Proposals for Reform of Securities Regulation:

An Overview

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I. INTRODUCTION

In the past few years there have been proposals from academic commentators to change the structure of United States (U.S.) securities regulation. I have identified six. All the proposals have in common the objective of giving participants in securities markets more choices as to the applicable legal regime under which they transact. These proposals reject the dogmatic paternalism of the securities acts as originally conceived, and assume that most participants in securities markets are as capable of evaluating the costs and benefits of the legal protections provided in their trans-

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actions as they are of evaluating the legal structure of the securities they buy or sell, as well as the underlying business strategies of the companies in which they invest or whose securities they sell.

That there have been such proposals is notable because the securities statutes and the agency that administers them, the Securities and Exchange Commission (SEC), are widely regarded as highly successful, and the U.S. model is recommended by many in the United States to the rest of the world. There is no groundswell of interest from either the industry or its customers to change the current regulation. It is as if the academic writers think it is 1932.

Of course, it might be 1929, or at least 1928. Just as the *Pecora Hearings* painted an indelible picture of securities markets in the late 1920s to a receptive audience burned by the crash of 1929—a picture of hustling stock promoters touting worthless stocks to an uninformed public—today’s markets, with their “wing and a prayer” and once highly-priced internet stocks, rampant and unstoppable stock fraud—even by fifteen-year-olds, lengthy prospectuses containing little useful information, and mind-boggling derivative products, could easily be portrayed to a receptive audience as in need of substantial regulatory reform. And perhaps they will be—in 2006. Are these scholars positioning themselves as future Brandeisees or Frankfurters, far-sighted conceptual architects of a new and improved regulatory regime?

For now, however, these proposals will not be viewed as important by practitioners, regulators or politicians. They are conceptual, and do not address difficult issues that would be raised by any effort to implement them. There is no concrete proposal on the table to be accepted or rejected. Nor are the proposals responsive to any identified problem with the existing regulation that might

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2. See Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777 (2000). Hu argues that securities markets now suffer from an irrational investor belief that stocks are always a good investment for the long term, and that this belief may have created a “bubble” which will burst. See *id.* at 778–79. He also argues that the SEC has played an important role in the propagation of that belief. See *id.* at 780. Hu, however, does not advocate changes in the structure of the regulation to overcome this problem. See *id.* at 837–60. Rather, he advocates changes in current SEC disclosure policies to warn more effectively of the risks of equity investing. See *id.*


motivate the relevant actors to embrace a corrective. This comment argues that viewing the proposals as unimportant misses the point of these proposals and overlooks their significance. The reason that these proposals are important is that they evidence a breakdown in the consensus understanding of securities regulation that has supported its structure for more than a half-century. These scholars are searching for new justifications for the securities laws because they no longer believe in the received orthodoxy. Their proposals are symptomatic of how far that breakdown has gone. The new justifications they suggest shed some light on the possible evolution of U.S. securities regulation.

The consensus understanding of securities regulation has been that the laws protect investors and would-be investors against their own folly. Investors are inadequately informed, unwise and subject to manipulation by issuers and their hired henchmen—he investment banking and brokerage industries. The regulation corrects this imbalance by imposing mandatory requirements on the sale and trading of securities, requirements which at least approximate the terms on which an adequately informed, wise and unmanipulated investor should transact. The authors of these new proposals no longer believe that investors are unable to protect themselves, or, if they are unable to protect themselves, that the regulation can help them.

The justification for the content of securities regulation under these new proposals is that the transaction and governance structures that emerge from a system of party choice reflect the preferred structures of the affected parties—the terms of a complex commercial "deal." Just as the parties to complex contracts are not required to justify the compromises and trade-offs (often arbitrary) in the terms of the contracts they enter, under these new proposals it would no longer be necessary to explain the customs, practices and requirements followed in securities transactions in terms of some identifiable public objective, such as making investors better off. The terms of the transaction would be the applicable terms of the transaction because the parties had a choice, and they are what they chose.

The proposals can be divided into two major groups. The first group contains proposals to alter the choice of law regime of U.S. securities law. The second group contains proposals to give nongovernment actors such as exchanges or investors a much more important role in shaping the applicable rules. Both groups in-
crease the range of choices available to parties in securities transactions.

The most prominent of the first group of proposals comes from Roberta Romano, Professor of Law at Yale,5 who has garnered admiration and even some incredulous amazement for the success of her long campaign to convert the perception of Delaware as a shameless incorporation safe-haven for self-aggrandizing managements in need of displacement by superior federal standards into a perception of the state as a diligent, hard-working and thrifty, competitive incorporation firm which has over time—as the result of shrewd strategies, a competent judicial system, wise legislation, and its Amtrak station in Wilmington—beat out its competitors fair and square for a disproportionate share of the incorporation business and the associated fee revenue.6 Romano now proposes, having driven back the claim of the Feds to be justified in invading Delaware’s historic domain of corporate governance, to extend Delaware’s proper domain into the previously federal area of securities regulation.

Romano’s proposal—along with similar proposals from Stephen Choi and Andrew Guzman,7 and Merritt Fox8—is to change the choice of law rule applicable to securities transactions. Under her proposal, the existing system of U.S. securities regulation would remain in place, but the parties would be free to select alternative jurisdictions to govern their transaction. She seems to have any of the U.S. states—including, of course, Delaware—most clearly in mind, but the same principle could apply to any non-U.S. jurisdic-


tion as well. Her proposal would be implemented by a federal statute imposing a choice of law rule on the federal government and the states that requires them to follow contractual choice of law clauses in securities transactions.

Choi and Guzman, whose proposal was published first, also have in mind permitting the parties to choose the applicable jurisdiction, but they suggest a choice among national jurisdictions. However, their approach can easily be extended to U.S. states as well. The proposals of Romano and Choi and Guzman have attracted critical comment, a sign that their proposals seem interesting enough to at least some students of securities regulation to offer a rebuttal.

Fox, too, would change the applicable conflict rule, but the choice of controlling jurisdiction would be determined not by the parties, but by the nationality of the issuer of the security—a nationality determined by “an identifiable economic center of gravity in a single country where its original entrepreneurial talent and the largest portion of its management and workers are concentrated.” However, since it is possible to reorganize corporations so as to change their nationality, even using a “real ties” test of nationality, this approach gives the issuer some range of choice as well.

All three proposals are conceptual; they do not generally address the implementing detail by, for instance, identifying the statutory changes that would be necessary to implement them, or even specifying the precise domain they cover. Romano addresses coverage issues somewhat more explicitly than the others. Her domain of free choice of law would extend to the disclosure requirements imposed on issuers in the original issue and secondary markets, to any action to enforce the rights conferred by the security, and for any fraud action arising out of the transaction. Her proposal does not extend to the regulation of the industry itself,

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11. Merrit B. Fox, Political Economy of Statutory Reach, supra note 8, at 733.
for instance to regulation of brokers, dealers and exchanges. She does not specify how these lines would be drawn. Choi and Guzman contemplate that the issuer’s choice of law would follow the security into the secondary markets, but they do not explicitly discuss the action for fraud or the regulation of industry actors.\textsuperscript{12} Fox focuses his discussion on disclosure rules: the format and requirements for disclosure documents, and would leave the fraud action and industry regulation unchanged.\textsuperscript{13}

The second group of proposals seeks to empower private market actors to make choices about the applicable regime instead of a governmental body. The most radical comes from Choi (of Choi and Guzman), who proposes to give investors, not the SEC, the power to decide what, if any, protections they need.\textsuperscript{14} Not only could investors invest in a security under any choice of law they were willing to accept, but they could also have choice of forum clauses, and to the extent they wished, specify the nature of the substantive regime. For instance, they could impose unique warranty undertakings and disclosure obligations. This proposal is radical because it flips the standard orthodoxy of securities regulation on its head. The standard orthodoxy explains securities regulation as a system of regulation that protects investors. “We are the investor’s advocate,” proclaims the SEC website (quoting William O. Douglas).\textsuperscript{15} Choi would transfer the function of protecting investors to investors themselves.

Choi realizes, however, that there are would-be investors who are gullible, uninformed and incapable of protecting not only the markets, but themselves. Indeed, he identifies the subgroup of incompetent investors as the source of the problem. So he proposes a pervasive licensing scheme which he analogizes to the federal licensing scheme for amateur radio operators or airplane pilots.\textsuperscript{16} For investors that have passed the exam and have their license,

\begin{footnotesize}
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\item See Choi & Guzman, Portable Reciprocity, supra note 7, at 903. In an earlier article, Choi advocated a standard of fraud liability which varies based upon the status of the company. See Stephen J. Choi, Company Registration: Toward a Status-Based Antifraud Regime, 64 U. CHI. L. REV. 567, 571 (1997). Basically, the fraud liability standard should be stricter for smaller companies than for larger ones. See id. This implies that the applicable law of fraud would not be governed by the choice of the parties.
\item See Fox, Political Economy of Statutory Reach, supra note 8; Fox, Securities Disclosure in a Globalizing Market, supra note 8.
\item See Choi, Regulating Investors Not Issuers, supra note 14, at 312.
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there would be complete freedom from regulatory constraint. For those who have not taken the exam, or worse yet, have failed it, there would be severe regulatory constraint—including, for the least proficient, a rule confining their choices to index funds, which could only be exercised under the watchful eye of a licensed industry intermediary.\(^{17}\)

Paul Mahoney, on the other hand, has argued for returning significant regulatory authority to exchanges—authority of the sort they exercised prior to the 1930s.\(^{18}\) The exchanges, not the SEC, would set the standard for the disclosure documentation required of issuers whose securities are traded on the exchange.\(^{19}\) In addition, they would establish trading rules and financial responsibility requirements for their members, as they do now, but presumably free from SEC oversight.\(^{20}\)

A proposal that does not easily fall in either group has been advanced by Palmiter.\(^{21}\) His proposal is to make the registration of securities under the 1933 Securities Act optional.\(^{22}\) He recommends that the SEC accomplish this through a regulation exempting offerors who so choose from the 1933 Act.\(^{23}\) This would free issuers and other sellers in primary markets to transact with investors as the parties wish, while leaving in place the 1934 Securities and Exchange Act to regulate secondary markets and securities fraud. His proposal would achieve in one quite neat move a system of company registration of the sort advocated by Cohen in the 1960s,\(^{24}\) and subsequently supported by practically all students of securities regulation. After the most recent fiasco—when the SEC’s own advisory committee recommended the expansion of company registration,\(^{25}\) and the SEC responded with its ghastly re-

17. See id. at 310 tbl.1 (summarizing “Permissable Associations Under Investor Regulation—Securities Markets Participants”).
19. See id. at 1455.
20. See id.
22. See id.
regulatory aircraft carrier proposal—this seems a perfectly simple and long overdue way of achieving a system of company registration. Although Palmeter proposes that the SEC do this through regulation, it may be that the SEC is so wedded to the metaphysics of the 1933 Securities Act that it would have to be done by Congress.

Palmeter’s proposal shares with the first group the creation of an expanded zone of contractual freedom, but only for public offerings of securities by issuers and control persons. It shares with the second group a transfer from the SEC to the transacting parties the power to determine the nature of the regime under which the sale takes place. However, it leaves in place all the reporting and other obligations imposed on reporting companies under the 1934 Securities and Exchange Act and preserves the fraud action under Rule 10b-5 for any purchase or sale of securities.

II. The Merits of These Proposals

Romano analogizes her proposed choice of law rule for securities regulation to the U.S. choice of law rule for the internal affairs of corporations, which is that the law of the jurisdiction of incorporation governs. Based on the U.S. experience with the corporate internal affairs rule, she argues that its beneficial effects can be extended to securities regulation.

There are, however, important differences between the two contexts. In the context of corporate internal affairs there are strong advantages to having a single rule. If the question is, for instance, the powers and duties of a member of the board of directors, there would be considerable complexity if multiple, different rules were applicable to the same director. In the securities context, however, it is entirely possible to have different legal regimes applicable to different securities transactions, whether the transactions involve sales by the issuer or resales in the trading markets. Indeed, that has been the pattern in securities regulation.

Another difference between the corporate internal affairs rule and Romano’s proposal for securities regulation is that the corporate internal affairs rule emerged from the voluntary choice of all the affected jurisdictions. The states have for the most part chosen


27. See Romano, Empowering Investors, supra note 5, at 2361.
to adopt the internal affairs rule, and the national government has chosen not to adopt a mandatory corporate statute of its own. Thus Delaware's role in corporate law is not the outcome of a competitive process in the way that competition is usually understood. Its role critically depends on the willingness of the other competitors to accept it—a reality that significantly constrains Delaware's behavior. It is a form of competition in which the competitors have the power to veto the outcome. For securities regulation, Romano proposes not a voluntary system, but a mandatory system implemented by a federal statute that would give the states no choice. She does not address the question why she is unwilling to give the states the same freedom to select their own choice of law rule that they have enjoyed in the internal affairs area, except to offer the observation that a federal statute would be "the most expeditious."

One argument that Romano might make is that a mandatory federal statute is now necessary because the existence of the federal securities statutes has, since their passage in 1933 and 1934, frozen the natural competitive process that would have led to her desired outcome. Thus, a statute requiring that the states respect the parties' choice of law is necessary now to overcome the fact that the mandatory federal securities acts prevented her desired outcome. The problem with this argument is that it appears that the process underway at the time of the securities acts was in the opposite direction—towards the application of the law of the jurisdiction of the buyer, not towards honoring the choice of law of the parties.

The most distinctive feature of Romano's proposal is that she extends it to the action for fraud arising out of a securities transaction. None of the other writers go this far. It is the most problematic feature of her proposal. On the one hand, her proposal is based on the assumption that the transacting parties can make informed choices about the applicable law, yet the very allegations of fraud call the assumption of informed choice into question. The

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29. See Romano, Empowering Investors, supra note 5, at 2401-02.

30. See id. at 2411.
reason why Romano considers it important to include the fraud action in her proposal is easy enough to understand. The line between regulation of disclosure requirements and the action for fraud is not a clear one. A basic question in an action for fraud is what kinds of omissions are misleading, an issue closely related to the question of what disclosures have to made in the first place. The standard formulation under Rule 10b-5 is that an omission is misleading if the information omitted is necessary to make the information disclosed not itself misleading, but there are many other possible answers to that question. Thus, if the line is drawn between disclosure requirements and the action for fraud, there is the risk that the action for fraud will become a back-door way of regulating disclosure requirements. For instance, the SEC, with no direct authority over disclosures contained in offerings of securities issued by state and local governments, has nevertheless regulated the content of such disclosures, by relying on its authority under section 15(c)(2)(B) of the 1934 Securities and Exchange Act over a "fraudulent, deceptive, or manipulative act or practice" by a securities dealer.\footnote{31}

It is difficult to imagine, however, that Congress could be persuaded to depart from the usual choice of law rule in fraud cases—the governing law is that of the place of the fraud.\footnote{32} Under the Romano approach, the California victim of a securities fraud for the sale of securities sold with Delaware law as their "securities domicile" would either have to sue in the Delaware courts under Delaware law or, at the very least, sue in California courts in an action governed by Delaware law.\footnote{33} The burden this would place on successful assertion of the fraud action is substantial.

Romano's proposal is in accord with the spirit of the recent trend of case law, which has tended to enforce choice of law, choice of forum and arbitration clauses, and to extend their application (where appropriately drafted) to tort actions relating to or arising out of a contractual relationship.\footnote{34} These cases, however,
have arisen in the context of commercial disputes between sophisticated commercial parties, not in the context of the mass marketing of financial products to investors. In the cases most clearly on point, the U.S. cases brought by U.S. investors against Lloyd's of London for fraudulently inducing their investments as "names" in the Lloyd's London insurance market, the federal courts of appeal did uphold a choice of law and choice of forum clause that required the names to sue in London, under United Kingdom law.\footnote{See generally Richards v. Lloyd's of London, 135 F.3d 1289 (9th Cir. 1998); Haynsworth v. Corporation, 121 F.3d 955 (5th Cir. 1997); Allen v. Lloyd's of London, 94 F.3d 923 (4th Cir. 1996); Shell v. R.W. Sturge, Ltd., 55 F.3d 1227 (6th Cir. 1995); Bonny v. Society of Lloyd's, 3 F.3d 156 (7th Cir. 1993), cert. denied, 510 U.S. 1113 (1994); Roby v. Corporation of Lloyd's, 996 F.2d 1353 (2d Cir. 1993), cert. denied, 510 U.S. 945 (1993); Riley v. Kingsley Underwriting Agencies, Ltd., 969 F.2d 953 (10th Cir. 1992), cert. denied, 506 U.S. 1021 (1992). The 106th Congress passed and sent to the President legislation that would have reversed the result in these cases. The 107th Congress is expected to take up this legislation again. See S. 3186, 106th Cong. § 1310 (2000); Bankruptcy Reform Act of 2000, H.R. 2415, 106th Cong. (2000); Deborah McGregor, Lloyd's to Face U.S. Claims, Fin. Times, Feb. 14, 2001.}

Yet, the Ninth Circuit, for instance, emphasized that Lloyd's required that investors fly to London and become names there, and pointed out that this procedure made it emphatically clear that United Kingdom law was applicable to the transaction.\footnote{See Richards v. Lloyd's of London, 135 F. 3d at 1294.}

If the action for fraud is dropped, her proposal becomes far more modest. Bernard Black, for instance, who has implicitly ignored the fraud issue, has dismissed her proposal as of little consequence.\footnote{Black views the choice of law proposals and the debate over them as limited to disclosure requirements. He wrote, My analysis suggests that this debate is misguided. It focuses primarily on disclosure rules, when the real competition is between complex national systems of fostering disclosure and controlling self-dealing. Disclosure rules are a small part of the network of institutions that support strong disclosure; the securities regulator's role in adopting disclosure rules is not critical to having good rules; and this role is a small part of the regulator's overall job. Bernard Black, The Core Institutions that Support Strong Securities Markets, 55 Bus. Law. 1565, 1605 (2000).}

From the macro perspective that Black writes—he seeks to identify the core institutions that support strong securities markets—such dismissal may be warranted, but the fact remains that changes of little consequence that are improvements are still improvements. Romano's proposal with the action for fraud removed is deeply conservative (as are the others in the first group)
in the sense that its enactment would lead to almost no immediate change. Indeed, it would seem to be extremely simple to implement, requiring only that Congress repeal Section 29(a) of the Securities and Exchange Act of 1934 and Section 14 of the Securities Act of 1933.\textsuperscript{38} The day after her proposal took effect, securities would still be sold in the same way, with the same regulation. Just as the day after the deregulation of the airlines took effect people still flew on the same airlines to the same destinations in the same airplanes, securities would still be publicly offered under the 1933 Securities Act and issuers would still report under the 1934 Securities and Exchange Act. Her proposal would, however, introduce the possibility of competitive variants. It would take time and learning for these variants to be developed and introduced, but the SEC would no longer have a regulatory monopoly. Perhaps at first the new possibilities would be used for niche products such as securitization transactions, an important contemporary institution that has always fit poorly within the structure of the securities acts. And the SEC would have an incentive to, and perhaps would, develop regulations more specifically tailored for the needs of these niche markets in order to keep from losing too much of the business.

The problem that the securities markets encompass so many different transactions, and the fact that not all participants in securities transactions are experienced and sophisticated is what compels Choi to offer his suggestion for a system of investor licensing. He realizes that as long as securities regulation encompasses sales to both sophisticated and unsophisticated, gullible people, there will be resistance to any system that gives investors choice. The problem is how to make this separation. The present rules make important use of a rather odd distinction—assets. If you are rich enough be highly attractive to a con man, your qualify as an “accredited investor” and are permitted to buy securities without the protections of the Securities Act.\textsuperscript{39} He proposes to make the “accredited” concept more meaningful, through possible changes such as a system of investor testing.


\textsuperscript{39} See Securities Act Rule 506, 17 C.F.R. § 230.506 (2000). The term accredited investor includes any individual whose net worth exceeds $1,000,000 or who has an income in excess of $200,000. See Securities Act Rule 501(a)(5), 17 C.F.R. § 230.501(a)(5).
Choi is not very specific about how or on what the investor is to be tested. He suggests that investors applying for an “issuer-level license” (the highest category, which would entitle the investor to buy securities issued by a for-profit corporation for their own account) would be required to demonstrate “detailed knowledge of different issuers in the market, the business of these issuers, and available investor protections.” He apparently would not require that the test examine prospective investors on how to identify a good investment, perhaps because it is unlikely that either Choi or the SEC itself would know how to grade the answer.

The logistics of preparing and administering such an examination to a significant portion of the population is formidable. It is difficult to imagine that the population would be willing to accept the restrictions imposed on those who would not take or fail the test. For instance, a mother would be unable to buy stock in her son’s startup company unless she had taken and passed the test. All of this is proposed without any evidence that the ability to pass a test is correlated with the judgment and common sense necessary to make wise investments. The broker’s exams administered by the National Association of Securities Dealers (NASD) under the SEC’s aegis give no reason to believe that the SEC could create and administer a meaningful exam. After all, the brokers who staff penny stock boiler rooms have passed the NASD broker exam.

Like Romano and Choi and Guzman, Palmiter permits an opt out in his proposal, but only from the Securities Act of 1933. This proposal focuses reform on the one statute whose rigid controls of the offering process combined with its harsh criminal, administrative and civil penalties, has frozen the offering transaction and deterred the development of innovative methods of distribution, such as those now made possible by the internet. But again, the implementation of Palmiter’s proposal would have little immediate effect. The Securities Act of 1933 and the SEC would still be in place to do what they have always done. Parties who wanted to make offerings outside the statute would have to clearly disclose that the offering was not being made subject to the act, and the offerings could only be sold if investors were willing to buy them without the act’s protections.

Indeed it is difficult to understand the basis for opposition to these proposals. If the safeguards of the securities acts are as im-

40. See Choi, Regulating Investors Not Issuers, supra note 14, at 311.
portant as their proponents claim, then it is difficult to understand why buyers would choose to buy securities without the advantage of their protections. And if buyers would so choose on a regular and continuing basis, it is difficult to understand what it is that is so wonderful about the securities acts’ protections.

The point is not that buyers of securities will not make mistakes. They will. But they will learn from their mistakes, just as they learn from their successes. We have just passed through a period during which numerous buyers made the mistake of purchasing dot com securities being sold by underwriters in full compliance with the procedures of the 1933 Securities Act. Their mistakes are now clear, but the social (as opposed to individual) harm flowing from their mistakes is not apparent.

Mahoney’s proposal to give exchanges a more central role in the regulatory process would be the hardest for the traditional proponents of the securities acts to swallow. Because it basically involves returning to the pre-1933 structure, it requires admitting that there was nothing wrong with that structure in need of correction, or at least that whatever was wrong with the pre-1933 structure was not corrected by the securities acts. The fact is, however, that the traditional proponents have never made it clear what was wrong with that structure—except that people made mistakes, some people were dishonest and the results were not “perfect.” But then life under the securities acts has not been perfect either.

III. WHY NOW?

Why is it that after many years of a near-unanimous consensus in support of U.S. securities regulation, there is now discussion of change? One explanation is that in spite of the appearance of surface consensus, five interrelated developments in recent years have undermined the assumptions that supported the consensus. They are: (1) the movement towards freer international trade and financial flows; (2) changes in communications and transportation technologies; (3) changes in the regulation itself; (4) the failure of the regulation to achieve its objectives; and (5) the collapse of a shared faith in the relevance of the helpless-investor model on which the regulation is based.

1. Freer international trade and financial flows

The first roughly forty years of the securities acts corresponded to an unusual historical period in which formerly interconnected
national securities markets were decoupled. Due to the financial crises of the depression in the 1930s, and then World War II, the free convertibility of currencies was replaced by a system of exchange controls. This created the risk that an investor who invested outside her home market would find it impossible to repatriate the proceeds of that investment. This caused investors to focus their interest in their home market. For U.S. investors and issuers, this meant that their only real choice was to transact in the United States, subject to the regulatory authority and requirements of the SEC.

All of this began to change slowly in the 1960s. A notable phenomenon was the emergence of the Eurodollar market in London.\footnote{For an overview, see E.P. Davis, Euromarkets, in 1 THE NEW PALGRAVE DICTIONARY OF MONEY & FINANCE, 783–86 (Peter Newman et al. eds., 1992).} The imposition of the interest equalization tax in 1963, designed to deter domestic U.S. borrowing, created an incentive for the use of the Eurodollar market, and contributed to its gaining critical mass. Although the Eurodollar market has always been conceived for political and regulatory purposes as a “foreign” market, far away across the Atlantic, it is in fact an artifact of U.S. regulatory policy, conducted in U.S. currency, with important U.S. participation on both the buying and selling side. The reintegration of global securities markets was further boosted when the United Kingdom successfully abandoned exchange controls in 1979 under the leadership of Margaret Thatcher,\footnote{See MARGARET THATCHER, THE DOWNING STREET YEARS 44 (1993).} a reform that was widely copied. David E. Van Zandt, who reviewed these developments, dated the emergence of a significant international capital market to 1984.\footnote{See David E. Van Zandt, The Regulatory and Institutional Conditions for an International Securities Market, 32 VA. J. INT’L L. 47, 57 (1991) [hereinafter Van Zandt, The Regulatory and Institutional Conditions]. Dean Van Zandt gave an overview of the underlying regulatory liberalization that made the emergence of a global market possible. See id. at 65–66.}

Pressures for freer global trade in securities were enhanced when the General Agreement on Tariffs and Trade (GATT) agenda was extended from free trade in products to free trade in products and services. One of the service sectors that is an important focus of this agenda is financial services.\footnote{The version of the GATT resulting from the Uruguay round of trade negotiations, included a General Agreement on Trade in Services in Annex 1B. See General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 108 Stat. 4809, 4815, 33 I.L.M. 1167, 1190–91 (1994). This is widely be-}
lieved that the United States has a comparative advantage in financial services, but that this advantage is hobbled by unnecessary restraints on the global provision of financial services. Free trade in securities would seem to mean at the most common-sense level that buyers and their brokers in any country would be free to buy securities issued by the national of any other country, or traded in the markets of any other country; and the sellers of securities would be able to sell anywhere. The reality is that this is difficult to do, and one of the principle reasons is securities regulation. U.S. securities regulation, in particular, is demanding in great detail about the requirements for the documentation that must accompany the sale of securities into the United States. A German or Japanese issuer cannot simply sell its securities, fully qualified for sale in the issuer’s home country, to a U.S. buyer with only home country documentation. The documentation must conform to U.S. requirements. This is not simply a matter of translating documents into English. In order to obtain documentation that meets U.S. requirements, it is necessary to retain the services of U.S. legal and accounting firms. This looks like a simple tie-in: the United States says: “You can access our markets, but only on condition that you use our service providers.”

The saliency of the free trade in services concern has been heightened by the New York Stock Exchange’s (NYSE) campaign to become a global market, with a significant business generated as a result of listings by non-U.S. firms. The NYSE has campaigned to liberalize the regulatory barriers which deter listing by non-U.S. firms, the principal barrier being the requirements imposed on listing firms by the SEC. Although the urgency of this campaign

Annex committed the signatories to a process of trade liberalization in services. See id. Services include transactions in securities. See id.


seems to have been moderated by the NYSE’s success in attracting listings, particularly Daimler-Benz and a number of other non-U.S. issuers, this remains an important issue for the exchange. Firms that, unlike Daimler-Benz, have no important business reasons for listing on the NYSE and issuers that have a significant home capital market, will still be deterred, at the margin, by the U.S. regulatory requirements.

It is probably no coincidence that most of the proposals address this issue. If the ideas of Romano, Choi (both versions), Guzman, Fox or Mahoney were implemented, regulatory costs flowing from the decision of a foreign issuer to list on the NYSE would be significantly reduced.

2. Changes in communications and transportation technologies

The significance of the regulatory reintegration of world securities markets has grown due to the increasing ease with which parties can communicate with and travel to foreign jurisdictions in order to conduct transactions there. This has been a causal factor of the regulatory changes which became worthwhile only when technology made them useful. It has also increased their significance because the greater ease with which the regulatory changes could be exploited increased their impact on the regulatory systems. In a world in which it is feasible for parties to transact in either New York, London or elsewhere, both they and the regulators become more aware of alternative systems. Most importantly, they become aware that regulatory options can be useful to the parties who take advantage of them, and that they have no harmful consequences for third parties. Why should parties, for instance, have to do a private placement in London only because the United States does not permit the same transaction to be done in New York?

3. Changes in securities regulation

The third factor explaining why scholars are now discussing changes in U.S. securities regulation is that the regulation itself has changed significantly in recent years. Some of these changes have been in significant part a response to the move to free international financial flows and the increased ease of doing business so as to avoid U.S. regulatory jurisdiction. Although the proposals seem radical when tested against the standard orthodoxy and traditional practices of securities regulation, significant elements of the pro-
posals can be found in the present "on the ground" implementation of the regulation. This is an aspect of current securities regulation that one of the authors comments on in depth.\textsuperscript{47} The most notable developments are:

a. In 1980, the SEC adopted Rule 506, a safe harbor for private placements.\textsuperscript{48} The rule introduced the concept of an "accredited investor," and provided that if sales were made without public solicitation and only to accredited investors, they would be exempt from the requirements of the 1933 Securities Act.\textsuperscript{49} The label "accredited investor" sounds like a category of investor who is particularly qualified. In fact, the regulation defines "accredited investor" not in terms of competence, but in terms of wealth. For individuals, an "accredited investor" is someone who has $1,000,000 in assets, regardless of competence level.\textsuperscript{50} Indeed, as indicated earlier, the requirement only ensures that accredited investors have enough money to be worth the time and attention of ambitious con artists.

With the prosperity of recent years, the number of investors who qualify for the accredited category has expanded enormously. It is now practicable to sell large issues of securities to a large number of accredited investors subject only to the regulatory requirement that the issue is sold without any public solicitation.\textsuperscript{51} And, disconcertingly for the standard orthodoxy, there is no sign that these investors, unprotected by the regulation, fare badly. Indeed, they seem to demand and receive protection such as written information about the issuer, which provides the protection, but is free of the detailed and costly requirements relating to timing and the precise requirements of disclosure forms that are imposed on a registered offering. The fact that a large number of transactions are occurring on a continuous basis without the protection of the 1933 Securities Act, and without any apparent harm to anyone, is inconsistent with the assertion that the regulation provides significant protection.

\textsuperscript{47} See generally Palmeter, supra note 21, at 29–85.
\textsuperscript{49} See id.
Joel Seligman’s passionate 1983 defense of mandatory securities disclosure was an attack on the SEC for the dramatic broadening of the exemptions from the Securities Act of 1933 that occurred in the late 1970s and early 1980s. Seligman criticized the SEC for broadening these exemptions without “publication of any analysis of the problems this may create for investors.” The basis of his criticism was a litany of frauds that had occurred in U.S. markets prior to the securities statutes, a litany that could be matched item for item by the frauds that have occurred in U.S. markets in the last ten years. But whether or not the broad exemptions should have been studied further before they were implemented, we now have the benefit of twenty years of experience with these exemptions. True, fraud continues to be a problem in U.S. securities markets and long bull markets seem to be inevitably accompanied by overpriced securities. But no one now argues that this fraud should be brought under control by narrowing the exemptions, or that registration under the Securities Act is a procedure that ensures that all registered securities will be a sound investment.

b. Regulation 144A has created an unregulated secondary market in the United States among large institutional investors for securities sold without registration. The existence of this unregulated secondary market—where securities can sometimes be purchased on terms better than those available in the regulated market—is an example of a securities market in which the parties have not only been permitted to opt out of the securities acts, but have chosen to do so. Again, the existence of this market has created no apparent problems for society at large.

c. Finally, Congress has accepted that many securities transactions can proceed without difficulty outside the provisions of the securities acts by conferring on the SEC blanket authority to exempt transactions and classes of transactions from all the provisions of the acts. Congress, in other words, has taken the position that there is no provision of the securities acts that is sufficiently important that the law should require that it be imposed. How

53. Id. at 61.
54. See id. at 9, 18–45.
better to define the class of transactions that should be allowed to proceed outside the requirements of the act than transactions in which the transacting parties have knowingly chosen to forgo their requirements?

4. The Failure of the regulation to achieve its objectives

The basic strategy of the securities acts is to use a system of regulatory licensing in order to reduce the incidence of fraud. Under the statutes, public offerings, brokers, dealers, exchanges and a host of others have to be registered with the SEC. The idea is that this registration process will weed out the bad apples, thereby reducing the incidence of fraud in the marketplace. Thus the statutes add a strategy of regulatory prevention to the standard fraud prevention strategy of criminal and civil proceedings initiated after the fraud has occurred.

This basic strategy has always been debatable. It is like trying to reduce the incidence of bank robberies by setting up a government agency to license people to enter banks. If the penalty for robbing a bank is a long jail sentence, and the penalty for entering a bank without a license is a long jail sentence, why should the requirement of a license deter bank robberies? Not only that, but the agency administering the licensing scheme is faced with an impossible problem. If it licenses everyone who has a need to enter a bank, it will license the bank robbers. And, if it works hard to examine every applicant in order to separate the bank robbers from the non-bank robbers, it will have great difficulty processing the license applications in a timely fashion, with significant negative economic effects on banks and their customers. Not only does preventive licensing seem a questionable strategy, but it has very large costs. Justified only by the need to reduce fraud, it catches every honest participant in the marketplace, forcing them to comply with the licensing procedure.

Whatever the original merits, the United States has tried it. The more than fifty years of experience that resulted provides ample familiarity and information on which to base the answer to the question: Does it work? As Joel Seligman points out, there were many fraudulent and overpriced securities sold before the securities acts.66 But why is he so confident that there are fewer sold today?

56. See generally Seligman, supra note 52.
At some point these questions may be asked outside academic circles. When they are, and if the new political consensus is that preventive licensing has not worked, the response can go in at least two quite different directions. One direction would be to redouble the ambition, pervasiveness and intrusiveness of the regulation on the grounds that the problem stems from the fact that we did not try hard enough. The other direction would be to decide that the ambition of the regulation was unrealistic, and return to a view of securities transactions as just one more form of financially significant but socially benign commercial transaction—best left to the contracting practices of the transacting parties. What is notable about the range of proposals that now have been seriously advanced is that they all choose, to a greater or lesser degree, to follow the second direction.

5. **Collapse of faith in the helpless-investor model**

The securities acts were based in part on the assumption that investors are unable to protect themselves. The solution was to mandate disclosure procedures to protect the investors, who were assumed not to have the sense to insist on the disclosure themselves. The problem is that if the investors lack the sense to protect themselves, they probably also lack the sense to make any use of the disclosures. The statutes seem to assume that the helpless investor can be helped by giving him a complex document to read and analyze.

In recent years, it has become common for analysts of mandatory disclosure to accept the point that helpless investors will not be helped by the disclosure documents. The argument is made, however, that although they will not be able to understand, and probably will not read, the disclosure documents, they nevertheless will be protected by the fact that other, sophisticated participants in the market will carefully read and analyze the document. Since these sophisticated participants will set the market price, the helpless investor is protected by simply relying on the market price. In other words, the helpless investor can simply follow the rule: if they can sell it, it is suitable for me to buy.

If this argument is correct, then why, in a regime of non-mandatory disclosure, would the sophisticated users of disclosure documents not also insist that they be provided with suitable disclosure documents before they consider purchase of the security? And why in that world, just as in the mandatory-disclosure world,
can the helpless investor not count on the presence of the sophisticated investor to make the market price a reliable indicator of value?

These positions have undermined the strength of the arguments for mandatory disclosure based on the helpless investor model. One response has been to search for other justifications for mandatory disclosure. The most ambitious effort comes from Merritt Fox. In a series of three articles, he has argued that (1) Romano's proposal is undesirable; (2) the correct conflicts rule is the "identifiable economic center of gravity" of the issuer; and (3) the purpose of securities disclosure is to enhance economic efficiency by overcoming information externality problems. He argues that firms are unable to make optimum investment decisions if they are uninformed about their competitors. Since the investment decision of any one firm is interrelated to the investment experience and plans of every other firm in its industry, the quality of investment decisions will be increased if managements have access to information about their competitors. In a non-mandatory system, however, the only information prospective investors would demand would be related to the value of their investment in the issuer, leaving behind information useful to competitors because it might reduce the value of their investment. The function of mandatory disclosure, then, is not to protect investors, but to enhance the efficiency of the economy by improving the information base of managers.

This view of the purpose of mandatory securities disclosure leads Fox to the economic center of gravity conflicts rule. The real interest in mandatory disclosure is that of the jurisdiction in which the issuer does business, not the jurisdiction where the securities are sold. Therefore, for instance, the United States has no interest

57. See generally Fox, Political Economy of Statutory Reach, supra note 8; Fox, Retaining Mandatory Securities Disclosure, supra note 10; Fox, Securities Disclosure in a Globalizing Market, supra note 8.

58. Fox also discusses optimization of agency costs within the firm. See Fox, Retaining Mandatory Securities Disclosure, supra note 10, at 1363–68; Fox, Securities Disclosure in a Globalizing Market, supra note 8, at 2545–46. However, he does not explain why prospective investors in a firm are unable to evaluate the adequacy of the disclosures as to agency costs as well as they are able to evaluate all the other information about the firm. See id.

59. I have argued that the absence in securities disclosure documents of information of the type that is useful to competitors demonstrates that the content of mandated securities disclosures reflects a trade-off between informing investors and protecting the value of the firm making the disclosures. See Edmund W. Kitch, The Theory and Practice of Securities Disclosure, 61 BROOK. L. REV. 763 (1995).
in whether the disclosures to investors by a Japanese issuer are sufficient because the operations of the Japanese issuer have no direct relevance to the U.S. economy.

This is an odd view of the world economy in which production facilities compete globally, and multinational companies have production facilities located in many different nations. It is also difficult to square both with the jurisdictional structure of the securities acts and the substance of the mandated disclosure. This rationale would require that mandatory disclosure be imposed on firms without regard to whether they have made a public offering of securities or whether their securities are publicly traded. All firms—whether publicly owned, privately owned or even state owned—should be required to provide relevant information about their operations because their activities will interact with that of all of their competitors. Yet, the mandated disclosure of the securities laws is limited to public companies. Second, multinational companies today, even though they may be identifiably German or French or Japanese, often have significant economic operations in other countries. Fox’s proposed conflict rule, however, would not mandate the disclosure of information about those operations. Third, the information to be found in mandated securities disclosure documents is so aggregated that it is of little use in economic planning by competitors. For instance, there is no production facility specific information—information of the sort that might enable competitors to determine a company’s rate of return in order to decide whether or not to build a comparable facility.

Finally, a striking feature of Fox’s effort to build a new rationale for mandated securities regulation is that it reflects his judgment that the old justifications based on investor protection are no longer persuasive.

IV. Conclusion

Senator Phil Gramm, Chairman of the Senate Banking Committee, has asked the Committee staff to undertake a comprehensive review of the securities laws.60 This may reflect the possibility that

60. Senator Phil Gramm, Chairman of the Senate Banking Committee, has asked his committee staff to review the U.S. securities laws from top to bottom. See Gramm Outlines Committee Agenda for the 107th Congress, Press Release (Jan. 22, 2001) <http://www.senate.gov/~banking/prl01/0122prcf.htm>. Today, the concerns about the
the unease with the standard orthodoxy of securities regulation has spread beyond the borders of the academy. What might his staff learn if it chooses to review the literature discussed in this essay and the papers resulting from this conference?

The first thing the staff will learn is that there are academic students of securities regulation who are receptive to changes in the statutes. The most important lesson, however, would be that it is possible to introduce significant flexibility into the present regulatory scheme without undertaking an ambitious reworking of the existing statutes or disrupting the expectations of the many regulators, professionals and issuers who have become familiar and comfortable with the existing regulation and its practices and procedures. It is possible to leave the entire structure in place, exactly as it is, while introducing one new rule: parties who wish to transact in securities under rules of their own making are free to do so. As a result, those who prefer the existing system can use it and those who believe that there are advantages in new and different procedures can try them. If the existing system is as advantageous as its proponents sometimes argue and the majority of investors agree, few will take advantage of the option. If some believe that other arrangements offer a superior cost and benefit trade off, they will try them, and time will tell if they were right.

difficulty and expense of obtaining market information that prompted the Securities Act of 1933 are no longer relevant. See id. The stock exchange model on which the Securities Exchange Act of 1934 was based is now universally regarded as obsolete. See id. Senator Gramm is quoted as saying, "[w]e need to pose the following question: Are the benefits we get from this regulation or this law greater than, equal to, or less than the cost they impose on the market? And if they're less, we ought to look at changing them or getting rid of them." Id.