TALKING THE TALK, OR WALKING THE WALK? OUTCOME-BASED REGULATION OF TRANSNATIONAL INVESTMENT

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I. INTRODUCTION

Today, U.S. retail investors have virtually limitless opportunities to invest their money.[1] Thanks to the revolution in information technology and development of markets outside of the United States, individual U.S. investors may even purchase the stocks of foreign companies listed on foreign stock exchanges with local currency. Nonetheless, U.S. investors do not have the opportunity to directly purchase the full range of individual securities offered by foreign issuers (such as bonds), nor do they have the opportunity to directly utilize the services of foreign brokers, securities exchanges, mutual funds, and other financial services firms. To take part in the gains of international investing, U.S. investors must currently choose from a relatively limited set of investment products, bear substantial transaction costs, or invest in foreign companies without protections typically offered under U.S. law.

1. A retail investor is an individual investor not wealthy enough to meet any of the wealth-based qualifications that high net worth individuals and institutional investors typically rely upon to be permitted to invest in private issuers and private investment funds. *See* JOHN DOWNES & JORDAN ELLIOT GOODMAN, BARRON'S FINANCE & INVESTMENT HANDBOOK 747-48 (2003) (stating that retail investors "typically buy shares of stock or commodity positions in much smaller quantities than institution"); Brian G. Cartwright, Gen. Counsel, U.S. Securities and Exchange Commission (SEC), The Future of Securities Regulation, Address at the University of Pennsylvania Law School Institute for Law and Economics n.1 (Oct. 24, 2007), http://www.sec.gov/news/speech/2007/spch102407bgc.htm ("By 'retail investor' I mean those investors who lack the sophistication or net worth to gain access to institutional markets; in other words, most individual investors.").

The Securities and Exchange Commission (SEC) has taken steps to increase investors' access to foreign markets by negotiating bilateral agreements with foreign regulators pursuant to a policy known as "mutual recognition."[2] Under mutual recognition, a foreign entity seeking to access U.S. capital markets does not need to comply with the full panoply of U.S. securities regulation. Rather, the foreign entity would be permitted to substitute compliance with its home country's regulations for compliance with U.S. regulation, as long as it agrees to submit to SEC antifraud jurisdiction in its dealings with U.S. investors. Similarly, U.S. firms could enter foreign markets without subjecting themselves to a second layer of regulation on top of what the SEC already requires.

This Article provides the SEC with a concrete and workable approach to mutual recognition. Under our outcome-based proposal, the SEC should permit substituted compliance with a foreign regulatory regime so long as that regime achieves investor-protection outcomes similar to the investor protection outcomes achieved by the SEC. In addition, if mutual recognition is consistently applied to allow a U.S. company to be bound primarily by the law of another nation in its dealing with U.S. investors, mutual recognition would allow a U.S. company to opt for foreign regulation and then sell its securities to U.S. investors as a foreign-regulated issuer. A foreign issuer of securities could similarly opt into U.S. regulation and then use mutual recognition to sell securities in its home country as a U.S.-regulated issuer. Mutual recognition would thereby dramatically increase competition among global securities regulators by implementing a regime of issuer choice. The implications of issuer choice are currently the subject of scrutiny and debate among legal scholars. Our own contribu-

2. Press Release, SEC, SEC Announces Next Steps for Implementation of Mutual Recognition Concept (Mar. 24, 2008), http://sec.gov/news/press/2008/2008-49.htm. In principle, we have no problem with a unilateral policy of allowing foreign firms to substitute compliance with their home regulatory system for compliance with SEC regulations, as long as the home regulatory system achieves investor protection outcomes similar to those of the SEC. This would give U.S. investors direct access to foreign securities and markets, but it would not guarantee that foreign investors would have the same access to U.S. issuers and markets. A policy of *mutual* recognition is likely to be more politically viable because it would enjoy support from U.S. issuers and other U.S. entities who would like other countries to permit direct access to foreign investors.

tion is to recognize that so long as mutual recognition is based on outcomes as we propose, it is likely to lead to a "race to optimality" and not compromise investor protection.[3]

Despite entering into a mutual recognition agreement with Australian authorities on August 25, 2008,[4] the SEC seems to have delayed implementing further agreements with other national regulators,[5] likely in part due to recent financial market developments. Since 2007, worldwide financial markets have experienced record losses and volatility from a crisis in the U.S. housing sector, disruptions in the credit markets, and a global recession. These losses have been concentrated in large established financial institutions. French financial services conglomerate Société Générale claims it lost $7.2 billion due to a rogue trader.[6] The value of Bear Stearns, one of Wall Street's most venerable investment banks, virtually evaporated in 100 hours.[7] Fannie Mae and Freddie Mac have become federally-owned enterprises; insurer AIG and major banks have either declared bankruptcy or received infusions of capital from taxpayers in exchange for equity stakes; and each major U.S. investment bank has either collapsed or converted itself into a bank holding company.[8] Under such conditions, ex-

3. *See infra* Part V.

4. Press Release, SEC, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008), http://www.sec.gov/news/press/2008/2008-182.htm.

5. Stefanie Gordon, *MTF's Take Advantage of Mutual Recognition Delay*, WALL ST. LETTER, Nov. 24, 2008, http://www.wallstreetletter.com/ArticleLogin.aspx?ArticleID=2052936 (reporting that the SEC is "shelving . . . its plans for increased mutual recognition" and that "[a]n SEC spokesman said there was no timeline for further action").

6. Robert Marquand & Emily Badger, *Fraud Shakes Up France's Financial Elite*, CHRISTIAN SCI. MONITOR, Feb. 28, 2008, at 7, *available at* http://www.csmonitor.com/2008/0228/p07s03-woeu.html.

7. Andrew Ross Sorkin, *A Quick Death for Bear Stearns*, INT'L HERALD TRIB., Mar. 18, 2008, http://www.iht.com/articles/2008/03/18/business/sorkin.php.

8. *See* Susanne Craig et al., *The Weekend That Wall Street Died*, WSJ.COM, Dec. 29, 2008, http://online.wsj.com/article/SB123051066413538349.html?mod=testMod (discussing the collapse of Lehman Brothers, Morgan Stanley, and others); Liam Pleven et al., *U.S. Revamps Bailout of AIG*, WALL ST. J., Mar. 2, 2009, at A-1, *available at* http://online.wsj.com/article/SB123589399651003021.html; Chris Dolmetsch, *Subprime Collapse to Global Financial Meltdown: Timeline*, BLOOMBERG.COM, Oct. 13, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aleqkSjAAw10# (providing a timeline that

panding retail investors' access to foreign markets may be the last thing on U.S. regulators' minds.

Yet delaying mutual recognition would be unfortunate. Investors can best protect themselves from risk by holding a diversified portfolio of assets whose risks are uncorrelated.[9] Regulatory systems that restrict investors' access to international securities make investors more vulnerable to the risks associated with the types of securities they *are* permitted to own. The subprime-triggered financial crisis had its biggest effects on American banks, whose shares are available to U.S. investors without restriction.[10] The fact that Americans have less ready access to foreign securities, whose risks may not be highly correlated with those of U.S. stocks hurt by the subprime crisis, has exposed U.S. investors to more overall risk, not less. Accordingly, the SEC should not abandon its mutual recognition efforts. The financial crisis has not altered the fact that opening foreign markets to U.S. investors helps them to diversify their portfolios against risk.

Indeed, the regulatory origins of the financial crisis and related events raise the question of whether the U.S. system of financial regulation generally advances investor protection more effectively than other regulatory regimes.[11] After all, the global credit crisis had its origin in mortgage lending, securitization, and banking practices overseen to various degrees by U.S. regulators. In addition, the multibillion dollar securities fraud perpetrated by Bernard Madoff was conducted through an SEC-registered broker-dealer and investment adviser and was carried out despite numerous SEC investigations and

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gives the dates when Fannie Mae and Freddie Mac became federally owned and when the banks collapsed).

9. *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 206-12 (2000) (providing a brief discussion of Modern Portfolio Theory).

10. International Monetary Fund, *Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness*, at 12-13 fig. 1.13 (Apr. 2008), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2008/01/index.htm.

11. *See* Sara Hansard, *Finra Questions Trading in Foreign Securities*, INVESTMENTNEWS.COM, Dec. 5, 2008, http://www.investmentnews.com/apps/pbcs.dll/article?AID=2008812059974 (reporting that Erik Sirri, Director of the SEC's Division of Trading and Markets, stated that "U.S. investor protection regulation is often, *but not always*, superior to regulation abroad") (emphasis added).

prominent media criticism.[12] In any case, regardless of the relative effectiveness of U.S. financial regulation, foreign regulatory regimes do not generally provide wholly inadequate protections for investors.[13]

This Article strikes a balance between leading proposals to increase competition among national securities regulators. In a 1998 *Yale Law Review* article, Roberta Romano offered an extensive "competitive federalism" proposal for international securities regulation that would allow issuers to choose their "securities domicile," which would determine whether federal, state, or another nation's regulatory regime governs the issuer's transactions with investors in the United States.[14] To achieve investor protection, Romano's proposal relies solely upon issuers' incentives to minimize their cost of capital by choosing the regulatory system that is optimal for their investors.[15] She notes that her proposal runs contrary to the overarching political trend to centralize all control over securities regulation in the federal government.[16]

However, a feasible mutual recognition proposal will most likely have to include some type of regulatory assurance that investors are adequately protected. In the Winter 2007 issue of the *Harvard International Law Journal*, Ethiopis Tafara and Robert Peterson advanced a proposal regarding how the SEC should engage in mutual recognition (the "Blueprint").[17] Tafara and Peterson suggest that any foreign entity seeking to substitute compliance with its home country regulations for

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12. *See* Kara Scannel, *Madoff Chasers Dug for Years, to No Avail*, WSJ.COM, Jan. 5, 2009, http://online.wsj.com/article/SB123111743915052731.html.

13. *See also* Eric J. Pan, *Single Stock Futures and Cross-Border Access for US Investors* 47 (Jacob Burns Inst. for Advanced Legal Studies, Working Paper No. 227, 2008), *available at* http://ssrn.com/abstract=1107024 (stating that "there is *no reason* to believe that foreign markets do a poor job in regulating insider trading and share price manipulation") (emphasis added).

14. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2428 (1998). Another prominent issuer choice reform proposal was advanced in Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998).

15. Romano, *supra* note 14, at 2365-67.

16. *Id.* at 2424.

17. *See generally* Robert J. Peterson & Ethiopis Tafara, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

compliance with SEC regulations must register with the SEC and submit to the SEC's antifraud jurisdiction in the United States. They also recognize that any practical proposal for mutual recognition will have to include criteria for judging which regulatory regimes are sufficiently similar to that of the U.S. to be substituted. Tafara and Peterson's suggested criteria, however, focus on comparing laws, regulations, philosophy, and enforcement activities.[18] Their approach could undermine investor protection if a foreign regulator has similar laws, regulations, and activities but effectively fails to produce investor protection due to different underlying market conditions, broader governmental structure, or culture. It could also prevent mutual recognition where it would be warranted; e.g., if a foreign jurisdiction achieves the same investor protection outcomes as the SEC but has different laws, regulations, or enforcement philosophy.

We chart a middle ground between the Romano and Tafara-Peterson approaches. We believe the appropriate criterion for mutual recognition is whether the regulatory systems under consideration actually produce comparable outcomes for investors—not whether they go through the motions without delivering the goods. An examination that focuses only on laws, regulations, processes, or outputs does not tell us whether or how regulation affects the investing public's well-being. We can discover if securities regulation actually achieves its investor protection goals if investor protection outcomes are defined and measured. Only by evaluating investor protection outcomes can the SEC accurately ascertain whether other regulatory regimes just "talk the talk" or truly "walk the walk."

Part II of this Article outlines the principal international investment opportunities available to U.S. investors today and explains why direct access to foreign issuers and markets would benefit investors. Part III establishes the foundation for our proposal by explaining the fundamental principles of outcome-based performance measurement and summarizes how the U.S. government implements these principles, both in general and at the SEC. Part IV presents four alternative ways of implementing outcome-based mutual recognition: harmo-

18. We evaluate Peterson and Tafara's criteria in greater detail in Part VI, *infra*.

nized outcome measurement, comparable outcomes, comparable regulatory effectiveness, and comparable regulatory transparency. Part V suggests why transaction cost reduction is likely only a small part of the benefit mutual recognition would create for U.S. investors; the more significant benefit is the ongoing "race to regulatory optimality" that our proposals would create. Part VI explains how our approach differs from Tafara and Peterson's proposal to base mutual recognition on "substantive comparability."

II. Investing in Foreign Issuers Amidst Increasing Complexity and Risk

As a result of increasing globalization and the rapid pace of financial innovation, the landscape for investors has changed in both dramatic and subtle ways in recent years.[19] Individual U.S. retail investors now have access to a vast and growing array of different securities and investment products regulated under the federal securities laws.[20] U.S. investors must also make their investment decisions in the face of an increasingly complex business and economic environment that exposes them to risks that prior generations of investors did not experience.[21] However, not included among the new investment opportunities available to U.S. investors is directly purchasing the securities of a foreign issuer with at least some guarantee of protection under U.S. law. Rather, investors may only purchase the securities of non-U.S. issuers indirectly, after bearing significant transaction costs and without any protections under U.S. law against foreign issuers. The current re-

19. For the purposes of this Article, "globalization" means the increase in flows of goods and services across national boundaries, in cross-border business transactions (deals), and in capital flows. For a highlight of recent trends, see McKinsey & Company, Mapping Global Capital Markets: Fifth Annual Report (2008), *available at* http://www.mckinsey.com/mgi/reports/pdfs/fifth_annual_report/fifth_annual_report.pdf. Financial innovation is a process that results in the successful commercialization of a new financial instrument, service, or institution. *See* Peter Tufano, *Financial Innovation*, *in* 1A Handbook of the Economics of Finance 307, 310 (George M. Constantinides et al. eds., 2003).

20. *See infra* Part II.A (describing developments in mutual funds, index funds, and exchange-traded funds).

21. *See infra* Part II.B (describing how factors such as heightened division of labor, specialization, and dependence on knowledge assets increase complexity and introduce new risks).

gime therefore exposes investors to the complexities and risks of investing in foreign issuers without the assurances provided by U.S. securities law.

A. *Increasing Investment Opportunities*

At the time the federal securities and investment fund regime was fully established in 1940, commercial and economic realities limited investors to a relatively narrow range of investment opportunities.[22] In what may be thought of as a traditional investment portfolio, investors had available for purchase either the equity or debt securities of U.S.-based issuers. These securities could be directly purchased from issuers or through a broker, or held indirectly through a pooled investment vehicle such as an actively managed mutual fund.[23] Mutual funds invest in a portfolio of securities based upon types of assets, such as stocks or bonds, and their performance is evaluated by comparing the fund's performance to the overall performance of the market or other relevant benchmark.[24] The number of mutual funds did not surpass 100 until 1951, and in 1990 they managed over $1 trillion in assets.[25] By year-end 2007, 8,752 U.S. mutual funds managed just over $12 trillion in assets.[26]

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22. The Securities Act of 1933 and Securities and Exchange Act of 1934 are respectively codified at 15 U.S.C. §§ 77a-77aa (2008) and 15 U.S.C. §§ 78a-78mm (2008). The Investment Company Act and Investment Advisers Act were passed in 1940 and respectively codified at 15 U.S.C. §§ 80a-1 to 80a-64 (2008) and 15 U.S.C. §§ 80b-1 to 80b-21 (2008).

23. *See* SEC, Invest Wisely: An Introduction to Mutual Funds, http://www.sec.gov/investor/pubs/inwsmf.htm ("Legally known as an 'open-end company,' a mutual fund is one of three basic types of investment companies."). For relevant definitions see 15 U.S.C. § 80a-4(3) (2007) (defining "management company"); Company Act § 5(a)(1), 15 U.S.C. § 80a-5(a)(1) (2007) (defining a management company as "open-end" if it "is offering for sale or has outstanding any redeemable security of which it is the issuer").

24. *C.f.* Bing Liang, *On the Performance of Hedge Funds*, 55 FIN. ANALYSTS J. 72, 72 (1999) (contrasting hedge funds with "mutual funds and other traditional investment vehicles" that evaluate returns relative to an external benchmark).

25. *See* MARK MOBIUS, MUTUAL FUNDS: AN INTRODUCTION TO THE CORE CONCEPTS 5 (2007).

26. INVESTMENT COMPANY INSTITUTE, 2008 INVESTMENT COMPANY FACT BOOK 9, 15 (48th ed. 2008), http://www.icifactbook.org/pdf/2008_factbook.pdf.

Mutual funds typically pursue a traditional, "long-only" investment strategy consisting of purchasing stocks and bonds, earning dividend or interest income, and ultimately selling the securities at a higher price. This traditional investment strategy does not employ leverage, invest in financial derivatives such as options or futures, or take short positions in securities (whereby investors can profit from the decline in the value of the security). Over time, mutual funds differentiated their products by investing in companies of different sizes (e.g., so-called large-cap, mid-cap, or small-cap funds), economic sectors (e.g., energy, technology, or real estate), and geographic location.[27]

In addition to mutual funds, financial innovation more recently presented investors with the opportunity to invest in two other types of pooled investment vehicles: index funds and exchange-traded funds, or "ETFs." Index funds and ETFs give investors a relatively low-cost way to gain indirect exposure to an enormous variety of general or specific segments of securities markets, in the United States or abroad. An index fund is a pooled investment vehicle that seeks to passively track the average performance of a general securities index such as the Dow Jones Industrial Average (DJIA) by investing in securities that comprise that index.[28] The first index fund was the Vanguard Index Trust, formed in 1975 to track the performance of the Standard and Poor's (S&P) 500 stock market index.[29] As of year-end 2007, U.S. investors held approximately $4.1 trillion of capital in index funds sponsored by major financial institutions.[30] Another type of passively managed investment vehicle is an ETF, which also tracks indices but, unlike index funds, is traded on an exchange like stocks.[31] The first ETF

27. *See* MOBIUS, *supra* note 25, at 19-25.

28. SEC, Index Funds, http://www.sec.gov/answers/indexf.htm.

29. John C. Bogle, Founder & Chairman, The Vanguard Group, The First Index Mutual Fund: A History of Vanguard Index Trust and the Vanguard Index Strategy, http://www.vanguard.com/bogle_site/lib/sp19970401.html.

30. *Top Managers of U.S.-Based Index Assets*, PENSIONS & INVESTMENTS, Mar. 17, 2008, http://www.pionline.com/apps/pbcs.dll/article?AID=/20080317/CHART/702793521/-1/INDEXMANAGERS.

31. *See* SEC, Exchange-Traded Funds (ETFs), http://www.sec.gov/answers/etf.htm.

was created in 1989 to track the performance of the S&P 500[32] and, as of January 2008, U.S. investors allocated $570 billion into ETFs.[33]

Financial innovation has also given investors the opportunity to invest in more than just the long side of investments by participating in non-traditional investment strategies. One development is the growth of *hedged* mutual funds, which are publicly registered investment companies that mimic hedge fund strategies and only require an average minimum investment of $5,000, with some as low as $500.[34] Investors also increasingly have the opportunity to gain exposure to investment strategies that involve substantial leverage and derivatives,[35] and also, through an on-line brokerage, to purchase

32. GARY L. GASTINEAU, THE EXCHANGE-TRADED FUNDS MANUAL 32-33 (2002).

33. Cal Mankowski, *Assets of U.S. ETFs Fall 6.2 Pct in January—Report*, REUTERS.COM, Feb. 12, 2008, http://www.reuters.com/article/companyNews/idUKN1227125320080212?symbol=SPY.A.

34. Adam Shell, *Investors Add a Bit of Hedge Fund to Portfolio Mix*, USA TODAY, Dec. 8, 2006, at B1; Vikas Agarwal et al., Hedge Funds for Retail Investors?: An Examination of Hedged Mutual Funds 1 (June 4, 2007) (unpublished article, *available at* http://www.fma.org/Orlando/Papers/HMF_January11_fma.pdf); Deborah Brewster, *The Long/Short Show Begins*, FINANCIALTIMES.com, Jan. 26, 2007, http://www.ft.com/cms/s/2/6f3524ae-ad4e-11db-8709-0000779e2340,dwp_uuid=bB2e7f792-b6a6-11db-8bc2-0000779e2340.html. Investors can also take short positions by purchasing the shares of ETFs that move in the opposite direction of indices such as the DJIA or the Chinese stock market. *See, e.g.*, Proshares, Short ProShares, http://www.proshares.com/funds?products=98616&fundType= (last visited Jan. 13, 2009) (quoting prices on short shares for January 12, 2009).

35. *See* Gail Marks Jarvis, *Taking All Ego Out of Investing in Hedge Funds*, CHI. TRIB., Oct. 29, 2006, at 5 (reporting that "individual investors may find [synthetic hedge fund clones] available in the retail market within three to five years"); Harry M. Kat & Helder P. Palaro, *Hedge Fund Returns: You Can Make Them Yourself!* 4–5 (City Univ. of London, Cass Bus. Sch., Alternative Inv. Research Ctr., Working Paper No. 0023, 2005) (June 8, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=800665 (suggesting how to create a clone using a "general procedure that allows us to design simple trading strategies in stock index, bond, currency and interest rate futures that generate returns with statistical properties that are very similar to those of hedge funds"); AFX News Limited, *Och-Ziff Capital to Follow Blackstone, Fortress IPOs*, FORBES.com, Sept. 2, 2007, http://www.forbes.com/feeds/afx/2007/07/02/afx3877517.html (discussing the availability of investments characterized by high leverage and derivatives trading); Marc Hogan, *Hedge Funds: Attack of the Clones*, BUSINESSWEEK.COM, Dec. 4, 2006, http://www.businessweek.com/investor/content/dec2006/pi20061204_627321.

options and future contracts and engage in short selling, with relatively little upfront capital and without the need to consult a professional broker.[36]

B. *Increasing Investment Complexity and New Risks*

In addition to a greater range of potential investment opportunities, investors also face an increasingly complex investment environment. A general source of increased investment complexity is that the operations of securities issuers are now more complex than in prior years. As economies develop and the division of labor intensifies, the production of goods and services becomes more specialized, technological, knowledge-intensive, and complex, and thereby more difficult for any individual to fully comprehend. Business complexity is, in part, driven by globalization, which makes the performance of transnational firms dependent upon myriad factors beyond domestic economic conditions, such as foreign exchange fluctuations and the conduct of foreign governments. In addition, the increasing dependence of the U.S. economy on knowledge assets has likely increased the complexity of the investment decisionmaking process.[37] Furthermore, innovations in financial instruments have introduced a vast array of complex derivatives into the financial system. Complex derivatives increase the complexity of the operations of non-financial companies, as they are used to manage risk and engage in other transactions.

A result of the combination of globalization, financial innovation, and complexity is a new level of interdependence in the financial markets, where seemingly isolated events in one market can manifest themselves in unpredictable risks in

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htm?chan=search (noting that the Merrill Lynch synthetic "Factor index is currently unavailable in the retail market, though Merrill executives say they are considering wider distribution").

36. Eleanor Laise et al., *Over Their Heads: Small Investors, Too, Get Nailed by Arcane Trades*, WALL ST. J., Aug. 14, 2007, at A1.

37. *See* Olufunmilayo B. Arewa, *Measuring and Representing the Knowledge Economy: Accounting for Economic Reality under the Intangibles Paradigm*, 54 BUFF. L. REV. 1, 45 (2006) ("As a result of the intangibles paradigm shift, financial statements have become less informative [to investors] from an accounting and economic perspective.").

others.[38] The combination of complexity, new risks, and global interdependence has led several recent commentators to observe that investment risk has reached a new level of unknowability and uncertainty.[39] The increasing complexity of financial markets means that the return and risk of a company's securities has a less cognizable relationship to the company's activities and the information contained in its financial statements. Mandatory disclosure is thus increasingly unable to provide retail investors with easily understandable information about the factors upon which the value of companies' shares depend. Accordingly, it is more likely that an investor may fail to fully appreciate the risks involved with an investment and make investment choices with less than complete information. In such an environment, new methods of diversification are especially important.

C. *Complexity, New Risks, and Diversification*

Despite the increasing complexity and new risks involved with investing, investing has not necessarily become more "risky" in the sense that investors are, on average, exposed to a greater chance of economic loss when purchasing securities. To the contrary, by exposing investors to sources of risk other than those associated with traditional investments in the U.S. economy, the new risks can help investors reduce their overall investment losses. Investment risk is the chance of suffering an economic loss from making an investment. Modern portfolio theory instructs investors to maximize risk-adjusted returns.[40] Risk-adjusted return is a measure of how much return

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38. *See* RICHARD BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION 1-6, 144-46 (2007) (providing examples of events in one market which resulted in negative outcomes in others and explaining the integration of global financial markets as a result of "tight coupling").

39. *See id.* at 154-56; Richard Barley, *Ability to Track Risk Has Shrunk "Forever"—Moody's*, REUTERS, Jan. 7, 2008, http://www.reuters.com/article/bondsNews/idUSL0455354520080107?pageNumber=1&virtualBrandChannel=0&sp=true (reporting that Moody's Investors Service concluded that because of increased financial complexity "[i]t is extremely unlikely that in today's markets we will ever know on a timely basis where every risk lies").

40. MPT was first developed by Nobel prize-winning economist Harry Markowitz in the 1950s. For detailed explanations of MPT, see generally Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952); HARRY M. MARKO-

an investor receives for accepting a given level of risk. Higher risk-adjusted returns give investors greater assurance that they will receive the return expected from an investment and not suffer a loss.[41] When an investor is receiving the highest possible return for the total amount of risk, risk-adjusted returns are maximized.

To maximize risk-adjusted returns, investors should diversify their portfolios, in addition to minimizing investment transaction costs (such as commissions paid to brokers). Diversifying means broadening the different sources of investment risk to which an investor is exposed. Diversification reduces risk to the extent that the returns of different securities are independent of one another, i.e., have a low correlation.[42] If different securities in a portfolio have a low correlation, when some perform poorly, others may not, and the net effect will be to reduce the portfolio's overall losses. Diversification in practice requires investing in a portfolio of numerous securities from a wide range of issuers and types of assets (such as stocks, bonds, commodities, and real estate).[43] Investing in international securities also helps to diversify a portfolio.[44] As explained by Nobel Prize-winning economist James Tobin, diversification cautions investors against putting all their "eggs in one basket."[45] Although securities with higher returns typically have higher risks, diversification allows an investor to reduce investment risk without having to decrease returns.[46]

WITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1959).

41. FRANÇOIS-SERGE LHABITANT, HANDBOOK ON HEDGE FUNDS 455 (2006).

42. *See* Burton G. Malkiel, *A Random Walk Down Wall Street, in* FOUNDATIONS OF CORPORATE LAW 29, 32-33 (Roberta Romano ed., 1999) (providing a simple example of this phenomenon).

43. LHABITANT, *supra* note 41, at 539-41.

44. *See generally* Robert R. Grauer & Nils H. Hakansson, *Gains from International Diversification: 1968-85 Returns on Portfolios of Stocks and Bonds*, 42 J. FIN. 721 (1987). *See also* MALKIEL, *supra* note 9, at 213-17 (showing that from 1977 to 1997 the optimal portfolio contained 76% U.S. stocks and 24 developing nation stocks).

45. James Tobin, Recipient of the 1981 Alfred Nobel Memorial Prize in Economic Sciences, Lecture at Trinity University (Apr. 30, 1985), *available at* http://www.trinity.edu/nobel/Tobin_files/Tobin%20web%20quotes.htm.

46. *See* MALKIEL, *supra* note 99, at 207-11 (explaining the relationship between risk and diversification).

Accordingly, the new investment opportunities and associated new risks can help investors diversify their portfolios. To the extent that investors diversify by investing in numerous different issuers from different international jurisdictions and across different classes of investments, and in both traditional and non-traditional investment strategies, the new opportunities and risks involved with investing may reduce investors' likelihood of losses. For example, international investing may insulate investors from fluctuations in the U.S. economy, and ETFs whose returns are opposite that of the general market can insulate investors from overall market downturns. In this way, the increasing complexity of financial markets may decrease investment risk and economic losses.

D. *The Missing Opportunity: Direct Access to Foreign Issuers and Entities*

Globalization and financial innovation have greatly expanded the types of securities available to investors beyond traditional investments. Due to the development and maturing of economies outside of the United States, the desire of foreign companies for capital from U.S. investors, and the concomitant demand by U.S. investors for the securities of foreign issuers, U.S. investors have been presented with increasing opportunities to gain exposure to the performance of foreign securities.[47] However, U.S. investors are not permitted to invest directly in the securities of a foreign issuer not registered with the SEC. Rather, to invest in a foreign issuer, U.S. investors can either invest in a pooled investment vehicle with exposure to foreign companies, purchase the shares of one of the limited number of foreign companies traded in the United States through an American Depository Receipt (ADR), or purchase foreign company shares listed on a foreign exchange through a U.S. broker with foreign affiliates.

As noted above, there are numerous mutual funds, index funds, and ETFs that offer investors a wide array of broad and specific foreign investment opportunities. Investing abroad through investment pools has the advantage of allowing investors to easily invest in a relatively diversified group of interna-

47. Aaron Lucchetti, *Global Investing Made Easy*, WALL ST. J., Aug. 12, 2006, at B1 (noting "Americans' voracious appetite for overseas investments").

tional securities. However, in addition to paying fund manager fees, intermediated pooled investing limits investors to the available offerings of foreign fund providers and does not allow U.S. retail investors to customize their international portfolio holdings. Pooled investment vehicles also do not give investors the opportunity to directly purchase the securities of individual foreign companies. Because substantial information about foreign companies is already accessible to U.S. investors,[48] the foregoing limitations decrease the ability of U.S. investors to diversify their portfolios.

U.S. investors may purchase the equity shares of a foreign issuer if the shares of that company trade on a U.S. exchange or over-the-counter as an ADR. An ADR is an instrument representing one or a fraction of the shares of a foreign company stock and which gives the ADR owner an interest in the securities of a foreign issuer deposited with a U.S. bank.[49] The price of an ADR is based upon the price of the foreign stock in the issuer's home jurisdiction.[50] Investing in foreign issuers through an ADR has advantages, such as allowing investors to invest in a single foreign issuer, and also to have the transaction and any related dividends take place in U.S. dollars. On the other hand, ADR depository banks may pass the additional costs of converting transactions to U.S. dollars along to investors.[51] The most significant disadvantage of ADRs for U.S. investors, however, is that the proportion of global public companies that list on U.S. exchanges through ADRs is extremely small. In 2006, the Bank of New York found that only 475 large companies are listed through ADRs, a mere 1.4% of globally traded companies.[52]

A third method for U.S. investors to purchase foreign securities is to utilize the services of a U.S. broker able to place trades of foreign securities listed on foreign stock exchanges. For example, E*Trade Financial, through its foreign affiliates,

48. *See* Pan, *supra* note 13, at 46 (noting that substantial foreign company information is available to U.S. investors in part because "[m]ost countries meet or exceed the" international disclosure standards promulgated by the International Organization of Securities Commissions).

49. *See* SEC, International Investing, http://www.sec.gov/investor/pubs/ininvest.htm.

50. *Id.*

51. *Id.*

52. Lucchetti, *supra* note 47, at B1.

enables U.S. investors to invest in the common stock of foreign companies listed on the London Stock Exchange, the Toronto Stock Exchange, the Tokyo Stock Exchange, the Hong Kong Stock Exchange, and Euronext Paris.[53] E*Trade offers investors stock and index charts about foreign companies, company news, and analyst research, with information including a foreign company's balance sheet, financial statements, and important economic ratios. E*Trade charges U.S. investors a commission of approximately $20 to $40 per trade, depending on the local currency utilized and applicable exchange rate.[54] This rate is substantially higher than the highest commission ($12.99) charged by E*Trade for U.S. stock and option trades.[55] Furthermore, specialized fees apply to purchasing Hong Kong- or London-listed shares. Investors must pay stamp duties of 0.1% and 0.5% of total value purchased to invest in stocks listed on the Hong Kong and London Stock Exchanges, respectively.[56] This means that for every $10,000 investment in stocks listed on the London Stock Exchange, an investor is charged $50.

Besides requiring investors to bear higher transaction costs, current policy means that the securities of foreign issuers do not fall under the jurisdiction of the SEC or any other U.S. regulator.[57] By purchasing such shares, a U.S. investor may not have any legal remedies available in a U.S. court and, even if a foreign company is successfully sued in the United States, investors may find it difficult to collect a monetary judgment.[58] Accordingly, if U.S. investors want to purchase indi-

53. *See* E*Trade Financial, Global Trading: Trade Without Boundaries, https://us.etrade.com/e/t/investingandtrading/globaltrading (last visited Jan. 14, 2009); Greg Morcroft, *E-Trade Offers Direct Access to Six Foreign Markets*, MARKETWATCH, Feb. 20, 2007, http://www.marketwatch.com/news/story/e-trade-offers-direct-access-six/story.aspx?guid{6FC2011F-7B03-40EB-AC69-BCA426C29F45}.

54. *See* E*Trade Financial, View Commissions and Fees, https://us.etrade.com/e/t/prospectestation/pricing?id=1206010000 (last visited Jan 14, 2009).

55. *Id.*

56. *Id.*; Lucchetti, *supra* note 47, at B1.

57. *See* E*Trade Financial, *supra* note 53 (noting the E*Trade foreign securities "are not regulated or overseen by the Securities and Exchange Commission, the Commodities Futures Trading Commission, or any of the securities or commodities self-regulatory organizations").

58. *See* SEC, *supra* note 49.

vidual shares, they must either choose from the extremely limited issuers making offerings through ADRs, or bear substantially higher risks by investing in companies not falling under the oversight of any U.S. regulator.

An improvement over the current situation would be to allow U.S. investors to have direct access to a wide array of foreign issuers and the different types of securities they issue (not just common stocks) without the additional costs and with some assurance that they are covered by investor protection regulation comparable to that offered by the United States. These objectives can most effectively be achieved by a regulatory system that permits foreign issuers to sell securities to U.S. investors so long as their home country regulatory regime achieves outcomes that reasonably serve as a substitute for compliance with U.S. law. By decreasing transaction costs and increasing the range of securities available for purchase, a system of outcome-based mutual recognition would allow investors to further maximize risk-adjusted returns.

III. Outcome-Based Regulation

A. *Basic Principles*

Outcomes are the actual benefits created, or harms avoided, for citizens. "*Outcomes are not what the program did but the consequences of what the program did.*"[59] Reduced fraud, improved health, lower crime rates, or lower prices for consumers are good examples of outcomes. Enforcement cases brought or regulations issued are outputs that may affect outcomes, but they are not outcomes. A regulator's activities benefit the public only to the extent that they help achieve socially desirable outcomes.

Of course, good management requires measurement of inputs, activities, and outputs, as well as ultimate outcomes. But the links between these things and outcomes must be clearly understood and verified if regulatory activity is to be based on a realistic understanding of reality rather than faith.[60]

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59. Harry P. Hatry, Performance Measurement: Getting Results 15 (1st ed. 1999) (emphasis in original).

60. Strategic planning is the process by which an agency generates alternative ways of accomplishing its goals, identifies how activities and outputs

Outcome indicators provide numerical measurements that track whether, and to what extent, an outcome was achieved.[61] In most cases, external factors beyond the regulator's influence affect outcomes and outcome measures. Stock ownership, for example, can be affected by fluctuations in economic growth that increase or decrease households' ability and willingness to save and invest. The most informative outcome indicators isolate the regulator's direct effect on the outcome from other causes and indicate how much of the change in the outcome was due to the regulator's action.[62] This may be especially important when comparing securities regulatory regimes from different nations, where cultural or policy differences unrelated to investor protection regulations may have a significant effect on the public's willingness to invest in securities.

When an indicator that directly measures the regulator's effect on the outcome cannot be constructed, it is still often possible to estimate how much the regulation affected the outcome through rigorous program evaluation that attempts to separate the effects of various factors.[63] Effective program evaluation controls for other factors that could affect outcomes in order to determine how much of the observed change can be attributed to a regulation or other government

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lead to outcomes, and then chooses the most effective means of accomplishing the outcomes. Strategic planning thus requires a realistic understanding of causality. *Id.* at 48-51. Ideally, programs or regulations are based not just on hypotheses about causality, but also on evidence demonstrating that the hypotheses are likely true. Thus, when a securities regulator initiates a regulatory program or adopts a major regulation, it should have a coherent theory and actual empirical evidence demonstrating that the regulation is likely to achieve the intended outcome. *See* Timothy J. Muris, *Rules Without Reason: The Case of the FTC*, REG., Sept.-Oct. 1982, at 20, 25 ("Rulemaking requires evidence that can be projected to an entire industry. Clear theories on why a practice is illegal and why the proposed remedy is necessary and likely to be effective are also essential.").

61. HATRY, *supra* note 59, at 55.

62. MAURICE MCTIGUE ET AL., 8TH ANNUAL PERFORMANCE REPORT SCORECARD: WHICH FEDERAL AGENCIES BEST INFORM THE PUBLIC 49 (2007), http://www.mercatus.org/uploadedFiles/Mercatus/Publications/20070403_Scorecard_FY_2006.pdf.

63. *Id.*

program.[64] It is simply the scientific method applied to government programs.

B. *Outcome Measurement in the U.S. Government*

The U.S. government has systems for defining and measuring outcomes produced by agencies and the regulatory programs they administer. The principal law mandating that agencies must define and measure outcomes is the Government Performance and Results Act (GPRA).[65] The principal system for applying GPRA's principles to defining and measuring program outcomes is the Office of Management and Budget's (OMB) Program Assessment Rating Tool (PART).[66]

1. *Government Performance and Results Act*

Enacted in 1993, GPRA requires most federal agencies to articulate the principal outcomes they seek to achieve for the public, measure achievement of these outcomes, and report annually on the measures.[67] For GPRA purposes, a federal "agency" is a Cabinet department, independent agency, or government corporation.[68] Thus, the SEC is subject to GPRA and produces the required plans and reports.

Section 3 of GPRA requires agencies to produce strategic plans that state their missions, goals, and objectives, "including outcome-related goals and objectives."[69] GPRA section 4(b) requires agencies to produce annual performance plans identifying measures that will be used to assess "the relevant outputs, service levels, and outcomes of each program activity"

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64. Office of Mgmt. & Budget, Exec. Office of the President, What Constitutes Strong Evidence of a Program's Effectiveness? 1-5, http://www.whitehouse.gov/omb/part/2004_program_eval.pdf.

65. Government Performance and Results Act of 1993 Pub. L. No. 103-62, 107 Stat. 285 (2008) [hereinafter GPRA].

66. For a brief explanation of the Program Assessment Rating Tool, see Eileen Norcross & Joseph Adamson, *An Analysis of the Office of Management and Budget's Program Assessment Rating Tool (PART) for Fiscal Year 2008*, at 2-5 (Mercatus Center at George Mason University, Working Paper), *available at* http://www.mercatus.org/uploadedFiles/Mercatus/Publications/20070725_Analysis_of_PART_for_FY_2008.pdf. OMB's PART materials and evaluations are available at http://www.expectmore.gov.

67. GPRA §§ 3, 4.

68. GPRA § 3.

69. GPRA § 3(a)(2).

and resources required to produce those results.[70] OMB requires agencies to submit performance budgets that satisfy all the legislative requirements of annual performance plans.[71] The performance budget should describe strategies to achieve outcomes: "These strategies include program, policy, management, *regulatory*, and legislative initiatives and approaches."[72]

The final main element of GPRA is the annual performance report. Annual performance reports must compare actual program performance with the goals in the performance plan.[73]

2. *Program Assessment Rating Tool*

OMB's Program Assessment Rating Tool applies GPRA-style analysis to individual programs.[74] PART consists of 25-30 questions intended to evaluate programs along four dimensions: Purpose and Design, Strategic Planning, Management, and Results. Each section receives a score between 0 and 100 points. The program's total score is a weighted average of the four scores: Purpose and Design (20%), Strategic Planning (10%), Management (20%), and Results (50%). If information on results is available, a program can be rated Effective (85 points and above), Moderately Effective (70-84 points), Adequate (50-69 points), or Ineffective (0-49 points). Regardless of the numerical score, a program can also be rated "Results Not Demonstrated" if it has not established goals and measures and collected data to evaluate performance.

"Programs" include regulatory programs. PART questions most relevant to regulatory outcomes include:[75]

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70. GPRA § 4(b).

71. Office of Mgmt. & Budget, Executive Office of the President, OMB Circular A-11, Preparation, Submission, and Execution of the Budget, §§ 51.8, 200.1 (2008) [hereinafter Circular A-11].

72. *Id.* § 51.8 (emphasis added).

73. GPRA § 4(b)(1116).

74. *See* Office of Mgmt. & Budget, The Program Assessment Rating Tool, http://www.whitehouse.gov/omb/expectmore/part.html (last visited Feb. 14, 2009).

75. The list below comes from Office of Mgmt. & Budget, Executive Office of the President, Program Assessment Rating Tool Guidance No. 2007-02 (2007), *available at* http://www.whitehouse.gov/omb/part/fy2007/2007_guidance_final.pdf.

- Does the program have a limited number of specific long-term performance measures that focus on outcomes and meaningfully reflect the purpose of the program?
- Are independent evaluations of sufficient scope and quality conducted on a regular basis or as needed to support program improvement and evaluate effectiveness and relevance to the problem, interest, or need?
- Are all regulations issued by the program/agency necessary to meet the stated goals of the program, and do all regulations clearly indicate how the rules contribute to the achievement of the goals?
- Did the program prepare adequate regulatory impact analyses if required by Executive Order 12866,[76] regulatory flexibility analysis if required by the Regulatory Flexibility Act and SBREFA,[77] and cost-benefit analyses if required under the Unfunded Mandates Reform Act;[78] and did those analyses comply with OMB guidelines?
- Does the program systematically review its current regulations to ensure consistency among all regulations in accomplishing program goals?
- Are the regulations designed to achieve program goals, to the extent practicable, by maximizing net benefits of its regulatory activity?

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76. Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (1993); *see also* OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, CIRCULAR A-4, REGULATORY ANALYSIS (2003), *available at* http://www.whitehouse.gov/omb/circulars/a004/a-4.pdf [hereinafter CIRCULAR A-4] (providing guidance on development of regulatory analysis as required by EO 12,866).

77. This legislation requires all agencies, including independent agencies, to perform for each proposed regulation a "regulatory flexibility analysis" that outlines the reason for and objectives of the regulation, the agency's statutory authority, the other overlapping federal regulations, the compliance burden on small entities, and the alternatives that would minimize the burden on small entities while still accomplishing the regulation's purpose. *See* Keith W. Holman, *The Regulatory Flexibility Act at 25: Is the Law Achieving its Goal*, 33 FORDHAM URB. L.J. 1119, 1120 (2006) (concluding that the Act is "succeeding in spurring most federal regulatory agencies to improve their treatment of small entities").

78. Title II of the Unfunded Mandates Reform Act applies to regulatory agencies and requires them to analyze the impact of proposed regulations on small entities if the regulation would require expenditures of more than $100 million. 2 U.S.C. § 1532 (2008).

- Has the program demonstrated adequate progress in achieving its long-term performance goals?
- Do independent evaluations of sufficient scope and quality indicate that the program is achieving results?
- Were programmatic goals (and benefits) achieved at least incremental societal cost and did the program maximize net benefits?

These questions clearly highlight OMB's concern that regulatory agencies identify and measure outcomes, conduct program evaluations to determine whether regulation actually caused the desired outcomes to occur, and take all costs of regulation to society into account in order to maximize the net benefits of regulation. It is not sufficient that a regulatory agency engage in activities intended to produce desired outcomes; the agency must also examine whether it actually did produce the outcomes, and at what cost. The SEC is required by statute to promote efficiency and capital formation.[79] The commission and OMB interpret this as a legislative requirement that the SEC perform regulatory analysis, including an assessment of costs and benefits.[80]

C. *Outcome Measurement at the SEC*

As GPRA requires, the SEC has written a strategic plan, annual performance plans (now performance budgets), and annual performance reports. Five major SEC programs that involve writing or enforcing regulations have undergone a PART analysis.[81] The results of these exercises demonstrate

79. 15 U.S.C. § 77b(b) (2008).

80. *See generally* Office of Mgmt. & Budget, Executive Office of the President, OMB PART Assessment, Regulation of Securities Trading and Market Participants (2007), *available at* http://www.whitehouse.gov/omb/expectmore/detail/10009060.2007.html (providing details of the regulatory analysis).

81. The programs do not map perfectly onto the strategic goals. For example, the SEC's budget justification for fiscal year 2008 allocates all of the full-time equivalent employees in two of the programs to the "enforcement" goal. However, the employees in the other three programs are allocated among the enforcement, healthy capital markets, and informed investors goals. SEC, IN BRIEF: FY 2008 CONGRESSIONAL JUSTIFICATION 6, 16-20 (Feb. 2007), *available at* http://www.sec.gov/about/secfy08congbudgjust.pdf. Below, we discuss the PART evaluations for each program under the SEC strategic goal for which that program's measures are most relevant.

how the SEC defines and measures its investor protection outcomes.

The most recent SEC strategic plan available to the public covers fiscal years 2004 to 2009. The SEC's mission statement mirrors its statutory mandate: "to protect investors; to maintain fair, orderly, and efficient markets; and to promote capital formation."[82] Though rather broad, the main elements of the mission are outcome-oriented. One might expect that the main elements of the mission would track directly into the commission's strategic goals, but such is not quite the case, as Table 1 below shows.[83] An examination of the SEC's most recent strategic plan, performance and accountability report, and PART evaluations reveals that few of the commission's goals and measures are truly outcome-oriented. Only in a few cases are the goals and measures a good guide to identifying the investor protection outcomes the commission seeks to achieve.

1. *Goal 1: Compliance*

The SEC's first goal is an activity, not an outcome: "Enforce Compliance with Federal Securities Laws." The "outcomes" listed under this goal involve detection and prevention of violations.[84] These are activities, not outcomes. The performance measures for the enforcement goal also focus on activities and outputs, such as the distribution of cases across en-

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82. SEC, 2004-2009 STRATEGIC PLAN (2004), *available at* http://www.sec.gov/about/secstrategicplan0409.pdf [hereinafter SEC STRATEGIC PLAN]; *see also* 15 U.S.C. § 77b(b) (2008) ("Whenever pursuant to this subchapter the [Securities and Exchange] Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall . . . consider . . . the protection of investors."); 15 U.S.C. § 78f(a) (2008) ("[T]he Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors."); 15 U.S.C. § 80a-2(c) (2008) ("Whenever . . . the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider . . . whether the action will promote efficiency, competition and capital formation.").

83. SEC, SEC 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 6 (2007) [hereinafter SEC P&A REPORT]. The outcomes are taken from SEC STRATEGIC PLAN, *supra* note 82, at 3. The SEC's fourth goal, not included in the table, is an internal management goal that is not relevant to this study.

84. *Id.* at 3.

Table 1: Three SEC Goals

Goal 1: Enforce Compliance with Federal Securities Laws

Outcomes:

1.1 Potential problems or issues in the securities markets are detected early and violations of federal securities laws are prevented.

1.2 Violators of federal securities laws are detected and sanctioned.

Goal 2: Promote Healthy Capital Markets Through an Effective and Flexible Regulatory Environment

Outcomes:

2.1 Investors are protected by regulations that strengthen corporate and fund governance and adhere to high quality financial reporting standards worldwide.

2.2 Industry efforts to provide innovative and competitive products and trading platforms are supported while the markets remain vibrant, fair, accessible, and financially sound.

2.3 Regulations are clearly written, flexible, and relevant, and do not impose unnecessary financial or reporting burdens.

Goal 3: Foster Informed Investment Decisionmaking

Outcomes:

3.1 Investors have accurate, adequate, and timely public access to disclosure materials that are useful and can be easily understood and analyzed across companies, industries, or funds.

3.2 Investors have a better understanding of the operations of the nation's securities markets.

forcement areas, number and percentage of cases resolved, and number of examinations performed.[85] Some of these measures might qualify as intermediate outcomes if rigorous research showed that increases in these activities and outputs cause the amount of bad behavior in securities markets to fall. As it is, it is not clear if an increase in examinations and case resolutions means that the amount of bad behavior is increasing or decreasing.

OMB's most recent PART analysis of the SEC's enforcement program, conducted in 2004, led to a rating of "Results Not Demonstrated" due to the absence of good outcome measures. OMB noted, "Without information on the level of violations, it is difficult to measure the agency's progress in meeting its long-term goals."[86] A separate PART evaluation of the SEC's compliance examination program in 2005 yielded a "Moderately Effective" rating, with only a 57 percent score on the "Program Results/Accountability" portion.[87] OMB classifies two of the program's measures as "outcomes": the percentage of firms that take mitigating action in response to findings by SEC examiners, and the percentage of exams resulting in deficiency letters requiring the registrant to take corrective action. While these might be considered results of the examinations, from an investor perspective, they are intermediate outcomes at best. They are valid measures of the impact on investors only if mitigating actions materially improve investor welfare—a hypothesis that is implicitly assumed, but not demonstrated.

2. *Goal 2: Healthy Capital Markets*

The second goal, "Promote Healthy Capital Markets Through an Effective and Flexible Regulatory Environment," is more outcome-oriented. The listed outcomes suggest a desire to achieve investor protection without imposing undue

85. *Id.* at 27-30.

86. Office of Mgmt. & Budget, Executive Office of the President, OMB PART Assessment, Securities and Exchange Commission–Enforcement (2004), *available at* http://www.whitehouse.gov/omb/expectmore/detail/10002344.2004.html.

87. Office of Mgmt. & Budget, Executive Office of the President, OMB PART Assessment, Examining Compliance with Securities Laws (2005), *available at* http://www.whitehouse.gov/omb/expectmore/detail/10004456.2005.html.

regulatory burdens. Regulatory burdens are, however, construed narrowly to mean reporting and compliance costs, rather than overall costs to investors or the economy that may result when firms and individuals respond to the full panoply of incentives created by regulations.

The SEC's 2007 Performance and Accountability Report lists several measures for this goal that focus on completion of activities or efficiency: meeting milestones on international regulatory cooperation, and the speed with which some activities are concluded.[88] Other measures are outcomes, but the extent to which SEC actions influence the outcomes is unclear and not documented in the report. Such measures include the percentage of U.S. households owning mutual funds, mutual funds as a percentage of assets in U.S. retirement accounts, and the number and dollar value of foreign securities registered with the SEC.[89] The mutual fund statistics may say something about U.S. investors' confidence in the SEC's regulatory regime, but as the SEC notes, many other factors also influence households' decisions to invest in mutual funds.[90] Similarly, the number of foreign issuers who register with the SEC, and the amount of capital they raise, may say something about how these issuers perceive the regulatory burden in the United States—but other factors may also significantly influence these decisions. To provide valid indicators of the outcomes of SEC regulation, the SEC would need to demonstrate whether the regulatory regime in fact had any effect on the trends in these variables.

A PART analysis of the SEC's regulation of the investment management industry (mutual funds) in 2006 gave the mutual fund and foreign security ownership measures credit for being outcome-oriented.[91] This program received a score of 93 percent in the "Program Results/Accountability" section because it articulated long-term performance goals and achieved them

88. SEC 2007 P&A REPORT, *supra* note 83, at 32, 34-35.

89. *Id.* at 32-34.

90. *Id.* at 32.

91. Office of Mgmt. & Budget, Executive Office of the President, OMB PART Assessment, Regulation of the Investment Management Industry (2006), *available at* http://www.whitehouse.gov/omb/expectmore/detail/10004113.2006.html#performanceMeasures.

while taking efforts to reduce the compliance burden.[92] Overall, the program was rated "Effective."

The SEC's program to regulate major securities market participants—such as broker-dealers, self-regulatory organizations, and transfer agents—likewise received an "Effective" rating in 2007.[93] The program has seven outcome measures that regulation may influence: percentage of U.S. households investing in the securities market, dollar amount of foreign ownership of U.S. securities, annual increase in New York Stock Exchange (NYSE) and Nasdaq share volume, percentage of market outages in stock-trading venues corrected within targeted timeframes, the number of Securities Investor Protection Corporation proceedings initiated following the liquidation of a broker-dealer, the aggregate dollar amount of free credit balances, and the dollar amount of foreign ownership.[94] Like the measures for mutual fund regulation, these outcomes are influenced by many other factors, and no materials in the PART analysis demonstrate how much of the changes in these variables was due to SEC regulation. The program received a score of 78 percent on "Program Results/Accountability" because it met most of its performance goals.

3. *Goal 3: Informed Investment Decisionmaking*

The third goal also suggests an outcome: well-informed investors who are equipped to make their own investment choices. Current performance measures do not assess how well-informed U.S. investors are. However, two of the measures do provide some indication of whether investors find information furnished by the SEC to be useful: investor education publications distributed in response to citizen requests by the Federal Citizen Information Center, and the number of online searches of the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) corporate information database.[95] The remaining measures assess activities, such as the speed of response to complaints and requests for information, percent

92. *Id.*

93. Office of Mgmt. & Budget, *supra* note 80.

94. *Id.*

95. SEC 2007 P&A REPORT, *supra* note 83, at 38.

of corporate filings reviewed by SEC staff, and percent of forms submitted electronically.[96]

A 2003 PART analysis of the corporate disclosure program led to a "Results Not Demonstrated" rating, largely because the SEC did not establish and track outcome-oriented performance measures.[97] OMB noted, "The Program's long-term performance goal is the adequate, accurate, and timely disclosure of material information to investors."[98] It is not clear whether the newer measures in the Performance and Accountability Report, which gauge public use of SEC data, sufficiently measure how well-informed investors are. They do seem to indicate that the information is available and used by many.

The foregoing discusses only the SEC's outcome goals and performance measures. Other key topics analyzed under GPRA and PART include an agency's or program's clarity of purpose; overlap or redundancy with other federal, state, local, or private initiatives; design flaws; efficiency; performance budgeting; targeting of resources; accountability of partners; financial management practices; and comparison with other programs that have similar goals. All of this is important information for policy decisionmakers and managers, but not as relevant for our purposes here, which is simply to establish how the SEC identifies and measures outcomes.

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96. *Id.* at 37-39.

97. Office of Mgmt. & Budget, Executive Office of the President, OMB PART Assessment, Securities and Exchange Commission–Full Disclosure Program (2003), *available at* http://www.whitehouse.gov/omb/expectmore/detail/10001171.2003.html. The first page of this evaluation notes that the program received a "Results Not Demonstrated" rating because it does not have outcome-oriented performance goals and measures and does not track the number of referrals to the Division of Enforcement that result in investigations or cases. Programs typically receive a "Results Not Demonstrated" rating when they lack performance goals or data. *See* Office of Mgmt. & Budget, Executive Office of the President, ExpectMore.gov, About Us, http://www.whitehouse.gov/omb/expectmore/about.html (last visited Mar. 14, 2009).

98. Office of Mgmt. & Budget, *supra* note 97.

IV. Four Proposals for Outcome-Based Mutual Recognition

To fill a current gap in the financial marketplace, the SEC should adopt a policy of permitting U.S. investors to directly purchase the securities of any foreign issuer so long as the issuer is subject to a regulatory regime that achieves regulatory outcomes comparable to those achieved by the SEC. Compliance with a regime having comparable regulatory outcomes would thereby serve as a substitute for standard registration and oversight by the SEC. Exception from SEC registration could be predicated upon mutual recognition by the SEC and the foreign issuer's regulator that each country's system of regulation affords sufficient protection to investors such that registering with a foreign regulator would be unnecessary and duplicative. As part of the process of mutual recognition, the foreign issuer, though exempt from ordinary SEC registration and disclosure, would still be liable in the United States for violating the antifraud provisions of the U.S. securities laws. Remedial actions would be coordinated with the foreign regulator pursuant to an information-sharing and enforcement agreement. Four different methods for comparing regulatory outcomes are considered below.

A. *Harmonized Outcome Measurement*

The most direct and rigorous method of comparing outcomes across regulatory regimes would be to measure the extent to which foreign regulators achieve the same investor protection outcomes the SEC seeks to achieve. This is a harmonization solution. The key difference between this harmonization proposal and most other harmonization proposals, however, is that it focuses on harmonization of outcome measurement rather than harmonization of laws, regulations, processes, or enforcement activities.

Harmonized outcome measurement would be easiest when foreign regulators articulate the same outcomes and adopt the same measures as the SEC. If the foreign regulator has its own performance measurement system, data used to gauge outcomes would naturally flow from the performance measurement the overseas regulator is already doing. But harmonized outcome measurement does not necessarily require that overseas regulators articulate and measure outcomes in

the same way the SEC does. Rather, it only requires that the investor protection outcomes sought by the SEC be measurable in other countries by someone. Indeed, the overseas regulators might even claim they seek somewhat different outcomes. In such cases, mutual recognition might still be possible if it is possible to measure investor protection in the foreign jurisdiction and the measures indicate that the overseas regulator has achieved an acceptable level of investor protection.

For this type of exercise, the principal investor protection outcomes and measures would be those currently employed by the SEC. Table 1 included three investor protection goals that are clearly expressed as outcomes. The SEC's performance budget, performance and accountability report, and PART analyses indicate at least eight outcome-oriented measures that accompany these goals:

- Governance: Investors are protected by regulations that strengthen corporate and fund governance and adhere to high quality financial reporting standards worldwide.[99]
  - Measures:
    - Percentage of households owning mutual funds.[100]
    - Percentage of households investing in securities.[101]
    - Percentage of retirement savings consisting of equities.[102]
    - Amount of foreign ownership of securities.[103]
    - Annual increase in major exchange share volume.[104]
    - Percentage of market outages in stock-trading venues corrected within targeted timeframes.[105]

99. *See supra* tbl. 1, Goal 2, Outcome 2.1.

100. SEC 2007 P&A REPORT, *supra* note 83, at 32.

101. *See* Office of Mgmt. & Budget, *supra* note 80.

102. SEC, FY 2008 PERFORMANCE BUDGET 145 (2008), *available at* http://www.sec.gov/about/2008budgetperform.pdf.

103. *See* Office of Mgmt. & Budget, *supra* note 80.

104. *Id.*

105. *Id.*

- Information: Investors have accurate, adequate, and timely public access to disclosure materials that are useful, and can be easily understood and analyzed across companies, industries, or funds.[106]
  - Measure: Searches of available corporate data conducted by the public.[107]
- Education: Investors have a better understanding of the operations of the nation's securities markets.[108]
  - Measure: Investor education information distributed in response to investor requests.[109]

One other SEC outcome-oriented measure relevant to governance—number of Securities Investor Protection Corporation proceedings initiated following the liquidation of a broker-dealer[110]—would probably require reformulation to apply to different countries that have different institutions for dealing with liquidation of broker-dealers.

To qualify as achieving comparable outcomes, a non-U.S. jurisdiction should not be expected to show the same numerical achievement on these measures as the SEC does. Numerical measures do not tell us whether the overseas regulator is achieving comparable outcomes unless the measures have been adjusted to control for factors other than the regulatory system that might influence outcomes, such as cross-national differences in culture, history, economic growth, attitudes toward share ownership, and other government policies. In the absence of such comprehensive calibration, the most workable approach would likely be for the SEC simply to negotiate with an overseas jurisdiction what constitutes an "acceptable" level of achievement for each outcome measure. The level of achievement that constitutes "acceptable" cannot easily be specified ex ante, but rather would emerge as negotiators from the SEC and the overseas regulator gain greater understanding of the market environment each faces.

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106. *See supra* tbl. 1, Goal 3, Outcome 3.1.

107. SEC 2007 P&A REPORT, *supra* note 83, at 38.

108. *See supra* tbl. 1, Goal 3, Outcome 3.2.

109. SEC 2007 P&A REPORT, *supra* note 83, at 38.

110. *See* Office of Mgmt. & Budget, *supra* note 80 (mentioning this criterion).

An overseas regulator might achieve acceptable levels for some measures but not others. In some cases, the outcome measures might indicate that the foreign regulator achieved acceptable outcomes for regulation of some types of entities—such as investment companies—but not for others, such as stock exchanges or issuers. In these cases, the most appropriate action would be partial mutual recognition, only for classes of entities for which regulation is achieving its intended outcomes.

If outcomes and measures are harmonized around the SEC's current practice, any regulator would seem to qualify for mutual recognition if it oversees a growing and efficiently-operated securities market, with securities owned both by domestic households and foreigners, and basic corporate financial information available to the public. Perhaps these minimal standards are all that is really necessary to ensure investor protection. Surely overseas regulators would be amply justified in arguing that if these are the standards the world's pre-eminent securities regulatory agency must meet to receive authorization and funding from the U.S. government,[111] then it is eminently reasonable to hold other jurisdictions to no higher standard.

Others may feel that harmonized outcome measurement based on current SEC practice sets an unacceptably low standard for foreign jurisdictions to meet. This is, of course, an indictment of the current state of outcome definition and measurement at the SEC. One response would be to delay mutual recognition until performance measurement at the SEC improves. Another option, however, would be to eschew harmonization around current SEC performance measures

111. One of GPRA's stated purposes is to "improve congressional decisionmaking by providing more objective information on achieving statutory objectives, and on the relative effectiveness and efficiency of Federal programs and spending." GPRA § 2(b)(5). OMB notes in its guidance to agencies: "Strategic plans should guide the formulation and execution of the budget. A strategic plan is a tool to be used in setting priorities and allocating resources consistent with these priorities." CIRCULAR A-11, *supra* note 71, § 210.1. OMB's discussion of PART notes that the detailed PART findings should influence budget recommendations. *See* ExpectMore.gov, Frequently Asked Questions, http://www.whitehouse.gov/omb/expectmore/faq.html#019 (last visited Feb. 10, 2009). Several studies find that programs with higher PART scores tend to receive larger budget increases. *See* Norcross & Adamson, *supra* note 66, at 26.

and seek alternative ways of comparing regulatory outcomes across jurisdictions. We offer several below.

B. *Comparable Outcomes*

Other regulatory regimes could be good candidates for mutual recognition if they achieve investor protection outcomes comparable to those the SEC seeks to achieve. They might achieve those outcomes even if they do not define or measure them precisely the same way the SEC does. Comparable outcome measurement requires only that the other regulator has valid and verifiable measures of investor protection outcomes similar to those the SEC seeks to achieve.

In an explanation of its statutory authority, the SEC enunciates two principles that neatly summarize the investor protection outcomes it seeks to achieve:

- "Companies offering their stock to the public must disclose the truth about their business, the securities they are selling, and the risks involved in investing."[112]
- "People who sell and trade securities—brokers, dealers, and exchanges—must treat investors fairly and honestly, putting investors' interests first."[113]

To be considered comparable on investor protection, another regulatory regime should achieve these two broad types of outcomes. If another regulator demonstrates that its system achieves an acceptable level of investor protection for both types of outcomes, mutual recognition should follow. If the other regulator shows acceptable achievement for only one of the two types of outcomes, then mutual recognition for entities subject to regulation related to that outcome ought to be possible. Thus, in one country some issuers might meet high standards for disclosure about their businesses and risks, even if some or all exchanges in that country offer an inadequate level of fairness and honesty. Mutual recognition could be extended to that country's issuers but not its exchanges. The issuers would have to sell securities to U.S. investors by getting listed in the United States or in some other country whose exchanges do enjoy mutual recognition by the SEC. Or perhaps the other jurisdiction's regulation of issuers protects investors

112. SEC STRATEGIC PLAN, *supra* note 82, at 5.
113. *Id.*

who buy stock in companies quite well, but its regulation of mutual funds leaves a lot to be desired. In that case, mutual recognition could be extended to that country's issuers but not to its investment companies; Americans could buy that country's securities but not mutual funds.

To see how an outcome-based approach would differ from a comparison of regulations or enforcement activities, consider some possible measures related to the first outcome, which deals with disclosure. The purpose of disclosure regulation is to ensure that investors have accurate and sufficient material information to evaluate the risks and returns of potential investments.[114] Outcome-oriented measures would indicate whether such information is actually available to investors. Some possible measures could include:

- Extent and quality of financial and operating information available via company web sites;
- Existence and quality of information available via a third party database similar to the SEC's EDGAR database;
- Extent of coverage of the foreign firms by investment analysts whose reports are available to the public;
- Extent of coverage of companies' financial and operating information by financial journalists, bloggers, and other commentators who write for the investing public;
- Existence and availability of company rankings and comparisons generated by assessment firms that communicate their results to the public, such as Morningstar.

All of these indicators assess whether key company data are available either to the investing public or to professionals whose audience is the investing public. We are not suggesting that a foreign regulatory system must score well on all of these measures; we merely offer them as examples of the types of things regulators should examine if they want to compare outcomes.

One key advantage of focusing on comparable regulatory outcomes is that it preserves an exclusive focus on outcomes without requiring agencies in different countries to define and

114. *See, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").

measure them in precisely the same way. Another, perhaps less obvious, advantage is that the negotiation process could spur both the SEC and overseas regulators to improve their definitions and measurement of outcomes and share best practices. As the SEC seeks to ensure that foreign regulatory systems adequately protect U.S. investors, and foreign regulators seek similar assurances in regard to U.S. regulation, both will critically assess the others' outcomes and measures. Mutual recognition will occur only when each regulator is satisfied with the other's outcomes and measures.

Comparable outcome measurement does share one drawback with harmonized outcome measurement: measurement of outcomes can be difficult. Regulators in the United States and abroad may both be reluctant to grant mutual recognition solely on the basis of outcomes until outcome measurement improves substantially. This reluctance could delay otherwise beneficial mutual recognition. Until outcome measurement improves, therefore, it may be necessary to rely on assessments that take factors other than outcomes into account—provided that the link between these other factors and outcomes is clearly articulated and verified.

C. *Comparable Regulatory Effectiveness*

"Comparable Regulatory Effectiveness" is our name for an outcome-oriented evaluation that would take into account some more easily measurable factors that are precursors to outcomes. Fortunately, the U.S. government has already developed a tool that evaluates a regulatory agency's strategy, activities, efficiency, and results: the PART. PART assesses a program's purpose and design, strategic planning, management, and results. A PART-like assessment of a foreign regulator's investor protection programs could be used to determine whether that regulation is sufficiently effective to permit mutual recognition.

Performing a PART assessment on an overseas regulator is not the same as harmonizing regulations and enforcement. Rather, the PART assessment helps gauge whether the overseas regulator is likely to accomplish investor protection outcomes in circumstances where outcome data alone are not sufficient to support this judgment. If an overseas jurisdiction has strong evidence that its regulatory strategy is likely to pro-

tect investors adequately, if the regulatory program is efficiently and effectively managed, and if the regulator uses information on outputs and outcomes to guide decisions, then it is highly likely that the system produces an adequate level of investor protection even if outcome data are not complete enough to prove this with 100 percent certainty.

What score on a PART evaluation would qualify a foreign regulator for mutual recognition? A literal interpretation of "comparable regulatory effectiveness" implies that the foreign regulator's investor protection programs should score at least as well as the SEC's investor protection programs do. The most recent PART evaluations rated the SEC's regulation of investment managers and financial market participants as "Effective,"[115] but regulation of corporate disclosure was rated "Results Not Demonstrated" due to a lack of outcome-oriented goals and measures.[116] The corporate disclosure program scored poorly on strategic planning criteria as well.[117] This raises a problem with holding foreign jurisdictions to the same standard under PART as the SEC: sometimes that standard may be unacceptably low. Thus, an absolute standard might be more appropriate.

One intuitively attractive standard would require that a foreign regulator's investor protection programs must receive a PART rating of "Effective." Because of the way PART is scored, this would guarantee that the regulatory regime being evaluated can show at least some evidence that it actually achieves intended investor protection outcomes. A program must earn at least 85 points to be rated "Effective" and the results section counts for 50 percent of the possible points. Thus, even a program that achieves perfect scores on purpose and design, strategic planning, and management cannot be rated "Effective" unless it has at least some satisfactory information about results. Very few programs that were rated "Results Not Demonstrated" because they lack outcome measures or data have achieved total PART scores above 75.[118] If some regulatory programs receive an "Effective" rating and others

115. *See supra* Part III.C.2.

116. *See supra* Part III.C.3.

117. The program received a score of 43% in Strategic Planning. *See* Office of Mgmt. & Budget, *supra* note 97.

118. Norcross & Adamson, *supra* note 66, at 5.

do not, then mutual recognition could be extended for the effective regulations and withheld for the others until they are rated effective.

D. *Comparable Regulatory Transparency*

A final outcome-based approach focuses on foreign investor protection outcomes as evaluated by investors, not regulators. As discussed more fully in this subpart, if enough investors properly evaluate the level of investor protection afforded by foreign regulatory regimes, then all investors will receive a premium for investing in companies operating under a low quality regulatory regime. This result facilitates investor protection policy as implemented under U.S. law. U.S. investor protection regulation seeks to ensure that investors make informed choices about the risks they take on but does not seek to prevent investors from taking on "too much" risk.[119] From an economic point of view, investor protection is furthered when investors are compensated for bearing additional risk,[120] including the risks arising from low quality regulatory regimes.

All three of the options outlined above ultimately rely solely on the expert judgment of national securities regulators to determine whether different regulatory regimes adequately protect investors. They are thus vulnerable to three drawbacks common to all decisions that rely on expert government judgments: political considerations that can interfere with expert judgment, the inherent limitations to even experts' ability to gather and process information, and behavioral biases impacting the soundness of regulatory judgment. Regulators, like market actors, act out of self-interest,[121] and in so doing,

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119. *See* S. REP. NO. 73-47, at 1 (1933) (noting that the "basic policy [of the Securities Act] is that of informing the investors of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation."); Ralston Purina Co., 346 U.S. at 124 ("The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").

120. *See* John E. Tracy & Alfred B. MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1048 (1934) (noting that a purpose of the Securities and Exchange Act disclosure requirements is to facilitate the accurate "evaluation of prices of securities" by stock exchanges).

121. *See* NICOLAS MERCURO & STEVEN G. MEDEMA, ECONOMICS AND THE LAW: FROM POSNER TO POST-MODERNISM 85, 93-94 (1997).

may take into account considerations such as the preferences of domestic interest groups when determining whether a foreign regulator regime achieves comparable outcomes. In addition, as Nobel laureate economist Friedrich Hayek suggested, decentralized processes are superior to centralized regulatory solutions because decentralized markets focus dispersed information—information that no one individual (not even a regulator) can obtain—and convey it effectively to market participants.[122] Decentralized markets also permit trial-and-error experimentation in order to discover things that would not otherwise be discovered.[123] Evidence abounds that individuals with diverse, localized knowledge can make choices, generate ideas, and solve problems far better than small groups of experts, no matter how well intentioned, knowledgeable, or intelligent.[124] Finally, the decisions of regulators are subject to psychological biases which may result in less than optimal decisions regarding mutual recognition, such as failing to appreciate the adequacy of the investor protection regulations of a foreign regime.[125] These drawbacks could lead U.S. regulators to withhold or delay mutual recognition when it would benefit investors, or possibly even grant mutual recognition before sufficient investor protections are in place.

Rather than directly assessing the outcomes produced by other regulatory regimes, U.S. regulators might assess whether foreign regimes are sufficiently transparent that U.S. retail investors and other market participants themselves could accurately assess the level of investor protection and associated risks. Mutual recognition would hinge on a finding that the other nation's securities markets and regulatory system are sufficiently transparent for investors to make an informed deci-

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122. *See generally* Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945) (discussing the theory of competition).

123. *See* FRIEDRICH A. HAYEK, NEW STUDIES IN PHILOSOPHY, POLITICS, ECONOMICS AND THE HISTORY OF IDEAS 179-81 (1978) (describing economic competition as a "discovery procedure").

124. *See generally* JAMES SUROWIECKI, THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES AND NATIONS (2004).

125. *See generally* Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); David Hirshleifer, *Psychological Bias as a Driver of Financial Regulation*, 14 EURO. FIN. MGMT. 856 (2008).

sion about investing in that nation's issuers. According to research by La Porta and colleagues, company disclosures and the availability of private remedies are particularly important for the development of capital markets.[126] By contrast, whether or not a national regulator has strong enforcement or oversight powers matters little to ensure a healthy capital market.[127] This finding suggests that, when comparing regulatory regimes instead of issuers, what matters most to investors is information about the quality of a regulatory scheme and not whether a particular nation enforces its laws as strictly as does the United States. So long as the overall regulatory quality of a foreign nation is known by U.S. investors, informed decision-making can take place and investor protection will not be compromised. This approach harnesses the "wisdom of crowds"[128] instead of relying on the judgment of a small group of experts.

Investors have plenty of fodder for rumination. Over the past decade, a vast body of economics and finance literature has studied the relationship between the legal protections a nation provides to investors and economic outcomes. In 1996, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny began a line of research on the relationship between legal systems and capital markets development, and concluded that greater investor protection law leads to more developed equity and debt markets because investors are more willing to invest if the law protects them from managerial misconduct.[129] Since that time, economists have studied the relationship between different nations' investor protection mechanisms and certain economic outcomes, each of which largely overlaps with either one of the three goals pursued by the SEC or the outcomes the SEC uses to measure attainment of its goals.[130] For instance, in a survey of thirty-one nations, Luez and colleagues found that companies operating under regimes with more extensive investor protections have higher

126. Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 27-28 (2006).

127. *Id.*

128. *See generally* SUROWIECKI, *supra* note 124.

129. *See* Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1149 (1997).

130. *See supra* Part IV.C.

quality financial reporting.[131] In 2006, La Porta and colleagues refined their original contribution. They found that nations where companies raising capital made greater disclosures to investors (e.g., delivering a prospectus, being transparent about insider compensation) had a greater ratio of stock market capitalization to gross domestic product, greater liquidity, and other measures of capital market development.[132] A subsequent study by Simeon Djankov and his collaborators found similar results using a sample of seventy-two nations and conceptualizing investor protection as the legal protection from self-dealing afforded to minority shareholders by company insiders.[133] All of this economic literature is public and readily available to investors who want to evaluate the risks and rewards posed by different regulatory regimes.

In addition to the economics and finance literature on investor protection and capital market development are more general sources of information relevant to regulatory transparency that stem from annual surveys of the quality of global legal regimes in relation to basic protections afforded to property owners in general and investors in particular. These surveys are important because it does investors little good to invest in a jurisdiction with a robust securities law (e.g., disclosure and liability) that otherwise fails to enforce contracts or suffers from rampant corruption. The annual International Property Rights Index published by the Property Rights Alliance evaluates and compares 115 nations by several measures, including the independence of the judicial system and transparency and stability of the overall legal system.[134] *The Economic Freedom of the World* annual report from the Fraser Institute measures economic freedom in 141 nations, including measures for judicial independence, enforcement of con-

131. Christian Luez et al., *Earnings Management and Investor Protection: An International Comparison*, 69 J. FIN. ECON. 505, 507-08 (2003).

132. La Porta et al., *supra* note 126, at 19.

133. Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 461, 463 (2008).

134. SATYA THALLAM, PROP. RIGHTS ALLIANCE, INTERNATIONAL PROPERTY RIGHTS INDEX (IPRI) 2008 REPORT 15, 20 (2008), *available at* http://www.internationalpropertyrightsindex.org/UserFiles/File/022508ot-report%20(2).pdf.

tracts, and regulation of credit markets.[135] The Heritage Foundation and the *Wall Street Journal* also publish an annual *Index of Economic Freedom* covering 183 countries, which measures outcomes such as how independent banks and capital markets are from state ownership and political interference.[136]

The importance of this research is not whether particular investor protection regulations or governance devices ultimately increase market valuation and securities prices.[137] Rather, this research is significant because it shows that information about the general quality of numerous nations' securities regulations and related laws is widely available and comparable across several different dimensions, thereby enabling investors to make informed decisions.[138] From the world's most advanced economies to those of Nigeria and Kazakhstan, there is hardly a regulatory system on earth so opaque that it would prevent investors from making informed investment decisions regarding its issuers. Indeed, there is already large body of practitioner-oriented literature for investors and their advisors on how to protect foreign investments from political risk and deal with other challenges from making global investments.[139] For instance, the Joel Kurtzman and Glen Yago Opacity Index, which measures the degree to which different nations "lack . . . clear, accurate, formal, clear-cut, and widely accepted practices in the broad arena where business, finance, and govern-

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135. James Gwartney & Robert Lawson with Russell S. Sobel & Peter T. Leeson, Econ. Freedom Network, Economic Freedom of the World 2007 Annual Report 10, 13 (2007), *available at* http://www.freetheworld.com/2007/EFW2007BOOK2.pdf.

136. Terry Miller & Kim R. Holmes, The Heritage Found. & Wall St. Journal, 2009 Index of Economic Freedom 2, 14 (2009), *available at* www.heritage.org/index/pdf/Index09Full.pdf.

137. *See generally* Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices* 67-68 (European Corporate Governance Inst., Working Paper No. 89/2007, 2007) (criticizing the use of corporate governance indices as predictors of firm performance).

138. *See* Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. Econ. Literature 285, 302 (2008) (noting that after a decade of research "there is by now a great deal of evidence that . . . legal rules and regulations . . . have substantial impact on important economic outcomes").

139. *See, e.g.*, Richard C. Allison & Jack J. Coe, Protecting Against the Expropriation Risk in Investing Abroad (1997); Noah Rubins & Stephan Kinsella, International Investment, Political Risk and Dispute Resolution: A Practitioner's Guide (2005).

ment meet," allows investors to easily compare the relative transparency of numerous different regimes.[140]

Even if retail investors are not generally sophisticated or otherwise willing to perform the necessary research about the quality of foreign regulatory regimes, there is already sufficient information available about the quality of numerous foreign jurisdictions' regulatory regimes that ordinary investors do not need to research the tables of academic studies to make informed investment decisions. Today, the prices of the securities of issuers regulated under almost any regime will reflect the regime's quality, regardless of the absolute level of protection it affords to investors. According to a long-standing pillar of financial economics known as the efficient markets hypothesis, the price of any security worldwide reflects all relevant information about that security, and any new price-relevant information is quickly reflected in its price by investors trading upon the new information.[141] Information about the risk of a particular security is perhaps the most important category of price-relevant information, because securities with a higher risk generally have to offer higher expected returns to compensate investors for accepting a greater chance of experiencing losses.[142]

One piece of information relating to the risk of a security is the quality of the regulatory regime governing the issuer of the security. If a security is issued by a company operating under a regime that affords investors little protection, or issuers do not voluntarily adopt investor protection mechanisms to attract and lower the cost of capital, then investors may be exposed to a higher risk of investment loss caused by managerial self-dealing.[143] As numerous empirical studies find, foreign jurisdictions with greater investor protection regulation,

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140. JOEL KURTZMAN & GLENN YAGO, GLOBAL EDGE: USING THE OPACITY INDEX TO MANAGE THE RISKS OF CROSS-BORDER BUSINESS xiii (2007).

141. RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 337 (8th ed. 2006).

142. *See* Malkiel, *supra* note 42, at 29-31.

143. *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 783 (2001) (arguing that a strong securities market requires that investors are provided "good information about the value of a company's business" and have "confidence that the company's insiders . . . won't cheat investors out of most or all of the value of their investment through 'self-dealing' transactions").

higher quality corporate governance, and better overall legal systems have lower costs of capital and greater liquidity.[144] This means that regulatory systems are sufficiently transparent and markets sufficiently efficient that investors are compensated for taking on the increased risk associated with purchasing securities from relatively low quality jurisdictions. Even if particular investors do not appreciate the greater risks involved with investing in companies from low quality regimes, they will still be compensated for doing so.

The SEC should consider a foreign regulatory regime sufficiently transparent such that its regulatory quality will be priced into the securities of issuers subject to that regime so long as one of two conditions are met. First, the regime publicly discloses its securities laws, regulations, and enforcement philosophy, and there is no reason to believe that enforcement is so lax that foreign issuers need not in fact comply with its mandates. Public disclosure of law ensures that sophisticated investors will appropriately discount regimes whose laws are opaque. In the alternative, even if the foreign regime is relatively opaque about its securities law, so long as the legal requirements of the regime are made public and subject to scrutiny by third parties such as academics and practitioners, then that regulatory regime has sufficient transparency. A good starting point for regimes in this latter category might be, for instance, each of the 49 regimes subjected to analysis in the law and finance literature inaugurated by La Porta and col-

144. *See, e.g.*, Hazem Daouk et al., *Capital Market Governance: How Do Security Laws Affect Market Performance?*, 12 J. CORP. FIN. 560, 563 (2006) (finding that issuers from nations with higher scores on a capital markets governance index have a lower cost-of-equity); Venkat R. Eleswarapu & Kumar Venkataraman, *The Impact of Legal and Political Institutions on Equity Trading Costs: A Cross-Country Analysis*, 19 REV. FIN. STUD. 1081, 1084 (2006) (finding lower trading costs in jurisdictions with "more efficient judicial systems, better accounting standards, and more stable political systems"); Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. ACCT. RES. 485, 488 (2006) (claiming that "[f]irms in countries with more extensive disclosure requirements, strong securities regulation, and more effective legal systems have a significantly lower cost of capital"); M. Deniz Yavuz, Why Does Investor Protection Matter for the Cost of Equity? (Apr. 5, 2007) (unpublished working paper), *available at* http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2007-Vienna/Papers/0518.pdf (finding that better investor protection decreases risk).

leagues. In their research, the authors have made public the level of investor protection of a given regime by interviewing practicing attorneys with regard to numerous specific questions such as whether insider transactions must be disclosed, the standard of civil liability for officers, directors, and accountants for securities fraud, and whether a securities investigator has subpoena power over witnesses.[145]

The advantage of comparable regulatory transparency is that it requires minimal "second-guessing" of foreign regulators by the SEC. Comparable regulatory transparency indeed comports with the basic investor protection and disclosure philosophy underlying U.S. federal securities law. The purpose of the disclosure regime is not to prevent investors from taking on high risks, but rather to protect investors by enabling them to make informed investment decisions based upon accurate, complete, and timely company disclosures.[146] Similarly, comparable regulatory transparency allows investors to take on high risks associated with investing under regulatory regimes with relatively poor quality so long as information about the risk—in this case, regulatory risk—is disclosed. Comparable transparency ensures that any residual risks to investors will be priced by the market. The main disadvantage of this approach is that it does not guarantee that the foreign jurisdictions

145. La Porta et al., *supra* note 126, at 3, 6-10.

146. *See* 15 U.S.C. § 80a-1(b)(1) (2008) (stating that adequate and accurate disclosure in the national public interest); SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (holding that the Securities Act was designed to promote full disclosure of information necessary for informed investment decisions); Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (noting that the purpose of the Advisers Act is to "'substitute a philosophy of full disclosure for the philosophy of *caveat emptor*' in the investment advisory profession" (quoting SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180, 186 (1963))); S. REP. NO. 73-47, at 1 (1933) (noting that the "basic policy [of the Securities Act] is that of informing the investors of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation."); Phillip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 245 (1959) (noting the registration and disclosure requirements of the Advisers Act sought to provide "a compulsory census of investment advisers and which would provide in small degree for the regulation of some of their activities") (internal quotation omitted); John E. Tracy & Alfred B. MacChesney, *The Securities and Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1048 (1934) (noting that the Exchange Act disclosure requirements facilitate accurate "evaluation of prices of securities").

would achieve the exact same quality of investor protection as under the U.S. regime.

E. *Which Proposal is Best for Investors?*

To determine which of the above options would best promote investor welfare, one must first identify the nature of the problem the SEC is trying to solve. Regulatory economists generally accept that government action can enhance consumer welfare in the case of a clear "market failure" that cannot be addressed adequately by other means.[147] This is because in the absence of market failure, voluntary action by individuals and organizations is very effective at allocating scarce resources to the uses that citizens value most highly.[148]

Through mutual recognition, the SEC appears to be trying to solve two related, but conceptually distinct, problems that may prevent unfettered securities markets from promoting investor welfare: fraud and insufficient information. When fraud is material, it of course harms the defrauded party by leading to less-than-optimal investment decisions. It may also induce other consumers to discount the reliability of truthful information provided by companies who are not engaging in fraud.[149]

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147. The term "market failure" is perhaps an unfortunate piece of economic jargon because to most people the term "market" implies some form of commercial, for-profit business activity. Market failure then presumably refers to any situation in which commercial activity fails to solve a perceived problem. For many economists, however, the term "market" often has a much broader meaning, referring to any type of voluntary interaction in which people mutually coordinate their activities rather than take directions from a higher (governmental) authority. We use the term in this broader sense. A "market failure" occurs when voluntary activity fails to direct resources to the uses that people value most. OMB Circular A-4 provides substantial guidance on how to identify and describe a market failure. CIRCULAR A-4, *supra* note 76, at 4-5.

148. *See* W. KIP VISCUSI ET AL., ECONOMICS OF REGULATION AND ANTITRUST 79-80 (4th ed. 2005) (explaining the theory of perfect competition in which consumer welfare is maximized under conditions of Pareto optimality).

149. *See* Howard Beales, Richard Craswell, & Steven C. Salop, *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 532 (stating that "[b]ecause literally false statements offer no benefit to consumers, there is no reason to allow them"). For an analysis of how false claims impede well-functioning markets, see *id.* at 505-06.

Insufficient information requires more subtle analysis, because information is not costless.[150] The classic statement by Beales, Craswell, and Salop about consumer information applies equally well to information provided to investors:

> Given the difficulties of separating imperfections from the fact that information is costly, intervention must be limited to those instances in which information imperfections demonstrably lead to significant consumer injury and which can be corrected in a cost-effective manner—without creating serious distortions or side-effects which lead to even greater injury. While it may sometimes be difficult to determine which instances of incomplete information pass this test, it is likely to be even more costly to ignore these issues and attempt to provide consumers with complete information. Policymakers must have adequate information for decision making and carefully weigh the benefits and costs of proposed intervention strategies.[151]

This general principle is echoed in the SEC's statutory mandate to promote investor protection, efficiency, and capital formation. Our proposals should be evaluated based on how well they make international investment opportunities available to investors while addressing fraud and information problems.

All four of our proposals deal with fraud by requiring foreign entities to submit to the SEC's antifraud jurisdiction. Thus, the SEC could still prosecute cases of outright securities fraud against U.S. investors committed by foreign entities, assisted in part by foreign regulators pursuant to the SEC's Bilateral Information Sharing Agreements with foreign regulators and international regulatory bodies.[152] It is always possible that this is not the optimal solution to fraud, but it would let the SEC offer U.S. investors a level of protection from fraud by

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150. For an explanation of the conditions under which information provision may be subject to market failure, as well as market institutions that may limit this market failure, see *id.* at 503-05.

151. *Id.* at 512.

152. As of February 6, 2006, the SEC had entered into thirty-two such agreements. *See* SEC, SEC Bilateral Information Sharing Arrangements, http://www.sec.gov/about/offices/oia/oia_bilateral.htm.

foreign entities comparable to that which the SEC gives U.S. investors when they deal with U.S. entities.

Our four proposals take somewhat different approaches in their treatment of information. The proposal from Part IV.D, Comparable Regulatory Transparency, seeks to ensure that adequate information about foreign regulatory regimes is available so that investors can accurately assess the risks of dealing with entities regulated under foreign regimes. It gives investors the widest possible access to international investments by allowing them to choose which kinds of regulatory risks they are willing to bear. Comparable Regulatory Transparency assumes that the primary type of information imperfection regarding foreign investments is information regarding the nature of the regulatory regime itself. If the regulatory regime is itself transparent, then a vigorous community of scholarly researchers and investment analysts can be relied upon to inform consumers about the extent of information available about entities regulated under each foreign regime. For this reason, we believe that proposal D best balances the investor's interests in wide access to international investment opportunities, protection from fraud, and access to information.

The proposals from Subparts A–C take a different approach. They assume that the primary information imperfection is lack of information about the issuers and other entities regulated by the foreign regimes. Under each of these proposals, the focus on identifying and measuring investor protection outcomes seeks to ensure that the foreign regulators achieve a similar degree of investor protection as does the SEC. Mutual recognition under these options substitutes the judgment of the SEC for the "wisdom of crowds." It is likely to lead to fewer mutual recognition agreements, and, if some foreign regulatory regimes that are very transparent nevertheless fail to demonstrate that they produce outcomes similar to those the SEC seeks to produce, fewer opportunities for U.S. investors. A foreign regulator's failure to demonstrate that it produces similar outcomes may occur because the foreign regime in fact fails to protect investors, or it may occur simply because the foreign regulator lacks the data or analytical resources to measure outcomes. In the latter case, proposals A–C would exclude from mutual recognition some foreign regulators who probably should be included.

If the SEC feels that it must assess the adequacy of information provided by entities regulated by foreign regimes, then we believe proposal B—Comparable Regulatory Outcomes—best promotes investor welfare. This is the option that truly assesses whether the foreign regulators achieve investor protection outcomes similar to those the SEC seeks to achieve. Of all the proposals A–C, it provides the greatest level of investor protection. Of those three proposals, it is also the one most likely to offer U.S. investors the widest range of international investing opportunities, because it does not force foreign regulatory regimes to use the same outcome measures as the SEC or undergo the "Made in the U.S.A.," PART-like evaluation contemplated under proposal C, Comparable Regulatory Effectiveness.

If proposal B is not adopted, we would prefer proposal C over proposal A. Proposal A relies on the SEC's current goals and measures, which are not very outcome-oriented. Hence, it would not measure outcomes very well. The principal argument in favor of proposal A is "What's sauce for the goose is sauce for the gander." Foreign entities might justifiably argue for proposal A on the grounds that their outcome definition and measurement should be held to no higher standard than the U.S. government holds the SEC. Nevertheless, that does not mean proposal A would be optimal for U.S. investors.

Proposal C retains some of the benefits of proposal B, because a PART-like evaluation inquires whether and how the agency measures its outcomes, and what results it achieves, without dictating what specific measures the agency must use. PART is also an already-developed methodology that the SEC could use off the shelf, which would probably save a great deal of time. But PART does not look solely at outcomes. This may be considered a strength if good outcome data are lacking but good data are available on other aspects of program purpose, design, and management that can be demonstrated to cause outcomes.

V. Increasing Regulatory Competition: The Hidden Benefit

All four of our proposals would give U.S. investors greater access to foreign issuers and capital markets. We have noted that retail investors in the United States have some ability to

access foreign markets and issuers.[153] Typically, however, those options are either lower quality or higher cost than the options investors would have if foreign entities could access the U.S. capital markets without submitting to an additional layer of SEC regulation on top of regulation from their home country.[154] Retail investors are less protected from market risks as a result, because their ability to diversify risk is hampered. Mutual recognition would offer U.S. investors more convenient ways to buy and sell the securities of foreign issuers with lower transaction costs. Perhaps the most important benefit of mutual recognition, however, is that it would give a substantial boost to the relatively limited regulatory competition that already takes place across the globe, and ensure that such competition serves the interests of investors.

A. *Mutual Recognition and Issuer Choice*

Issuers currently have some, though by no means complete, choice regarding of regulatory regime. U.S. issuers can choose to be regulated by (1) the SEC, by conducting a traditional initial public offering (IPO) on a U.S. exchange; (2) a foreign regulatory regime, by performing an IPO on a foreign exchange and not selling to U.S. investors in the initial offering or in a secondary market for one year[155]; or (3) effectively no regime, by undertaking private placement of securities pursuant to an SEC registration exemption such as Securities Act section 4(2) or Regulation D.[156] Foreign issuers seeking capi-

153. *See supra* Part II.D.

154. *See id.*

155. *See* COMMITTEE ON CAPITAL MARKETS REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET 1 (2001), *available at* http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf ("[U]nder U.S. regulation, a U.S. company that does a foreign IPO cannot sell its stock to a U.S. resident, nor can these investors buy shares in the secondary market for a period of two years (soon to be reduced to one year under a recent SEC rule change)."). The ability of issuers to list on a foreign exchange and governed by a foreign regime has been facilitated by mergers between international exchanges, a process which itself contributes to regulatory competition. *See* Chris Brummer, *Stock Exchanges and the New Market for Securities Laws*, 75 U. CHI. L. REV. (forthcoming 2009) (manuscript at 5-6, 44-48), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1014683.

156. Rule 506 of Securities Act Regulation D, 17 C.F.R. § 230.506 (2008); *see also* 15 U.S.C. § 77d(2) (2006) (exempting any "transaction not involving

tal from U.S. investors can choose to be regulated by their home country regulator and by the SEC by cross-listing their shares on a U.S. exchange, or they can be regulated by only their home country regulator and still raise capital from qualified U.S. investors through a variety of private placement options such as by selling securities to qualified institutional buyers through a Rule 144A private placement.[157] Mutual recognition would increase U.S. issuers' choices to include the choice to raise capital from investors in a comparable jurisdiction without being subject to a second layer of regulation from that jurisdiction (since SEC registration would substitute as compliance); and vice versa for foreign issuers.

If consistently applied, mutual recognition would dramatically add to the regulatory choices available to issuers and other market participants. Consistent application means that a U.S. issuer would be permitted to raise capital from U.S. retail investors solely by complying with the law of a comparable foreign regime. If a U.S. company chose to list its shares on a foreign exchange in a jurisdiction recognized by the SEC as sufficiently comparable, U.S. investors would be able to purchase the securities of U.S. companies exempt from SEC registration under the same exemption applicable to foreign issuers. The U.S. company would thereby be treated as a foreign-regulated issuer from a mutually recognized jurisdiction.[158]

Preventing U.S. issuers from selling to domestic investors as a foreign issuer by requiring them to remain registered with

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a public offering" from §5 of the Securities Act). Private offerings are nonetheless fully subject to the antifraud provisions of the Securities Act. *See, e.g.*, Regulation D Preliminary Note 1, 17 C.F.R. § 230.501 (2007).

157. Securities Act Rule 144A, 17 C.F.R. § 230.144A (2006) (providing that sales made in accordance with its provisions are not "distributions" under the Securities Act such that re-sellers are not deemed underwriters); *see also* Letter from Keith F. Higgins, Chairman, Comm. on Fed. Regulation of Sec., Am. Bar Assoc., to John W. White, Dir., Div. of Corp. Fin., SEC (Mar. 22, 2007), *available at* http://www.abanet.org/buslaw/committees/CL410000pub/comments/20070322000000.pdf (discussing the actions taken by investment banks tin transactions that are exempt under §4(2)).

158. By contrast, the law of the European Union generally requires companies to first list and be regulated under the regime of the nation in which their corporate headquarters is located. *See* Hal S. Scott, *An Overview of International Finance: Law and Regulation* 28 (Working Paper, 2005), *available at* http://ssrn.com/abstract=800627.

the SEC could put U.S. issuers at a competitive disadvantage: foreign issuers would be allowed to sell to U.S. investors without registering with the SEC, yet U.S. issuers would not. However, if compliance with a foreign jurisdiction is good enough for a foreign issuer to substitute for compliance with U.S. law, then it should suffice for U.S. firms as well. Without an equal application of mutual recognition to U.S. companies, U.S. investors would ultimately be harmed, as some U.S. firms would continue to list on foreign exchanges and decline to raise capital from U.S. investors in order to benefit from a foreign regulatory system more tailored to their businesses.

B. *Issuer Choice and Regulatory Competition*

Under ordinary market competition, firms compete against one another for the revenue from buyers necessary for firm growth and survival. This is because buyers have a choice, and to out-compete rivals firms must sell products with some combination of lower price and/or higher quality (functionality), a process which leads to the continual improvement of goods and services over time. Given that mutual recognition would increase the choices of issuers, brokers, and other market participants regarding which regime they are subject to, one key issue is whether increased choice among regulators would also lead to competition by regulators as it does in the market context.

At the outset, it should be noted that mutual recognition satisfies a formal condition required for regulatory competition to occur. Competition requires regulators to give up their geographical monopoly over securities transactions and to respect the regulatory choice of law decision of issuers.[159] One means to accomplish this task would be for regulators to negotiate at the executive level, a development regulatory competition scholars have typically assessed as highly unlikely.[160] However, contrary to the expectations of even advocates of interna-

159. *See* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 1, 11-12 (2001).

160. *Id.* at 12-13 (arguing that the SEC is unlikely to voluntarily abandon its regulatory jurisdiction); *see also* Frederick Tung, *Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation* 39 GA. L. REV. 525, 561-81 (2005) (arguing that geographical monopoly over securities law is likely to persist because of efficiencies associated with remaining with a home country regulator and interest group pressure).

tional regulatory competition, the SEC, on May 24, 2007, took its first public steps towards enacting the type of national-level mutual recognition agreements required for regulatory competition to occur.[161] The SEC's initiation of a policy of mutual recognition follows a pattern observed by Jonathan Macey, where increased cooperation among national regulators arises in response to increased global competition and successful regulatory arbitrage.[162] Perhaps most fundamentally, mutual recognition is a specific application of the centuries-old choice of law principle known as the internal affairs doctrine, which requires different legal jurisdictions to recognize that a company is primarily governed by the law of its home jurisdiction.[163]

Beyond the purely legal and institutional framework for regulatory competition, how would regulators respond if issuers and other entities could choose their regulator? It is doubtful that regulators would respond exactly as if they were profit-maximizing firms. Unlike suppliers of goods and services on the market, the typical regulatory agency does not directly benefit in the form of monetary payments (revenue) from regulated entities; regulators' income is usually derived from taxpayer funds not directly related to the quality or quan-

161. The SEC's first public action was the announcement of a roundtable on mutual recognition. Press Release, SEC, SEC Announces Roundtable Discussion Regarding Mutual Recognition (May 24, 2007), *available at* http://www.sec.gov/news/press/2007/2007-105.htm.

162. Jonathan Macey, *Regulatory Globalization as a Response to Regulatory Competition*, 52 EMORY L. J. 1353, 1355, 1358 (2003). Tafara and Peterson also note that mutual recognition will decrease regulatory arbitrage, whereby an issuer relocates to a low cost/low quality jurisdiction yet uses a regulatory loophole to raise capital in a higher cost/higher quality jurisdiction. *See* Peterson & Tafara, *supra* note 17, at 52, 55-56.

163. *See* Erin O'Hara & Larry Ribstein, *Corporations and the Market for Law* 4 (Ill. Law & Econ. Working Paper Series, Working Paper No. LE07-002, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=800627; *see also* Steven M. Davidoff, *Regulating Listings in a Global Market*, 86 N.C. L. REV. 89, 96 (2007) (identifying mutual recognition as a conflict-of-laws principle). For a probing analysis of the history of the internal affairs doctrine, see generally Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine* (Law & Econ. Research Paper Series, Working Paper No. 07-8, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=957844.

tity of services provided.[164] Nonetheless, the SEC may benefit from the growth of the markets under its jurisdiction more directly than the typical regulator, because the SEC receives its funding via user fees attached to registration, mergers, and securities transactions.[165] Congress, however, must still approve the SEC's annual appropriation budget.[166] The user fees enter the federal budget as "offsetting collections."[167] The vast majority of the revenues come from registration and transactions fees, which the SEC must adjust periodically to collect the target amount approved by Congress.[168] The growth of entities and transactions under U.S. jurisdiction presumably helps the SEC make a case that it has more work to do, and hence should receive a larger appropriation. Thus, in an indirect way, SEC officials may view their agency's growth as linked to the health of U.S. markets, notwithstanding that the link is less direct compared to an ordinary business firm.

At the same time, under mutual recognition, market participants would not be voluntarily paying only for those regulatory services of their choosing. Rather, regulated entities would be required to abide by the law of at least one regime among the network of regimes subject to mutual recognition. Issuers would not have a complete choice of regulator, nor would they have the option of not being subject to any regulatory regime.

Nonetheless, although regulatory agencies do not maximize profits as do market-based firms, they likely seek to maximize other objectives and thereby, like profit-seeking firms, are responsive to how regulation impacts regulated entities and other interested parties. As political science and legal scholars have noted, regulators likely seek to regulate a greater number of entities overall. This is because, as the jurisdiction of a regulator grows, it is likely that the regulators' budget,

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164. *See* Gillian Hadfield & Eric Talley, *On Public versus Private Provision of Corporate Law* 22 J.L. ECON. & ORG. 414, 418 (2006) (noting that the fundamental distinction between state legislatures providing corporate law and private providers of corporate law is that "[t]he marginal benefits to [state legislatures] is not equal to the marginal increase in net revenues (profits)").

165. *See* SEC, *supra* note 81, at 13-15 (explaining the sources of fees for fiscal years 2006-2008).

166. *See id.* at 1 (providing the appropriation language from Congress).

167. *Id.* at 13.

168. *Id.*

discretion, prestige, and personnel compensation will also increase.[169] Regulators may also seek to maximize the expertise they gain during their tenure as government officials and, towards that end, may seek to increase oversight over sophisticated market participants in particular. In addition, to the extent different regulatory agencies specialize in regulating particular sub-types of entities within a particular class (e.g., manufacturing companies), they may seek to maximize not the total number of entities which could fall under their jurisdiction, but rather the total number of entities among a subset for which their regulation and expertise are best suited.[170]

In addition, regulators are likely to respond to pressure by the entities they regulate or those whose income is derived from regulated entities. In the context of U.S. state legislatures' competition to provide corporate charters, competition is driven by local attorneys and their clients bringing legal reform proposals to the attention of legislatures, and legislatures' responsiveness to such proposals.[171] Pressure by the domestic securities bar, and other financial services professionals, likely also makes national securities regulators responsive to those they regulate.[172] Thus, so long as regulators seek to maximize (and maintain) either the absolute number or type of entity they regulate, or are responsive to domestic pressure groups, regulators have incentives or are otherwise likely to engage in rivalrous competition with other regulators. Crucially, for competition to exist among regulators, it is not the case that regulators need to receive monetary payment in proportion to the number or kind of entities they regulate.

Even under the relatively limited choice available to issuers, there is evidence of competition between national securities regulators in the provision of regulation. For example, U.S. financial regulators have expressed concern that foreign listings of U.S. companies may indicate that regulatory reforms

169. *See* WILLIAM A. NISKANEN, BUREAUCRACY AND PUBLIC ECONOMICS 38 (1994); Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855, 1861 (1997).

170. *Id.* at 1876-82 (discussing that competition among national securities regulators may yield a diversity of regulatory regimes).

171. Roberta Romano, *Is Regulatory Competition A Problem or Irrelevant for Corporate Governance?*, 21 OXFORD REV. ECON. POL. 212, 219-21 (2005).

172. *See* Brummer, *supra* note 155, at 35-39.

promulgated pursuant to the Sarbanes-Oxley Act of 2002 (SOX) are not optimal for all U.S. companies and their investors.[173] In response, the SEC delayed for six years SOX compliance by smaller public companies (i.e., those with a market capitalization of less than $75 million), adopted less stringent disclosure requirements for such companies, and offered guidance to issuers to minimize the compliance costs in implementing the regulation, and the Public Company Accounting Oversight Board revised its auditing standard related to internal control assessments under SOX.[174] The SEC also eased restrictions on foreign issuers seeking to de-register from its purview—to attract them to its oversight in the first place.[175] Other instruments of the federal regulatory apparatus also sought to ensure the competitiveness of the U.S. regulatory regime, with legislators seeking to subsidize small companies' compliance with SOX, the Government Accountability Office

173. *See Sarbanes-Oxley Section 404: New Evidence on the Cost for Small Companies: Before the H. Comm. on Small Bus.*, 110th Cong. 1 (2007) (statement of Christopher Cox, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2007/ts121207cc.htm (acknowledging that SOX places too great a burden on public companies with a market capitalization of less than $75 million); COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT xiii (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (finding in a study spearheaded by U.S. Treasury Secretary Henry Paulson that "the implementation of SOX 404 by the SEC and the PCAOB [Public Company Accounting Oversight Board], together with the prospect of catastrophic liability faced by auditors, has produced a regime that is overly expensive").

174. *See generally* Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. 933, 945 (Jan. 4, 2008) (codified in scattered sections of 17 C.F.R.); Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 Fed. Reg. 35323 (June 27, 2007) (to be codified as 17 C.F.R. pt. 241). *See also* Press Release, Public Company Accounting Oversight Board, Board Approves New Audit Standard For Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule (May 24, 2007), *available at* http://pcaobus.org/News_and_Events/News/2007/05-24.aspx (noting that in comparison to Auditing Standard No. 2, "[t]he new standard is more risk-based and scalable, which will better meet the needs of investors, public companies and auditors alike").

175. Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 Fed. Reg. 16933 (Apr. 5, 2007) (to be codified as 72 C.F.R. pts. 200, 232, 240 and 249).

(GAO) performing its own study on SOX's impact on smaller public companies, and a New York Senator and the mayor of New York City spearheading a study on the efficacy of U.S. financial markets regulation.[176] Perhaps the strongest piece of evidence that U.S. financial market regulators are in competition with foreign regulatory regimes was the announcement in April of 2008 by then-U.S. Treasury Secretary Henry Paulson recommending a *complete* overhaul of the structure and scope of U.S. financial markets regulation specifically modeled on the Australian "objectives-based" approach.[177]

Conduct by the British regulatory regime subsequent to SOX also indicates a degree of regulatory competition. In December of 2006, the British parliament enacted legislation granting the U.K. financial regulator, the Financial Services Authority (FSA), veto power over any attempt by a U.S.-based exchange to impose SOX on a U.K. exchange subsequent to a merger.[178] According to the FSA's Director of Enforcement, the veto power was meant to ensure that U.K. regulation retained its "competitive advantage" over U.S. regulation.[179] The London Stock Exchange, which is a private regulatory body in competition for listing with the New York Stock Exchange, announced itself as a "SOX Free" listing venue. As the fallout from SOX shows, regulatory competition exists—dominant regulators behave *as if* the market for registrants is com-

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176. *See generally* Small Business Sarbanes-Oxley Compliance Assistance Act of 2006, S. 3919, 109th Cong. (2006); U.S. GOV. ACCOUNTABILITY OFFICE, REPORT TO THE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, U.S. SENATE: SARBANES-OXLEY ACT: CONSIDERATION OF KEY PRINCIPLES NEEDED IN ADDRESSING IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES (2006), *available at* http://www.gao.gov/new.items/d06361.pdf; MCKINSEY & COMPANY & THE NEW YORK CITY ECONOMIC DEVELOPMENT CORP., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

177. U.S. DEPT. OF TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 13 (2008), http://www.treas.gov/press/releases/reports/Blueprint.pdf.

178. Investment Exchanges and Clearing Houses Act, 2006, c. 55; Gary Parkinson, *Government Acts to Protect LSE from U.S. Regulators*, INDEPENDENT, Sept. 14, 2006, at 41, *available at* http://www.independent.co.uk/news/business/news/government-acts-to-protect-lse-from-us-regulators-415936.html.

179. Margaret Cole, Director of Enforcement, Financial Services Authority, Lecture at Fordham Law School: The UK FSA: Nobody Does it Better?, (Oct. 17, 2006) (transcript *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1017_mc.shtml).

petitive—so long as *some* other regulators seek to and are potentially able to compete and attract entities away from dominant regulatory bodies such as the SEC. As Romano notes in the context of regulatory competition among U.S. states, competition does not require all regulatory bodies to actively seek out more entities to regulate or to be responsive to domestic pressure groups.[180]

Indeed, even legal reforms providing new *exemptions* from SEC registration are a form of competition. A company that raises capital pursuant to a private placement of securities is nonetheless subject to federal antifraud law and reporting requirements relating to investing in companies registered with the SEC.[181] While taking action to attract issuers to register with a regulator may be a first-best option from the point of view of the regulator, a national securities regulator may prefer that companies raise capital under relatively limited oversight in its jurisdiction than not raise capital in its jurisdiction at all. For example, in 1990 the SEC promulgated Rule 144A to facilitate the private raising of capital by domestic and foreign issuers.[182] The 144A equity market has since grown larger than the market for public issues,[183] and has likely given

180. Romano, *supra* note 171, at 217-18.

181. Private offerings made pursuant to section 4(2) of the Securities Act or Regulation D are subject to the antifraud provisions of the Securities Act of 1933. Securities Act § 17(a), 15 U.S.C. § 77q(a) (2008) (applying its provisions to "the offer or sale of any securities," public or private); Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985); Regulation D Preliminary Note 1, 17 C.F.R. § 230.501 (2008). Privately raising capital pursuant to a Rule 144A transaction also subjects an issuer to SEC antifraud jurisdiction because the transaction first requires the issuer to privately place capital under a Securities Act section 4(2) exemption. Letter from Keith F. Higgins, *supra* note 157 ("Investment banks (individually or in small or large syndicates) purchase securities from issuers in transactions exempt under § 4(2) . . . and resell to [qualified institutional buyers] in accordance with Rule 144A."). For a summary of the most significant reporting requirements under the Securities and Exchange Act applicable to any entity trading publicly registered securities, *see* Houman B. Shadab, *The Law and Economics of Hedge Funds*, 6 BERKELEY BUS. L. J., (forthcoming 2009) (manuscript at 15-19), *available at* http://ssrn.com/abstract=1066808.

182. Robert A. Barron, *Control and Restricted Securities: Some Comments on SEC Rule 144A*, 18 SEC. REG. L.J. 400, 401 (1991) (quoting Richard C. Breedon, Chairman, SEC, Opening Remarks at Open Meeting of the SEC (Apr. 19, 1990)).

183. Liz Moyer, *Barely Private Exchanges*, FORBES.COM, Aug. 14, 2007, http://www.forbes.com/business/2007/08/14/private-placement-exchanges-biz-

the SEC jurisdiction over foreign issuers that would have not raised capital in the United States but for the 144A reform.

C. *Competition Among National Securities Regulators*

Given that national securities regulators seem to compete to attract entities under their full or at least partial oversight, and that mutual recognition would likely lead to a dramatic increase in the competition between regulatory regimes, the fundamental policy issue is what impact such competition would have on investor welfare. In other words, on what basis do regulators compete for registrants and on what basis *would* they compete if mutual recognition was predicated upon achieving a comparable level of investor protection outcomes? Evaluations of regulatory competition are typically framed in terms of a "race to the bottom" or a "race to the top."[184] In the securities context, this distinction reflects the difference between regulators competing to attract issuers by promulgating regulation that serves the interest of company insiders to the detriment of investors versus competing to provide efficient regulation that maximizes firm value and hence investor welfare generally.

To attract registrants amidst entity choice of regulators, a regime must be attractive to insiders in the firm making the regulatory choice decision, which, in the case of public companies, is management or controlling shareholders. A salient issue is whether investor demand for companies subject to high quality regulatory regimes and that practice good firm-level governance will steer corporate insiders away from choosing jurisdictions that serve their own interests at the expense of investors. This issue stems from a potential tradeoff or agency problem: on the one hand, insiders may have a greater ability to benefit themselves at the expense of minority shareholders when operating under a legal regime with weak investor protections or possessing poor governance at the firm level.

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cx_lm_0814private.html (reporting that in 2006 "144a equity issues totaled $162 billion, eclipsing the $152 billion raised in first and secondary stock listings on NYSE Group, Nasdaq and American Stock Exchange").

184. *See, e.g.*, John C. Coffee, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 7 COLUM. L. REV. 1757, 1831 (2002) (stating that the "[t]he 'race to the top' via cross-listing should be encouraged-but it will slow if 'issuer choice' is permitted").

These private benefits of control for insiders include consuming perquisites or undertaking inefficient projects. On the other hand, protecting the rights of minority shareholders may reduce the cost of capital (external financing) and benefit insiders by allowing the firm to take greater advantage of growth opportunities.[185] Cheaper capital means that a firm must give up fewer equity shares and/or debt interest payments to raise a given amount of funds.[186]

As discussed below, the relevant empirical evidence supports the notion that regulatory competition would, on balance, benefit investors because regulators would compete to provide regimes most conducive to firms' maximizing overall value. At the very least, the relevant empirical studies cast serious doubt upon the notion that issuer choice would necessarily benefit managers at the expense of investors: Enough investors seem to demand and appreciate high quality regulation and governance, and insiders seem responsive enough to be willing to relinquish private control benefits to meet investor demand.

First, as noted above, regimes with greater investor protection, higher quality corporate governance, and better overall legal systems have lower costs of capital and greater liquidity.[187] This finding implies that investors demand high quality regulation and are able to distinguish between high and low quality regimes.[188] Investors, especially institutional investors, demand that companies disclose information so that they can make informed investment decisions, and prefer stocks from firms governed by high quality regimes.[189] Issuers disclosing

185. *See* Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. FIN. ECON. 205, 206 (2004).

186. *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 261-62 (1958).

187. *See supra* note 144 and accompanying text.

188. If high quality regulation was *not* associated with lower costs of capital, then the judgment of investors could appropriately be brought into question.

189. *See* Romano, *supra* note 159, at 4, 32; *see also* Miguel A. Ferreira & Pedro Matos, *The Colors of Investors' Money: The Role of Institutional Investors Around the World*, 88 J. FIN. ECON. 499, 501 (finding that mutual funds and investment advisers have invested more "in firms in countries with strong legal environments"); Christine Williamson, *Institutional Interest Lights Transparency Fire*, PENSIONS & INVESTMENTS, Oct. 15, 2007, http://www.pionline.

less information than demanded by investors typically pay a price through a higher cost of capital.[190] When investors invest in companies governed by regimes other than their home-country regulator (e.g., international securities), they are averse to investing in companies with characteristics such as high inside ownership, low quality disclosures, weak protection of minority shareholder rights, and regulation by a weaker legal regime.[191] In particular, Luez and colleagues found strong evidence that U.S. retail and institutional investors find companies under regimes with low quality regulation and otherwise poor governance to be unattractive investments and to limit their holdings accordingly.[192]

Investors are also willing to pay more for the shares of foreign companies when they cross-list their shares in the United States (a cross-listing premium), and more when non-U.S. companies cross-list on an organized exchange, which may reflect investors' willingness to reward companies with

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com/apps/pbcs.dll/article?AID=/20071015/PRINTSUB/71012043/1031/TOC (reporting that institutional investors are demanding greater transparency from hedge funds).

190. *See* Warren Bailey et al., *The Economic Consequences of Increased Disclosure: Evidence From International Cross-listings*, 81 J. FIN. ECON. 175, 178 (2006) (finding that increased returns subsequent to announcement of a U.S. cross-listing are attributable to greater U.S. disclosure requirements); Christine A. Botosan & Marlene A. Plumlee, *A Re-examination of Disclosure Level and the Expected Cost of Equity Capital*, 40 J. ACCT. RES. 21, 22 (2002) (finding that the cost of capital decreases as annual report disclosures increase); David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553, 1578 (2004) (finding that "investors demand a higher return to hold stocks with greater private information"); Jere R. Francis et al., *Disclosure Incentives and Effects on Cost of Capital Around the World*, 80 ACCT. REV. 1125, 1125 (2005) (finding that in a sample of 34 countries not including the United States, "that firms in industries with greater external financing needs have higher voluntary disclosure levels, and that an expanded disclosure policy for these firms leads to a lower cost of both debt and equity capital").

191. *See* Woochan Kim et al., *How Does Corporate Governance Risk At Home Affect Investment Choices Abroad?* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 13721, 2008) *available at* http://www.nber.org/papers/w13721 (summarizing the relevant empirical literature on international investor holdings).

192. Christian Luez, Karl V. Lins & Francis E. Warnock, *Do Foreigners Invest Less in Poorly Governed Firms?* (Nat'l Bureau of Econ. Research, Working Paper No. 12222, 2006), *available at* http://www.nber.org/papers/w12222.

greater transparency and investor protection.[193] The overall U.S. cross-listing premium has been estimated to be as high as seventeen percent but has also fallen significantly since the turn of the century due, in part, to the development of global capital markets and inefficient U.S. regulation.[194] Researchers have found that the cross-listing premium also applies to listings on exchanges in the United Kingdom, Europe, and Japan, which may indicate that investors reward companies not just because they are subject to the U.S. regulatory regime (and its attendant benefits), but more generally to the extent that companies commit to increasing investor protection.[195] Indeed, voluntary disclosures seem to be a substitute for cross-listing in a higher quality regime,[196] which is consistent with the more general finding that investors recognize increased

193. Ole-Kristian Hope et al., *Bonding to the Improved Disclosure Environment in the United States: Firms' Listing Choices and Their Capital Market Consequences* 4 (Working Paper, 2007), *available at* http://ssrn.com/abstract=948670 (finding "that exchange-listing firms receive a higher valuation than other cross-listed firms that do not list on an organized exchange"); G. Andrew Karolyi, *The World of Cross-Listings and Cross-Listings of the World: Challenging Conventional Wisdom*, 10 REV. FIN. 99, 118 (2006).

194. Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. 1857, 1881-82 (2007) (finding "a strong decline in cross-listing premia of foreign companies subject to SOX"); Craig Doidge et al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices over Time* 32 (Fisher Coll. of Bus. Working Paper No. 2007-03-012, 2007), *available at* http://ssrn.com/abstract=982193 (finding a cross-listing premium of 17%). *See generally* Luigi Zingales, *Is the U.S. Capital Market Losing Its Competitive Edge?*, (European Corp. Governance Inst. Fin. Working Paper Group, Paper No. 192/2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1028701# (attributing loss of cross-listing premium to a number of factors, including the reduced liquidity advantage of the U.S. equity market vis-à-vis developed equity markets, the increased cost of compliance, and the significant increase in the risk of liability).

195. Peter Clarkson et al., Is the Cross-listing Premium Really Related to Investor Protection? 16-17 (June 18, 2006) (unpublished working paper), *available at* http://www.afaanz.org/research/AFAANZ%200639.pdf; *see also* Peter Roosenboom & Mathijs A. van Dijk, The Market Reaction to Cross-Listings: Does the Destination Market Matter? 17 (Nov. 2007) (unpublished working paper), *available at* http://ssrn.com/abstract=1047261 (finding little evidence that the cross-listing premium for continental European and Japanese exchanges reflects bonding).

196. Irene Karamanou & George P. Nishiotis, Disclosure vs. Legal Bonding: Can Increased Disclosure Substitute for Cross-Listing? 5 (Mar. 2007) (unpublished working paper), *available at* http://www.hec.unil.ch/urccf/seminar/IAS%20vs%20CL.pdf.

disclosure as valuable and are willing to pay for it.[197] U.S. investors also seem to invest more in cross-listed companies to the extent cross-listing increases the availability and quality of information about a foreign company.[198] These empirical regularities indicate that investors are able to distinguish between investor-friendly regimes and those affording investors little protection.

At the same time, the characteristics and behavior of companies that cross-list their securities in a foreign regime suggests that insiders respond to the demand for high quality regulation and governance. Companies cross-list their securities and raise funds in foreign jurisdictions for a variety of reasons, such as overcoming barriers to international investment that lead to market segmentation, increasing their visibility and access to deeper and more liquid capital markets, and signaling their already-existing high quality governance.[199] Another reason for cross-listing, though perhaps not the most important,[200] may be for insiders operating under low quality regimes to commit to greater investor protection in order to reduce their cost of capital. To the extent cross-listing in the United States provides more investor protection than a firm's home country regime, then cross-listing may reflect corporate insiders' willingness to give up private control benefits by "bonding" to stricter SEC regulation and enforcement and the reputational benefits of U.S. financial markets scrutiny.[201]

197. *See supra* notes 189-190.

198. John Ammer et al., *Look at Me Now: The Role of Cross-Listing in Attracting U.S. Investors* 31-32 (Fed. Reserve. Bd. Int'l Fin. Discussion Papers No. 815, 2004), *available at* http://www.federalreserve.gov/pubs/ifdp/2004/815/ifdp815.pdf.

199. *See* Arturo Bris et al., *A Breakdown of the Valuation Effects of International Cross-Listing*, 13 EUR. FIN. MGMT. 498, 499-501 (2007) (reviewing the various theories for cross-listing and the relevant literature); Sergei Sarkissian & Michael J. Schill, *Are There Permanent Valuation Gains to Overseas Listing?*, 22 REV. FIN. STUD. 373, 374-76 (2008).

200. Bris et al., *supra* note 199 at 499-501 (finding evidence consistent with the notion that legal bonding is not the most important motivation for cross-listing).

201. *See generally* Coffee, *supra* note 184, at 1780-83 (explaining the "bonding" hypothesis); John C. Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 284-92 (2007) (explaining the bonding hypothesis); Rene M. Stulz, *Globalization, Corporate Finance, and the Cost of Capital*, 12 J. APPLIED CORP. FIN. 8 13-15 (1999) (discussing the role of corporate governance in reducing capital costs).

Cross-listing in the United States requires foreign firms to submit to SEC jurisdiction and likely to scrutiny by U.S. financial markets' reputational intermediaries (such as underwriters, analysts, and private plaintiffs).[202] Cross-listing on a major exchange (such as the NYSE or NASDAQ) typically requires firms to increase disclosures and protect minority shareholders by complying with the full SEC regime of disclosure and enforcement and conforming their financial statements to U.S. generally accepted accounting principles (GAAP). Cross-listing over-the-counter on "pink sheets" or through a 144A private placement generally places less stringent requirements on firms than exchange listing and subjects them to less financial market scrutiny.[203]

Although the U.S. legal regime may not effectively provide investors in cross-listed companies with as much protection as those in U.S.-based companies, empirical studies find substantial evidence supporting the notion that foreign companies cross-list in order to have access to cheaper external financing by protecting the rights of minority shareholders.[204] Of particular relevance are studies finding that companies from regimes with weaker regulation are the type most likely to undertake and receive an increase in share price from listing in the United States, and that subsequent to listing in the United States firms make governance changes that increase investor protection.[205] In a study of over 1,000 U.S. cross-listings

202. However, foreign issuers publicly raising capital in the United States are subject to less stringent regulation and disclosure under the Securities Act and Securities and Exchange Act. *See* Davidoff, *supra* note 163, at 130-32.

203. Cross-listing on an over-the-counter (OTC) market requires an issuer to file a Form F-6 and subjects the company to enforcement by the SEC pursuant to the Foreign Corrupt Practices Act. 144A cross-listings require no additional disclosures.

204. *See* Karolyi, *supra* note 193, at 116-21 (reviewing literature supporting and undermining the bonding hypothesis); Mark Lang et al., *Earnings Management and Cross Listing: Are Reconciled Earnings Comparable to US Earnings?*, 42 J. ACCT. & ECON. 255, 256 (2006) (finding that cross-listed firms exhibit more earnings management than U.S. firms reporting in accordance with U.S. GAAP and suggesting such as evidence that SEC regulation is not fully effective for cross-listed firms).

205. Karolyi, *supra* note 193, at 117-20; *see also* Laurent Fresard & Carolina Salva, Does Cross-Listing in the U.S. Really Improve Corporate Governance? Evidence from the Value of Corporate Liquidity 9 (unpublished manuscript, 2007 Ljubljana Meetings of the European Fin. Ass'n), *available at* http://ssrn.com/abstract=958506 (finding evidence in a study of cash holdings con-

from 1992 to 2003, Hail and Luez found that companies from relatively low quality regulatory regimes experienced the most significant decreases in their cost of capital when cross-listing, and that these cost of capital decreases were greater when cross-listing took place on an organized U.S exchange.[206]

Studies find that among the firms that do cross-list in the United States, those from regimes with relatively lower disclosure requirements, and those with relatively large controlling shareholders, are less likely to list on organized exchanges and more likely to cross-list on the over-the-counter (OTC) pink sheets or through the 144A private placement market.[207] This likely shows that insiders in foreign firms seek, at least to some extent, to benefit from access to U.S. capital markets while retaining benefits that may be derived from lower governance.[208] Nonetheless, the insiders of cross-listed companies

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sistent with the proposition that cross-listing improves corporate governance especially for firms from low investor protection regimes); Darius P. Miller & Ugur Lel, *International Cross-Listing, Firm Performance and Top Management Turnover: A Test of the Bonding Hypothesis* (Fed. Reserve Bd., Int'l Fin. Discussion Paper No. 877, 2006), *available at* http://ssrn.com/abstract=926606 (finding that companies from weak investor protection regimes cross-listed on a major U.S. exchange are more likely to fire a poorly performing CEO than those cross-listing elsewhere).

206. *See* Luzi Hail & Christian Leuz, *Cost of Capital Effects and Change in Growth Expectations Around U.S. Cross-Listings* (Eur. Corp. Governance Inst., Fin. Working Paper No. 46/2004, 2006), *available at* http://ssrn.com/abstract=938230 (finding that cross-listing on a U.S. exchange with more oversight and disclosure requirements reduces the cost of capital more than listing over the counter). For their sample, Hail and Leuz find that the average cost of capital reduction for listing on a U.S. exchange was economically significant and between 0.85% and 1.6% per year, while the reduction associated with cross-listing on the OTC markets was between 0.3% and 0.5%. *Id.* at 20. *See also* Sarkissian & Schill, *supra* note 199, at 398 (finding an annual cost of capital reduction for firms cross-listing in the United States in 1998 of 0.7% a year).

207. Hope, *supra* note 193, at 4-5. *See also* Craig Doidge et al., *Private Benefits of Control, Ownership, and the Cross-Listing Decision* 2 (European Corporate Governance Inst., Finance Working Paper No. 77/2005, 2006), *available at* http://ssrn.com/abstract=668424 (finding "strong evidence that when controlling shareholders have high levels of control, their firms are less likely to be listed on a U.S. exchange").

208. *See* Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT'L. L. 141, 162-63 (2003) (arguing that cross-listing firms are often reluctant to give up private benefits of control, and may cross-list in order to increase their access to capital and their visibility to reputational intermediaries).

from weak legal regimes will likely have to give up at least some private benefits since even companies raising capital privately (i.e., not on an exchange) are still subject to SEC jurisdiction over fraud and insider trading, and also to increased scrutiny by reputational intermediaries.[209] Furthermore, investors seem to reward cross-listed firms from weaker disclosure regimes with a higher premium if they are *not* listed on an exchange.[210] Foreign issuers may therefore simply be responding to the overall costs and benefits of cross-listing. In any case, the fact that firms more likely to extract benefits from minority shareholders seem to consistently stay away from organized exchanges provides a clear signal to investors about regulatory regime and investor protection, and how to tailor their investments accordingly. Indeed, when taking into account all companies cross-listed in the United States, investors seem to reward cross-listed firms not on an exchange with a lower cross-listing premium.[211] Even if insiders are generally reluctant to give up private control benefits, the association between regimes that provide investor protection and those that provide access to more developed capital markets creates an incentive for insiders to seek out investor-friendly regimes.

D. *Regulatory Competition Under Outcome-Based Mutual Recognition*

Concerns about whether regulatory competition will result in a race to the top or bottom are to a large extent obviated if such competition takes place within the context of an outcome-based approach to mutual recognition. The only

209. Fresard and Salva find evidence consistent with the proposition that firms cross-listing through OTC of 144A listing "voluntarily provide additional disclosures and implement governance improvements even if they are not required to do so." *See* Fresard & Salva, *supra* note 205, at 29.

210. Hope and colleagues discuss several potential reasons for this phenomenon, such as investors failing to appreciate the growth potential of exchange-listed firms from low quality jurisdictions. *See* Hope et al., *supra* note 193, at 31-32. In addition, this lower listing premium for exchange-listed firms from weak regimes may reflect the fact that exchange-listing may actually *decrease* the stock price informativeness for such companies. *See* Nuno Fernandes & Miguel A. Ferreira, *Does International Cross-Listing Improve the Information Environment?*, 88 J. FIN. & ECON. 216, 242 (2008) (finding that "in emerging markets, cross-listing is associated with lower firm specific return variation").

211. *See* Doidge, *supra* note 185, at 221-22.

regulators competing for issuers and other entities would be those achieving comparable investor protection outcomes. Whether a regime offering investors little protection would be able to out-compete higher quality regimes is simply irrelevant: regulatory competition would be taking place among only among the network of comparable regimes.

Pursuant to the proposals from Part IV, if the SEC and other regulators engaged in mutual recognition on the basis of each achieving the same or comparable investor protection outcomes, each would have incentives to promulgate those regulations which produce better outcomes and to improve the transparency of its regulatory process so that domestic and foreign market participants would be informed of the benefits of choosing that regulator. Similarly, if comparative regulatory effectiveness were the basis for mutual recognition, regulators may be spurred to compete on the basis of the effectiveness of their regulations and to improve the quality of applicable measures. Finally, if a comparable degree of regulatory transparency was the basis for mutual recognition, regimes with relatively low regulatory transparency would have incentives to improve the transparency of their regulatory mechanisms so that firms under their jurisdiction could sell directly to U.S. investors.

If a regulator adopts a new regulation ultimately detrimental to investors, the regulator will be punished through capital flight as some companies and investors move to a regulatory regime more conducive to operating a successful business.[212] Because there is no single set of optimal regulations for all companies, competition among the mutual recognition network would allow for a diversity of approaches to regulation and does not require any single regulator to accommodate every type of firm and investor.[213] Under a system of mutual recognition, those regulators within the set of mutually recognized jurisdictions would be competing for issuers and others to willingly submit to their jurisdiction, not because entities must do so to raise capital or otherwise do business in that jurisdiction, but because that regulator has the best rules by

212. Romano, *supra* note 171, at 216.
213. *See* Romano, *supra* note 159, at 9.

which to be bound.[214] Regulators would essentially be competing for a "registration premium," whereby the securities registered with higher quality regulators would trade at a premium over those with relatively lower quality regulations.

Thus, if issuers, brokers, and other entities may choose their regulator among comparable regimes, a regulatory "race to optimality," as Tafara and Peterson label the process, will likely occur.[215] Crucially, a regime seeking to attract issuers from those regimes comparable to the SEC would not be able to compete on grounds other than offering some mix of better investor protection or operating efficiency. A regime that sought to lure companies by lowering investor protection far below that of the network of mutually recognized regimes would run the risk of being denied access to the network, and substantially decreasing the value of its regime to companies. This is because listing in a regime not among those in the SEC's mutual recognition network might make it more costly to raise capital, since the depth of a non-recognized regime's liquidity pool may be lower.[216]

Even under a system of regulatory competition among comparable regimes, it highly unlikely that major U.S. firms would choose to list in other jurisdictions and raise capital from U.S. investors as a foreign issuer. First, there are purely economic reasons, such as prior familiarity with potential investors, why an issuer's home market is likely the most efficient place for it to be regulated.[217] In addition, the U.S. financial

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214. *See* Christopher Cox, Chairman, SEC, Remarks at Harvard Business School Global Leadership Forum: Cross-Border Exchange Mergers in the Context of Global Trade (June 22, 2006) (transcript available at http://www.sec.gov/news/speech/2006/spch062206cc.htm) (noting that under regulatory competition "[j]ust as companies in their own competitive markets are under constant pressure to provide better quality at lower prices, so too will regulators increasingly be required to give their customers—their nation's investors—better information in more useful ways, and at lower cost").

215. Peterson & Tafara, *supra* note 17, at 67.

216. If mutual recognition is carried out so as to only include those regimes substantively similar to the U.S. regime, then the network of mutually recognized regimes runs the risk of becoming a de facto regulatory cartel whose membership is attractive primarily because it provides additional liquidity to issuers and not necessarily optimal regulation. *See* Brummer, *supra* note 155, at 55-56.

217. Tung, *supra* note 160, at 561-66.

regulatory system is a high quality regime relative to other regimes. As U.S. financial market regulators often claim, the quality of the U.S. securities regime of disclosure, liability, and enforcement is among the highest, if not the highest, in the world.[218] Academic commentators, too, argue that the SEC's current regulatory approach should serve as a model for other regulators.[219] Indeed, Mark Roe has recently suggested that the SEC even out-competes Delaware, the leading U.S. producer of corporate law, when it comes to the most important issues in corporate governance.[220] If these claims are correct, then the SEC should want to let issuers and other financial market participants choose among comparable regulatory regimes, as competition would likely increase the total number of SEC-registered entities.

At the same time, to the extent the U.S. regulatory regime needs improving, greater regulatory competition would provide U.S. regulators with a clear signal that investors find other regimes to best serve their interests, and provide clues on how to tailor reforms accordingly. The response of issuers subsequent to SOX is instructive. Although SOX imposed substantial compliance costs on all U.S. public companies, the empirical evidence suggests that SOX only caused certain types of issuers, such as smaller and riskier companies, to choose another regime because for those issuers the U.S. regime became on the whole less attractive.[221]

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218. Henry M. Paulson, Secretary, U.S. Treasury Dept., Remarks at the Economic Club of New York: The Competitiveness of U.S. Capital Markets (Nov. 20, 2006) (transcript available at http://www.ustreas.gov/press/releases/hp174.htm) (stating that the U.S. financial markets "regulatory structure . . . is second to none" in the world); *cf.* SEC 2007 P&A REPORT, *supra* 83, at 3 (noting the SEC's overarching goal of delivering "high-quality standards" to U.S. investors).

219. *See, e.g.*, Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 839 (2006).

220. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600 (2003); Mark J. Roe, *Regulatory Competition in Making Corporate Law in the United States—and its Limits*, 21. OXFORD REV. ECON. POL. 232, 238 (2005).

221. *See, e.g.*, Joseph D. Piotroski & Suraj Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings*, 46 J. ACCT. RES. 383, 387 (2007) (finding that small foreign firms choosing between NASDAQ and the London Alternative Investment Market increasingly chose the latter post-SOX); Xi Li, *The Sarbanes-Oxley Act and Cross-Listed Foreign Private Issuers* (Jan. 18, 2007) (Second Annual Conference on Empirical Legal Studies Working Paper), *available at* http://ssrn.com/abstract=952433 (finding

VI. The Outcome-Based Approach Versus the Blueprint

Regardless of the whether the SEC chooses to base mutual recognition on identical outcomes, comparable outcomes, comparable regulatory effectiveness, or comparable regulatory transparency, an outcome-based approach to mutual recognition would greatly broaden the range of investment opportunities available to U.S. investors. However, if the SEC engages in mutual recognition by comparing laws, activities, or outputs instead of actual outcomes, it runs the risk of failing to recognize jurisdictions that advance investor protection, recognizing jurisdictions that do not advance investor protection, and turning the mutual recognition process into a de facto attempt to achieve regulatory harmonization.

Because Tafara and Peterson's "Blueprint"[222] for mutual recognition has already garnered substantial academic attention and will likely be very influential in future SEC efforts towards mutual recognition,[223] it is an approach worth examin-

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non-U.S. private issuers more likely to delist from U.S. exchanges post-SOX); *see also* Litvak, *supra* note 194, at 1881-82 (2007) (finding "a strong decline in cross-listing premia of foreign companies subject to SOX"); Zingales, *supra* note 194 (attributing loss of cross-listing premium to a number of factors, including the reduced liquidity advantage of the U.S. equity market vis-à-vis developed equity markets, the increased cost of compliance, and the significant increase in the risk of liability).

222. Peterson & Tafara, *supra* note 17, at 53-64.

223. A large portion of the Winter 2007 edition of the Harvard International Law Journal was devoted to Peterson & Tafara's Blueprint, and included four comments on their proposal and one online comment. *See id.*; Richard Murray, *The Emperor Has Unsuitable Clothes (and by the Way, He Is No Longer the Emperor)*, 48 Harv. Int'l L.J. 15 (2007); *see also* Margaret R. Blake & Nicole M. Crum, *Mutual Recognition of Broker-Dealers—The Great Unknown*, Insights: The Corp. & Sec. Law Advisor, Oct. 2007, at 14, 15 (discussing Tafara and Peterson's position on mutual recognition regimes and describing it as the least restrictive of proposed regimes for dealing with foreign broker-dealers who want to sell foreign securities within the United States); Edward J. Ferraro, *Cross-Border Access to U.S. Investors: Some Recent Proposals*, J. Investment Compliance, 2007, at 19, 25 (analyzing the Tafara/Peterson proposal and its success in initiating the debate about convergence of global securities regulation); Eric J. Pan, *The New Internationalization of U.S. Securities Regulation: Improving the Prospects for a Trans-Atlantic Marketplace*, 11 (Cardozo Law Sch. Jacob Burns Inst. for Advanced Legal Studies, Working Paper No. 217, 2008) (describing the Tafara/Peterson proposal as a significant step towards increasing opportunities for foreign investment), *available at* http://ssrn.com/abstract=1089491; Brummer, *supra* note 155, at 10 (stating that the Tafara/Peterson proposal is an important type of choice of law reform).

ing in some detail. The Blueprint envisions granting a new exemption to standard SEC registration based upon a foreign entity's "compliance with substantively comparable foreign securities regulation and laws and supervision by a foreign securities regulator with oversight powers and a regulatory and enforcement philosophy substantively similar to the SEC's."[224] Along with the exemption would be a bilateral agreement to share extensive information relating to enforcement and supervision. The SEC would retain jurisdiction to prosecute the foreign entity if it committed securities fraud in the United States.[225] Although not subject to the normal SEC registration and oversight requirements, the foreign entity would be subject to a minimal form of registration.[226] Nonetheless, the SEC would not be enforcing the foreign jurisdiction's laws, and oversight of the foreign entity would primarily be the responsibility of the foreign regulator.[227]

The Blueprint recommends a four-step process for mutual recognition of a foreign jurisdiction as substantively comparable to the U.S. securities regime. The four steps are: (1) a petition from the entity to the SEC seeking exemption; (2) a comparability assessment of the entity's home country regulatory regime; (3) an agreement by the entity to be bound by U.S. antifraud law; and (4) a public notice and comment period regarding the desirability of the exemption.[228]

The Blueprint requires that the SEC and a foreign regulator both assess the comparability of each others' trading rules, prudential requirements, examinations, financial statement review processes, enforcement capabilities, and regulatory philosophy. To the extent the regimes are not "fully comparable" or potential regulatory gaps and economy-wide risks persist, the Blueprint requires regulators to make adjustments that bring the two systems "into harmony."[229] The Blueprint also recommends comparing broader oversight and enforcement activities, such as whether the foreign regulator adequately enforces the OECD Convention against Bribery of Foreign Public

224. Peterson & Tafara, *supra* note 17, at 32.
225. *Id.* at 32, 57.
226. *Id.* at 57.
227. *Id.*
228. *Id.* at 58-59.
229. *Id.* at 58.

Officials in International Business Transactions and the remedies available to shareholders.[230]

As applied specifically to foreign trading exchanges seeking exemption, the Blueprint states that an assessment must necessarily compare how the exchanges are licensed and registered, how customer funds are protected, and how regulation of the foreign exchange compares in terms of record keeping, reporting and audit requirements, internal governance, and the exchange's rules and rule approval process. The Blueprint seeks a similar comparability assessment for foreign broker-dealers seeking exemption, including comparing broker-dealer sales practice standards and requirements to disclose potential conflicts of interest.[231] Finally, the Blueprint would also require comparing regulations and governance standards applicable to issuers. This would include assessing disclosure requirements (including whether those requirements are "designed to ensure that issuer disclosures are accurate and complete"), accounting and auditor standards, other governance standards such as director independence, internal control, and shareholder protection provisions.[232] The Blueprint appears to require comparison of almost everything except the actual outcomes the regulation produces for investors. While Howell Jackson is correct to suggest that a comparability assessment in line with the Blueprint should also focus on different regimes' actual levels of enforcement resources and activity, the suggestion indicates that mutual recognition under the Blueprint places a greater emphasis on regulatory inputs and outputs than on outcomes.[233]

Although the Blueprint's approach could lead to mutual recognition, it is not the best way for the SEC to engage in mutual recognition. It is both too lenient and too strict. First, the Blueprint does not focus on domestic or foreign regulatory outcomes. The Blueprint fails to recommend that the SEC assess whether a foreign regulator achieves comparable outcomes or has a comparable level of regulatory effectiveness, or whether the quality of the foreign regulatory regime is

230. *Id.* at 61.

231. *Id.* at 60-61.

232. *Id.* at 61.

233. Howell E. Jackson, *A System of Selective Substitute Compliance*, 48 HARV. INT'L L. J. 105, 115-16 (2007).

transparent enough to be reflected in the prices of securities governed by the regime. Rather, the Blueprint focuses on inputs, activities, and outputs, most of which are related to whether the foreign regulator requires compliance with laws comparable to those in the United States. This is problematic because the SEC's fundamental mission is to achieve outcomes that benefit investors and the U.S. economy generally.[234] The federal securities laws mandate that SEC actions must promote investor protection, efficiency, competition, and capital formation, and GPRA requires the SEC to articulate and achieve outcomes.[235] Furthermore, two of the three goals articulated in the SEC's strategic plan ("Healthy Capital Markets" and "Informed Decisionmaking") focus on outcomes. While compliance with federal securities laws is a goal articulated by the SEC, by focusing solely on compliance-related activities, the Blueprint neglects to engage in a comparability assessment of the outcomes sought after by the SEC and definitive of its mission as a regulator.

A deeper and related problem with focusing on activities is that achieving the outcomes sought by the SEC does not require a foreign regulator to have comparable compliance activities. Empirical evidence does not support what seems to be the Blueprint's implicit assumption that *only* comparable types of rules, governance mechanisms, licensing requirements, and so on are able to achieve the outcomes the SEC seeks. For example, it is not necessarily the case that mandatory disclosure is actually necessary for firms to make disclosures material to investors, or that mandating disclosures as the U.S. securities regime necessarily makes investors better off.[236] At the

234. SEC STRATEGIC PLAN, *supra* note 82, at 4.

235. *See supra* Part III.C.

236. Anat Admati & Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 REV. FIN. STUD. 479, 479 (2000) (modeling disclosure choices which suggest that "regulation that requires a minimal precision level [of disclosure] sometimes but not always improves welfare"); Botosan & Plumlee, *supra* note 190, at 22 (finding that increases in timely disclosures increase the cost of capital); Francis et al., *supra* note 190, at 1125 (finding in a sample of thirty-four non-U.S. regulatory regimes that "voluntary disclosure incentives appear to operate independently of country-level factors, which suggests the effectiveness of voluntary disclosure in gaining access to lower cost external financing around the world"); Jennifer Francis et al., *Voluntary Disclosure, Earnings Quality, and Cost of Capital*, 46 J. ACCT. RES. 53 (2008) (finding that the quality of reported financial earnings, not in-

same time, comparable activities are no guarantee of comparable outcomes. As recent and ongoing problems with U.S. financial markets demonstrate, strict compliance and enforcement regimes are no guarantee of investor protection.

A final issue with the Blueprint is that it may lead the SEC to find that only very similar regulations satisfy the comparability assessment and thereby inadvertently lead to harmonization under the guise of mutual recognition. Although the Blueprint's comparability assessment may be interpreted at a fairly high level, if enacted at a granular level, it would require substantive comparisons between different aspects of the SEC's and the foreign nation's regulatory system.[237] For instance, with respect to issuers, the Blueprint requires a comparative assessment of corporate governance standards such as director independence and internal control. Subsequent to passage of the SOX,[238] it is hard to conceive of the SEC assessing as comparable any system of governance that does not meet the standards mandated by SOX. The Sarbanes-Oxley Act requires public companies to have a fully independent audit committee and for managers to maintain and evaluate internal control. Would a foreign jurisdiction that allows an audit committee to be dominated by insiders be comparable to the United States? If so, then the entire enterprise of engaging in a comparative assessment of the compliance activities of foreign regulators would be undermined. Why inquire into the sales practice standards of foreign-broker deals if foreign issuers are not required to have fully independent audit committees? If, on the other hand, a foreign corporate governance regime must require public issuers to have fully independent audit committees to be comparable to the U.S. system, then the Blueprint would effectively implement a harmoniza-

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creased disclosures per se, accounts for why increased disclosures are correlated with lower capital costs); Romano, *supra* note 159, at 79-108 (reviewing the empirical finance literature and finding that disclosures mandated by SEC regulation do not necessarily increase investor welfare).

237. Edward F. Greene, *Beyond Borders: Time To Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L. J. 85, 91 (2007) (noting that "if a detailed rule-by-rule assessment and harmonization is indeed contemplated, the second-step in the [Blueprint] is likely to become indistinguishable from a requirement of regulatory convergence").

238. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (Supp. II 2002)).

tion plan, which would not recognize another nation's securities regime until it adopted SOX. Because of the inherent tension resulting from basing a comparability assessment on compliance-related activities, the Blueprint may simply be unworkable as anything but a push towards regulatory convergence.

VII. Conclusion

Investors can best protect themselves from risk through diversification into investments whose returns are less correlated with the rest of their portfolios. Foreign securities are one such investment. U.S. investors currently have significant access to some types of foreign securities, but choices are limited and the transaction costs are higher than necessary. Outcome-based mutual recognition would expand investors' choices and reduce transaction costs by giving U.S. investors direct access to foreign issuers and capital markets. Moreover, investors would benefit from healthy transnational competition between regulatory systems. Such competition would allow investors to hold a portfolio of securities regulated by different nations in order to diversify against the risk of regulatory failure by any one national regulator.

We offer several possible approaches to implementing outcome-based mutual recognition: harmonized outcomes, comparable outcomes, comparable regulatory effectiveness, or comparable regulatory transparency. Under any of these proposals, entities seeking to access U.S. markets would have to register with the SEC and submit to the SEC's anti-fraud jurisdiction for transactions in the United States. All other investor protection regulation would be the responsibility of the home country. The pool of competing national regulators would be limited, however, to those whose regulatory regimes produce investor protection outcomes similar to those the SEC seeks to produce. This condition should ensure that regulatory competition becomes a "race to optimality" rather than a "race to the bottom."

Outcome-based mutual recognition is a promising strategy to give investors the benefits of regulatory competition while still ensuring investor protection. Mutual recognition based solely on a comparison of laws, regulations, philosophy, or enforcement activity could either grant recognition to na-

tions that fail to achieve adequate investor protection or withhold recognition from nations that achieve investor protection via means that are different from those employed by the SEC. We can only know if another regulatory system offers investors comparable protection if that regulatory system's investor protection outcomes are transparently defined and measured.