Introduction: Privatization and Its Prospects

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Proposals to permit issuers of securities to allocate by contract the regulatory supervision of their financial instruments have become salient in the academic legal literature. This was the topic of the Sixteenth Sokol Colloquium held at the University of Virginia School of Law on October 8, 2000.

To allow parties to privately reoder their legal relations governing securities is to “privatize” or “contractualize” securities law. Privatization proposals differ in the aspects of securities regulation subject to contractual choice or the options within which choice is to be made. Some recommend retaining the mandatory character of laws governing broker-issuer and broker-investor relations. Other proposals would put both ongoing disclosure regulation and the current federal antifraud amalgam of statutory and common law beyond contractual choice. Still other recommendations would make the choice of a judicial forum for the adjudication of disputes involving securities laws mandatory, by making such disputes nonarbitrable. Privatization proposals frequently limit the contractual choice to selection among government securities regimes. Others recommend that the selection of nongovermental, stock exchange-based regulatory regimes be allowed. Some privatization proposals would allow unrestricted choice of regulation, including antifraud laws and nongovermental securities regimes. The portion of securities law amenable to contract, as well as the range within which private reordering can occur, does not affect the character of the proposals. All proposals advocate that one or more aspects of securities law be governed by contractual choice.

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against a background of default rules.¹ All, therefore, recommend the replacement of the mandatory nature of current securities regulation by private ordering. This is privatization in a nonpickwickian sense.

Two "generations" or strands can be identified in the literature advocating the privatization of securities laws. The first generation of privatization literature advocates unrestricted choice of securities regimes by issuers of securities.² Its policy prescription is based on an extension to securities regulation of an argument favoring jurisdictional competition in corporate law. According to the argument, as a positive market, the market for corporate charters among states produces corporate governance rules that maximize the value of shareholders' investments in firms.³ The argument is combined with an observation about the interaction of corporate law and securities regulation: aspects of securities regulation ranging from insider trading and proxy and disclosure rules to foreign bribes bear on corporate governance. In fact, the distinction between corporate law and securities regulation in places is blurred. Securities regulations therefore can also affect the value of shareholders' investments. Given this observation, the extension of the argument to securities regulation from jurisdictional competition in corporate law is straightforward. Since the market for corporate charters produces rules which maximize the value of shareholder investments, and securities regulation affects that value, jurisdictional competition for securities laws also increases the value of those investments. Securities law should have the same character as most of the rules in corporate law—default rules alterable by private reordering. A recommendation of unrestricted issuer choice would be as follows: issuers should be al-

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owed to select the system of securities regulation governing the securities they issue.

The second generation of privatization literature finds a more limited role for private ordering.\textsuperscript{4} In different ways, it makes a case against the unrestricted choice of regulatory regime by issuers of securities. The case argues that jurisdictional competition produced by unrestricted issuer choice is either unnecessary, undesirable or infeasible, and politically unstable. Only the charge of undesirability denies that jurisdictional competition produces securities laws that maximize the value of shareholders’ investments. According to the argument, issuer choice is unnecessary because the SEC is responsive to issuer or exchange-driven preferences for particular rules. The range of disclosure and registration exemptions in effect gives issuers a significant choice among regulatory regime. Unrestricted contractual choice of regime is unlikely to increase shareholder welfare. It also is undesirable where jurisdictional competition produces nonpecuniary externalities, such as liquidity effects in financial markets or impairment of cultural norms, or where unsophisticated investors do not accurately price protections given by an issuer’s selected regulatory regime. Furthermore, the scheme is infeasible and politically unstable: unfeasible because legal and regulatory inertia make the recommended change unlikely, and politically unstable because it is likely to be altered in response to significant short-term downward trends in domestic financial markets. Thus, unrestricted privatization is unlikely to be implemented and, if implemented, difficult to sustain.

Most of the papers presented at the Sokol Colloquium belong to the second generation of privatization literature. Kimberly Krawiec advocates limiting the federal insider trading law to the use of proprietary information by insiders.\textsuperscript{5} Use of such information by outsiders is to be left to regulation by private agreement and state contract law. John Coates’s and Edmund Kitch’s contributions describe the possible political instability of unrestricted is-


suer choice.\textsuperscript{6} Amir Licht identifies as further impediments doctrinal barriers raised by the character of securities regulation as public law.\textsuperscript{7} Stephen Choi's proposal restricts investments in securities by particular classes of investors without restricting an issuer's choice of regulatory regime.\textsuperscript{8} It, therefore, could be counted among the first generation of privatization literature. However, Choi's proposal in effect restricts the contractual choice of regulatory regime by issuers. By limiting the range of investments particular classes of investors can make, affected issuers cannot sell securities to these investors. A consequence of this restriction is that an issuer's choice of securities regime is unenforceable against these investors. If the issuer cannot contract with select investors, it cannot contract with them for a particular securities regime. An issuer's choice of securities regime therefore is limited by restrictions on its contracting partners. Thus, the effect of Choi's proposal would have the same result as when limits are placed on an affected issuer's choice of law with respect to securities sold to particular classes of investors. For this reason, even Choi's proposal might be included among the second generation of privatization literature.

A complete defense of proposals to allow contractual choice of securities regulatory regimes must contain four elements: (1) a reliable estimate of the benefits and costs favoring contractual choice over particular mandatory rules supplied by securities laws; (2) a specification of default rules as well as their character (e.g., as rules or standards, as tailored according to characteristics of types of issuers or investors); (3) a finding that doctrinal and institutional barriers to implementing contractual choice can be overcome; and (4) a description of the institutional mechanisms for enforcing the regulatory rules chosen by an issuer. To date, privatization proposals have not supplied all of these elements. In different ways,


the papers at the Sokol Colloquium focus on estimates favoring contractual choice, or doctrinal and institutional barriers to implementing privatization proposals.

Precise estimates of the comparative costs and benefits of privatization and mandatory regulation are difficult. This is not just because direct measurements of the size of regulatory costs of registration, disclosure and litigation, for instance, are hard to make. The more serious problem is estimating the demand for regulation made by issuers under a regime of issuer choice. In order to compare the costs of regulation between regimes of mandatory and contractual regimes, the amount of regulation preferred under a regime of issuer choice must be gauged. Indirect evidence of this demand, based on existing patterns of choice of financing in capital markets, is weak. This is because inferences drawn from such patterns are inconclusive. The size and liquidity of the public equities market in the United States, alongside its significant and growing private equity market, does not show that the regulatory costs of public markets are low. Nor does the increased number of foreign listings on U.S. exchanges. As William Carney notes, a large market in private placements could develop because of the high regulatory costs issuers face in public equities markets. Increased foreign listings are also consistent with high regulatory costs. Foreign firms could choose to raise capital in U.S. equity markets in part because public offerings in domestic markets are infeasible.

Both data are consistent with issuer choice reducing the demand among domestic and foreign firms for regulation in public equity markets. Hence existing patterns of capital formation say nothing about the comparative size of regulatory costs under privatization and mandatory regulation.

Even predicting the political consequences of implementing a regime of issuer choice is difficult. The case for issuer choice depends on describing the contract equilibrium for most investors. In order to be feasible, contractual outcomes must continue to be politically accessible in the long term. Coates speculates that the political equilibrium realized by issuer choice is unstable over

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time. A short-term secular decline in financial markets could bring a popular demand for re-regulation at higher levels than at present, an inferior outcome. With the SEC’s regulatory role reduced or eliminated, it could not serve as a buffer to proposed change. Significant adverse short-term changes in financial markets, he concludes, therefore are more likely to induce a regulatory backlash: heightened re-regulation. 12 Coates’s judgment that issuer choice yields an unstable political equilibrium may be correct, but other judgments are equally plausible. 13 A contrary judgment begins by noting that political sentiment for re-regulation alone is causally inert. What matters is whether the sentiment is translated into a successful political initiative. The success of a political initiative for re-regulation may be endogenous to the operation of a regime of issuer choice. It is not an exogenous variable assumed by Coates. In general, the way in which privatization is implemented can decrease the risk that re-regulation occurs. 14 For instance, issuer choice could result in the predominant selection of U.S. securities regulatory regimes, private or government-sponsored, among particular sorts of domestic and foreign firms. Their selection might increase the issuers’ interest in assuring that a regime of issuer choice is retained in the United States. (Case law and a fund of experience with U.S. regulatory regimes could increase the value of choosing such regimes.) If so, the issuers might invest in opposing initiatives for re-regulation at a sufficient level for their opposition to be successful. In these circumstances, issuer choice would describe a stable political equilibrium.

On the benefit side, direct or indirect evidence of the superiority of a particular regime also is hard to come by. The problem is that the same data can be used to support contrary inferences. SEC regulations currently exempt from registration or ongoing disclosure a range of private or limited offerings of securities. Issuances of securities to raise prescribed small amounts of capital are subject to limited disclosure or no SEC clearance. 15 In raising capital, issuers, therefore, effectively can select from a prescribed "menu" the amount of disclosure and regulation they desire. Coates infers

13. Cf. Roe, supra note 12, at 240 (conjecture of backlash a "matter for judgment calls").
15. See Coates, supra note 6, at 544–49; Palmiter, supra note 4, at 34–36.
from this that the SEC is not acting as a regulatory monopolist, maximizing private benefits by increasing the cost to issuers of raising capital. Rather, he concludes, it is mostly responsive to the amount and type of disclosure or regulation demanded by issuers. Regulation FD,\textsuperscript{16} which prohibits selective disclosure by domestic issuers, and the former enforcement of exchange rules requiring fixed broker commissions, presumably are simply anomalies.

A contrary inference is possible based on the same data. The increased mobility of capital increases the cost to regulators of the anticompetitive pricing of securities regulation. So, too, does the development of "unilateral recognition," reported by Licht, under which national securities regulations allow specified foreign disclosure requirements to satisfy local requirements.\textsuperscript{17} Both developments in effect allow issuers to choose among capital and regulatory markets: the former by making domestic regulatory restrictions irrelevant to the cost of capital formation; and the latter by reducing the impact of domestic regulatory restrictions. More competitive capital and regulatory environments therefore decrease the opportunities for the SEC to act as a regulatory monopolist. SEC regulations allowing an effective choice of disclosure or regulation could be a response to the prospective loss in regulated trading volume, which would result from pricing above marginal cost. The history of the SEC's position on the ban on fixed commission rates is consistent with the possibility.\textsuperscript{18} The inference is that the SEC's current "menu-like" approach to disclosure is the product of effective issuer choice among regulatory regimes, not that the SEC does not act as a regulatory monopolist when it can do so. Thus, the limited range of choice given by the SEC's menu of disclosure options does not reflect the preferences of issuers. Issuers therefore might select appreciably different amounts and types of disclosure or regulation than is contained on the menu currently offered by SEC regulation. Regulation FD is an instance of the divergence between regulation and the preferences of domestic issuers.

What follows from the difficulty of measuring the relevant variables? The conclusion is not that the case for privatization fails. The case would fail only if its proponents bore the burden of proof

\textsuperscript{17} See Licht, Stock Exchange Mobility, supra note 7, at 597-604.
\textsuperscript{18} See Mahoney, supra note 2, at 1494-95.
as to the comparative size of regulatory costs and benefits. They do not. Neither side bears the burden of proof. Burdens of proof are appropriately assigned only in adjudicatory settings or when backed by a well-confirmed theory. They are inappropriate here, where a proposal's soundness, not a finding of liability, is at issue. Here too there is no well-confirmed general theory of regulatory behavior, for instance. Regulators may act to maximize investor welfare, supply economic rents to their paying constituents, or maximize returns to themselves. Different pieces of legislation or regulation may be explained by different theories. Fox's discussion of the justification of Regulation FD's exemption for foreign issuers illustrates the difficulty of explaining all the features of even an isolated regulation. Only "capture" theories systematically predict that the SEC is likely to be responsive to issuers' preferences for securities regulation. Without a generally accepted understanding of regulatory behavior, requiring that proponents of privatization demonstrate that issuers would demand different regulations is simply arbitrary. One could with equal justification require the proponents of mandatory regulation to prove the opposite. Thus, talk of burdens of proof adds nothing. Only the weight of direct and indirect evidence, however difficult to obtain, as well as better theories therefore support or undermine the case for privatization.

Implementing a scheme of issuer choice realistically requires governmental cooperation. This is true both with respect to choice of law and enforcement of law chosen. An issuer's ability to choose a regulatory regime to govern a securities contract is valuable only if the choice is respected. This requires that all forums give effect to the issuer's choice. Otherwise, the value of the issuer's choice of regime is discounted by the probability of suit in a

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19. For instances in which the burden of proof is assigned to proponents of the elimination of mandatory disclosure rules, see Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment, 85 VA. L. REV. 1335, 1395 (1999) and Easterbrook & Fischel, supra note 9, at 714. Fritz Machlup describes well the effect of assigning a burden of proof in the context of patent law:

- If we did not have a patent system, it would be irresponsible, on the basis of our present knowledge of its economic consequences to recommend instituting one.
- But since we have had a patent system for a long time, it would be irresponsible, based on our present knowledge, to recommend abolishing it.


20. See Fox, supra note 16.
forum that may or may not honor its selection. Where the investor can select among forums that do not respect issuer choice, the expected value of doing so can approach zero. Convergence among governments or national regulators to a choice of law rule honoring an issuer's selection of securities regime is unlikely. Even within the United States, the mild (and controversial) trend among some courts to honor parties' choice of foreign securities law constitutes too weak and episodic a focal point to coordinate around.\footnote{21} Instead, cooperation required among governments must realistically take the form of a multilateral choice of law treaty for securities. A choice of law treaty is not unprecedented, although the characteristics of different investors and default rules might complicate the product. The European Union Convention on the Law Applicable to Contractual Obligations is a prominent example of a relatively uncomplicated treaty in which contractual choice is paramount.\footnote{22} The need for governmental involvement here is not inconsistent with privatization any more than the enabling and default rules set by contract law are inconsistent with private ordering.

Treaties also are likely to be needed to enforce securities regulations selected in an issuer's contract with its investors. Enforcement raises at least three questions: (1) will a forum accept jurisdiction to decide a dispute involving only extraterritorial conduct and assets?; (2) will national regulators enforce another nation or self-regulating organizations' securities regulations when selected by contract?; and (3) will national regulators or regulatory agencies of the securities regulations selected by contract initiate enforcement of the standards selected? A multilateral treaty is a feasible mechanism for implementing answers to these questions. Blocking statutes and international law principles potentially barring the application of domestic law to purely foreign securities disputes can limit enforcement of contractually selected securities regimes.\footnote{23} Memoranda of understanding among securities regula-

\footnote{21. See, e.g., Haynsworth v. The Corporation, 121 F.3d 956 (5th Cir. 1997); Allen v. Lloyd's of London, 94 F.3d 923 (4th Cir. 1996). Both cases upheld choice of law and forum clauses in arbitration agreements. Cf. Romano, supra note 2, at 2411–12 (recognizing the possible ineffectiveness of judicial decision as a mechanism for interstate coordination enforcing choice of law clauses).}

\footnote{22. See Convention on the Law Applicable to Contractual Obligations, 1980 O.J. (L 266).}

\footnote{23. See James D. Cox, Regulatory Duopoly in U.S. Securities Markets, 99 Colum. L. Rev. 1200, 1240 (1999) (finding a "serious question" as to whether international law prin-}
tors concerning enforcement usually are limited to cooperation in ancillary matters such as evidence gathering and the sharing of information.\textsuperscript{24} They are non-binding bilateral agreements and do not require enforcement of foreign securities law. A treaty overcomes domestic judicial hostility to forum selection clauses or the enforcement of contractually selected foreign securities law. The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards is a precedent here, eliminating domestic law impediments to the enforcement of commercial arbitration agreements and foreign arbitral awards.\textsuperscript{25} Treaties also avoid doctrinal barriers of international law that presumably apply in the absence of agreement among governments. As with choice of law, the point simply is that the use of a treaty to enforce the regulations of contractually selected regulatory regimes is not inconsistent with privatization. To be sure, honoring forum selection clauses or foreign securities regimes involves a cross-subsidy of contracting parties’ litigation costs by taxpayers in the selected forum. But such cross-subsidies occur whenever suit is allowed or foreign law is applied; it is not unique to a scheme of contractual choice of securities regulations. The cross-subsidization often is present, for example, when foreign arbitral awards are enforced under the New York Convention. Cross-subsidies alone therefore do not make proceeding by treaty infeasible or objectionable.

The choice of regulatory agency initiating enforcement by treaty or otherwise is a closer question. Choi proposes that the regulatory agency associated with the contractually selected securities regimes have that responsibility.\textsuperscript{26} The regime-selected regulator is to seek compliance where the issuer maintains its assets or in the capital markets in which the issuer sells its securities. National regulators (or investors) do not have the responsibility of doing so. Choi’s preference for a regulatory agency is based on the compara-


\textsuperscript{26} See Choi, \textit{Promoting Issuer Choice in Securities Regulation}, supra note 8.
tively better expertise and enhanced incentives of regime-selected regulators in interpreting their own regulations and detecting violations.\footnote{See Choi & Guzman, supra note 2, at 930.} However, though Choi's case is plausible, a different assessment is possible. Since enforcement requires knowledge of the relevant regulations and the capacity to gather evidence, control conduct or reach assets, national regulators might have a net advantage. The better expertise and enhanced incentives of regime-selected regulators over national regulators at interpretation may be slight, while the advantages of national regulators in the detection and control of regulated behavior are significant. An assessment of the extent of advantage facing regime-selected regulators must take into account dynamic considerations present when a scheme of privatization is in operation. Under such a scheme, national regulators would be required to administer a number of different securities regulations, depending on the size and composition of their securities markets. In doing so, national regulators could acquire considerable expertise at interpreting the rules of different regimes. They might acquire the administrative counterpart of the expertise local lawyers maintain in advising corporate clients on matters of Delaware law.\footnote{See William J. Carney, The Production of Corporate Law, 71 S. CAL. L. REV. 715, 723 (1998).} Their incentive to make accurate interpretations is based on the benefits of being considered accurate interpreters of regulatory rules. Thus, over time, the advantage regime-selected regulators might have at interpretation is modest.

National regulators are likely to enjoy significant advantages at detecting and controlling violations. This is so when evidence, conduct, assets, or traded securities are in a different place than the locus of contractually selected regulations. Because enforcement requires detection and control, the removal from regulatory reach tends to dramatically increase enforcement costs. Here territoriality matters. Within its territory, a government enjoys economies of scale in detecting and enforcing compliance with regulations. In assuring compliance, government is the superior agency of enforcement by considerable margin. As Carney and others note, however, economies of scale in enforcement are likely to end at a nation's (or state's) borders.\footnote{See Carney, supra note 10, at 741.} Equally important, the per unit enforcement costs plausible are considerably higher for regime-selected regulators than for national regulators when evi-
dence, conduct, assets or traded securities are in a different location than the regime-selected regulators. This is also true for initiating enforcement, because doing so requires accurate information about conduct, which national regulators are comparatively better placed to obtain. Thus, even as a generalization, regime-selected regulators might be in an inferior position to seek enforcement in foreign jurisdictions.

A potentially significant legal barrier to implementing privatization through treaties is the doctrinal characterization of securities regulations. Licht reports on the prevalent and persistent characterization of such regulations across legal systems as “public law.”30 As public law, securities law is taken to be mandatory and not subject to private ordering. Licht’s observation is indirectly confirmed by treaties in which exceptions are made for the application of mandatory law or “fundamental public policy” of signatory nations.31 It is also supported by case law and commentary, which consider securities laws to be mandatory even when arbitrable.32 Whether the doctrinal description of the “public” nature of securities regulations is a legal impediment to privatization obviously depends on its source. There are two possibilities. One is that its classification as public law is simply the product of a history of securities laws that have imposed a scheme of mandatory restrictions on participants in capital markets. Its description as public law only summarizes the mandatory nature of securities regulations currently in effect. If a scheme of private ordering is implemented, eliminating mandatory restrictions, securities regulations will be recharacterized as matters of private law. The other possibility is that doctrinal classification has independent force, creating a type of legal inertia. If so, doctrinal characterization matters because it can be a factor preventing privatization schemes from being adopted initially or making adoption more difficult. For instance, it could serve as a sort of tie-breaker against adop-

30. See Licht, Stock Exchange Mobility, supra note 7, at 604–15.
31. See, e.g., Convention on the Law Applicable to Contractual Obligations, supra note 22, art. 7 (effect may be given to mandatory law of country having “close connection” to “situation”); New York Convention, supra note 25, art. V(2)(b), 21 U.S.T. at 2520, 330 U.N.T.S. at 40 (non-recognition or enforcement of foreign arbitral award when doing so would violate “public policy” of country).
tion. Where the case for or against privatization is close and inconclusive, doctrinal descriptions of securities law as public law could make a difference.