet" market[13] require foreign companies to comply with U.S. GAAP standards.[14]

In an effort to make the U.S. national exchanges more competitive in the market for foreign listings, the NYSE has actively led a movement[15] to exempt foreign companies listed on a U.S.

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are equally efficient despite their lower disclosure standards. *Id.* Thus, investors do not necessarily benefit from the increased U.S. disclosure requirements. Third, foreign accounting standards may actually provide more useful information because foreign data is often not comparable in U.S. GAAP form. *Id.* Fourth, institutional investors are better able than the SEC to acquire meaningful financial data from foreign companies given their increasing power to affect securities prices. *Id.* Finally, the protectionist mission of the SEC now forces U.S. investors to trade abroad at higher costs and without the protection of U.S. securities law—precisely the opposite effect sought by the SEC. *Id.*

For a discussion of GAAP and its relation to foreign listings, see *infra* notes 32, 63.

13. The U.S. securities market is comprised of two distinct markets: the exchanges and the over-the-counter market. The over-the-counter market is a dealer market composed of all transactions *not* executed on an exchange. LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 599-600 (1988). The over-the-counter market is further divided into "pink-sheet" issues and NASDAQ issues. The pink-sheet issues are trades that are negotiated for customers between broker-dealers. Historically, trades were executed on pink slips of paper, hence the name "pink-sheet" market. NASDAQ issues are also traded between broker-dealers but real-time price quotes are available on the NASDAQ system. *Id.* at 599-602. Unlike the pink-sheet market, companies must subscribe and qualify to be quoted on the NASDAQ system.

The bulk of U.S. securities trades, however, occurs on securities exchanges. The U.S. exchanges, which include the New York Stock Exchange, American Stock Exchange, and other regional exchanges, are extremely well-organized and efficient auction markets. *See infra* note 48.

14. *See infra* part I.B.

15. Although the NYSE, AMEX, and NASDAQ each have a substantial stake in the foreign listings debate, the reform movement is primarily a product of the NYSE's efforts. SHOW-MAO CHEN, U.S. FINANCIAL REPORTING REQUIREMENTS FOR PRIVATE FOREIGN ISSUERS: POLICY IMPLICATIONS OF RECENT EMPIRICAL STUDIES 7-8 (New York Stock Exchange Working Paper No. 92-06, 1993); COCHRANE, *supra* note 12, at 8-9. William Donaldson, chairman of the NYSE, first proposed reforming the SEC's treatment of foreign listings in 1991. CHEN, *supra*, at 8.

The SEC has also been involved in the public debate of the foreign listings issue. Richard Roberts, a Securities and Exchange Commissioner, has been publicly outspoken about the need to reform the SEC's treatment of foreign listings in the United States. *See* Richard Y. Roberts, Remarks at the National Regulatory Services Supervision/Compliance Conference (May 7, 1993) (transcript on file with the *Minnesota Journal of Global Trade*). However, the current SEC Chairman, Arthur Levitt, has expressed serious reservations about the NYSE's proposal. *See Written Responses of Arthur Levitt, designate-Chairman of the Securities and Exchange Commission, to the Senate Banking Comm.*, 103d Cong., 1st Sess. (1993) [hereinafter *Written Responses of Arthur Levitt*]

national exchange from U.S. GAAP standards.[16] By exempting foreign listings from U.S. GAAP standards, the Securities and Exchange Commission (SEC)[17] would thus recognize foreign accounting standards as sufficient to list on a U.S. national exchange.[18] The SEC is now faced with essentially three choices: (1) to entirely reengineer the disclosure requirements for all companies, foreign or domestic;[19] (2) to exempt only foreign companies listed on a U.S. national exchange from U.S. GAAP standards and thereby accept foreign accounting standards;[20] or (3) to maintain the status quo.

(released following the July 13, 1993 confirmation hearings for now-SEC Chairman Arthur Levitt). Chairman Levitt cites investor protection concerns and the disturbing situation of having U.S. companies subject to more burdensome accounting standards than foreign companies. *Id.*

16. COCHRANE, *supra* note 12, at 8-9.

17. The SEC is authorized by Congress to make such rules and regulations as necessary to implement U.S. securities law in the Securities Act of 1933 at 15 U.S.C. § 77s, and the Securities Exchange Act of 1934 at 15 U.S.C. § 78w. For a discussion of the SEC's mission, see *infra* part I.A.

18. The SEC has refused to support or adopt the proposal to recognize foreign accounting standards for several reasons: First, U.S. companies would be disadvantaged in their home market due to the greater registration and reporting requirements that would not apply to foreign issuers. SECURITIES AND EXCHANGE COMMISSION, PARTICIPATION OF FOREIGN ISSUERS IN THE UNITED STATES SECURITIES MARKET, *supra* note 3, at 2. Second, investors would be prejudiced because information essential to their investment decisions would be unavailable or incomparable. *Id.* Third, insider trading would be an even greater danger considering that investors would not be privy to the information regarding the adjustment and management of net income common in many countries. *Id.* Finally, Rule 144A is now available to provide greater access and liquidity to the private placement securities market. *Id.*; *see infra* text accompanying notes 93-98.

19. Freund, *supra* note 5, at A6; James D. Cox, *Rethinking U.S. Securities Laws In The Shadow of International Regulatory Competition*, 55 LAW & CONTEMP. PROBS. 157, 169-70 (1992); *see also* Roberts, *supra* note 15, at 8-11 (discussing the foreign listings controversy from the perspective of U.S. issuers, foreign issuers, and the SEC); *Hearings*, *supra* note 7 (testimony of William H. Donaldson, Chairman and Chief Executive Office, New York Stock Exchange) (discussing the long-term effects of maintaining the current disclosure system and the need for immediate action).

20. The NYSE actually supports a less comprehensive exemption which would exempt only "world-class" issuers from U.S. GAAP standards. *Hearings*, *supra* note 7, at 13; COCHRANE, *supra* note 12, at 9. World-class issuers would be the approximately 200 largest non-U.S. companies in terms of revenue, market value, and trading volume outside the United States. COCHRANE, *supra* note 12, at 9-10. These world-class issuers could be used as a pilot program for a comprehensive exemption that would later apply to all foreign listings. *Id.*

In 1991, the SEC took a first step toward recognizing foreign accounting and disclosure standards when it signed a bilateral agreement with Canada. Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Sec. Act Release No. 6902, [1991

The outcome of the foreign listings debate will have significant long-run effects in the United States considering the vital role that the national exchanges play in the U.S. economy.[21] The exchanges employ thousands of Americans directly and indirectly,[22] and, more importantly, they provide billions of dollars of capital each year to U.S. businesses.[23] Unless the U.S. national exchanges remain dominant among the world's capital markets, U.S. businesses and investors will increasingly utilize other securities markets to satisfy their capital and investment needs.[24] As a result, the SEC faces increasing pressure to preserve the preeminent position held by the U.S. national exchanges, and thereby prevent the loss of another leading U.S. industry to foreign competition.[25]

This Note examines whether foreign listings should be exempted from U.S. GAAP standards. Part I describes the principal U.S. securities laws and the options currently available to foreign issuers. Part II details common criticisms of the U.S. disclosure system and recent SEC action related to foreign se-

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Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,812 (June 21, 1991). *See infra* part II.B. The SEC adopted a multijurisdictional disclosure system (MJDS) that allows certain Canadian companies to satisfy SEC registration and reporting requirements with disclosure documents prepared in accordance with Canadian standards. *Id.* The MJDS with Canada is designed to better facilitate cross-border listings and cash tender and exchange offers. *Id.*

21. *See Written Responses of Arthur Levitt, supra* note 15 (describing the U.S. national exchanges as a "vital asset" to the U.S. economy); *see also* Baumol & Malkiel, *supra* note 5, at 39 (concluding that current SEC rules are "potentially detrimental" to the U.S. economy).

22. The member-companies of the Securities Industry Association alone employed more than 260,000 persons in 1991. SECURITIES INDUSTRY YEARBOOK 1990-91, at 10-33 (1990).

23. *Written Responses of Arthur Levitt, supra* note 15. *But see* LESTER THUROW, HEAD TO HEAD: THE COMING ECONOMIC BATTLE AMONG JAPAN, EUROPE, AND AMERICA 42-43 (1993) (arguing that the possession of capital by one's home country is no longer a necessity to economic success due to the ease with which world capital markets can now be accessed).

24. According to Baumol & Malkiel, *supra* note 5, when U.S. investors and businesses transact in foreign markets three direct costs are incurred: the false sense of familiarity with translated foreign accounting data, higher trading costs, and the loss of business in the United States. *Id.* at 42-43. *See also Hearings, supra* note 7, at 12 (testimony of William H. Donaldson, Chairman and Chief Executive Office, New York Stock Exchange) (stating that U.S. investors will be forced to trade in "relatively illiquid foreign markets without the protections afforded by our domestic markets").

25. Over the past several decades the United States has surrendered its dominance in numerous industries including automobiles, steel, semiconductors, consumer electronics, machine-tools, telecommunications equipment, and various other high-technology industries. *See* THUROW, *supra* note 23, at 114-16, 177-80, 183-88, 193-200.

curities. Part III describes and evaluates the principal arguments for accepting foreign accounting standards. This Note concludes that the stringent SEC disclosure requirements, instituted to protect investors, should be maintained because there is little evidence that they put the U.S. national exchanges at a competitive disadvantage to either the U.S. pink-sheet market or foreign exchanges.

I. SEC REGULATION AND FOREIGN LISTINGS

The ability of the U.S. national exchanges to compete in the market for foreign listings is inextricably bound with the disclosure requirements of the SEC. Nevertheless, the SEC and the national exchanges have different motivations and goals with respect to foreign listings. The national exchanges undoubtedly seek to maximize their share of the foreign listings market. The SEC, however, has a more paternalistic mission of protecting investors, effectuated through the regulation of corporate disclosure.

A. THE MISSION OF THE SEC

Since 1934, the SEC has been responsible for "maintaining the efficiency and integrity of the American securities markets"[26] by ensuring "full and fair" disclosure to investors.[27] Efficiency in a securities market is achieved by facilitating the trading process, typically by lowering transaction costs, broadening investor participation, and shortening settlement periods.[28] Meanwhile, the integrity of a securities market is maximized by providing investors with accurate, unbiased, and meaningful financial information.[29] While the tradeoffs between efficiency and integrity are not zero sum, inordinate emphasis on one goal will frustrate the other.[30] At some point, the

26. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 9 (2d ed. 1990).

27. Rule 146— Transactions by an Issuer Deemed Not to Involve Any Public Offering, Sec. Act Release No. 5487, 2 Fed. Sec. L. Rep. (CCH) ¶ 2710 (April 23, 1974); K. FRED SKOUSEN, AN INTRODUCTION TO THE SEC 7, 22 (5th ed. 1991).

28. For a more detailed discussion of the efficiency of securities exchanges, see *infra* part III.C.

29. *See* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULAITON IN SEARCH OF A PURPOSE 28-29 (1979) (citing the comments of then-SEC Chairman A. A. Sommer, Jr.).

30. *See* Edward A. Perell et al., *Regulation S and Rule 144A: A Non-US Issuer's Perspective*, INT'L FIN. L. REV./CORP. FIN. 13 (Sept. 1990 Supp.); J. William Hicks, *Securities Regulation: Challenges in the Decades Ahead*, 68 IND. L.J. 791 (1993).

costs of compliance to issuers surpass the benefits that additional disclosure confers to investors.[31]

The SEC has historically emphasized the goal of maximizing market integrity and investor protection by increasing disclosure requirements.[32] However, pressure is now building on the SEC to bring U.S. disclosure requirements more in line with the requirements of other major countries[33] as the globalization of capital markets continues and the competition among worldwide exchanges intensifies.[34] The SEC readily agrees that disclosure costs must be minimized in order to increase foreign listings in the United States, but it also insists that any reform must be consistent with the goal of protecting investors.[35]

In meeting this goal, the SEC primarily uses the Securities Act of 1933[36] and the Securities Exchange Act of 1934.[37] The

31. *See* Hicks, *supra* note 30, at 791, 805 (stating that "securities law is optimal where at any given moment a proper balance is struck between the private interest, which stresses freedom and efficiency, and the public interest, which allows for limitations and proscriptions").

32. *See* KRIPKE, *supra* note 29, at 28-29. The SEC errs on the side of overdisclosure because it views the risks of too little disclosure as being significantly greater than the risks of too much disclosure. R. K. MAUTZ, FINANCIAL DISCLOSURE IN A COMPETITIVE ECONOMY 32 (1978). Indeed, securities regulations were established to protect investors, not to weigh the impact of disclosure on the economy. *Id.* The Financial Accounting Standards Board (FASB), the group responsible for establishing U.S. GAAP standards, similarly views the economic effects of its actions as only an ancillary consideration. FINANCIAL REPORTING AND CHANGING PRICES, Statement of Financial Accounting Standards No. 33, at 26 (Fin. Accounting Standards Bd. 1979). FASB perceives its primary function as the development of standards which properly measure business income and investment. *Id.*

33. U.S. disclosure requirements are undoubtedly the most comprehensive and exacting in the world. For a survey of numerous studies on disclosure levels, see Gary C. Biddle & Shahrokh M. Saudagaran, *The Effects of Financial Disclosure Levels on Firms' Choices Among Alternative Foreign Stock Exchange Listings*, 1:1 J. OF INT'L FIN. MGMT. & ACCT. 55 (1989) [hereinafter *Effects of Financial Disclosure*]. In addition, a survey of 142 persons involved in the area of foreign listings, ranked the following countries from the most to the least stringent in disclosure requirements: United States, Canada, United Kingdom, Netherlands, France, Japan, Germany, Switzerland. Gary C. Biddle & Shahrokh M. Saudagaran, *Foreign Stock Listings: Benefits, Costs, and the Accounting Policy Dilemma*, ACCT. HORIZONS, Sept. 1991, at 69, 74 n.22 [hereinafter *Foreign Stock Listings*].

34. *See supra* notes 8, 9. See KRIPKE, *supra* note 29, at 28-29, for a comprehensive critique of U.S. disclosure system.

35. Simplification of Registration and Reporting Requirements for Foreign Companies, Sec. Act Release No. 7029, 1 Fed. Sec. L. Rep. (CCH) ¶ 85,252, at 84,684 (Nov. 3, 1993) (to be codified at 17 C.F.R. pts. 229, 230, 239, 249) (proposed Nov. 3, 1993).

36. Securities Act of 1933, 15 U.S.C. § 77a-77aa (1988).

37. Securities Exchange Act of 1934, 15 U.S.C. § 78a to 78*ll* (1988).

Securities Act of 1933 (Securities Act) deals with the distribution of securities, while the Securities Exchange Act of 1934 (Exchange Act) deals with the trading of securities after distribution.[38] The Securities Act requires that a public offering or sale of securities be registered with the SEC unless it qualifies as an exempted security or transaction.[39] The Securities Act thereby provides an initial set of disclosure documents for most securities that are publicly offered or sold. The Securities Act also prohibits any deceptive or fraudulent practices in the sale or offering of securities.[40]

The Exchange Act governs the post-distribution trading of securities.[41] The Exchange Act requires that securities be registered[42] with the SEC before any trading occurs on an exchange

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In addition to the Securities Act of 1933 and the Securities Exchange Act of 1934, federal securities law is comprised of three other statutes enacted in 1939 and 1940. The Trust Indenture Act of 1939 applies to public offerings of debt securities in excess of $10 million. 15 U.S.C. § 77aaa-77bbb (1988). The Investment Company Act of 1940 requires the registration of investment companies and also regulates the actions and structure of such companies. 15 U.S.C. § 80a-1 to 80a-64 (1988). Finally, the Investment Advisors Act of 1940 regulates the activities of investment advisors. 15 U.S.C. § 80b-1 to 80b-21 (1988).

38. LOSS, *supra* note 13, at 87.

39. For a discussion of exempted securities versus exempted transactions and other exemptions available under the Securities Act, see generally LOSS, *supra* note 13, at 272-349 (1988 & Supp. 1992).

40. Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), is a general antifraud section that relates to fraud in the sale or offering of securities, whether registered or exempt. In general, Section 17(a) makes it unlawful to employ any scheme to defraud, or engage in any practice which constitutes fraud or deceit. *Id.; see also* 3 HAROLD S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 8.01 (1993).

41. LOSS, *supra* note 13, at 36. The Exchange Act also requires that broker-dealers, national exchanges, and dealer associations be registered with the SEC. 3 BLOOMENTHAL, *supra* note 40, § 1.03[1]. In addition, the Exchange Act formally established the SEC, its structure, and charged it with the administration of federal securities laws. *See generally* SKOUSEN, *supra* note 27, at 7-17 (discussing the origins of the SEC).

42. "Registration under the Securities Act does *not* constitute registration under the Exchange Act." HAROLD S. BLOOMENTHAL & HOLME ROGERTS & OWEN, SECURITIES LAW HANDBOOK § 12.06[1] (1993 ed.) (emphasis added). Nevertheless, previous registration under the Securities Act greatly simplifies registration under the Exchange Act. *Id.* A U.S. issuer must register any nonexempt security under the Exchange Act if (1) the issue is listed on an exchange or NASDAQ, or (2) if the issuer has total assets exceeding $5 million and 500 or more stockholders. 15 U.S.C. § 78*l*(g)(1); LOSS, *supra* note 13, at 405. The Exchange Act originally applied to issuers with total assets in excess of $1 million, but Rule 12g-1 of the Exchange Act modified the threshold to $5 million. 17 C.F.R. § 240.12g-1 (1993); System of Classification for Purposes of Exempting Smaller Issuers From Certain Reporting and Other Requirements, Exchange Act Release No. 18,647, 47 Fed. Reg. 17,046, 17,047 (April 15, 1982).

or in an over-the-counter market.[43] Upon registration, publicly-traded companies must adhere to a continuous disclosure system by filing quarterly and annual reports.[44] The Exchange Act thereby provides an ongoing set of disclosure documents for publicly traded companies.

B. FOREIGN REPORTING REQUIREMENTS

Foreign companies that wish to participate in the U.S. securities market generally choose one of two alternatives. A foreign company may have its *existing* securities listed on a national securities exchange or traded in the over-the-counter market—typically in the form of an American Depository Receipt (ADR).[45] Alternatively, a foreign company may go one step

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In addition, the category of "exempt" securities under the Exchange Act is wholly different from those under the Securities Act. *See infra* note 50.

A U.S. issuer can thus avoid registration and continuous reporting under the Exchange Act if its security is traded over-the-counter, and has less than 500 shareholders or less than $5 million in total assets. For a description of the over-the-counter market, see *supra* note 13. See part I.B.1., for a discussion of the Exchange Act exemptions available to a *foreign* issuer.

43. 15 U.S.C. § 78*l*(a), (g)(1). For a description of the U.S. securities market, securities exchanges, and over-the-counter market, see *supra* note 13.

44. The principal reports required under the continuous disclosure system for U.S. issuers are the annual Form 10-K and the quarterly Form 10-Q. 17 C.F.R. § 249.308a, .310 (1993). Form 10-K must be filed within 90 days of the fiscal year-end, and Form 10-Q must be filed within 45 days of the quarter-end in all quarters except the year-end quarter. *Id.*

Companies registered under the Exchange Act must also distribute Annual Reports to shareholders as part of proxy rules relating to the annual shareholder meetings. 17 C.F.R. § 240.14a-3 (1993). Annual Reports are not required as part of the filings to the SEC. 3 BLOOMENTHAL, *supra* note 40, § 3.11. Companies registered under the Securities Act are not required to provide Annual Reports to shareholders because proxy rules are not applicable. *Id.*

45. *See generally* Harold Schimkat, Note, *The SEC's Proposed Regulations of Foreign Securities Issued in the United States*, 60 FORDHAM L. REV., S203, S205-10 (1990) (discussing ADRs in-depth); GERALD WARFIELD, HOW TO BUY FOREIGN STOCKS AND BONDS 24-31 (1985). American Depository Receipts are certificates representing a fractional ownership of a foreign security issued and traded abroad. Schimkat, *supra*, at S205. The certificates are issued by a depository institution (i.e., a U.S. bank) with or without the support of the foreign company. *Id.* at S205-09. ADRs are "sponsored" if the foreign company participates in or requests the formation of the ADR, or "unsponsored" if a bank creates the ADR at the request of brokers or investors. *Id.* at S206-09. The bank physically possesses the underlying foreign security to back the ADRs issued. *Id.* at S205.

ADRs offer numerous advantages to U.S. investors. Most importantly, ADRs offer a vehicle through which to own a foreign security in the United States without having to incur the high transactions costs associated with directly purchasing foreign securities. *Id.* at S206. These transactions costs normally include increased broker fees, longer settlement periods, greater

further by raising *new* capital in the United States via a public offering, and subsequently listing the new security on a national securities exchange or over-the-counter market.

1. Establishing an American Depository Receipt

A foreign issuer that establishes an ADR in the United States must choose between listing the ADR on a national securities exchange or having it traded in the pink-sheet market.[46] The choice is crucial because it often dictates whether a company must register and continuously report under the Exchange Act.[47] If a foreign company lists an ADR on a national securities exchange[48] or NASDAQ,[49] it must register and report under the

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exchange rate exposure, and the management fees associated with international mutual funds. *Id.* ADRs also offer the added benefit of being denominated in U.S. dollars and paying dividends in U.S. dollars. *Id.*

Historically, ADRs were issued as a means to avoid burdensome U.S. disclosure laws. In 1983, however, the SEC recognized ADRs as a distribution of securities in the United States. Therefore, ADRs are now subject to the registration and reporting requirements of Securities Act of 1933 and Securities Exchange Act of 1934, unless specifically "exempted." *Id.* at S207. *See infra* part I.B.1.

46. *See* Schimkat, *supra* note 45, at S203, S205-10. For a discussion of the U.S. pink-sheet market and the U.S. capital markets, see *supra* note 13.

47. The choice is also important because foreign companies that register under the Exchange Act must also submit to the jurisdiction of the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 101-04, 91 Stat. 1494 (1977) (codified as amended at 15 U.S.C. §§ 78m(b), (d)(1), (g)-(h), 78dd-(1), (2), 78ff(a), (c) (1988)). RICHARD W. JENNINGS, ET AL., SECURITIES REGULATION CASES & MATERIALS 1578 (7th ed. 1992). The Foreign Corrupt Practices Act of 1977 provides criminal penalties for corrupt practices to the extent that U.S. jurisdiction is possible. *Id.* In addition, the act requires that foreign companies establish and maintain an accurate and adequate internal accounting system so that accounting records "reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush fund[s] and payments of bribes." BLOOMENTHAL, *supra* note 42, § 22.05.

48. There are eight active registered national exchanges in the United States. 1991 SEC ANN. RPT. at 25. The exchanges include two national exchanges—the New York Stock Exchange (NYSE) and American Stock Exchanges (AMEX)—and other smaller regional exchanges such as the Pacific Stock Exchange (PSE) and the Midwest Stock Exchange (MSE). *See* LOSS, *supra* note 13, at 597-99.

49. Prior to 1983, foreign securities traded on NASDAQ could avoid Exchange Act registration and reporting under Rule 12g3-2(b). *See infra* notes 53-54 and accompanying text. On October 6, 1983, however, the SEC eliminated the exemption for NASDAQ issues. Foreign Securities, Exchange Act Release No. 20,264, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,435 (Oct. 6, 1983). The SEC did so "because of its belief that foreign issuers whose securities are traded in the United States as a result of voluntary acts taken by the issuer should be subject to substantially the same disclosure requirements as [a] U.S. issuer." 3D BLOOMENTHAL, *supra* note 40, § 15.13[4]. All foreign issu-

Exchange Act.[50] However, if a foreign company has an ADR traded in the pink-sheets, registration may not be required.

A foreign company with an ADR traded in the pink-sheets can avoid Exchange Act registration and reporting requirements in three ways. First, if the issue has less than 500 total shareholders, or the foreign company has less than $5 million in total assets, the company is not required to register or report under the Exchange Act.[51] Second, if the issue has less than 300 shareholders who are residents of the United States, the issuer is also exempt.[52] Finally, a foreign issuer that is unable to meet either of the first two threshold tests can obtain a Rule 12g3-2(b) exemption.[53] To qualify for a Rule 12g3-2(b) exemption, a foreign company must agree to submit to the SEC on a current basis all material information that is made public in the company's home country, filed with a foreign stock exchange, or provided to foreign shareholders.[54] Unless a foreign company is traded in the pink-sheet market and meets one of these three exemptions, the company is required to register and report under the Exchange Act.

Foreign companies required to register and continuously report under the Exchange Act use Form 20-F to file annual re-

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ers already trading on the NASDAQ, except Canadian issuers, retained the exemption by virtue of a grandfather clause granted to prevent a sudden withdrawal of NASDAQ foreign issuers. *Id.* Existing Canadian issuers were permitted to rely on the exemption only until January 1, 1986. Thereafter, Canadian issuers were required to register and report under the Exchange Act. *Id.*

50. In combination, Section 12(a) and 12(b) of the Exchange Act make a registration mandatory for any security listed on a national securities exchange or NASDAQ. 15 U.S.C. § 78*l*(a) to (b). Section 12(a) makes it unlawful to trade any security on a national securities exchange unless it is registered pursuant to Section 12(b). *Id.* § 78*l*(a). There are a few instances where a security may be listed as an "exempted security" on a national securities exchange without registration, such as governmental securities. Nevertheless, "for all practical purposes there is no exemption from registration under the Exchange Act for securities listed on a national securities exchange." BLOOMENTHAL, *supra* note 42, § 12.05; *see also supra* note 49 (discussing the exemption once available under Rule 12g3-2(b) for NASDAQ issues).

51. 15 U.S.C. § 78*l*(g)(1); 17 C.F.R. § 240.12g-1 (1993); LOSS, *supra* note 13, at 69.

52. 17 C.F.R. § 240.12g3-2(a) (1993).

53. 17 C.F.R. § 240.12g3-2(b) (1993); LOSS, *supra* note 13, at 70. Until 1983, ADRs traded on NASDAQ were also able to obtain a Rule 12g3-2(b) exemption. *Id.* at 71; *see supra* note 49.

54. 17 C.F.R. § 240.12g3-2(b) (1993); LOSS, *supra* note 13, at 71. *See generally* 3D BLOOMENTHAL, *supra* note 40, § 15.13[3][a] (discussing the exemptions available to foreign issuers under the Exchange Act).

ports.[55] Form 20-F is not required to conform to U.S. GAAP standards. Form 20-F may instead conform to the accounting standards of the issuer's home country.[56] However, a foreign company must discuss and quantify any material variations in the income statement or balance sheet so as to reach similar results under U.S. GAAP standards.[57] In filing Form 20-F, foreign companies can therefore incorporate their Annual Reports[58] with only *partial* reconciliation to U.S. GAAP standards. Nevertheless, the partial reconciliation to U.S. GAAP standards required for an ADR still represents significantly more disclosure than is required in other foreign markets.[59]

Although U.S. companies must file quarterly statements (Form 10-Q) in addition to their annual statement (Form 10-K), foreign companies with ADRs are not required to do so.[60] Foreign companies must instead provide U.S. investors with equal dignity via Form 6-K.[61] Form 6-K, like Exchange Act Rule 12g3-2(b), requires that a foreign company disclose all material

55. 17 C.F.R. § 249.240f (1993).

56. 3D BLOOMENTHAL, *supra* note 40, § 15.13[1][c]. However, Form 20-F must conform to or be fully reconciled with U.S. GAAP standards if the foreign company has conducted a public offering under the Securities Act. *Id.*; *see infra* part I.B.2.

57. 3D BLOOMENTHAL, *supra* note 40, § 15.13[1][c]. The SEC will consider simplifications or modifications on Form 20-F on a case-by-case basis for foreign companies unless the company is subject to the Exchange Act due to a public offering. Rules, Registration and Annual Report Form for Foreign Private Issuers, Exchange Act Release No. 16,371, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,363 (Nov. 29, 1979), 44 Fed. Reg. 70,132 (1979).

58. An Annual Report is distinct from an annual SEC filing such as Form 20-F. Annual Reports are reports distributed at annual shareholder meetings where company directors are elected. Besides including the basic financial statements, an Annual Report is "largely an unstructured document in which management is free to report what it chooses." BLOOMENTHAL, *supra* note 42, § 5.04. The annual Form 20-F under the Exchange Act may incorporate by reference the Annual Report, but the Annual Report is not sufficient if the Form 20-F is used as the principal document for a registration under the Securities Act on Form F-3 because it does not contain all the required information. *Id.* § 31.02, at 31-10, -11.

59. JENNINGS, *supra* note 47, at 1577.

60. 17 C.F.R. § 240.13a-13 (1993). Regardless of SEC regulations, the NYSE and AMEX exchanges require quarterly reports from their members, subject to individual exceptions. *See* Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the American Stock Exchange, Inc. and New York Stock Exchange, Inc. To Amend the Exchanges' Listing Standards for Foreign Companies, Exchange Act Release No. 24,634, 52 Fed. Reg. 24,230 (June 23, 1987); JENNINGS, *supra* note 47, at 1577-78. *See generally* LOSS *supra* note 13, at 429-33 (1988 & Supp. 1992) (discussing the general requirements for listing on the NYSE and AMEX).

61. 17 C.F.R. §§ 240.13a-16, 249.306 (1993).

information that is made public in the company's home country, filed with a foreign stock exchange, or provided to foreign shareholders.[62]

2. Conducting a Public Offering

Foreign companies that raise capital through an initial or secondary public offering must fully conform to U.S. GAAP standards.[63] A public offering is therefore much more burdensome in terms of registration and reporting than simply establishing an ADR based on an existing security.

Under the Securities Act, a foreign company conducting its first public offering must register and file Form F-1.[64] Form F-1 requires that financial statements be prepared according to U.S. GAAP standards or provide a full reconciliation to U.S. GAAP standards. The statements must include all supplemental information that is required only in the United States such as executive compensation, segmented financial data, and transactions between management and the corporation.[65] A foreign company may incorporate its Annual Report by reference in Form 20-F, but it must still fully reconcile all financial information to U.S. GAAP standards under the Securities Act.[66] A public offering also subjects a foreign issuer to the reporting requirements of the Exchange Act.[67]

Whether a foreign company conducts a public offering in the United States or establishes an ADR, it will be subject to much greater disclosure requirements than in other countries.[68] Therefore, the choice between simply listing an existing security

62. Form 6-K, General Instruction B., 5 Fed. Sec. L. Rep. (CCH) ¶ 84,812.

63. 3D BLOOMENTHAL, *supra* note 40, § 15.13[1][c]; *see also* BLOOMENTHAL, *supra* note 42, §§ 31.02-.04 (discussing the options available to foreign issuers on Form 20-F and Forms F-1-2-3-4).

U.S. GAAP standards go beyond most foreign accounting standards by requiring detailed information on segmented financial data, pension liabilities and other under-funded liabilities, depreciation and amortization, business combinations, deferred and capitalized costs, extraordinary items, discontinued operations, and changes in accounting methods. SEC DIVISION OF CORPORATE FINANCE, SURVEY OF FINANCIAL STATEMENT RECONCILIATIONS BY FOREIGN REGISTRANTS 3-7 (1993).

64. Form F-1, General Instruction I.A., 2 Fed. Sec. L. Rep. (CCH) ¶ 6,952; *see also* 3D BLOOMENTHAL, *supra* note 40, § 15.13[1][c], [2][a].

65. Form F-1, *supra* note 64; 3D BLOOMENTHAL, *supra* note 40, § 15.13[1][c], [2][a]; *see* SEC DIVISION OF CORPORATE FINANCE, *supra* note 63, at 3-7; *see also supra* note 63.

66. BLOOMENTHAL, *supra* note 42, § 31.03, at 31-12.

67. Sec. Exchange Act § 15(d), 15 U.S.C. § 78o(d) (1988).

68. *See supra* note 33.

or actually conducting a public offering is one which foreign issuers will evaluate in terms of the marginal costs and benefits of gaining access to U.S. capital.[69]

II. CRITICISMS OF THE U.S. DISCLOSURE SYSTEM AND RECENT SEC RESPONSES

The primary criticism of the U.S. disclosure system is that requiring foreign issuers to abide by onerous U.S. GAAP standards constitutes a significant barrier to entry to U.S. capital markets.[70] The NYSE and other advocates of reform (reformists) claim that current disclosure standards thwart the ability of the U.S. national exchanges to compete for foreign listings.[71] As a result, reformists contend that the long-run competitiveness of the U.S. national exchanges is in jeopardy, especially as other worldwide exchanges become increasingly more attractive.[72]

A. DETERRENTS TO FOREIGN LISTINGS

Although the primary criticism of the U.S. disclosure system is that foreign issuers are required to comply with U.S. GAAP standards, reformists also emphasize several other factors that purportedly deter foreign issuers from raising capital or listing securities in the United States.[73] Reformists assert that foreign issuers must also: (1) incur added delay in getting offers to market due to the lengthy registration procedures required under the Securities Act of 1933;[74] (2) participate in the costly continuous disclosure system under the Securities Ex-

69. See Biddle & Saudagaran, *Foreign Stock Listings*, *supra* note 33, at 69-74, for a detailed discussion of the costs and benefits evaluated by a foreign issuer.

70. Edwards, *supra* note 6, at 58; Freund, *supra* note 5, at A6; *see also* Raghavan & Sesit, *supra* note 1, at A1 (reporting the wave of foreign issues in the United States and the continuing criticism of SEC requirements).

71. Edwards, *supra* note 6, at 70; Freund, *supra* note 5, at A6.

72. Edwards, *supra* note 6, at 70; Freund, *supra* note 5, at A6. Some reformists argue that the NYSE has already lost its status as the world's premier exchange, and now shares that status with the stock exchanges in Tokyo, London, and Frankfurt. *E.g.*, Gregg A. Jarrell, *SEC Crimps Big Board's Future*, WALL ST. J., June 19, 1992, at A10. Furthermore, some claim that the NYSE has already lost much of its dominance in the United States. *Id.* In terms of trading volume, the NYSE's share of U.S. trading fell to 59% in 1991 from over 80% in the late 1970s. *Id.*

73. For a discussion of foreign issuers' objections to the U.S. reconciliation requirement, see McLaughlin, *supra* note 12, at 94.

74. JENNINGS, *supra* note 47, at 1573.

change Act of 1934;[75] (3) develop and maintain an internal accounting system that provides accurate and adequate financial records;[76] (4) disclose sensitive business information, such as executive compensation, that would not otherwise be available in foreign markets;[77] (5) subject themselves to broader civil liability under the antifraud provisions of the securities acts and other U.S. class action suits;[78] and (6) subject themselves to broader criminal prosecution for any corrupt or misleading practices under statutes such as the Foreign Corrupt Practices Act of 1977.[79]

These types of costs, however, are not unique to the United States. Foreign exchanges have many similar requirements, but typically not to the extent of the U.S. securities markets.[80] A foreign issuer's decision of where to raise capital or list securities is based on an evaluation of the costs and benefits of each market.[81] Although the costs associated with a U.S. listing or offering are not increasing,[82] reformists insist that the benefits are declining relative to the benefits of other countries. They claim that the relative decline in benefits is a result of increased liquidity, greater depth, and decreasing transaction costs in foreign capital markets.[83] In other words, foreign exchanges are steadily approaching the capabilities of U.S. exchanges in terms

75. *See* COCHRANE, *supra* note 12; Edwards, *supra* note 6.

76. *See supra* note 47.

77. *See supra* part I.B.2. and note 63.

78. For example, one out of every fourteen companies listed on the NYSE was subject to a securities fraud suit from 1988 to 1991. Vincent O'Brien, *The Class Action Shakedown Racket*, WALL ST. J., Sept. 10, 1991, at A20. Contrary to popular belief, it is not young and small companies that are usually the subject of these lawsuits. Over 75% of the companies sued during this period were in existence for over 10 years, and companies with $30 billion in annual revenues were just as likely to be sued as a $10 billion company. *Id. See generally* 3D BLOOMENTHAL, *supra* note 40, § 15.13[5] (discussing the extraterritorial application of the antifraud provision contained in U.S. securities laws).

79. Foreign Corrupt Practices Act of 1977, 91 Stat. 1494; *see supra* note 47.

80. *See* James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 HASTINGS INT'L & COMP. L. REV. 149, 149 (1993) (asserting that even though Japanese securities law is based on the U.S. securities law of the 1930s, "[i]t is well documented that the U.S. mandatory disclosure requirements are far more demanding in breadth and detail than those of Japan and other developed countries").

81. *See* Biddle & Saudagaran, *Foreign Stock Listings*, *supra* note 33, at 69-74.

82. With the SEC's recent actions and proposals related to foreign securities, the costs of a U.S. listing or public offering may actually be declining. *See infra* part II.B.

83. *See, e.g.*, Edwards, *supra* note 6, at 58.

of size, depth, trading costs, and efficiency, but at lower costs to a foreign issuer. Therefore, reformists contend that the U.S. national exchanges suffer from an increasing competitive disadvantage vis-a-vis foreign listings.[84]

B. RECENT SEC ACTION

The SEC has stated that one of its top priorities is "achieving a truly global market system."[85] As part of its efforts, the SEC has taken deliberate and measured steps in the last decade to relax foreign securities requirements, thereby increasing the worldwide competitiveness of U.S. national securities exchanges. Beginning in 1982, the SEC extended the integrated disclosure system to foreign issuers.[86] The integrated disclosure system is designed to simplify the duplicative disclosure required by the Securities Act of 1933 and Securities Exchange Act of 1934.[87]

In 1991, the United States established a multijurisdictional disclosure system (MJDS) with Canada.[88] The MJDS permits certain Canadian companies to prepare and submit disclosure documents under the Canadian disclosure system for an extensive array of securities transactions.[89] The SEC has recently proposed a similar multijurisdictional disclosure system with the United Kingdom.[90] Although these agreements indicate a willingness on the part of the SEC to recognize foreign disclosure standards, Canada and the United Kingdom were easy first steps because of the similarity of their disclosure requirements and regulatory systems to those in the United States.[91] The United States is unlikely to reach similar MJDS agreements

84. *See id.*, *supra* note 6, at 58, 70; Freund, *supra* note 5, at A6.

85. Securities and Exchange Commission, *Policy Statement on Regulation of International Securities Markets* (Nov. 14, 1988 Press Release) (cited in 3D BLOOMENTHAL, *supra* note 40, § 15.15[1]).

86. Adoption of Foreign Issuer Integrated Disclosure System, Sec. Act Release No. 6437, Fed. Sec. L. Rep. (CCH) ¶ 72,407 (Nov. 19, 1982).

87. SKOUSEN, *supra* note 27, at 46. "The system is based on the belief that a single, comprehensive reporting system, one that integrates the requirements of the 1933 and 1934 Acts, as well as those of shareholders' reports, will improve financial reporting in general and reduce the costs of compliance." *Id.*

88. Sec. Act Release No. 6902, *supra* note 20.

89. *See* 3D BLOOMENTHAL, *supra* note 40, § 15.15[1].

90. Regulatory Flexibility Agenda and Rules Scheduled for Review, Sec. Act Release No. 6909, 56 Fed. Reg. 203, 203 (Sept. 12, 1991); *see also* 3D BLOOMENTHAL, *supra* note 40, § 15.15[1] (discussing the countries that are likely to be chosen as candidates for future MJDS agreements with the United States).

91. 3D BLOOMENTHAL, *supra* note 40, § 15.15[1].

with nations such as Germany, whose disclosure standards and regulatory systems are markedly different.[92]

The most significant actions related to foreign securities came in 1990. The first was the adoption of Rule 144A[93] which permits the resale of privately placed securities[94] to qualified institutional buyers (QIBs)[95] without registration under the Securities Act.[96] Although private placements were already the primary method used by foreign firms to raise capital in the United States,[97] Rule 144A partially removed the most significant restraint on privately placed securities—the difficulty of reselling the security once purchased. Rule 144A therefore creates greater liquidity in the private placement market by permitting resale to QIBs.[98] In addition, although Rule 144A applies to domestic as well as foreign privately placed securities, it represents a significant step toward further increasing foreign participation in U.S. capital markets.

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92. *Cf. id.* (discussing that the SEC seeks to form agreements with countries most similar to the U.S. disclosure and regulatory systems). Germany's disclosure system, for example, is diametrically different from the U.S. system. Duffy & Murray, *supra* note 3, at A14. The German practice of stockpiling profits in hidden or "reserve" accounts for later use is a legitimate German accounting practice, but one that is prohibited under U.S. GAAP standards. John Schmid, *Daimler-Benz Reports First-Ever Loss, Reflecting New Accounting, Lower Sales*, WALL ST. J., Sept. 20, 1993, at A10. For example, Daimler-Benz used "reserved" earnings to avoid ever reporting a loss, even in the worst of times. Duffy & Murray, *supra* note 3, at A14. When it entered the U.S. market in 1993, however, it was forced to report its first-ever loss under stricter U.S. GAAP standards. *Id*; Schmid, *supra*.

93. 17 C.F.R. § 230.144A (1993). Rule 144A was adopted on April 23, 1990 and became effective immediately. Resale of Restricted Securities, Sec. Act Release No. 6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,523 (April 23, 1990).

94. Privately placed securities are securities sold directly to a small number of individual or institutional investors such as pension funds and insurance companies. The primary advantage of private placements is that they are not subject to SEC disclosure requirements. *See, e.g.*, EUGENE F. BRIGHAM & LOUIS C. GAPENSKI, FINANCIAL MANAGEMENT: THEORY AND PRACTICE 579-80 (6th ed. 1991).

95. In most cases, qualified institutional buyers (QIBs) are institutions with over $100 million invested in securities. *So Are Investors Ready For 144A?*, INT'L FIN. L. REV./CORP. FIN. 3 (Sept. 1990 Supp.). QIBs are typically mutual funds, pension funds, insurance companies, and money managers. *Id.*

96. Perell, *supra* note 30, at 15.

97. In 1989, foreign companies privately placed $24.1 billion compared to only $10.3 billion in public offerings. Securities and Exchange Commission, Foreign Issuer Private Placements and Registered Offerings (1993) (on file with the *Minnesota Journal of Global Trade*). In fact, since 1985 the volume of private placements has consistently been one and one-half to two times the amount of private offerings. *See id.*

98. Perell, *supra* note 30, at 14.

The second major action in 1990 was the adoption of Regulation S.[99] Regulation S limits the applicability of the Securities Act by providing a safe harbor for "offshore" securities distributions.[100] Regulation S codifies the general principle that "offers and sales of securities occurring outside the United States are not subject to the registration requirements of the Securities Act."[101] Thus, under Regulation S, the long-arm of the Securities Act does not grant U.S. jurisdiction over most offshore distributions. In combination, Rule 144A and Regulation S will open a major market for offshore issues (pursuant to Regulation S) that can be resold to QIBs in the United States (pursuant to Rule 144A) without the typical private placement market restrictions or delays.[102]

In 1993, the SEC proposed to streamline the reconciliation process for foreign companies.[103] The proposal would require foreign companies to reconcile financial data for only the previous two years, rather than the current requirement of five years.[104] The SEC would also accept cash flow statements prepared in accordance with International Accounting Standards, rather than U.S. GAAP standards.[105] Finally, six supplemental financial schedules would be eliminated from the reporting process because the SEC considers the information provided in these schedules insufficient to justify the costs of reconciliation.[106] According to the SEC, these three provisions are part of its "ongoing efforts" to ease the entry of foreign companies into the U.S. disclosure system and lower the costs of compliance.[107]

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99. 17 C.F.R. § 230.901-.904 (1993). Regulation S was adopted on April 24, 1990 and became effective immediately. Offshore Offers and Sales, Sec. Act Release No. 6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524 (April 24, 1990).

100. To qualify as an offshore transaction (1) the offer must be made to a person not in the United States, and (2) the buyer must not place the order in the United States, or the seller must at least "reasonably believe" that the buyer is not in the United States when placing the buy order. 17 C.F.R. § 230.902(i) (1993); 3D BLOOMENTHAL, *supra* note 40, § 15.12[6][a].

101. KRIPKE, *supra* note 29, at 17.

102. One hundred eighty-four foreign companies have raised capital in Rule 144A transactions since its adoption in April 1990. Sec. Act Release No. 7029, *supra* note 35, at 84,684. Twelve of those companies later entered the U.S. public markets for the first time. *Id.*

103. Sec. Act Release No. 7029, *supra* note 35.

104. *Id.* at 84,686.

105. *Id.*

106. *Id.* at 84,689.

107. *Id.* at 84,684. The proposal would also ease the entry of foreign issuers into the U.S. markets by (1) increasing the number of firms eligible to use the short-form and full shelf registration pursuant to the Securities Act, (2) provid-

These steps demonstrate that the SEC recognizes the importance of foreign securities in the United States.[108] They further indicate that the SEC is keenly aware of the crucial role that foreign listings and public offerings play in the ability of U.S. capital markets to remain internationally competitive.[109]

III. RECOGNIZING FOREIGN ACCOUNTING STANDARDS: ARGUMENTS AND ANALYSIS

The SEC now stands at a critical juncture in determining the future role that U.S. exchanges will play in the international securities markets.[110] Reformists contend that recognizing foreign accounting standards is the principal means of preserving the preeminent position of the U.S. national exchanges.[111] The SEC's key challenge is to determine whether recognizing foreign accounting standards will increase foreign listings in the United States without unraveling the strength and integrity of U.S. capital markets or jeopardizing U.S. investor safeguards.

A. THE NATIONAL AND INTERNATIONAL "TWO-TIER" MARKETS FOR FOREIGN LISTINGS

The U.S. national exchanges compete for foreign listings internationally as well as domestically. Internationally, the U.S national exchanges compete for foreign listings with other major exchanges such as those in London, Tokyo, and Frankfurt. Domestically, the U.S. national exchanges compete for foreign list-

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ing a new safe harbor for company announcements vis-a-vis exempt offerings or unregistered offshore offerings, and (3) expanding protection for analyst reports relating to large foreign companies traded offshore. *See id.* at 84,684-87, 84,689-90.

108. *See Written Responses of Arthur Levitt, supra* note 15; *see also supra* text accompanying note 85.

109. *See, e.g., Written Responses of Arthur Levitt, supra* note 15.

110. *Hearings, supra* note 7, at 1 (testimony of William H. Donaldson, Chairman and Chief Executive Officer, New York Stock Exchange).

> It has been 20 years since Congress last conducted a thorough examination of these markets, an examination that led to the Securities Acts Amendments of 1975. . . . [T]he focus can no longer be solely on the competitiveness of the markets that operate within our borders. Rather, the competition in which we engage has become truly international. . . . We must provide our financial markets with every opportunity to compete as effectively as possible in this new environment. . . . At the same time, we must also ensure that our markets continue to provide the high level of investor protection that has always been the hallmark of the U.S. market system.

Id. at 1-2.

111. *See* Freund, *supra* note 5; COCHRANE, *supra* note 12; McLaughlin, *supra* note 12.

ings with the U.S. pink-sheet market. Both markets are similar, however, as each is essentially a "two-tier" market. The international and domestic markets each have one tier that requires foreign companies to fully comply with the exchange's domestic accounting standards; each market also has another tier that recognizes a company's home country accounting standards. In both the international and domestic markets, the U.S. national exchanges occupy the "reporting" tier because of the SEC's requirement that foreign companies comply with U.S. GAAP standards in order to trade on a U.S. national exchange.

1. The U.S. Rivalry: The National Exchanges and the Pink-Sheet Market

The distinguishing factor between the two tiers of the U.S. market is whether or not a company is obligated to report to the SEC under the Exchange Act. The first tier consists of "reporting" foreign companies which are primarily listed on the national exchanges and NASDAQ.[112] The second tier consists of "non-reporting" foreign companies which can be traded only in the over-the-counter pink-sheet market.[113] Foreign companies listed on the "reporting" tier are required to reconcile or conform their financial statements to U.S. GAAP standards. Conversely, foreign companies traded on the "non-reporting" tier are not required to report to the SEC or conform to U.S. GAAP standards.[114] Home-country accounting standards are thus acceptable for non-reporting companies.

Reformists insist that by requiring foreign companies to reconcile or conform to U.S. GAAP standards in order to list on a national exchange, the SEC has created a distinct competitive advantage for the pink-sheet market.[115] Reformists cite the fact

112. Although the vast majority of reporting foreign companies are listed on the national exchanges or NASDAQ, there are also foreign companies traded in the pink-sheet market that report to the SEC. As of August 31, 1993, there were 124 foreign companies traded in the pink-sheet market reporting to the SEC. NEW YORK STOCK EXCHANGE, FOREIGN REPORTING ISSUERS LISTED ON MAJOR EXCHANGES AND THE COMBINED U.S. MARKETS, Aug. 31, 1993 (on file with the *Minnesota Journal of Global Trade*); SECURITIES AND EXCHANGE COMMISSION, *supra* note 3, at 5.

113. *See supra* note 13. Before October 1983, foreign companies traded on the NASDAQ were not required to report to the SEC under Rule 12g3-2(b). The SEC then eliminated the exemption for NASDAQ issues so that now any company listed on a national exchange or NASDAQ must report to the SEC. Exchange Act Release No. 20,264, *supra* note 49; *see supra* note 49.

114. *See supra* text accompanying notes 51-54.

115. *See* Edwards, *supra* note 6, at 62-63; COCHRANE, *supra* note 12, at 7; McLaughlin, *supra* note 12, at 91.

that over the past decade the number of non-reporting foreign companies has significantly increased in the United States.[116] For instance, from 1983 to 1992 the number of non-reporting American Depository Receipts (ADRs) nearly tripled from 335 to 922.[117] Not surprisingly, as the number of ADRs traded in the pink-sheets tripled, the national exchanges began the movement to reform SEC disclosure requirements.[118] Thus, the debate over foreign listing disclosure requirements is a product of the battle for market share in the foreign listings market.[119]

Besides the significant increase of foreign issues in the pink-sheet market, reformists also cite the history of foreign listings on NASDAQ as evidence of the competitive advantage now enjoyed by the pink-sheet market.[120] From 1977 to 1982, the number of foreign issues quoted on NASDAQ more than tripled from 85 to 294.[121] However, from 1983, when NASDAQ joined the "reporting" tier upon losing its Rule 12g3-2(b) reporting exemption,[122] to 1991, the number of foreign issues fell to 213.[123]

Reformists maintain that the decline in foreign listings on NASDAQ is a direct result of the added costs of SEC reporting under U.S. GAAP.[124] In light of the increase in foreign issues traded in the pink-sheet market, and the simultaneous decline in NASDAQ foreign listings after it joined the "reporting" tier, reformists argue that the benefits associated with a national exchange listing are not great enough to compensate for the increased costs associated with SEC reporting and compliance

116. Edwards, *supra* note 6, at 63; COCHRANE, *supra* note 12, at 7.

117. NEW YORK STOCK EXCHANGE, REPORTING AND NON-REPORTING ADRS (1993) (on file with the *Minnesota Journal of Global Trade*).

118. *See, e.g.*, *Hearings*, *supra* note 7, at 11-13 (testimony of William H. Donaldson, Chairman and Chief Executive Officer, New York Stock Exchange). Chairman Donaldson stated that until worldwide harmonization of accounting standards occurs, "a necessary interim solution is to develop a system of global recognition of accounting standards." *Id.* at 2.

119. In recent years, for example, the NYSE has captured only one out of every five foreign listings in the United States. Richard C. Breeden, The Globalization of Law and Business in the 1990's, Keynote Speech at the Wake Forest Law Review 1993 Business Law Symposium (Apr. 2, 1993), *in* 28 WAKE FOREST L. REV. 509, 516 (1993). However, Richard Breeden, a former SEC Chairman, recently stated that this "is not an American problem; it is a problem for the New York Stock Exchange. While such facts might concern the United States, one must remember that the national interest entails more than the interest of any organization." *Id.*

120. COCHRANE, *supra* note 12, at 7-8; Edwards, *supra* note 6, at 63.

121. COCHRANE, *supra* note 12, at 7-8; Edwards, *supra* note 6, at 63.

122. See *supra* note 49 and accompanying text.

123. Edwards, *supra* note 6, at 63.

124. *See, e.g.*, *id.* at 59, 63.

with U.S. GAAP standards.[125] Therefore, to correct the imbalance between the costs and benefits of a national exchange listing, the costs of an exchange listing must be lowered by accepting home-country accounting standards.

For a foreign issuer, the costs associated with each tier in the United States are undoubtedly imbalanced. By listing on a national exchange, a foreign issuer must register and report under the Exchange Act and thereby incur substantial costs.[126] By trading in the pink-sheet market, however, a foreign company avoids the costs associated with SEC reporting and registration according to U.S. GAAP.[127] Nevertheless, the pink-sheet market offers significantly less in benefits. The pink-sheet market provides no real-time price quotes, no last-sale reporting, and substantially lower liquidity than the national exchanges or NASDAQ.[128] Investors are also forced to pay large bid-ask spreads[129] on each trade in the pink-sheet market.[130] By contrast, the national exchanges offer access to the most efficient, deep, and liquid exchanges in the world.[131] Investors thereby benefit from lower transactions costs, faster settlement, and broader participation.[132] Reformists contend, however, that the history of foreign issues quoted on NASDAQ, and the simultaneous growth of ADRs traded in the pink-sheet market, illustrate that the costs of a national exchange listing are even greater than the benefits.[133] Reformists conclude that because the benefits of an exchange listing are accompanied by even greater costs, the pink-sheet market is preferable to foreign issuers.[134]

The evidence cited by reformists, however, provides an incomplete picture. The focus on the absolute growth of the foreign issues traded in the pink-sheet market ignores the simultaneous growth in foreign issues traded on national ex-

125. *See id.*
126. *See supra* part II.A.
127. *See supra* text accompanying notes 51-54.
128. Edwards, *supra* note 6, at 62. *See also* LOSS, *supra* note 13, at 599-602 (1988 & Supp. 1992) (comparing the OTC or pink-sheet market to the national exchanges).
129. A spread in the over-the-counter market is the difference between the bid and asked prices for a security, and represents a dealer's profit. BRIGHAM & GAPENSKI, *supra* note 94, at 71 n.2.
130. *See, e.g.*, Edwards, *supra* note 6, at 64.
131. *See generally* 3 BLOOMENTHAL, *supra* note 40, § 3.09[3] (discussing the advantages of an exchange listing from the perspective of the issuer and investor).
132. *Id.* § 3.09[3][b].
133. *See supra* text accompanying notes 116-25.
134. *See* Edwards, *supra* note 6, at 58, 63.

changes (reporting issuers).[135] A more complete analysis compares the relative, as opposed to absolute, number of foreign issues traded on each tier. This analysis reveals that the number of reporting foreign issues has experienced a similar growth rate to that of non-reporting foreign issues.

For example, although the number of non-reporting ADRs has tripled in the last decade, the *ratio* of ADRs traded in the pink-sheet market (non-reporting) to the number of exchange-listed ADRs (reporting) has remained constant. In 1983, there were 335 non-reporting ADRs and 165 reporting ADRs, approximately a 2:1 ratio of non-reporting to reporting ADRs.[136] From 1983 to 1988, however, the number of non-reporting ADRs rose to 1,684, increasing the ratio of non-reporting to reporting ADRs to almost 5:1.[137] This tremendous growth period for non-reporting ADRs, not surprisingly, is the time period emphasized by reformists.[138]

By 1993, however, the number of non-reporting ADRs had decreased from 1,684 to 922, while the number of reporting ADRs had increased from 343 to 442.[139] The approximate ratio of non-reporting to reporting ADRs has thus returned to 2:1. More importantly, the trend over the last five years indicates that the ability of the U.S. exchanges to attract foreign issues has substantially improved as compared to the pink-sheet market. The relative numbers of foreign issues on each tier therefore provide an entirely different picture than that normally painted by reformists.

Moreover, even using the absolute numbers cited by reformists, there is a record level of activity now occurring on the national exchanges. In 1992, a record sixteen foreign companies listed on the NYSE alone.[140] This record was surpassed in 1993 when thirty-seven foreign companies listed on the NYSE.[141] The trend is likely to continue. Latin American companies, for

135. *See, e.g., id.* at 62-63.

136. NEW YORK STOCK EXCHANGE, *supra* note 117.

137. *Id.* There were 343 exchange-listed reporting ADRs in 1988. *Id.*

138. *See* Edwards, *supra* note 6, at 62-63; COCHRANE, *supra* note 12, at 7.

139. NEW YORK STOCK EXCHANGE, *supra* note 117.

140. Craig Torres, *Latin American Firms Break With Past, Scramble to Be Listed on U.S. Exchanges*, WALL ST. J., Sept. 28, 1993, at C1. Reformists argue, however, that the recent growth in foreign securities listed on the NYSE has occurred in spite of, not because of, U.S. disclosure requirements. *See* COCHRANE, *supra* note 12, at 8.

141. NEW YORK STOCK EXCHANGE, ADDITIONS/SUSPENSIONS OF NON-U.S. SECURITIES 2 (1993) (on file with the *Minnesota Journal of Global Trade*).

instance, "are scrambling to get their stock listed" on U.S. exchanges.[142]

Finally, the reformist position ignores the fundamental link between SEC disclosure requirements and the superiority of the national exchanges over the pink-sheet market. The rigorous disclosure requirements associated with a national exchange listing have created the very benefits that the exchanges offer over the pink-sheet market.[143] Investors simply place a calculable value on the increased disclosure. As a result, companies benefit through lower costs of capital, higher trading volume, and more diverse investor participation.[144] If the SEC accepts foreign accounting standards, the costs of a national exchange listing will undoubtedly be lower for foreign companies, but the benefits of an exchange listing may not remain constant. Therefore, any SEC ruling that recognizes foreign accounting standards will jeopardize the very institutional benefits now offered by the national exchanges over the pink-sheet market.[145]

2. The International Rivalry: The U.S. National Exchanges and Foreign Exchanges

Similar to the two-tier system that exists in the United States, an international two-tier market has also developed along the lines of disclosure requirements. On one tier, the U.S. national exchanges stand virtually alone, arguably accompanied by Canada and the United Kingdom.[146] The other tier is composed of most other major markets, such as Germany and Ja-

142. Torres, *supra* note 140, at C1. Although Latin American accounting standards have been heavily influenced by American accounting standards, Latin American companies still face significant "adjustments for inflation and under-funded liabilities, such as pension payments and deferred taxes." *Id.* These companies are listing on U.S. exchanges to improve liquidity, increase investor awareness, and adjust to the capital needs of the North American Free Trade Agreement. *Id.*

143. *See* Schapiro, *supra* note 5; Cox, *supra* note 19, at 187.

144. *See* Schapiro, *supra* note 5; Cox, *supra* note 19, at 187.

145. Consider this hypothetical example often used to illustrate the dilemma faced by the SEC with regard to accepting home-country accounting standards. Suppose that after dozens of new foreign firms are admitted to the national exchanges, a major scandal occurs involving a foreign company. Although the foreign country's more lenient disclosure standards or insider trading rules are likely at fault, an event such as this would be blamed on the SEC and its Congressional overseers. The fallout would not only hurt foreign companies, but it could possibly shake overall investor confidence in the national exchanges to the point that even U.S. companies would suffer from increased costs of capital. *See, e.g.*, Jarrell, *supra* note 72.

146. *See* Biddle & Saudagaran, *Effects of Financial Disclosure*, *supra* note 33, at 60.

pan.[147] Like the pink-sheet market in the United States, the non-U.S. tier is now a formidable competitor for the U.S. national exchanges.[148] The costs of participation in each tier depend primarily on the registration, reporting, and disclosure requirements. The benefits offered by each market depend on the size, breadth, and strength of the market. According to reformists, the non-U.S. exchanges now offer a level of benefits comparable to U.S. exchanges, but with lower costs of disclosure.[149]

Despite the alleged uncompetitiveness of the U.S. national exchanges, the number of foreign listings in the United States has increased while the number on other foreign exchanges has declined. As of June 30, 1993, 559 foreign companies were trading in the United States and complying with U.S. GAAP standards.[150] There were 562 foreign companies trading on the London exchange, 352 in Frankfurt, 201 in Paris, and 115 in Tokyo.[151] An even more compelling indication of U.S. competitiveness, however, is the three-year trend of foreign listings on each exchange. The United States has gained 120 foreign listings in the last three years,[152] while London has lost 40, Tokyo has lost 10, and the other exchanges have remained relatively constant.[153] The fact that foreign listings have increased on U.S. exchanges, while other foreign exchanges have lost listings, indicates that the United States still offers superior benefits to foreign issuers over other foreign exchanges.

The dollar volume of offerings in the United States demonstrates a similar trend. Since 1981 the dollar volume of public offerings in the United States has climbed steadily.[154] Like the number of listings, the largest gains in dollar volume have occurred since 1990.[155] In 1991 and 1992 respectively, $14.8 bil-

147. *Id.*

148. *See* Edwards, *supra* note 6, at 58.

149. *See id.*; Freund, *supra* note 5.

150. Schapiro, *supra* note 5. The number of foreign firms listed in the United States further increased to 575 by September 30, 1993. SEC OFFICE OF LEGISLATIVE AFFAIRS RELEASES, REPORTING FOREIGN ISSUERS AS OF SEPT. 30, 1993 (on file with the *Minnesota Journal of Global Trade*).

151. Schapiro, *supra* note 5.

152. *Id.* From 1989 to 1993, there were 203 new foreign securities listings in the United States. Breeden, *supra* note 119, at 516. There were 121 foreign company public offerings in 1992 alone. *Id.*

153. Schapiro, *supra* note 5.

154. *See* SEC OFFICE OF LEGISLATIVE AFFAIRS, FOREIGN COMPANY PRIVATE PLACEMENTS AND PUBLIC OFFERINGS (1993) (on file with the *Minnesota Journal of Global Trade*).

155. *See id.*

lion and $18.7 billion of equity was publicly offered by foreign companies in the United States.[156] In the first half of 1993 alone, nearly $16.3 billion of foreign securities was publicly offered in the United States.[157] The number and dollar volume of foreign listings in the United States demonstrate that the globalization of securities markets has not impeded the competitiveness of the U.S. national exchanges.

B. STEMMING U.S. CAPITAL FLIGHT

As the globalization of securities markets progresses, U.S. investors continue to lead the way.[158] U.S. investors are increasingly investing in other developed countries and emerging markets in the search for higher yields and the desire to globally diversify their portfolios.[159] Consequently, U.S. investors are exposing themselves to considerably more risk while incurring greater expenses.[160] The greater risks of international investing are a function of currency fluctuations, foreign political instability, volatile foreign economic conditions, and the lack of investor safeguards such as are available in the United States.[161] The added expense of international investing is a result of higher transaction costs incurred when trading in other markets.[162] Even small investors who invest internationally through global mutual funds incur greater transaction costs in the form of higher management fees.[163]

Reformists allege that despite the added risks and expense, U.S. investors are circumventing the SEC and its protection by investing overseas at record levels.[164] Therefore, they argue that the SEC should keep these foreign securities trades in the United States by encouraging more foreign listings through

156. *Id.*

157. *Id.*

158. *See supra* note 9 and accompanying text.

159. Jeanne B. Pinder, *Americans Rush to Funds That Invest Abroad*, N.Y. TIMES, Oct. 12, 1993, at D1. The amount of new funds invested in foreign equity mutual funds is now nearly half of all new mutual fund investments. *Id.* In August 1993 alone, $5.4 billion flowed into foreign equity mutual funds, and from January to October 1993 a total of $17.4 billion was invested. *Id.* By contrast, in all of 1992 only $6.9 billion flowed into foreign equity mutual funds. *Id.*

160. Edwards, *supra* note 6, at 63; Freund, *supra* note 5.

161. *See generally* WARFIELD, *supra* note 45, at 20-21 (1985).

162. Edwards, *supra* note 6, at 63-64.

163. *Id.* at 64.

164. *See* Freund, *supra* note 5; Edwards, *supra* note 6, at 62.

lower U.S. disclosure requirements.[165] By accepting home-country accounting standards, the SEC would provide foreign issuers with an even greater incentive to raise capital or list securities in the United States. More importantly, reformists claim that U.S. investors would benefit from the ability to trade more foreign securities in the United States, with lower trading costs, higher liquidity, and recourse under U.S. antifraud laws.[166] Finally, the U.S. securities industry and U.S. economy would benefit from more foreign listings as a result of increased trade and employment.[167]

However, the fact that large amounts of capital are currently flowing overseas does not in itself warrant wholesale abandonment of stringent U.S. disclosure laws. The amount of funds invested abroad is still relatively small in comparison to domestically invested funds.[168] For example, of the $5 trillion of American institutional and mutual fund assets, less than seven percent is invested in foreign securities.[169] Moreover, large capital outflows are not necessarily due to U.S. capital market inadequacies. Capital is currently flowing overseas in record amounts, primarily due to the higher yields available in foreign markets.[170] The increasing level of overseas investment is thus a natural result of the celebrated globalization of securities markets. In fact, the United States will likely be the largest participant in the global securities market, given the enormous amount of capital at its disposal. Even if reformists are correct in assuming that accepting foreign accounting standards will increase the number of foreign listings on U.S. exchanges, the forces of globalization are simply too powerful to stem the flow of U.S. capital abroad.

Finally, despite the fact that some investors are willing to succumb to the greater risks associated with foreign markets and their lower disclosure levels, the average U.S. investor should not be put at risk.[171] The comprehensive disclosure re-

165. *See* Freund, *supra* note 5; Edwards, *supra* note 6.

166. *See, e.g.*, *Hearings*, *supra* note 7, at 12 (testimony of William H. Donaldson, Chairman and Chief Executive Officer, New York Stock Exchange).

167. *See* McLaughlin, *supra* note 12, at 91 (concluding that U.S. broker-dealers lose business as a result of U.S. capital flight). For a discussion of the impact and importance of the securities industry on the U.S. economy, see *supra* notes 22-23 and accompanying text.

168. *See* Pinder, *supra* note 159, at D1.

169. Duffy & Murray, *supra* note 3; *see also* Pinder, *supra* note 159, at D1.

170. Pinder, *supra* note 159, at D1.

171. *See* James R. Doty, *The Role of the Securities and Exchange Commission in an Internationalized Marketplace*, 60 FORDHAM L. REV. S77, S89 (1992).

quired in the United States lowers the risks of entry for small investors.[172]

C. THE EFFICIENCY OF SECURITIES EXCHANGES

Another major foundation of the reformist movement is based on the comparable levels of market efficiency that exist in U.S. exchanges and other foreign exchanges.[173] Market efficiency is determined by the ability of investors to quickly reflect newly disclosed information into securities prices.[174] If buyers and sellers effectively incorporate new information immediately upon release, arbitrage opportunities—the ability of investors to make consistently superior returns based on technical or fundamental analysis—will be eliminated.[175]

Numerous studies indicate that other major foreign exchanges are just as efficient as U.S. exchanges.[176] Thus, investors on the Tokyo, London, or New York stock exchanges cannot consistently profit from technical analysis or fundamental analysis. Reformists therefore contend that the additional disclosure

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U.S. investors who wish to invest overseas while minimizing the risks and transaction costs can readily do so through foreign securities mutual funds. Jarrell, *supra* note 72.

172. *See* Schapiro, *supra* note 5.

173. *See* Baumol & Malkiel, *supra* note 5, at 39-40, 46-51; Freund, *supra* note 5; Edwards, *supra* note 6, at 64-66. *But see Hearings*, *supra* note 7, at 12 (testimony of William H. Donaldson, Chairman and Chief Executive Officer, NYSE, stating that foreign markets "generally offer less efficient trading and settlement practices than U.S. markets, and certainly offer less protection to U.S. investors").

174. *See, e.g.*, Baumol & Malkiel, *supra* note 5, at 47. The degree of a market's efficiency depends on several factors, including the level of institutional or professional participation, the liquidity of a market, and the speed and ease with which transactions occur. *See generally* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 289-309 (4th ed. 1991) (explaining the Efficient Market Hypothesis and its implications in finance).

175. Baumol & Malkiel, *supra* note 5, at 39-40. Technical analysts study past securities prices to predict future cycles of securities prices. BREALEY & MYERS, *supra* note 174, at 295. Fundamental analysts study an individual company's business and financial data to uncover mispriced securities. *Id.* These two types of investment techniques are ultimately what make markets efficient. *Id.*

176. *See* Gabriel Hawawini, *European Equity Markets: Price Behavior and Efficiency*, *in* 4/5 MONOGRAPH SERIES IN FINANCE AND ECONOMICS (Anthony Sanders ed., 1984) (concluding that European markets are equally efficient after reviewing numerous studies); Robert E. Cumby & Jack D. Glen, *Evaluating the Performance of International Mutual Funds*, 45 J. OF FIN. 497 (1990); Baumol & Malkiel, *supra* note 5, at 39-40, 46-51.

in the United States is without value to investors because foreign exchanges are equally as efficient as U.S. exchanges.[177]

Even if U.S. exchanges and foreign exchanges are equally efficient, however, the conclusion drawn by reformists assumes that market efficiency and disclosure levels interact. More specifically, reformists assume that the *speed* with which a market incorporates new information enables policymakers to identify the optimal *amount* of financial disclosure.

To examine the relationship, if any, between market efficiency and disclosure levels, consider two hypothetical capital markets at the opposite extremes of disclosure levels. Market *A* requires comprehensive, segmented, and fully annotated financial statements similar to those required in the United States. Market *Z* requires the disclosure of only one item, net income. As information is released in each market about a particular company, investors will buy and sell based on their evaluation of the newly released information. As a result, the prices of securities in both markets will eventually reflect the newly released information.[178] The speed with which each market incorporates the new information determines its degree of efficiency. Yet, regardless of how efficient Markets *A* and *Z* are, empirical studies have shown that securities prices in both markets will eventually reflect that market's best estimate of a company's risk and required rate of return.[179] Securities prices in Market *A*, however, will reflect *more* information due to the higher level of disclosure.

The fact that both Market *A* and Market *Z* will eventually reflect all publicly available information, despite their unequal disclosure levels, indicates that the degree of efficiency in each market is independent of the disclosure level. Market *A* and Market *Z* further illustrate that the reformist's reliance on market efficiency is misguided, due to the confusion of two very distinct concepts of efficiency: *trading* efficiency and *productive* efficiency.

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177. *See, e.g.*, Baumol & Malkiel, *supra* note 5, at 51.

178. All public information will eventually be reflected in securities prices because arbitragers will continually trade until the opportunity for excess returns is eliminated.

179. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 24-2 J. FIN. 383 (1970); Eugene F. Fama, *Efficient Capital Markets: II*, 46-5 J. FIN. 1575 (1991); BRIGHAM & GAPINSKI, *supra* note 94, at 250. These tests have shown that technical and fundamental analysis cannot be used to consistently outperform the market. *See id.*

Trading efficiency, commonly referred to as market efficiency, measures the ability of a market to eliminate arbitrage opportunities by incorporating new information into securities prices.[180] By contrast, productive efficiency measures the accuracy with which a market adjusts securities prices.[181] Each concept is concerned with a unique aspect of market information. Trading efficiency is concerned with the *speed* with which information is used to adjust securities prices and thereby determine a company's cost of capital, while productive efficiency is concerned with the *amount* of information used. A greater level of disclosure will reduce the level of uncertainty faced by investors and permit a more efficient allocation of capital among companies.[182]

Therefore, the level of disclosure in a market primarily impacts a market's productive efficiency, rather than, as reformists assert, its trading efficiency. Market *A* and Market *Z* can both be perfectly trading efficient, that is, they can both instantaneously eliminate arbitrage opportunities. At the same time, however, Market *A* is more productively efficient. Market *A* is more productively efficient because the greater level of information available will permit a more precise allocation of capital among high and low quality companies. Investors in Market *A* will use the highly detailed, company-specific information available to individually assign costs of capital to each company. Investors in Market *Z*, however, will merely assign average costs of capital to all companies due to the lack of detailed information. High-quality companies in Market *Z* will be forced to effectively subsidize inferior companies due to the inability of investors to distin-

180. See *supra* note 174 for factors that effect the degree of a market's trading efficiency.

181. *See* MAUTZ, *supra* note 32, at 43, 78-79 (explaining that a market's ability to effectively distribute scarce resources is essential to long-run increases in productivity). A security or portfolio of securities is accurately priced when it provides the highest expected return for a given level of risk, or the lowest degree of risk for an expected return. *See, e.g.*, BRIGHAM & GAPENSKI, *supra* note 94, at 120, 126, 139-55. When securities are accurately priced in a capital market (i.e., the market is productively efficient) the market will achieve its ultimate function: the allocation of an economy's scarce resources to the most productive activities. MAUTZ, *supra* note 32, at 43, 77.

The SEC also refers to productive efficiency as "operational efficiency." KRIPKE, *supra* note 29, at 134.

182. *See* MAUTZ, *supra* note 32, at 28-29. The more effectively capital is distributed in an economy, the more likely a society is to achieve the primary economic goal of increasing production. *Id.* at 43.

guish among them.[183] Therefore, although these two markets can be identical in terms of trading efficiency, Market *A* benefits from greater disclosure in the form of more a precise allocation of capital—i.e., greater productive efficiency.

This example suggests several important points about different disclosure levels. First, companies in a high disclosure market will be assigned a more accurate cost of capital. Second, investment will be lower in countries with lower levels of disclosure.[184] Investment in a low disclosure economy will be lower because investors are unable to distinguish between high and low risk companies and this ultimately makes equity investments less attractive overall.[185] Finally, and most importantly, the concept of trading efficiency is of little value in the debate over the optimal level of disclosure in the United States.

Consequently, the proposition that foreign exchanges are just as efficient as U.S. exchanges lends little support to the reformist movement. A market can be perfectly trading efficient regardless of how much disclosure is required— even in a market with zero disclosure. Although disclosure levels of major world markets lie on a tighter continuum than that of the Market *A* and Market *Z* example, the optimal level of disclosure in a market is not determined by market (or trading) efficiency.[186]

D. THE SEARCH FOR AN OPTIMAL LEVEL OF DISCLOSURE AND THE PRIVATE INCENTIVE TO DISCLOSE

An obvious solution to the financial disclosure debate is to establish international accounting standards.[187] Several organizations have been negotiating international standards for de-

183. In a low disclosure market, high quality companies will effectively subsidize low quality companies by lowering the cost of capital that would otherwise be charged to low quality companies. The cost of capital for low quality companies would be lowered because of the inability of investors to differentiate between high and low quality companies. In short, all companies would pay an industry average cost of capital, with high quality companies paying too much and low quality companies paying too little.

184. *Cf.* MAUTZ, *supra* note 32, at 29 (stating that *companies* that do not disclose sufficient information will be deemed unattractive investments and will likely go unfunded).

185. *See id.*

186. If foreign markets were shown to be as productively efficient as the U.S. market despite their lower disclosure requirements, the conclusion could then be drawn that some of the SEC disclosure requirements are without value. *See* Edwards, *supra* note 6, at 64-65. However, this type of evidence is very difficult to produce. *Id.* at 64.

187. The NYSE, for example, supports the efforts to establish international accounting standards as a viable long-run solution to the disclosure debate.

cades.[188] However, until the prolonged steps of international negotiations actually produce a comprehensive set of international standards, the SEC is committed to preserving the preeminent position of the U.S. securities markets with the current disclosure system.

While reformists continue to lobby for a short-term solution to the purported U.S. disclosure disadvantage, it is important to consider the effects of maintaining the current disclosure requirements in a globalized capital market. If U.S. disclosure laws do impose additional costs on foreign issuers, basic economics suggests that foreign companies will seek listings elsewhere unless the added benefits of a U.S. listing are substantial. If the marginal benefits equal the marginal costs, foreign issuers should be indifferent between exchanges. Although each company's estimate of the costs and benefits will differ,[189] recent activity in foreign listings indicates that foreign companies still place a positive value on a U.S. listing. Indeed, as previously noted, the number of foreign listings in the United States continues to rise while other foreign exchanges have stabilized or declined in foreign participation.[190] Moreover, the relative number of foreign companies that trade on the U.S. national exchanges, as compared to the pink-sheet market, has substan-

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Hearings, *supra* note 7, at 13 (testimony of William H. Donaldson, Chairman and Chief Executive Officer, New York Stock Exchange).

188. The organization with the most promise is currently the International Accounting Standards Committee (IASC). Abdel M. Agami, *Global Accounting Standards and Competitiveness of U.S. Corporations*, MULTINATIONAL BUS. REV., Spring 1993, at 38, 42. The IASC has representatives from 75 nations and follows a democratic process in the establishment of accounting standards. *Id.* The SEC has been actively involved with the IASC in its efforts to establish international accounting standards. 1991 SEC ANN. RPT. at 66. The United Nations and the International Organization of Securities Commissions (IOSCO) are also involved in the pursuit of international accounting standards. *See* Agami, *supra*, at 42; Edwards, *supra* note 6, at 70.

Other organizations are committed to establishing accounting standards for certain geographic regions. The European Union has 12 member nations and periodically issues "directives" that provide guidance to its member nations on accounting and disclosure matters. Agami, *supra*, at 42. Other organizations with similar commitments include: the Organization for Economic Cooperation and Development (OECD), which has 24 member nations that represent most industrialized countries; the Asociacion Interamericana de Contabilidad (AIC), which has 21 member nations representing North and South American countries; and the Confederation of Asian and Pacific Accountants (CAPA), which has 20 member nations from the Pacific Rim. GERHARD G. MUELLER ET AL., ACCOUNTING: AN INTERNATIONAL PERSPECTIVE 46-48 (2d ed. 1991).

189. *See generally* Biddle & Saudagaran, *Foreign Stock Listings*, *supra* note 33, at 69-74 (discussing the benefits and costs of a foreign listing).

190. *See supra* text accompanying notes 150-53.

tially increased since 1988,[191] and the NYSE continues to list record numbers of foreign companies.[192] Trends such as these indicate that the higher disclosure levels in the United States still confer superior benefits to foreign companies.

However, the superior benefits associated with a U.S. national exchange listing may not be purely a function of more stringent U.S. disclosure laws. The benefits of detailed disclosure may also be attributable to market demand. Investors in the United States and around the world have created a significant private incentive for companies to disclose information.[193] The primary incentive for a company is to lower its cost of capital.[194] Companies which feel that more disclosure will lower their cost of capital will do so regardless of the statutory disclosure requirements.[195] Eventually, companies which choose not to disclose detailed financial information will be assessed a higher cost of capital because investors will assume the worst about the company.[196] Even marginal companies will have an incentive to disclose information to avoid being associated with high risk companies. In theory, investors could make low disclosure requirements irrelevant by charging costly risk premiums

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191. *See supra* text accompanying note 139.

192. *See supra* text accompanying notes 140-41.

193. *See* Edwards, *supra* note 6, at 61; KRIPKE, *supra* note 29, at 124. Voluntary disclosure routinely occurs in the U.S. private placement market as well as in U.S. venture capital transactions. *Id.* at 118-22. Voluntary disclosure was common even before the SEC and U.S. securities law existed. Edwards, *supra* note 6, at 62. Voluntary disclosure also occurs in foreign markets, see *infra* note 198 and accompanying text.

The private incentive for a company to disclose information has been called the "lemons problem." SANFORD GROSSMAN, THE INFORMATION ROLE OF PRICES 166-89 (1989). For example, consider the case of a product produced by many companies, some high quality and some low quality. If there is no way for high quality producers to distinguish themselves from low quality producers, all products will sell for the same price. *Id.* However, if the high quality producers can distinguish themselves by disclosing information about the quality of their product, prices will vary. *Id.* The companies that disclose less than full information will sell for the lowest price because consumers will assume that non-disclosing companies produce the lowest quality products. *Id.* at 166.

The "lemons problem" applies to investments as well. Companies which do not disclose sufficient information will be deemed unattractive investments and will likely go unfunded. MAUTZ, *supra* note 32, at 29.

194. *See* MAUTZ, *supra* note 32, at 29.

195. *See* Clifford W. Smith, *On Trading Foreign Securities in U.S. Markets*, *in* MODERNIZING U.S. SECURITIES REGULATION 77, 79 (Kenneth Lehn & Robert Kamphuis eds., 1992).

196. *Id.*; *see also supra* note 193.

to dissuade companies from disclosing only the statutory minimum amount of information.[197]

Many companies already realize the advantage of disclosing more information than is required by their home country or exchange.[198] The Swiss company, Nestlé, is a visible example. Nestlé voluntarily discloses information that conforms to the accounting principles developed by the International Accounting Standards Committee (IASC).[199] The IASC's disclosure standards are sufficiently detailed to allow Nestlé to list on most of Europe's exchanges.[200] Nestle's incentive for voluntarily disclosing detailed financial information is the desire to lower its cost of capital. As more companies take advantage of the private incentive to disclose information, the incentive to do so will become even more powerful. In other words, the remaining companies will be subject to increasing risk premiums due to their unwillingness to satisfy investors' demand for voluntary disclosure.

Private incentives to disclose information will also increase as companies become less able to rely on market structural factors that limit the need to disclose information. Many foreign countries have capital market structures that minimize the demand for disclosure. Japanese companies, for example, are divided into business groups whose members own the vast majority of each other's equity.[201] The need for disclosure is thus limited, given that only a small amount of each company's stock is publicly-owned and traded.[202] In Germany, financial institutions provide the bulk of capital needed by companies, and

197. Investors will assess higher risk premiums by lowering a company's stock price. All other things equal, a lower stock price raises a company's cost of capital.

198. Continental European firms listed on the London Stock Exchange regularly disclose more information than is required by the exchange. 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. STUDIES, 315, 326-33 (1989). The primary reasons identified for the voluntary disclosure were the competitive pressures incurred in the international capital markets. *Id.* at 320-21, 332-33.

199. *No More EC Directives on Accounting Standards and Practices*, Bus. Europe, July 12, 1993, *available in* LEXIS, World Library, Allnws File. *See supra* note 188.

200. *Id.*

201. THUROW, *supra* note 23, at 134-36. Seventy-eight percent of the shares listed on the Tokyo stock exchange are owned by business group members. Carla Rapoport, *Why Japan Keeps on Winning*, FORTUNE, July 15, 1991, at 72, 85.

202. *See* Rapoport, *supra* note 201, at 85.

use this dependency to impose significant control over corporate governance.[203] The Deutsche Bank of Germany alone owns more than a ten percent stake in seventy companies, and its executives sit on more than four hundred corporate boards.[204] With the enormous costs of German reunification, however, large companies can no longer rely on their domestic financial system.[205] As a result, large German companies such as Daimler-Benz now have a significant incentive to disclose more detailed information in order to access the world's largest securities exchanges—the NYSE, AMEX, and NASDAQ.

The German situation exemplifies the powerful effects of globalization. To benefit from international listings, companies must now satisfy different investor demands throughout the world. As globalization progresses, the private incentive to disclose detailed information will grow stronger. The search for international disclosure standards may thus arrive sooner than anticipated as investors create implicit disclosure minimums. Meanwhile, the purported disadvantage of the U.S. national exchanges will diminish as high disclosure levels become the norm.

IV. CONCLUSION

Pressure continues to mount on the SEC to relax U.S. disclosure laws for foreign companies. The principal argument is that U.S. accounting standards pose a significant barrier to entry and thus threaten the preeminence of U.S. capital markets. However, the U.S. national exchanges show no signs of weakening in their ability to compete for foreign listings. In fact, evidence illustrates that the U.S. national exchanges continue to outpace the U.S. pink-sheet market and foreign exchanges in the foreign listings market.

In addition, the fact that U.S. investors continue to invest capital overseas in record amounts lends little support to the current reformist movement. This trend is a natural result of the globalization of securities markets which makes it possible to easily capitalize on worldwide disparities in interest rates and

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203. Corinne A. Franzen, Note, *Increasing the Competitiveness of U.S. Corporations: Is Bank Monitoring the Answer?*, 2 MINN. J. GLOBAL TRADE 271, 284-87 (1993). *See also* Duffy & Murray, *supra* note 3.

204. THUROW, *supra* note 23, at 34. The Deutsche Bank even owns 28% of Daimler-Benz. *Id.*

205. *Company Law: Daimler-Benz New York Listing May Impact on EC/US Talks on Accounts Standards*, European Information Service, July 20, 1993, *available in* LEXIS, World Library, Allnws File.

investment opportunities. Moreover, the fact that foreign exchanges are equally as trading efficient as U.S. exchanges is immaterial. The amount of information disclosed in a market affects a market's productive efficiency, not its trading efficiency.

The globalization of securities markets may also resolve the debate over disclosure levels as companies are increasingly forced to compete internationally for capital. The increased competition, along with the increase in institutional investor leverage, has created and will continue to strengthen the incentive for companies to voluntarily disclose detailed financial information, regardless of statutory disclosure requirements.

Thus, the continued success of the U.S. national exchanges in acquiring new foreign listings, combined with the powerful effects of globalization, shed serious doubt on the necessity of lowering U.S. disclosure standards. If the SEC decides to drastically alter disclosure standards in order to place the national exchanges at par with the pink-sheet market and foreign exchanges, it must be prepared to risk the efficiency and integrity of the U.S. market that it has developed over the last sixty years.