

# Article

## Empowering Investors:

## A Market Approach to Securities Regulation

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The U.S. securities laws have repeatedly been assailed as burdensome or ineffective. Reform efforts have conversely been attacked for undermining an effective mechanism by which shareholders can discipline management. Moreover, even reformers have been dissatisfied with the effectiveness of their product. For example, after enacting the Private Securities Litigation Reform Act of 1995,<sup>1</sup> members of Congress became concerned that their efforts to rein in frivolous private lawsuits under the federal securities laws were being circumvented by state court filings and introduced legislation to preempt such action.<sup>2</sup> There is some validity to their concern: In a report to President Clinton on the impact of the 1995 Act, the Securities and Exchange Commission (SEC) cited preliminary studies indicating a decrease in federal court filings and an increase in state court filings.<sup>3</sup>

This Article contends that the current legislative approach to securities regulation is mistaken and that preemption is not the solution to frivolous lawsuits. It advocates instead a market-oriented approach of competitive federalism that would expand, not reduce, the role of the states in securities regulation. It thereby would fundamentally reconceptualize our regulatory approach and is at odds with both sides of the debate over the 1995 Act, each of which has sought to use national laws as a weapon to beat down its opponent's position by monopolizing the regulatory field.

The market approach to securities regulation advocated in this Article takes as its paradigm the successful experience of the U.S. states in corporate law, in which the fifty states and the District of Columbia compete for the business of corporate charters. There is a substantial literature on this particular manifestation of U.S. federalism indicating that shareholders have benefited from the federal system of corporate law by its production of corporate codes that, for the most part, maximize share value.<sup>4</sup> This Article proposes extending the competition among states for corporate charters to two of the three principal components of federal securities regulation: the registration of securities and the related continuous disclosure regime for issuers; and the antifraud provisions that police that system. The third component, the regulation of market professionals, is not included in the proposed reform. The

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1. Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C.A. § 77 (West 1997)).

2. See Securities Litigation Improvement Act of 1997, H.R. 1653, 105th Cong.; Securities Litigation Uniform Standards Act, H.R. 1689, 105th Cong. (1997).

3. See U.S. SEC. & EXCH. COMM'N, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, pt. IV, at 22, pt. VII, at 72 (1997) (summarizing a study by National Economic Research Associates of securities litigation filings after the Act). Joseph Grundfest and Michael Perino also document a shift to state court filings. See JOSEPH A. GRUNDFEST & MICHAEL A. PERINO, SECURITIES LITIGATION REFORM: THE FIRST YEAR'S EXPERIENCE (Stanford Law School, John M. Olin Program in Law & Econ. Working Paper No. 140, 1997). More recent data, however, suggest a reversal of this trend, with state filings declining and federal filings increasing in the first half of 1997. See 1995 Private Securities Litigation Reform Act: Federal Securities Class Action Filings Rise as State Filings Fall, NERA Finds, 29 Sec. Reg. & L. Rep. (BNA) 1001 (July 18, 1997).

4. See generally ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

proposed market approach can be implemented by modifying the federal securities laws in favor of a menu approach to securities regulation under which firms elect whether to be covered by federal law or by the securities law of a specified state, such as their state of incorporation.

Under a system of competitive federalism for securities regulation, only one sovereign would have jurisdiction over all transactions in the securities of a corporation that involve the issuer or its agents and investors. The aim is to replicate for the securities setting the benefits produced by state competition for corporate charters—a responsive legal regime that has tended to maximize share value—and thereby eliminate the frustration experienced at efforts to reform the national regime. As a competitive legal market supplants a monopolist federal agency in the fashioning of regulation, it would produce rules more aligned with the preferences of investors, whose decisions drive the capital market.

Competitive federalism for U.S. securities regulation also has important implications for international securities regulation. The jurisdictional principle applicable to domestic securities transactions is equally applicable to international securities transactions: Foreign issuers selling shares in the United States could opt out of the federal securities laws and choose those of another nation, such as their country of incorporation, or those of a U.S. state, to govern transactions in their securities in the United States. The federal securities laws would also, of course, not apply to transactions by U.S. investors abroad in the shares of firms that opt for a non-U.S. securities domicile. Under this approach, U.S. law would apply only to corporations affirmatively opting to be covered by U.S. law, whether they be U.S.- or non-U.S.-based firms. It therefore would put an end to the ever-expanding extraterritorial reach of U.S. securities regulation, which currently extends to transactions abroad involving foreign firms, as long as there are any U.S. shareholders or U.S. effects.<sup>5</sup>

Stemming the trend of extraterritorial application of U.S. law will not harm U.S. investors because they have, in fact, often been disadvantaged by the expansion of U.S. securities jurisdiction. For example, to avoid the application of U.S. law, foreign firms have frequently explicitly excluded U.S. investors from takeover offers, and such investors have thus missed out on bid premiums.<sup>6</sup> In addition, adoption of the market approach would facilitate foreign firms' access to capital, as they would be able to issue securities in the United States without complying with U.S. disclosure and accounting rules that differ substantially from their home rules, a requirement that has been a

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5. For a discussion of SEC and court efforts at extraterritorial coverage in the context of securities regulation of takeover bids, see Arthur R. Pinto, *The Internationalization of the Hostile Takeover Market: Its Implications for Choice of Law in Corporate and Securities Law*, 16 BROOK. J. INT'L L. 55 (1990).

6. See *id.* at 66-76.

significant deterrent to listings.<sup>7</sup> This consequence of the proposed modification of U.S. law would also benefit U.S. investors, who would no longer incur the higher transaction costs of purchasing shares abroad in order to make direct investments in foreign firms.

The market approach to securities regulation is a natural extension of the literature on state competition for corporate charters, and commentators, recognizing the possibility of this extension, have occasionally mentioned it as an alternative to the current system of securities regulation.<sup>8</sup> Advancing those earlier suggestions, this Article makes a systematic case for competitive federalism by articulating the rationales for the approach and by crafting the mechanics of its implementation. The position advocated in this Article—elimination of the exclusive mandatory character of most of the federal securities laws—may seem on first impression to many readers surprising, if not unrealistic or worse. In my judgment, a compelling case can be made on the substantive merits of the proposal.

There may be an understandable desire to discount the need for the proposal because of the vibrancy of U.S. capital markets and the calls for piecemeal reform rather than comprehensive revamping of the current regime by issuers and investors. This would be a mistake. While U.S. capital markets are the largest and most liquid in the world, it is incorrect to attribute this fact to the federal regime. U.S. capital markets were the largest and most liquid global markets at the turn of the century,<sup>9</sup> before the federal regime was established, and their share of global capitalization has declined markedly over the past two decades,<sup>10</sup> facts at odds with the contention that the current federal regime is the reason for the depth of U.S. capital markets. The absence of calls for comprehensive reform is a function of a lack of imagination, rather than evidence that the current regulatory apparatus does not produce

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7. See Franklin R. Edwards, *SEC Requirements for Trading of Foreign Securities on U.S. Exchanges*, in *MODERNIZING U.S. SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES* 57, 57-58 (Kenneth Lehn & Robert W. Kamphuis, Jr. eds., 1992) [hereinafter *MODERNIZING U.S. SECURITIES REGULATION*].

8. See, e.g., ROMANO, *supra* note 4, at 99-100, 107-08; Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 *CARDOZO L. REV.* 909, 935-36 (1994); JEFFREY G. MACINTOSH, *INTERNATIONAL SECURITIES REGULATION: OF COMPETITION, COOPERATION, CONVERGENCE, AND CARTELIZATION* 31-32 (University of Toronto Faculty of Law, Law & Econ. Working Paper WPS-48, 1996).

9. See R.C. MICHIE, *THE LONDON AND NEW YORK STOCK EXCHANGES 1850-1914*, at 34 (1987) (arguing that the New York exchange gained preeminence among world's security markets from World War I).

10. See BRUNO SOLNIK, *INTERNATIONAL INVESTMENTS* 168 exh.6.1 (3d ed. 1996) (reporting that the U.S. share of global capitalization dropped from 57% to 36% between 1974 and 1994). With the recent market boom, the U.S. share rose to 41% in 1996. See IBBOTSON ASSOCS., *AI/RI GLOBAL PORTFOLIO INTENSIVE CLASSROOM PROGRAM* 1997, at Day 1-16 (1997) (citing *Developed Markets*, MORGAN STANLEY CAPITAL INT'L EAFE AND WORLD PERSPECTIVE (Morgan Stanley Capital Int'l, New York, N.Y.), Jan. 1996, at 5; IFC EMERGING MARKET DATA BASE MONTHLY REVIEW OF EMERGING STOCK MARKETS 8 (n.d.)).

deadweight losses.<sup>11</sup> Blind adherence to the securities regulation status quo imposes real costs on investors and firms, and there is a better solution.

Some may conclude that the proposal does not go far enough, and that all government interference in capital markets, whether federal or state, should be abolished. I believe that the intermediate position advocated in this Article is a more sensible public policy than eliminating all government involvement. This is because state competition does not foreclose the possibility of deregulation should that be desired by investors: A state could adopt a securities regime that delegates regulatory authority over issuers to stock exchanges, just as the current federal regime delegates regulatory authority for market professionals to the stock exchanges and National Association of Securities Dealers (NASD). State competition permits experimentation with purely private regulatory arrangements, while retaining a mechanism to reverse course easily—migration to states that do not adopt such an approach—which is not present in a purely private regime. On a more pragmatic level, there is a more immediate point to the Article: to caution against the current impetus to extend the federal government's monopoly over securities regulation. Instead of supplanting state securities regulation, Congress should rationalize it by legislatively altering the multijurisdictional, transactional basis of state regulatory authority to an issuer-domicile basis.

The argument proceeds as follows. In Part I, a market-based approach to U.S. securities regulation is outlined, and the mandatory federal system is critiqued. The rationale for excluding from the proposal the third component of the federal securities regime, the regulation of market professionals, and comparisons with alternative market-oriented reforms, such as regulation by exchanges, are also provided. Part II discusses the details for implementing the proposal, including changing the current choice-of-law rule for securities transactions from one that focuses on the site of the transaction to an issuer-based approach analogous to the internal affairs rule applied in corporate law, and conditioning opting out of the federal regime upon compliance with two procedural requirements. The requirements, which seek to ensure the integrity of the investor decisions that drive the regulatory competition, are the disclosure of the issuer's securities domicile at the time of a security purchase and a shareholder vote to effectuate a change in securities domicile. Finally, Part III extends the proposal to international securities regulation.

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11. Issuers have focused their efforts on removing regulatory authority from the states to the federal level because they have not recognized the possibility of removing the source of the state-level problems of plaintiff forum shopping and burdensome registration requirements. Such problems could be solved by altering the state jurisdictional rule of investor domicile to that proposed in this Article, under which only one state, chosen by the issuer as its securities domicile, would have jurisdiction over all transactions in the firm's securities.

## I. COMPETITIVE FEDERALISM: A MARKET APPROACH TO SECURITIES REGULATION

Although both the states and the federal government regulate securities transactions, the current regulatory arrangements are a far cry from competitive federalism. The federal securities regime, consisting of the Securities Act of 1933<sup>12</sup> and the Securities Exchange Act of 1934,<sup>13</sup> applies to all publicly traded firms and is a mandatory system of disclosure regulation, bolstered by antifraud provisions. While the federal laws do not preempt all state regulation,<sup>14</sup> states cannot lower the regulatory standards applicable to firms covered by the federal regime because its requirements are mandatory. They have also been prevented from raising regulatory standards on some occasions.<sup>15</sup> As a consequence, the states have essentially abandoned the regulation of public firms to the SEC. In the proposed system of competitive federalism, state and federal regulators would stand on an equal regulatory footing, and firms would be able to choose the applicable regulatory regime.

### A. *The Essence of Competitive Federalism*

A market approach to U.S. securities regulation requires two significant departures from current law. First, a public corporation's coverage under the national securities laws must be optional rather than mandatory. Second, the securities transactions of a corporation that elects not to be covered by the federal securities laws are to be regulated by the corporation's selected domicile for securities regulation. This approach is premised on the idea that competition among sovereigns—here the fifty states, the District of Columbia, and the federal government (represented primarily by the SEC)—in the production of securities laws would benefit investors in public corporations by facilitating the adoption of regulation aligned with investors' preferences, as has been true of the competitive production of corporation codes. The motivation for the proposal is that no government entity can know better than market participants what regulations are in their interest, particularly as firms' requirements are continually changing with shifting financial market conditions. Competing regulators would make fewer policy mistakes than a

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12. 15 U.S.C.A. §§ 77a to -bbb (West 1997).

13. *Id.* §§ 78a to -mm.

14. Although both statutes originally expressly reserved the rights of states to regulate securities, the 1933 Act was amended in 1996 to preempt state regulation of the registration of publicly traded securities. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102, 110 Stat. 3416, 3417-20 (codified at 15 U.S.C.A. § 77r).

15. See, e.g., *Edgar v. MITE Corp.*, 457 U.S. 624, 640-46 (1982) (invalidating a state takeover regulation that was more extensive than the federal regulation as a burden on interstate commerce). Only a plurality of the Court in *MITE* held that the takeover statute was preempted by the federal act. See *id.* at 634-40.

monopolistic regulator as competition harnesses the incentives of the market to regulatory institutions.

Regulatory competition is desirable because when the choice of investments includes variation in legal regimes, promoters of firms will find that they can obtain a lower cost of capital by choosing the regime that investors prefer. For example, as long as investors are informed of the governing legal regime, if promoters choose a regime that exculpates them from fraud, investors will either not invest in the firm at all or will require a higher return on the investment (that is, pay less for the security), just as bondholders charge higher interest rates to firms bearing greater risk of principal nonrepayment.<sup>16</sup> Investors set the price because financial capital is highly mobile and financial markets are highly competitive; the set of investment opportunities is extensive, and with the use of derivatives, virtually limitless. It is plausible to assume that investors are informed about liability rules given the sophistication of the institutional investors who comprise the majority of stock market investors and whose actions determine market prices on which uninformed investors can rely.<sup>17</sup> Promoters thus will bear the cost of operating under a legal regime inimical to investor interests, and they will

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16. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 17-21 (1991) (discussing how entrepreneurs choose terms that enhance investors' expected returns in order to increase securities prices); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 275-76 (1977) (arguing that securities of firms incorporated in states with codes unfavorable to shareholders will be unattractive investments).

17. In 1995, for example, institutional investors—pension funds, insurance companies, mutual funds, and bank-managed investment funds—held 50% of total equity in the United States, including 57.2% of the largest 1000 firms, see CAROLYN K. BRANCATO, *INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE* 19-20 (1997), compared to less than 10% of total equity in 1950, see NEW YORK STOCK EXCH., *FACT BOOK 1995 DATA* 57 (1996), and 46.6% of the top 1000 firms in 1987, see BRANCATO, *supra*, at 20. Although there are formal models of informationally inefficient capital markets (markets with, for instance, speculative bubbles) that depend on the existence of irrational, uninformed traders termed “noise traders,” these models provide no theory that can predict when irrational pricing will occur and are simply unrealistic with regard to market behavior. Namely, informed investors and arbitrageurs will trade against the irrational individuals, preserving market efficiency, as the noise traders experience significant losses and stop trading. For the development of this critique, see MILTON FRIEDMAN, *The Case for Flexible Exchange Rates*, in *ESSAYS IN POSITIVE ECONOMICS* 157 (1953); Eugene F. Fama, *The Behavior of Stock-Market Prices*, 38 J. BUS. 34, 37-39 (1965); and Paul A. Samuelson, *The “Fallacy” of Maximizing the Geometric Mean in Long Sequences of Investing or Gambling*, 68 PROC. NAT'L ACAD. SCI. 2493 (1971). Modelers of inefficient markets have been unable to amend the models to respond to these criticisms. For example, in models where noise traders affect price, they cannot be shown to survive over time (and thus to affect prices in the long run), see J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 713, 717 (1990), but in the models in which noise traders can “survive” over time (i.e., they do not go bankrupt from their irrational trading), their misperceptions do not affect prices (i.e., the model is unsolvable if they are allowed to affect prices), see J. Bradford De Long et al., *The Survival of Noise Traders in Financial Markets*, 64 J. BUS. 1, 2 (1991). In addition, more generalized versions of models in which noise traders can affect prices have multiple equilibria, including the classical (efficient pricing) equilibrium. In such models, the noisy (inefficient pricing) equilibria require very strong and unrealistic assumptions concerning noise traders, such as their ability to hold infinite positions. See Ravi Bhushan et al., *Do Noise Traders “Create Their Own Space?”*, 32 J. FIN. & QUANTITATIVE ANALYSIS 25, 28 (1997). There is, however, one context in which unsophisticated investors are not protected by the actions of institutional investors (that is, they cannot rely on prices set by informed investors): their relations with brokers. This provides another reason for excluding the regulation of brokers from the proposal. See *infra* notes 27-29 and accompanying text.



therefore select the regime that maximizes the joint welfare of promoters and investors.

The analytical point concerning the ability of capital markets to assess legal regimes and consequently the beneficial effect of competition is confirmed by empirical research in the bond indenture and corporate law contexts: Creditor protection provisions in bond indentures are positively priced,<sup>18</sup> and firms experience statistically significant positive changes in stock prices upon changing their incorporation state.<sup>19</sup> The entrepreneurial motivation to reduce capital costs that operates in a competitive legal system mitigates the otherwise core problem for a government regulator of identifying what regulation will benefit investors in capital markets.

Federal intervention in capital markets in the 1930s was justified by a contention that securities markets operate poorly on two dimensions: First, they fail to protect investors from stock price manipulation and fraud; and second, they produce an inadequate level of corporate disclosure because the benefits of information concerning a firm cannot be appropriated solely by the firm that bears the cost of the information's production (that is, corporate information is a public good).<sup>20</sup> Analytically, a demonstration that there are information externalities necessitating government intervention depends on the mix of informed and uninformed investors.<sup>21</sup> But a theoretical need for government regulation to prevent a market failure is not equivalent to a need for a monopolist regulator. The premise of competitive federalism is that if, for example, corporate information would be underproduced to investors'

18. See, e.g., Robert E. Chatfield & R. Charles Moyer, "Putting" Away Bond Risk: An Empirical Examination of the Value of the Put Option on Bonds, *FIN. MGMT.*, Summer 1986, at 26, 31-32; Leland Crabbe, *Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants*, 46 *J. FIN.* 689, 690 (1991); Richard J. Kish & Miles Livingston, *Estimating the Value of Call Options on Corporate Bonds*, *J. APPLIED CORP. FIN.*, Fall 1993, at 95, 97.

19. See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 *J.L. ECON. & ORG.* 225, 271 (1985); Jianghong Wang, *Performance of Reincorporated Firms 14-18*, 21 (Nov. 17, 1995) (unpublished manuscript, on file with the *Yale Law Journal*).

20. See EASTERBROOK & FISCHER, *supra* note 16, at 277 (explaining the antifraud rationale); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 *J. CORP. L.* 1, 9 (1983) (discussing the optimal disclosure level rationale). The economic theory underlying the argument concerning information production is ambiguous, however: Capital markets can overproduce information as well as underproduce it. The informational efficiency of capital markets implies that only the first investor to obtain private information about a firm is likely to realize the value of the information through trading, and this creates an incentive for investors to engage in costly duplicative efforts at information production (that is, overproduction) in a race to be first. See Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 *AM. ECON. REV.* 561, 565-66 (1971). From this perspective, mandatory disclosure could be beneficial by reducing the amount of privately produced information.

21. The formal models indicate that information will not be underproduced if the proportion of investors who are informed (that is, capable of understanding the significance of nondisclosure) is not too low. See MICHAEL J. FISHMAN & KATHLEEN M. HAGERTY, *MANDATORY VS. VOLUNTARY DISCLOSURE IN MARKETS WITH INFORMED AND UNINFORMED CUSTOMERS* 17 (Department of Fin., Kellogg Graduate Sch. of Management, Northwestern Univ. Paper No. 233, 1997); Ronald A. Dye, *Investor Sophistication and Voluntary Disclosures* 18 (1997) (unpublished manuscript, on file with the *Yale Law Journal*). As these papers show, if all investors are informed, no information externality exists—investors draw negative inferences from nondisclosure, forcing firms to reveal both good and bad information. See FISHMAN & HAGERTY, *supra*, at 1-2; Dye, *supra*, at 1.

detriment in an unregulated market, then there would be a demand for, matched by a supply of, mandated disclosure regulation in a regime of state competition for securities regulation, just as in the monopolist SEC system.

A third rationale more recently offered for federal intervention is a refinement of the public good rationale. This rationale identifies the information problem as involving information that would benefit an issuer's competitors as well as investors.<sup>22</sup> According to this theory, because competitors can use such information to compete more effectively with the issuer and thereby diminish the issuer's profitability, investors as well as firms would not wish to reveal such information, even though it would improve investors' ability to evaluate firms. Such an externality would render mandatory disclosure rules necessary. It can be shown analytically, however, that even in the case of such third-party externalities, mandatory disclosure is not always optimal compared to voluntary disclosure, and it would in all likelihood be extremely difficult for a regulator to determine when mandatory disclosure is optimal.<sup>23</sup> But putting aside the theoretical uncertainty of the need for a mandatory regime, even this third-party externality argument does not require an exclusive federal regulator. The majority of investors hold portfolios, not single shares of stock, and therefore, unlike the issuer, they will internalize the externality if they make the disclosure decision. That is, they will desire a regime requiring the information's disclosure because, by definition of a positive externality, the expected gain on their shares in competitors will offset the loss on their shares in the issuer.

Because the antifraud rationale does not depend on the presence of an externality for government action, it presents even less of an objection to a system of competitive federalism than the mandatory disclosure rationale: It is silly to contend that investors will choose regimes that encourage fraud. Joel Seligman states that a federal antifraud law was needed in the 1930s because state securities laws did not reach out-of-state sellers.<sup>24</sup> Whatever the merit of the argument at that time, it is not applicable to modern jurisdictional doctrines and is therefore not relevant to today's policy discussions.<sup>25</sup>

22. See EASTERBROOK & FISCHEL, *supra* note 16, at 290-91.

23. See Ronald A. Dye, *Mandatory Versus Voluntary Disclosures: The Cases of Financial and Real Externalities*, 65 ACCT. REV. 1, 15-16, 18-19 (1990) (providing a formal model indicating that divergence between voluntary and mandatory disclosure depends on information—specifically, detailed a priori knowledge of the covariances of firms' returns—that regulators are unlikely to obtain).

24. See Seligman, *supra* note 20, at 21.

25. Frank Easterbrook and Daniel Fischel suggest an analogous reason for a federal law: the efficiency of enforcing all claims involving a particular transaction in one case. See EASTERBROOK & FISCHEL, *supra* note 16, at 285. The choice-of-law reform discussed *infra* Part II, which adopts the issuer-based jurisdictional approach of corporate law for state securities regulation, can resolve this concern: As is true of shareholder class action claims for fiduciary breach, all securities claims can be consolidated into one court action, with one law applying, that of the issuer's securities domicile. This reform also resolves Easterbrook and Fischel's other explanation for why state competition would not work in the securities context: The potential to exploit out-of-state shareholders with rules favoring in-state shareholders given the multistate jurisdictional rules based on shareholder residence, *see id.* at 300-01, would disappear because

Moreover, if there was concern in the 1930s over the states' capacities to handle securities fraud cases, this is no longer a serious issue. Given the overlapping nature of the current antifraud regime, the states have developed active securities law enforcement divisions and coordinating capacities to deal with interstate fraud.<sup>26</sup>

The federal securities regime regarding the regulation of securities markets and market professionals who broker transactions between investors and issuers is excluded from the proposed market approach.<sup>27</sup> Brokers are excluded because the domicile choices of their employing organizations are not subject to the same capital market forces that prod regulatory competition to adopt rules preferred by investors as are issuers. The owners of broker-dealers, whose preferences would dictate the choice of securities regime, are not the customers whose interests the securities regime seeks to protect.<sup>28</sup> Unless the interests of broker-owners and customers are identical on this dimension (that is, share value is maximized under the securities regime customers prefer), the owners may not choose the regime that customers desire.

Reputational concerns in the competition for customers surely affect brokerage firms' incentives regarding the choice of regime. But reputation provides lower-powered incentives here than in the case of issuers because there are many potential conflicts of interest between broker-owners and customers over the desirable rules.<sup>29</sup> This scenario is different from the choice

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the reform would result in only one state's law governing all shareholders' transactions, regardless of the shareholder's residence.

26. See, e.g., Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 504-05 (1993). A recent example illustrates the vigor of state enforcement activity. The New York state prosecutor's criminal enforcement action against an insider trading on material information was undercut by the federal government: The U.S. attorney seized the case and struck a plea bargain with the defendant after the state prosecutor had developed the case and obtained an indictment. See *Morgenthau v. White*, N.Y. TIMES, Dec. 6, 1997, at A18. The states have also agreed to coordinate regulation of electronic offerings on the Internet. See John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1231-32 (1997). Indeed, the Internet is likely to facilitate state enforcement efforts, as it has for the SEC, as state securities regulator websites will offer a ready means for communication of complaints by nonresident investors. See *Microcap Fraud, Staffing Issues Top Enforcement Agenda*, 29 Sec. Reg. & L. Rep. (BNA) 1773 (Dec. 19, 1997) (reporting the statement of SEC Enforcement Division Director William McClucas that the Internet has made it easier for people to get in touch with the SEC concerning complaints, as well as for the agency to "run down" people engaged in misconduct because their electronic interactions with investors leave identifying trails).

27. Trading by such professionals that would fall under current antifraud provisions and is not related to their relationship with a customer, such as trading on inside information in violation of section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j (1994). see *United States v. O'Hagan*, 117 S. Ct. 2199 (1997), is included in the proposal (as is any such activity conducted by any non-issuer-affiliated third party).

28. This is also true for investment advisers, who are regulated under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 to -18a.

29. Brokers that are also dealers have multiple revenue sources, which can create conflicts of interest in trading policies. See, e.g., E.F. Hutton & Co., Exchange Act Release No. 34-25,887, 41 SEC Dock. 473 (July 6, 1988) (finding a conflict between market-making activities and brokerage activities regarding customer limit orders although dividing on the appropriate practice). After the *E.F. Hutton* decision, the NASD revised its rules to eliminate the conflict by according priority to customer limit orders, which was subsequently approved by the SEC. See Exchange Act Release No. 34,279, 59 Fed. Reg. 34,883 (1994) (approving the rule). In addition, although competition should restrain the conflict between brokerage firms

of securities regime by the owners of issuers, because the issuer-related provisions of the securities laws concern precisely the relation between issuers and owners. A further consequence of this distinction between the regulation of issuers and brokers is that brokerage customers who are not informed of the relevant securities regime may not be protected by the presence of informed investors in the market. In contrast, uninformed stockholders benefit from informed investors' evaluation of issuers as it is revealed in stock prices.

There is one change that must be made in the regulation of market professionals, however, to maintain the integrity of the market approach to securities regulation for issuers. In order to prevent the SEC from being able surreptitiously to regulate issuers not subject to its jurisdiction, the small subset of SEC regulations that relate market professionals' conduct to substantive SEC regulation of issuers, such as the requirement that brokers and dealers obtain issuers' periodic SEC filings before providing quotations,<sup>30</sup> will have to be modified to refer to the substantive law of the issuer's domicile. Such a reform would not undermine the SEC's responsibility to oversee market professionals. Given that none of the SEC's substantive issuer disclosure requirements are drafted with its market professional oversight responsibilities in view, where states require a different or reduced set of issuer disclosures than the SEC, such information would also be adequate for the SEC's oversight purposes, as competition would produce the level of issuer disclosure deemed cost-effective by investors.

Whether exchanges should be included in the proposed regulatory reform is more complicated. Exchanges are also not investor-owned corporations; they are not-for-profit organizations controlled by member trading firms. They are, however, exposed to incentive-aligning market forces. Competition for trading across exchanges tends to align exchange members' regulatory choices with investors' preferences, to the extent that trading volume is maximized under trading rules preferred by investors. If there is a conflict between rules maximizing trading volume and investor welfare, the market will not provide exchanges with high-powered incentives.

There is disagreement in the literature over whether there is a conflict between increased trading volume and the trading rules preferred by investors,<sup>31</sup> but the severity of any such conflict is likely to be small and controllable. For example, Yakov Amihud and Haim Mendelson, who believe

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and customers over trading costs, the securities industry recently reached a substantial settlement in litigation charging dealer collusion over bid-ask spreads in the over-the-counter market. See Patrick McGeehan, *Settlement of Nasdaq Suit To Hit Some Firms Harder*, WALL ST. J., Dec. 24, 1997, at C1.

30. See 17 C.F.R. § 240.15c2-11 (1997).

31. Compare Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Trading Across Securities Markets*, 71 N.Y.U. L. REV. 1411, 1434-42 (1996) (emphasizing the conflict between exchange and investor preferences), with Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 123-25 (1987) (emphasizing the compatibility of exchange and investor preferences).

there is a conflict, contend that if issuers, rather than exchanges, controlled the listing decision, the incentive problem regarding exchanges' choice of trading rules would be eliminated.<sup>32</sup>

There is, moreover, a further, pragmatic reason to exclude exchanges from the proposal that is independent of the debate over exchanges' incentives: to target the proposal where it will do the most good. In contrast to corporate issuers, exchanges are self-regulating under the federal securities scheme. Rather than specify regulatory requirements for exchanges and their members, federal law delegates regulatory authority to the exchanges themselves, subject to oversight by the SEC. The benefits from regulatory competition would thus be far more attenuated for exchanges than for issuers.<sup>33</sup> Even more important than in the context of market professionals, there is a critical change that must be made to the existing regulatory regime for exchanges to integrate successfully the exchanges' continued oversight by the SEC with a competitive regime for issuers. The SEC's authority over exchanges must be statutorily limited to non-issuer-related matters, such as trading rules. Otherwise, the agency would be able to undermine the market approach by introducing mandatory rules for issuers in the form of exchange requirements that preempt competing state regimes.

Finally, mutual funds, which are regulated by the SEC under the Investment Company Act of 1940,<sup>34</sup> a regime that entails far more than disclosure requirements, present a more complicated regulatory context. Some funds could easily come under the proposal—the mutual funds that are subject to the same investor-driven market forces as corporate issuers because their owners are their customers, the objects of securities regulation. There is, however, a potentially important difference between these funds and issuers: The most informed investors in the stock market, large institutions, hold securities directly and typically do not invest in mutual funds that are held by individual investors. Thus, for competitive federalism to work for mutual fund registration, there must be a sufficient number of individual investors in mutual fund shares who are informed about the legal regimes governing their shares such that their regulatory preferences will govern fund domicile outcomes. Under such circumstances—a set of informed fund investors—the overall

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32. See Amihud & Mendelson, *supra* note 31, at 1442-46.

33. This is not to say that the SEC's oversight of exchange rules has unambiguously benefited investors. It has not. For example, the SEC supported the anticompetitive fixed commission rule of the New York Stock Exchange (NYSE) for many years, see SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* 53-89 (1981), and the benefit to investors from the SEC's commitment to developing multiple markets in NYSE stocks has been questioned, see Amihud & Mendelson, *supra* note 31, at 1454. Rather, it is simply to acknowledge that there is a need for priorities and that the SEC's exclusive jurisdiction over issuers is a source of greater harm to investors than is its oversight of exchange rules because, in contrast to its policies toward issuers, the SEC has not successfully imposed uniformity on all exchange rules and practices. See, e.g., Macey, *supra* note 8, at 937-38 (discussing the SEC's failed effort through Rule 19c-4 to impose a one-share one-vote requirement on all exchanges).

34. 15 U.S.C. § 80a-1 to -64 (1994).

mechanics of competitive federalism for investment companies would follow the mechanics for issuers.

Many funds are not, however, customer-owned. For these funds, potential incentive-alignment concerns regarding owner and customer interests would be present, as they are in the broker and exchange contexts. The competitiveness of the mutual fund industry suggests that funds would have incentives to ensure that investors are informed about the benefits of their domiciles, as compared to those of competitors, just as funds advertise their rates today. Moreover, the fast-developing access to information concerning securities regulation on the Internet suggests that the probability that competition would work in this context is quite high.<sup>35</sup> But given the absence of research that pertains to this issue, the alignment of regime choice across fund owners and customers is not assured. Accordingly, this Article does not provide a detailed proposal to implement a market approach to mutual fund regulation.

#### B. *Is Abandoning a Mandatory Federal Securities Law Justified?*

This section first reviews the empirical literature that has sought to measure the impact of the federal securities regime on investors. The analysis rests on contemporary empirical studies because the historical “evidence” of market abuses whose revelation congressional investigators orchestrated during the hearings preceding the creation of the federal regime as part of the New Deal agenda has been shown to be inaccurate.<sup>36</sup> The hearings were held for the purpose of furthering a political end (federal regulation of the stock market), and the statistical techniques used by modern researchers were not available to researchers in the 1930s to develop the case for or against regulation. Even today, little empirical evidence suggests that the federal regime has affirmatively benefited investors. To develop an educated prediction of what the counterfactual (a competitive securities regime) would produce, this section then reviews the empirical evidence on investor welfare of the next best thing—state competition for corporate charters. It compares favorably.

The difficulty of discerning an affirmative impact on investors from the federal regime detailed in this section supports abandoning its exclusivity. While it does not prove the counterfactual—that state competition would be better—the near total absence of measurable benefits from the federal regulatory apparatus surely undermines blind adherence to the status quo. Under regulatory competition, lawmakers have incentives to replace regimes

35. See, e.g., *Technology Issues Priorities for SEC in '98*, *Barbash States*, 29 *Sec. Reg. & L. Rep.* (BNA) 1720 (Dec. 12, 1997) (summarizing the SEC Division of Investment Management Director's prediction that Web sites containing major securities laws from regulators around the world will be available to investors by the end of 1998).

36. See HAROLD BIERMAN, JR., *THE GREAT MYTHS OF 1929 AND THE LESSONS TO BE LEARNED* 133-46 (1991); see also *infra* text accompanying notes 72-74.

that do not measurably support their objectives with those that do. In a competitive regulatory system, undesirable mandatory policies cannot be maintained over time, because they are not enforceable: Firms will migrate to the regulatory regime that does not impose such mandates.

The competitively produced state corporation codes, in contrast to the federal securities laws, consist primarily of enabling provisions that reduce the cost of business by providing firms and investors with a standardized contractual form to govern their relationships. Thus, to the extent the empirical literature suggests that federal securities laws have been fashioned from a set of misguided premises, adoption of the market approach to securities regulation will weed out inefficiencies in the federal regime, by permitting capital market participants to establish a new regulatory equilibrium with a mix of enabling and mandatory provisions, if that is what investors prefer.

### 1. *Empirical Evidence on the Rationales for Federal Securities Regulation*

#### a. *Mandatory Disclosure*

There is little tangible proof of the claim that corporate information is “underproduced” in the absence of mandatory disclosure, or that the benefits to investors from information that firms would not produce in the absence of mandatory disclosure actually outweigh their costs. For instance, before the enactment of the federal securities laws in the 1930s, public corporations voluntarily disclosed financial statements, typically under a stock exchange listing requirement, that contained substantially all of the information subsequently required under the federal laws. In an important and still underappreciated study, George Benston found that the only major mandated item that was not reported by a significant set of firms prior to the 1934 legislation was sales. Comparing the pre- and post-legislation stock returns of the firms for which the legislation was relevant (firms that had not previously reported their sales, which were 38% of New York Stock Exchange (NYSE)-listed corporations) with those for which it was not (the remaining 62% of NYSE corporations that had disclosed sales information), he found no significant price effect from the new mandated disclosure.<sup>37</sup>

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37. See George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 144-45 (1973) [hereinafter Benston, *Evaluation*]; see also George Benston, *An Appraisal of the Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements*, LAW & CONTEMP. PROBS., Summer 1977, at 30, 51-52 [hereinafter Benston, *Appraisal*]. Joel Seligman criticizes the significance of this finding, see Seligman, *supra* note 20, at 16-17, but his objections, which follow those of Irwin Friend and Randolph Westerfield, see Irwin Friend & Randolph Westerfield, *Required Disclosure and the Stock Market: Comment*, 65 AM. ECON. REV. 467 (1975), actually reinforce Benston's conclusions. For example, in criticism of Benston's finding of no stock price effect of the SEC's disclosure requirements, Seligman cites more recent studies showing that the data in SEC filings

Benston's finding, upon reflection, should not be surprising: Because firms need capital and investors need information, firms have powerful incentives to disclose information if they are to compete successfully for funds against alternative investment opportunities. Consistent with this explanation, studies have found that the quantity and quality of publicly traded firms' voluntary disclosures (such as earnings forecasts) are positively correlated with the issuance of securities<sup>38</sup> and with information asymmetry in the market for the firm's stock (that is, managers release information voluntarily when there is greater information asymmetry, as measured by the stock price's bid-ask spread),<sup>39</sup> and negatively related to the cost of capital (that is, increased voluntary disclosure reduces firms' cost of capital).<sup>40</sup> In addition, European firms listing in London typically comply with the higher United Kingdom disclosure requirements rather than with the lower ones of their home countries, although they need not comply with U.K. rules under the European Community disclosure directives.<sup>41</sup> A further datum relevant to the issue of

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affect stock prices in an effort to prove that the SEC's mandated disclosure program is of value to investors. See Seligman, *supra* note 20, at 16. But it is not the SEC's disclosure requirements that are affecting stock value in these studies, because they have not added any new items into the information mix already disclosed: The information examined in the studies Seligman cites, earnings, was disclosed, as Benston demonstrates, even prior to the creation of the SEC and would continue to be disclosed if there were no SEC. See Benston, *Evaluation, supra*, at 135-36. Seligman acknowledges this point by adding that the issue is whether the SEC compels information that otherwise would not have been voluntarily disclosed, rather than where the item is disclosed (SEC report or otherwise). See Seligman, *supra* note 20, at 16. But the studies he cites, *see id.* at 16 n.48, do not bear upon this issue. Seligman also objects to Benston's test because it did not adequately distinguish between disclosure and nondisclosure firms, as all the firms in his sample disclosed earnings. But this is precisely Benston's point: The SEC's mandated disclosure added only one item—sales—that had not been disclosed by NYSE firms, and release of the new information under its requirement had no effect on the stock prices of those firms that previously had not been disclosing sales. See Benston, *Evaluation, supra*, at 141-42.

38. See, e.g., Richard Frankel et al., *Discretionary Disclosure and External Financing*, 70 ACCT. REV. 135, 141 (1995) (finding that firms are significantly more likely to forecast earnings if they access capital markets over the sample period); Mark Lang & Russell Lundholm, *Cross-Sectional Determinants of Analyst Ratings of Corporate Disclosures*, 31 J. ACCT. RES. 246, 265-69 (1993) (finding that a firm's Financial Analyst Federation disclosure quality rating increases with security issuance); William Ruland et al., *Factors Associated with the Disclosure of Managers' Forecasts*, 65 ACCT. REV. 710, 720 (1990) (finding that firms reporting forecasts are more likely to issue new capital); cf. Frederick D.S. Choi, *Financial Disclosure and Entry to the European Capital Market*, 11 J. ACCT. RES. 159, 168-70 (1973) (finding that firms entering the Eurobond market increase disclosure).

39. See CAROL A. MARQUARDT & CHRISTINE I. WIEDMAN, VOLUNTARY DISCLOSURE, INFORMATION ASYMMETRY, AND INSIDER SELLING THROUGH SECONDARY EQUITY OFFERINGS 16, 19-20, 22 (John M. Olin School of Business, Washington Univ. Working Paper No. 97-05, 1997) (finding that, in secondary offerings, managers act as if reduced information asymmetry is correlated with reduced cost of capital, such that their participation in an offering explains the frequency of voluntary disclosure); Maribeth Coller & Teri Lombardi Yohn, *Management Forecasts and Information Asymmetry: An Examination of Bid-Ask Spreads*, 35 J. ACCT. RES. 181 (1997) (finding that firms with increasing bid-ask spreads release forecasts to reduce spread).

40. See Christine A. Botosan, *Disclosure Level and the Cost of Equity Capital*, 72 ACCT. REV. 323, 344, 346 (1997) (showing that voluntary disclosure in the annual report significantly explains the cost of capital of firms with small analyst followings).

41. See HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 314 (3d ed. 1996) (citing references concerning Danish and French firms' compliance with United Kingdom standards); G.K. Meek & S.J. Gray, *Globalization of Stock Markets and Foreign Listing Requirements: Voluntary Disclosures by Continental European Companies Listed on the London*



information production is the fact that European stock markets are no less efficient than U.S. stock markets even though the European accounting and disclosure regimes require the revelation of considerably less information than does the SEC.<sup>42</sup>

There is, accordingly, ample evidence that firms voluntarily disclose significant amounts of information beyond that mandated by securities regulators. It is difficult to prove what, if any item, among required disclosures is of less value to investors than items voluntarily disclosed, but the great variety in content across disclosure regimes—a recent study identified one hundred SEC disclosure items deemed excessive compared to international standards<sup>43</sup>—suggests that a number of mandates are not cost effective. Although the estimates are extremely crude and conservative, Susan M. Phillips and J. Richard Zecher calculated in 1975 that the termination of the SEC's mandatory periodic disclosure programs would reduce corporate disclosure costs by at least \$213 million.<sup>44</sup> These data make it plain that regulators do not have superior knowledge concerning what information investors need (otherwise firms would not on occasion disclose more than required), which bolsters the desirability of regulatory competition, as it will reduce regulatory mistakes.

In a detailed defense of federal legislation, Seligman challenges Benston's findings with data compiled by the SEC during the 1940s and 1950s in order to expand its jurisdiction, data which indicate that small firms not subject to the federal securities laws disclosed less information than the SEC required of its larger-sized registrants.<sup>45</sup> In particular, Seligman notes that the SEC reported that most of the small firms did not disclose management compensation or insider transactions in proxy statements and that some firms did not furnish income statements or provided inadequate accounting information, compared to SEC requirements, in their balance sheets.<sup>46</sup> But these data do not provide proof of the efficacy of the federal securities regime. The failure to provide voluntarily the information that the SEC mandates does

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*Stock Exchange*, 20 J. INT'L BUS. STUD. 315 (1989) (reviewing a sample of European companies trading in London).

42. See GABRIEL HAWAWINI, *EUROPEAN EQUITY MARKETS: PRICE, BEHAVIOR AND EFFICIENCY* (1984); William J. Baumol & Burton G. Malkiel, *Redundant Regulation of Foreign Security Trading and U.S. Competitiveness*, in *MODERNIZING U.S. SECURITIES REGULATION*, *supra* note 7, at 39, 46-50; Edwards, *supra* note 7, at 64-66.

43. See Frederick D.S. Choi, *Financial Reporting Requirements for Non-U.S. Registrants: International Market Perspectives*, 6 FIN. MARKETS INSTITUTIONS & INSTRUMENTS 23, 29 (1997). There are also significant differences in the securities disclosure regimes of emerging markets, where we might expect a need for substantial disclosure to encourage foreign investment. See Shahrokh M. Saudagaran & Joselito G. Diga, *Financial Reporting in Emerging Capital Markets: Characteristics and Policy Issues*, ACCT. HORIZONS, June 1997, at 41.

44. See PHILLIPS & ZECHER, *supra* note 33, at 49-51. Their estimate of the extra costs imposed in the 1975 new issue market was \$193 million. *See id.* at 51.

45. See Seligman, *supra* note 20, at 36-39.

46. *See id.* at 36.

not demonstrate that such disclosure enhances investor welfare. It does so only with an additional assumption—that the SEC, and not the firms, has made the correct cost-benefit calculation.

To address the issue of the adequacy of the differential level of disclosure by nonregistrants, we need to know the answers to the following questions: Were financial analysts and shareholders unable to value firms accurately under the more limited voluntary disclosures? If so, did they underpay or overpay for the shares (that is, did promoters and insiders bear the cost of the allegedly inadequate disclosure, or did the outside investors)? It would be difficult to make such judgments directly, although a finding of significant changes in stock prices upon firms' increased disclosures under SEC requirements would be probative on the issue.

There is no study of which I am aware that examines the effect of the 1965 extension of the continuing disclosure requirements to small firms. But there was no significant increase in stock prices after enactment of the 1933 Act for new issue registration,<sup>47</sup> a finding that strongly suggests that the new federal regime had, at best, no effect on investor welfare. If the 1933 Act did not increase stock prices of covered firms, it is unlikely that the 1965

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47. See George J. Stigler, *Public Regulation of Securities Markets*, 37 J. BUS. 117, 120-21 (1964) (finding that SEC registration requirements had no effect on returns); see also Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Securities Issues*, 24 J.L. & ECON. 613, 645, 666 (1981) (reaching the same conclusion by examining returns over five years from issuance); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 305 (1989) (finding no effect on returns of NYSE and seasoned regional exchange issues). Simon did find that one subsample of firms, unseasoned issues traded on regional exchanges, had greater returns after the enactment of the Act (they were overpriced before the Act), see Simon, *supra*, at 305-06, but this subsample performed significantly worse in all periods than the other new issues in the study, see *id.* at 308. Irwin Friend and Edward S. Herman, in a study on which Seligman relies heavily, criticized Stigler's interpretation of his data because, although not statistically significant, post-Act issues had higher returns than pre-Act issues, and because there was a significant positive return after four years. See Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382, 391 (1964). These criticisms do not, however, impeach Stigler's findings. The length of the interval over which they find a stock price effect—four years—is so long that it is impossible to attribute the price change to the legislation. Friend and Herman also do not provide a theory explaining why the 1933 Act should improve a new issue's returns only four years after its issuance. Not only is such a result inconsistent with a relatively efficient stock market, but we would also expect mandated disclosure to have the greatest impact over the shorter interval of Stigler's study, as short-term performance would be more predictable than long-term performance from financial disclosures. Nor do Friend and Herman explain why statistically insignificant findings should be given any evidentiary weight, counter to conventional social scientific practice. Further damaging to Friend and Herman's critique is the confirmation of Stigler's basic results by the more recent studies of Jarrell and Simon. A study of existing stocks, rather than new issues, finds that the 1933 Act had a negative price impact, which the author attributes to the Act's restrictions on accounting procedures, which may have adversely affected the firms' ability to comply with debt covenants that were based on accounting numbers. See Chee W. Chow, *The Impacts of Accounting Regulation on Bondholder and Shareholder Wealth: The Case of the Securities Acts*, 58 ACCT. REV. 485, 489, 502, 507 (1983). Chow expected to find a wealth transfer from shareholders to bondholders given the accounting covenants hypothesis, but he was unable to identify such an effect. Because the sample stocks were not new issues (to which the 1933 Act applied), it is difficult to interpret the study's results without knowing whether these firms planned to issue new securities in the future. A further difference, which is a serious shortcoming, between this study and the others is that, in contrast to the other studies, it did not adjust stock returns for market movements, which may account for the results. See *id.* at 503.

extension of the Act did so, for the absence of a price increase after 1933 suggests that the market elicited the right level of disclosure. A similar conclusion can be drawn from studies of a more specific instance of SEC-mandated disclosure—the requirement that large corporations disclose the current replacement cost of inventories, plant, and equipment. Researchers found no stock price effect when firms disclosed the newly mandated replacement cost information, suggesting that investors did not find the SEC's mandated disclosure useful for valuing firms.<sup>48</sup>

The variance of stock returns, however, decreased after the enactment of the 1933 Act.<sup>49</sup> A plausible interpretation is that the legislation simply forced riskier investments off the market.<sup>50</sup> Consistent with this explanation, after the 1933 Act there was a decrease in the proportion of outstanding new issues of common stock compared to debt, and there was a dramatic increase in private placements of debt concentrated among bonds of higher risk.<sup>51</sup> Such a result—reduction in the investment opportunity set—does not obviously benefit investors, who merely require higher compensation for riskier securities, while in all likelihood it reduces social welfare by restricting the availability of financing for the riskiest ventures.

The finding of a decrease in return variance has also been interpreted as indicating that the disclosure mandated by the Act enabled investors to form more accurate price predictions.<sup>52</sup> Even this alternative explanation does not, however, demonstrate that the Act benefited investors. A core tenet of modern finance theory is that investors are compensated for bearing market risk, and it was firm-specific risk and not market risk that was measured to have decreased with the 1933 Act. In this regard, it is not surprising that there is no stock price effect: A reduction in own-return variance (that is, more accurate stock prices) is of no value to diversified investors. Consequently, commentators who point to the return variance reduction as evidence affirming the efficacy of the 1933 Act are mistaken; investors benefit only from reductions in risk that is priced.

Seligman provides a further datum in support of the contention that the SEC's mandatory disclosure program benefits investors: From 1955 to 1971, "approximately two percent of the registration statements filed with the SEC were withdrawn after receipt of an SEC letter of comment [seeking additional

48. See ROSS L. WATTS & JEROLD L. ZIMMERMAN, POSITIVE ACCOUNTING THEORY 174 & n.9 (1986) (citing studies).

49. See Jarrell, *supra* note 47, at 646; Simon, *supra* note 47, at 309; Stigler, *supra* note 47, at 122.

50. See Jarrell, *supra* note 47, at 648-49, 668; Stigler, *supra* note 47, at 122. Seha Tinic offers a further gloss on this explanation, finding that the kind of securities that underwriters were willing to offer changed to larger, less risky issues after enactment of the 1933 Act because the underwriters were fearful of their legal liability under the Act. See Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 813 (1988).

51. See Jarrell, *supra* note 47, at 661, 664, 667, 669.

52. See Seligman, *supra* note 20, at 10; Simon, *supra* note 47, at 313.

disclosures] or . . . [an SEC] stop order.”<sup>53</sup> This datum does not, however, indicate that the SEC’s program aided investors. The key datum, which is not knowable, is whether, had those withdrawn issues been marketed as planned, investors would have overpaid for the issue or otherwise been defrauded concerning the firms’ value. Emphasis on registration withdrawal data presupposes gross investor stupidity by assuming that an investor reading a prospectus that SEC staff thought deficient would not similarly recognize the deficiency and discount the share price. Why assume that the analytical ability of the SEC staff is superior to that of financial analysts or investors? Such an assumption simply does not square with what we know.

One reason for the surreal character of the arguments based on historical data that are raised in support of the federal regime is that capital markets have changed dramatically since the securities laws were adopted. The institutional investors who dominate today’s markets have far greater ability, as well as financial incentives, to process information and price securities than does the SEC staff.<sup>54</sup> Institutional investors’ pricing determinations better protect unsophisticated investors than any of the SEC’s mandated disclosure requirements because, given the efficiency of U.S. capital markets in information aggregation, and the fact that securities sell for one price, institutional investors cannot use their superior information-processing ability to extract wealth systematically from uninformed investors, particularly those long-term investors who follow a buy-and-hold strategy.<sup>55</sup> The federal regime has not adapted well to this changed context. The interests of sophisticated and unsophisticated investors in the choice of securities regime will not diverge for the issuer-investor relations that come under the regime of competitive federalism proposed by this Article, and will, in fact, be better served by the new regulatory arrangement.

One particularly egregious example of the SEC’s problematic disclosure policies will serve to underscore the point that it would be a profound mistake to presume that the SEC gets things right. The SEC prohibited for decades the disclosure of projected earnings. Such information, however, is far more valuable to investors than the accounting information the SEC required,

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53. Seligman, *supra* note 20, at 43.

54. This discrepancy in expertise is evident in recent rulemaking activity by the SEC. By abandoning its usual approach of standardized disclosure requirements in its new rule requiring disclosure of the market risk of derivative securities, the SEC implicitly acknowledged that it is, and will always be, woefully behind market participants in understanding and developing the most accurate valuation techniques for these complex instruments. See Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments, Exchange Act Release No. 33-7386, 62 Fed. Reg. 6044, 6048 n.45, 6057 (1997) (to be codified at 17 C.F.R. pts. 210, 228, 229, 239, 240, 249) [hereinafter SEC Derivatives Disclosure] (explaining why the rule permits choice of quantitative disclosure methods, including model parameters).

55. For a recent review of the research on market efficiency, see Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1600-02 (1991).

because stock value is a function of future cash flows not historical data.<sup>56</sup> The SEC modified its position in 1979 to permit the disclosure of projections within a safe harbor rule,<sup>57</sup> but even today the agency's approach is still quite guarded when it comes to such disclosures. For instance, when Congress recently legislated a safe harbor from civil liability for forecasts, the SEC was responsible for the extended list of transactions excluded from the safe harbor provision.<sup>58</sup>

The SEC's historic concern was that projections were more susceptible to abuse than accounting data. This concern was premised on a bizarre view of investor decisionmaking, that investors believe all figures are "written on stone" and do not discount managers' optimism and therefore have to be protected from all but "verifiable" information (namely, historical cost).<sup>59</sup> This approach has made SEC disclosure documents of limited value for investment decisionmaking and was the subject of sustained criticisms throughout the 1970s. Ironically, the SEC's approach particularly disadvantaged public investors by closing off their ability to obtain information on projected earnings, as firms would not make public earnings forecasts for fear of liability, although they would provide them to analysts and other professionals.<sup>60</sup>

The 1979 modification did not substantially increase public forecasts, given firms' liability concerns,<sup>61</sup> and was clearly outmoded for modern markets populated by institutional investors. Congress therefore sought to increase the disclosure of forecasts in the 1995 securities reform legislation by explicitly creating a safe harbor from civil liability for the release of forecasts.<sup>62</sup> Whether the legislation will have the intended effect is not yet ascertainable, but some early indications suggest that the new law is having minimal impact on the disclosure of projections.<sup>63</sup> The restrictions on the applicability of the

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56. See, e.g., Homer Kripke, *Can the SEC Make Disclosure Policy Meaningful?*, J. PORTFOLIO MGMT., Summer 1976, at 32, 35-37.

57. See 17 C.F.R. § 240.3b-6 (1997), originally promulgated in Safe Harbor Rule for Projections, Exchange Act Release No. 33-6084 (June 25, 1979), available in 1979 WL 16388; 17 C.F.R. § 230.175 (1997).

58. See, e.g., Noelle Matteson, Comment, *Private Securities Litigation Reform Act of 1995: Do Issuers Still Get Soaked in the Safe Harbor?*, 27 GOLDEN GATE U. L. REV. 527, 548 n.139 (1997) (citing sources indicating that the SEC supported the provision only after Congress agreed to the SEC's proposed transaction exclusions).

59. Kripke, *supra* note 56, at 40.

60. See Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1199 (1970).

61. See Safe Harbor for Forward-Looking Statements, Exchange Act Release No. 33-7101, 59 Fed. Reg. 52,723, 52,728-29 (Oct. 19, 1994), available in 1994 WL 562021, at \*7-8.

62. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 102, 109 Stat. 737, 749-56 (codified at 15 U.S.C.A. §§ 77z-2, 78u-5 (West 1997)).

63. See, e.g., *Panelists Dispute Reform Law's Impact on Private Class Securities Fraud Litigation*, 29 Sec. Reg. & L. Rep. (BNA) 1134 (Aug. 15, 1997); Matteson, *supra* note 58, at 550-51. A recent study, however, finds that forecasts by a sample of high technology firms increased after the Act. See Marilyn Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms* (Jan. 2, 1998) (unpublished manuscript, on file with the *Yale Law*

safe harbor so vigorously advanced by the SEC surely enhance the likelihood that the statute's impact will be limited, and they serve as a useful reminder of how difficult it is for a monopolist government agency to alter course and implement significant policy changes.

This illustration of utterly misguided SEC disclosure mandates makes plain that an SEC disclosure initiative does not itself provide evidence that the market is inadequately producing relevant information and, consequently, should not be privileged by assuming that the agency is always (or even more often than not) right. It indicates quite the opposite, that the SEC may not possess even a rudimentary understanding of, much less a superior capacity over anyone else to identify, what information investors require for decisionmaking. Such regulatory mistakes would be far less likely with competition: Investors would be able to reveal their preference for particular information by bidding up the price of firms subject to a regime in which they could make forecasts, compared to firms subject to one that prohibits such disclosures.

b. *Mandatory Disclosure Involving Third-Party Externalities*

Proponents of the third-party externality rationale have not specified what information requirements the rationale justifies, let alone whether that information is the focus of SEC disclosure requirements. In fact, such information is at times explicitly excluded from the SEC's mandated disclosure.<sup>64</sup> It is thus difficult to use empirical studies of SEC mandates as tools for investigating this rationale compared to the more general information underproduction rationale. One area that might be seen as an instance of mandated disclosure designed to assist third parties is the segment or line-of-business financial reporting requirements promulgated by the SEC in 1969.<sup>65</sup> These requirements mandated separate disclosure of both profits and revenues of firms' different business product lines. Such disclosure could enable rival firms to discern more precisely firms' costs, facilitating competitive strategies. The results of studies investigating whether the additional information disclosed under the segment-reporting requirements benefited investors essentially duplicate the results of the studies of the 1933 Act. They report no significant change in stock price and an increased consensus among financial statement users concerning predicted earnings, but are in disagreement over

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*Journal*).

64. See, e.g., Regulation S-K, Item 101, 17 C.F.R. § 229.101(c)(ii) (1997) (providing that an issuer is not required to disclose narrative information concerning new business lines and products "the disclosure of which would affect adversely the registrant's competitive position").

65. See Adoption of Amendments to Forms S-1, S-7 and 10, Exchange Act Release No. 4988 (July 14, 1969), available in 1969 S.E.C. LEXIS 709.

whether there was a significant change in firms' market risk from the increased disclosure.<sup>66</sup>

The absence of any consistent discernible effect on firm value of the line-of-business disclosures is consistent with Edmund Kitch's contention that the SEC's segment-reporting requirements do not lead to disclosure of information of competitive value because of the discretion necessarily afforded management, under the disclosure rules, in the allocation of costs and grouping of activities.<sup>67</sup> If Kitch's analysis is correct and proprietary information is not effectively disclosed by line-of-business reporting, then it is not an example of a disclosure mandate that mitigates third-party externalities. Kitch further contends that it is virtually impossible in practice to implement a disclosure regime that includes proprietary information—either firms will not meaningfully disclose information that can benefit their competitors, or they will delist to avoid such disclosure.<sup>68</sup> This contention, supported by the empirical research on segment reporting, highlights an essential weakness of the third-party externality rationale for the federal regime of mandatory disclosure: A theory that cannot be implemented effectively cannot serve as the basis for public policy.

### c. Antifraud Provisions

The federal antifraud laws have not been a focus of as much empirical research as the federal disclosure regime.<sup>69</sup> But even here there is little evidence indicating that federal, as opposed to state, securities laws are necessary to protect investors from fraud and manipulation. In truth, the data that would be probative of the efficacy of the federal antifraud regime have not

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66. See, e.g., Bipin B. Ajinkya, *An Empirical Evaluation of Line-of-Business Reporting*, 18 J. ACCT. RES. 343, 357-59 (1980) (reporting no effect on returns and increased consensus in probability assessments); Daniel W. Collins & Richard R. Simonds, *SEC Line-of-Business Disclosure and Market Risk Adjustments*, 17 J. ACCT. RES. 352, 372-73, 378-80 (1979) (noting change in market risk); Bertrand Horwitz & Richard Kolodny, *Line of Business Reporting and Security Prices: An Analysis of an SEC Disclosure Rule*, 8 BELL J. ECON. 234, 239, 241-42, 246 (1977) (reporting no effect on market risk or on returns). See generally Rosanne M. Mohr, *The Segmental Reporting Issue: A Review of Empirical Research*, 2 J. ACCT. LITERATURE 39, 45-52, 56-62 (1983) (reviewing the literature and concluding that there was no effect on returns, some improvement in analyst forecasts, increased consensus, and mixed evidence concerning whether market risk shifted).

67. See Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 858 (1995).

68. See *id.* at 874.

69. If disclosure reduces the frequency of fraud and fraudulent issues are generally of high risk, then one explanation of the finding that the 1933 Act reduced the variance of stock returns could be that the 1933 Act eliminated fraudulent issues. See Jarrell, *supra* note 47, at 649. Jarrell sought to test this hypothesis by examining the performance of pre-SEC new issues but excluding from the pre-1934 sample the firms that would have been screened out by the SEC's regulation (the riskiest issues) had the Act been in effect in the earlier years. See *id.* at 650. He found that the screened sample performed no better than the entire pre-SEC sample. See *id.* Jarrell concludes that the reduction in variance after the Act is not due to effective deterrence of fraud, because high variance is not connected to poor performance in the unregulated period. See *id.*

been compiled. Because all states had antifraud statutes prior to the adoption of the federal securities laws, and only Nevada did not have an administrative entity to investigate securities fraud at that time,<sup>70</sup> an investigation of whether reported instances of investor fraud decreased after the enactment of federal securities laws would be a useful step in determining the efficacy of the federal regime. The difficulty, however, of establishing a preenactment baseline rate (given differences in enforcement regimes across states, for example), probably would make the task infeasible. Other probative research would examine whether securities issued outside of the SEC's jurisdiction (intrastate issues of small firms, state and local government securities, or foreign issues) have higher frequencies of fraud and price manipulation than SEC-registered securities, although, again, developing good estimates of comparative base-rate frequencies would be quite difficult.

Seligman cites SEC testimony to Congress in the 1940s and a 1963 SEC study as part of the agency's twenty-year effort to expand its jurisdiction over small firms, indicating that the SEC initiated more fraud investigations against issues exempt from federal registration requirements than against those that were registered.<sup>71</sup> These data are of little import. First, we do not know whether the SEC allocated more resources to investigating exempt issues than to investigating registered issues, an altogether plausible possibility given the SEC's agenda at the time, the extension of its disclosure requirements to small firms exempt from its regulation. Such an enforcement policy would make it impossible to draw any conclusion concerning relative rates of fraud from the data. And, of course, the initiation of an investigation does not mean that fraud actually occurred. Second, it is important to ascertain the level of state antifraud activity against such issuers to determine whether federal intervention was necessary. Third, even if one accepted Seligman's contention that massive securities frauds went undeterred by the states and necessitated the enactment of the federal laws, it is important to determine whether fraud occurred more frequently in small rather than large firms. Such a finding would indicate that the lower rate of fraud investigations for firms covered by the 1933 Act would not be a function of the mandatory disclosure regime, but of the population's lower underlying occurrence rate.

But the evidence supporting the contention that rampant fraud necessitated the federal laws is itself quite thin. After reviewing the legislative record and other sources, Benston concludes, in contrast to Seligman, that there is scant evidence of fraudulent financial statements prior to the 1934 Act.<sup>72</sup> Harold Bierman has also reviewed the evidence concerning stock market fraud and manipulation prior to the 1929 crash, scrutinizing in particular the sensational

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70. See EASTERBROOK & FISCHER, *supra* note 16, at 277.

71. See Seligman, *supra* note 20, at 34-35.

72. See Benston, *Evaluation*, *supra* note 37, at 135.



charges raised against several prominent financiers in the Pecora hearings that led to the federal securities legislation. He concludes that the hearings and the attempted prosecutions in their aftermath did not uncover fraudulent or dishonest behavior on Wall Street and that the amount of manipulation in the 1920s was "surprisingly small."<sup>73</sup> More important, a recent empirical study of the operation of stock pools that were a principal focus of the congressional investigation leading to the enactment of the federal securities laws found no evidence that the pools manipulated stock prices.<sup>74</sup>

In short, a fair reading of the empirical literature on the effects of the federal securities laws points to an expansive regulatory apparatus with no empirical validation for its most fundamental objectives. The SEC appears to be a regulatory edifice without foundation. A competitive regulatory system would put such a characterization to the test, as firms would be able to seek out the securities regime that investors prefer.

## 2. *Empirical Evidence on Corporate Charter Competition*

The most prudent approach to the considerable data reviewed in the previous subsection, which cast doubt on the efficacy of the federal securities regime, is to replace the monopolist federal regulator with regulatory competition. This is, of course, the gist of the market approach embedded in a system of competitive federalism. To find fault with a market approach one must maintain that a competitive regulatory setting will do a worse job than the federal monopolist in achieving the investor-protection goals of securities regulation. For such a contention to be correct, a further assumption is required, that the states will engage in a "race for the bottom" and enact rules that favor promoter-issuers over investors.<sup>75</sup> This assumption cannot be directly tested because there is at present no competitive regime for securities laws; besides the national mandates, the governing regime is fixed by the investor's residence or place of sale. But there is a competitive regime for corporate charters. The most important data bearing on the question whether the federal securities regime should be eliminated is, consequently, the research on the impact on shareholder welfare of state competition for charters. This research indicates convincingly, in my judgment, that investors are at a minimum not harmed from the competition and, in all likelihood, benefit from changes in corporate domicile to states such as Delaware, the leading incorporation state.

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73. BIERMAN, *supra* note 36, at 133-45.

74. See Paul G. Mahoney, *The Stock Pools and the Securities Exchange Act*, J. FIN. ECON. (forthcoming 1999) (manuscript at 38, on file with the *Yale Law Journal*).

75. Seligman, for example, asserts that there is a need for mandatory national securities laws "because of the history of state corporate law 'chartermongering.'" Seligman, *supra* note 20, at 53-54.

There have been six event studies of the effect of state competition on shareholder wealth. The wealth effect is measured by the stock price reaction to a domicile change. Measured over a variety of time periods and sample firms, these studies find either a significant positive stock price effect or no significant price effect upon reincorporation.<sup>76</sup> No study observes a negative stock price effect. The empirical research on state competition undermines the race-for-the-bottom argument against eliminating the federal securities monopoly by demonstrating that choice of jurisdiction does not leave investors defenseless against unscrupulous promoters.<sup>77</sup>

The race-for-the-bottom view of state competition is no longer the consensus view of scholars in the debate over the efficacy of state competition

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76. See Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 66-67 (1989) (significant positive returns on the event date and approximately one month before); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 272-75 (1980) (significant positive returns two years before the event date); Allen Hyman, *The Delaware Controversy—The Legal Debate*, 4 DEL. J. CORP. L. 368, 385 (1979) (positive returns four days before the event date); Jeffrey Netter & Annette Poulsen, *State Corporation Laws and Shareholders: The Recent Experience*, 18 FIN. MGMT. 29, 35-37 (1989) (positive returns roughly one month around the event date that were significant at the 10% level only); Romano, *supra* note 19, at 270-71 (significant positive returns at three-day, one-week and one-month intervals around the event date); Wang, *supra* note 19, at 14-18, 21 (significant positive returns for the full sample over a three-day event interval and significant positive returns for Delaware firms over 40 days before the event date and over a three-day interval if the shareholder meeting date is used as the event date).

77. In an attempt to explain away the non-negative stock price effects of reincorporation, Lucian Bebchuk asserts that stock price studies are not probative of whether state competition benefits shareholders because state competition may produce some provisions that are harmful to shareholders even if the overall package of provisions is not. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1449-50 (1992). This is not a particularly damaging contention against competition and in favor of a federal monopolist for several reasons. First, it is the net wealth effect of a code on investors that is important, and that effect is positive for state corporate law. Second, because state corporation codes are enabling statutes, firms can avoid any such harmful provisions by customizing their charters or bylaws. See *infra* text accompanying note 82 (discussing numerous firms' opting out of the Pennsylvania takeover statute). Indeed, Bebchuk does not identify specific mandatory (hence unavoidable) provisions in state codes that he believes benefit managers over shareholders. Third, Bebchuk offers no support for the prediction that a federal corporation code would contain fewer harmful provisions than state codes. An examination of the lobbying process in the corporate context indicates that the differences between federal and state politics are, in fact, minimal. See *infra* notes 84-89 and accompanying text. Bebchuk offers two other speculations to refute the validity of the empirical research, but they are incorrect. His contention (offered to explain insignificant price effects of reincorporation) that both the original and the destination state's laws are equally harmful to shareholders, see Bebchuk, *supra*, at 1449-50, is not borne out by the evidence. Not only do some studies find significant positive results, see *supra* note 76, but more important, the legal regimes of the destination states differ significantly from those of the states of origin: The destination states are more responsive to reincorporating firms' demands than the originating states in enacting code innovations; and reincorporating firms perceive significant differences between the legal regimes of the two states and offer them as a reason for moving, see Romano, *supra* note 19, at 246-47, 258-60. Bebchuk's other contention (offered to explain positive stock price effects) that any price effects of reincorporation are due to changes in the firm's business accompanying or anticipated by the move rather than a reflection of investors' assessment of the new regime, see Bebchuk, *supra*, at 1449, while plausible, is not supported by the data. I tested for significant differences in abnormal returns across reincorporating firms grouped according to such potentially confounding transactions, where some transactions would be hypothesized to be negative and others positive, for shareholder wealth, and found none. See Romano, *supra* note 19, at 272. This finding is strong evidence that the positive price effects for the full sample in my study were due to investors' positive assessments of the domicile change and not of the accompanying or anticipated transactions.

for corporate charters precisely because its advocates cannot provide tangible proof that competition is, in general, harmful to investors. There is no reason to expect state competition to operate differently for securities law than it does for corporate law. The informational efficiency of capital markets and the dominant presence of institutional investors in such markets ensure that the content of legal regimes will be impounded in the cost of capital, whether they concern only corporate governance or include securities transactions. Accordingly, if mandatory securities rules benefit shareholders, notwithstanding the absence of empirical support in their favor, then competitive federalism will produce mandatory rules as well.

This is not to say that state competition is perfect. In the 1980s, when hostile takeovers emerged as a mechanism for changing control and, correlatively, for replacing incumbent management, the vast majority of states enacted laws that attempted to lower the probability of a hostile takeover. Because shareholders receive substantial premiums in hostile takeovers, most commentators hypothesized that the objective of these statutes was not to enhance shareholder welfare, but to entrench management.<sup>78</sup> Indeed, some antitakeover statutes made explicit their non-shareholder-wealth-maximization objectives. Such laws, referred to as “other constituency statutes,” permit management to consider interests other than those of shareholders (that is, factors besides the offered price) in deciding whether to oppose a bid.<sup>79</sup>

Consistent with the view that restricting hostile takeovers is not beneficial to shareholders, the enactment of antitakeover laws produced negative or statistically insignificant stock price reactions.<sup>80</sup> Delaware, with the largest

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78. See, e.g., EASTERBROOK & FISCHER, *supra* note 16, at 220-22. Some commentators contended, however, that takeover defenses benefited shareholders by solving a coordination problem created by dispersed stock ownership and thereby enabling managers to negotiate higher bid prices. See, e.g., Lucian Arye Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197 (1988); William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341.

79. For an analysis of these statutes, see Roberta Romano, *What Is the Value of Other Constituency Statutes to Shareholders?*, 43 U. TORONTO L.J. 533 (1993). I found these statutes had no significant stock price effect on the specific legislative event dates and within two-day event intervals. See *id.* at 537. John C. Alexander et al., however, found a significant negative price effect (for firms without poison pills or antitakeover charter amendments) for two of the statutes that I examined when a longer event interval of two days before and three days after was used, and for a third statute, enacted by Indiana in 1989, that was improperly included in their sample because Indiana had had an other-constituency statute in effect since 1986. See John C. Alexander et al., *Nonshareholder Constituency Statutes and Shareholder Wealth: A Note*, 21 J. BANKING & FIN. 417, 427 (1997). In fact, I found a negative effect for the earlier Indiana statute, see Romano, *supra*, at 539, but it is not a “clean” statute in that it was passed with another antitakeover provision. I did not find any difference for firms with or without defensive tactics in place, but the sample was not subdivided by firm characteristics for each state statute separately, and therefore the results cannot be compared. In addition, my sample consisted of larger firms, as it was constructed solely from NYSE listings while Alexander et al. include firms traded on the American Stock Exchange and NASD’s Automated Quotation System (NASDAQ). Because at least one study has found that it is small firms that experience negative price effects from takeover statutes, see M. Andrew Fields & Janet M. Todd, *Firm Size, Antitakeover Charter Amendments, and the Effect of State Antitakeover Legislation*, 21 MANAGERIAL FIN. 35 (1995), the difference in the studies’ samples may explain the difference in the results.

80. The most comprehensive study, which finds a small but significant negative stock price effect, is

stake in the chartering business, stands out, however, as an anomaly in the takeover statute legislative process. In contrast to its position as an innovator in corporation code provisions, in the takeover context Delaware was a laggard behind other states, and its regulation is considerably less restrictive of bids.<sup>81</sup> More important, charter competition limits the extent to which states can restrict takeovers: When Pennsylvania enacted what was considered to be a draconian statute, a majority of firms opted out of its coverage because of demands made by their investors, who raised the prospect of selling their shares and reinvesting in firms incorporated in states with no statutes or less restrictive statutes, such as California and Delaware.<sup>82</sup> Consequently, other states did not adopt the Pennsylvania statute.<sup>83</sup>

There is also no evidence that a monopolist-regulator enforcing one national corporation law would produce better takeover regulation than the states. Quite to the contrary, in all likelihood a monopolist regulator would make the situation worse. The political dynamics of takeover regulation at the state level would be unchanged at the national level. The groups that are influential in state politics outside of Delaware—local firm managers—are as influential in Washington. They provide, for instance, the bulk of the witnesses testifying for takeover regulation.<sup>84</sup> In addition, members of Congress whose districts included hostile takeover targets were the principal advocates for antitakeover legislation,<sup>85</sup> just as states with hostile targets were the enactors of similar protective legislation.<sup>86</sup> Moreover, the congressional legislation on takeovers enacted under the securities laws, the Williams Act,<sup>87</sup> paralleling the state statutes, favors incumbent managers over bidders by delaying bids, and the overwhelming majority of bills introduced concerning federal takeover regulation since the Williams Act have sought to make hostile bids more difficult.<sup>88</sup>

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Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. FIN. ECON. 291 (1989), which assesses 40 statutes. ROMANO, *supra* note 4, at 60-69, reviews the empirical research on takeover statutes and shareholder wealth.

81. Correspondingly, in contrast to the antitakeover statutes of other states, the Delaware statute did not have a negative stock price effect. See John S. Jahera, Jr. & William Pugh, *State Takeover Legislation: The Case of Delaware*, 7 J.L. ECON. & ORG. 410, 416-19 (1991) (finding insignificant or positive returns over eight two-day event intervals); Karpoff & Malatesta, *supra* note 80, at 315 (finding an insignificant price effect over a two-day event interval).

82. See ROMANO, *supra* note 4, at 68-69.

83. See *id.* at 70.

84. See Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 485 (1988). Only witnesses employed by the government participated in a greater number of takeover legislation hearings than corporate managers. See *id.*

85. See *id.* at 482-84; Kenneth Lehn & James W. Jones, *The Legislative Politics of Hostile Corporate Takeovers* (1987) (unpublished manuscript, on file with the *Yale Law Journal*).

86. See Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365 *passim*; Romano, *supra* note 84, at 461.

87. Pub. L. No. 90-439, 82 Stat. 454 (1968) (amending Securities Exchange Act of 1934 § 14(d), (e), 15 U.S.C. § 78n(d), (e) (1994)).

88. See Romano, *supra* note 84, at 470-74.

With only a national law, there would be no safety valve offered by a competing jurisdiction (such as California and Delaware in the current federal system of corporate law) to constrain takeover legislation, and a legislative or judicial mistake would be more difficult to reverse, as Congress moves considerably more slowly than state legislatures.<sup>89</sup> As the experience with state takeover laws indicates, although in the short run there will be deviations from the optimum in a federal system, in the longer run competitive pressure is exerted when states make mistakes, as in the example of firms opting out of Pennsylvania's takeover statute. Such pressure is absent in an exclusive one-regulator system.

The empirical literature concerning the efficacy of state competition for corporate charters has been my focus of analysis, not only because an assessment of the efficacy of charter competition underlies the arguments for and against the market approach to securities regulation, but also because economic theory provides limited guidance concerning whether a monopolist will provide the optimal degree of product quality, variety, or innovation, issues of importance in the regulatory context. Whether a monopolist's choice of quality is socially optimal depends on the difference between the marginal and average consumers' willingness to pay for quality, as is true of price-taking competitors; whether the monopolist will undersupply quality compared to the competitive market depends on the elasticity of demand.<sup>90</sup> There is a similar ambiguity concerning whether a monopolist will produce too few or too many products; the answer again depends on the elasticities of demand and whether the goods in question are substitutes.<sup>91</sup>

Extending the theory of monopolistic firms to regulators, William P. Albrecht et al. present a model in which competing regulators, in contrast to a monopolist (or to collusive regulators), provide efficient regulation when the

89. See ROMANO, *supra* note 4, at 48-49. This explains why Congress did not amend the Williams Act to restrict takeovers further in the 1980s. Over the course of its lengthy deliberative process on takeover legislation, the Supreme Court upheld state takeover regulation, *see CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987), and firms redirected their lobbying efforts from Congress to the states, which could provide a target with relief more quickly than Congress, *see* sources cited *supra* note 86.

90. In other words, while a social planner would set quality by the average consumer's valuation because she looks at all consumers' welfare, the monopolist, concerned with profits and not social surplus, sets quality by the marginal consumer's valuation because the price increase for higher quality can be passed on to all inframarginal consumers. As the marginal consumer is not likely to be representative of the population, the monopolist's product quality choice will differ from that of the social planner (i.e., it will undersupply quality if the average valuation exceeds the marginal valuation). The bias in quality introduced by the monopolist can be identified only if output will be the same in both cases; this is generally not the case because a monopolist tends to produce less output for a given quality. *See* JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 100-02 (1988).

91. When the monopolist can produce only one product because the monopolist cannot appropriate the net consumer surplus from introducing a new product design, there may be too few products under monopoly compared to the social optimum; when the monopolist can offer multiple products that are substitutes, it may introduce "too many" products compared to the social optimum because if it charges an above-marginal price for one good it can create demand for a second good, which would not exist if the first good was competitively priced. *See id.* at 104-05. The analysis concerning the monopolist's choice for product diversity is substantially the same as that for product innovation.

goods regulated are substitutes.<sup>92</sup> Although it is most plausible to conceptualize the products in the securities regulation context as substitutes, as all states' securities codes are available to all firms, if different states' laws are appropriate for specific types of firms and diversified investors desire to hold such firms in fixed proportions, the products could be conceptualized as complements. Lacking information on demand elasticities for securities laws, Albrecht et al.'s model is only suggestive of the benefits of the policy advocated in this Article, and we must rely instead on the best available empirical evidence, the evidence from state competition for corporate charters. Charter competition has not resulted in product differentiation across states (that is, corporate law regimes are substitutes),<sup>93</sup> and investors have benefited from the competition. These data are consistent with the existence of substantial benefits for investors from opening securities regulation up to competition as well.

### C. *How Would State Competition for Securities Regulation Work?*

For states to compete in the production of specific laws, a state must receive some benefit from the activity. In the corporate law setting, the benefit is financial: States collect franchise tax revenues from locally incorporated firms. Over the past thirty years, the franchise tax revenue collected by Delaware, which is the leading incorporation state despite having few local corporations, averaged 16.7% of its total tax revenue (see Appendix Table 1). This revenue greatly exceeds what Delaware spends on its corporate law system.<sup>94</sup> If the regulation of securities transactions depended on the incorporation state as well, the incentive to obtain franchise tax revenues would increase, as there would be more dimensions on which a state could serve its corporate clientele. That is, a state could increase the number of incorporations, and hence its franchise tax revenues, by offering a desirable securities regime as well as a desirable corporation code.

An additional potential revenue source for states competing over securities regulation is filing fees, which accompany the registration of a public offering

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92. See William P. Albrecht et al., *Regulatory Regimes: The Interdependence of Rules and Regulatory Structure*, in THE INDUSTRIAL ORGANIZATION AND REGULATION OF THE SECURITIES INDUSTRY 9, 27 (Andrew W. Lo ed., 1996).

93. See ROMANO, *supra* note 4, at 45-48.

94. The figures in Appendix Table 1 provide a conservative estimate of the profitability of Delaware's chartering business because they overstate its expenditures by including, in addition to the appropriations for the Division of Corporations in the Office of the Secretary of State, which administers the corporate registration process, the total appropriations for the Chancery Court and Delaware Supreme Court, which hear corporate law cases at trial and on appeal, respectively, although such cases are a fraction of their caseload. For example, only 30% of Chancery Court cases are corporate law cases. See *Chancery Court High Stakes in Delaware*, NAT'L L.J., Feb. 13, 1984, at 32. In addition, the outlays for the Division of Corporations were separately itemized only after 1972; for the years before 1972, the table includes the entire appropriation for the Secretary's Office, although in the subsequent years the ratio of the budget for the Division to the budget for the Office was slightly under 80%.

of securities. These fees can be substantial, as indicated in Appendix Table 2, which reproduces the fees collected by the SEC over the past thirty years for the registration of securities and various other filings.<sup>95</sup> Since 1983, the SEC's fee collections have been more than 100%, often more than 200%, of its gross outlays.<sup>96</sup> As a monopolist, the SEC has been able to charge a higher fee for registration than could competitive states, but competition need not drive such fees to zero. Delaware, for instance, charges higher incorporation fees than other states and is still the leading incorporation state—a phenomenon indicating that firms are willing to pay a premium for a superior legal product.<sup>97</sup>

Securities transaction taxes could be a further source of revenue, as they would accrue to the securities-regulating state, but the competitiveness of capital markets has constrained states from imposing substantial taxes on share transfers. The trend in European countries, for example, has been to reduce or eliminate securities transaction taxes because of competition for stock exchange business.<sup>98</sup> Annual securities domicile franchise fees, analogous to incorporation franchise fees, would be preferable to securities transaction taxes as a revenue source, however, because they are assessed per firm, rather than according to individual trades, and will thus not adversely affect liquidity by deterring particular transactions.

The financial incentives generating state charter competition have resulted in a race that has tended to the top in corporate law. This result suggests that it would be beneficial for investors to create similar financial incentives for states in the securities law context. Presently, however, states have little of value to offer firms in return for the payment of securities “franchise” taxes. State securities case law is not as extensive as that for corporate law because

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95. The bulk of the SEC's fee revenue comes from securities' registration. For example, in 1996, securities registered under the 1933 Act accounted for 75% of the agency's fee revenue, and transactions of covered exchange-listed securities comprised a further 17%. See *SEC 1996 Annual Report* (visited Jan. 5, 1998) <<http://www.sec.gov/asec/annrep96/polas.htm>>. The figures for fees collected in the 1960s-1970s include the fees from the registration of exchanges and brokers as well as securities. See, e.g., 33 SEC ANN. REP. 149 (1967) (figures for 1965-1967); 36 SEC ANN. REP. 210 (1970) (figures for 1968-1970).

96. See CONGRESSIONAL BUDGET OFFICE, 104TH CONG., 1ST SESS., MEMORANDUM ON GROWTH OF FEDERAL USER CHARGES: AN UPDATE (Comm. Print 1995). The SEC's revenue is so great that for many years it sought to be self-financing. Congress initially refused its request, preferring to retain a system in which the fees from SEC filings entered into general revenues and the SEC was allocated a budget far lower than the revenues it produced. In 1996, however, Congress enacted legislation reducing SEC fees over time so that eventually the SEC will collect no more in fees than it costs to run the agency. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, §§ 402-405, 110 Stat. 3416, 3441-44 (codified at 15 U.S.C.A. §§ 78a, 77f(b), 78ee (West 1997)). That statute also restricted states' ability to charge filing fees for the registration of securities traded on national exchanges, at the same time as it preempted their ability to regulate such issues' registrations. See *id.* § 102(a), 102(c)(2)(D), 110 Stat. at 3417, 3420 (codified at 15 U.S.C.A. § 77r). The change in securities regime advocated in this Article would reword this restriction, to permit the securities domicile alone to charge such fees. The domicile would be a state, foreign country, or the SEC, depending on the issuer's selection.

97. See Romano, *supra* note 19, at 257.

98. See Colin Jamieson, *Stamp Duties in the European Community: Harmonisation by Abolition?*, 1991 BRIT. TAX REV. 318, 318-19.

until recently the national securities laws have occupied the field, given expansive interpretations of the federal antifraud provisions by the SEC and courts and the desirability of using federal courts.<sup>99</sup> State securities law is not a complete void, however, because some litigants began turning to state actions in the aftermath of the Supreme Court's restrictive interpretations, beginning in the 1970s, of the federal antifraud provisions.<sup>100</sup> This trend is expected to increase given Congress's recent tightening of procedural requirements for federal securities actions,<sup>101</sup> unless Congress enacts the proposed preemption bills.<sup>102</sup>

The relative dearth of a developed body of securities case law places states at a distinct disadvantage in competing for corporations with the federal government in terms of substantive securities regulation. In choosing their statutory domicile, corporations place a premium on the presence of comprehensive case law because a stock of precedents facilitates business planning: Firms can structure transactions to minimize the possibility of liability.<sup>103</sup> States can, however, compensate for the problem of meager judicial precedents by formally incorporating federal court decisions interpreting the national laws, through either legislation or judicial action, to the extent that the state's statutory language tracks the national laws. This approach is not novel and has, in fact, been adopted in the corporate law context: It facilitated the replacement of New Jersey as the leading incorporation state by Delaware when corporations sought an alternative statutory domicile after a lame-duck Governor Woodrow Wilson and the Progressive Party majority in the New Jersey legislature drastically revised the corporation code. Delaware's judiciary had incorporated New Jersey precedents in interpreting its code, which was modeled on the former New Jersey statute.<sup>104</sup> Moreover, a state such as Delaware, with a specialized corporate

99. See, e.g., THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* 769, 773 (3d ed. 1996) (discussing the courts' expansion of statutory scope). While the 1934 Act provides the federal courts with exclusive jurisdiction for 1934 Act violations, see 15 U.S.C. § 78aa (1994), the 1933 Act does not, see 15 U.S.C. § 77v, and plaintiffs can bring claims under state securities laws for conduct that would be a 1934 Act violation. Nevertheless, the preponderance of securities lawsuits are brought in federal court. See GRUNDFEST & PERINO, *supra* note 3, at 3-9 (discussing filing trends in securities legislation).

100. See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462, 474-77 (1977) (holding that a breach of fiduciary duty was not a violation of federal securities law); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (requiring scienter for liability under federal securities fraud statutes).

101. For an overview of the advantages to investors of bringing securities claims in state rather than federal courts, see Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 418-27 (1993). Grundfest and Perino note the incentives created by the 1995 Reform Act for plaintiffs to use state courts. See GRUNDFEST & PERINO, *supra* note 3, at 39.

102. See sources cited *supra* note 2.

103. See ROMANO, *supra* note 4, at 32-34 (discussing how firms reincorporate to reduce litigation costs); Romano, *supra* note 19, at 249-51 (same).

104. See *Wilmington City Ry. v. People's Ry.*, 47 A. 245, 251 (Del. Ch. 1900). For a more recent example of this approach, see *Santa Fe Hills Golf & Country Club v. Safehi Realty Co.*, 349 S.W.2d 27, 34-35 (Mo. 1961).



law court, can compensate for the dearth of precedents by offering litigants the prospect of far greater judicial expertise than the federal courts.

The limited experience of states with securities regulation is one important reason for maintaining a federal government option—at a minimum as a transitional mechanism—in the context of creating competitive federalism for securities law in contrast to corporate law, for which there is no analogous federal code in the United States. It is, however, probable that opening securities regulation up to state competition would enhance Delaware's dominant position as an incorporation state. This is because, to the extent that the national securities laws have been accurately taken to task for requiring costly and excessive disclosure and fostering frivolous antifraud litigation, Delaware, in all likelihood, would offer a securities regime that mitigates these problems.

Delaware's fiscal prosperity depends to a significant extent upon providing rules that reduce firms' costs of doing business. As a small state, it would not have indigenous income sources to replace the substantial revenue it derives from the franchise tax were it to lose incorporations to a state more responsive to business needs. This motivation is a key to Delaware's chartering market success: Delaware's reliance on franchise tax revenues serves as a commitment device to ensure firms that it will continue to enact legislation that firms desire (statutes that maintain share values as new business conditions warrant code revision).<sup>105</sup> Such a commitment device is critical to the production of corporate charters because a corporate charter is a relational contract, extending over many years during which unforeseen contingencies are likely to arise. Such uncertainty makes it difficult for contracting parties to specify in advance their obligations, and, as performance is not simultaneous, the possibility of opportunistic breach is increased. In particular, firms select their domicile and pay franchise taxes based on the extant legal regime and run the risk that as business conditions change thereafter, the state will not adapt its code (or will repeal key provisions to firms' disadvantage). The opportunism problem of relational contracting is exacerbated when one of the contracting parties is the state, given its role as the enforcer of contracts through the court system.

Delaware has surmounted the commitment problem by investing in assets that have no value outside of the chartering market, thereby guaranteeing to firms that it will continue to be responsive in its code after they incorporate. These assets include its specialized corporate court system and a reputation for responsiveness dependent on its high ratio of franchise taxes to total tax revenues. To the extent that Delaware can gain further franchise revenues from crafting a responsive securities regime, the same factors will operate in the

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105. For the details of the argument, see ROMANO, *supra* note 4, at 38; and Romano, *supra* note 19, at 240-42.

securities, as in the chartering, context, and Delaware will have stronger incentives than the SEC to find the desirable regulatory balance.

D. *Regulatory Innovation and Competition: Variety and Uniformity in State Securities Laws*

A more traditionally articulated benefit of federalism that is integrally related to the incentive effects of competition is that it permits experimentation in legal rules, as states implement different solutions to specific problems. This, in fact, occurs in the corporate chartering context. Successful corporate law innovations diffuse rapidly across the states.<sup>106</sup> For instance, to address a perceived crisis in directors' and officers' liability insurance in the mid-1980s, states enacted a variety of statutory approaches, including permitting firms to cap or eliminate monetary liability of outside directors for negligence and changing the fiduciary duty standard of care from negligence to willful misconduct or recklessness.<sup>107</sup> Within a few years, the vast majority of states copied Delaware's approach, permitting charter amendments to eliminate liability.<sup>108</sup>

There is, however, far greater variation in state approaches to securities regulation than to corporate law, which has tended to uniformity in key default provisions through the diffusion of statutory innovations.<sup>109</sup> For example, some states have merit review regimes, which condition securities' registration on their meeting a standard of investment worthiness or merit, while the majority of states employ a disclosure approach, similar to the federal securities laws.<sup>110</sup> The distinction across state securities regimes is not, after all, entirely clear-cut, because merit review for compliance with the investment standard can take the form of requiring greater disclosure of aspects of an issue viewed with disfavor by the regulator, rather than denial of registration.<sup>111</sup>

106. See William J. Carney, *Federalism and Corporate Law: A Non-Delaware View of the Results of Competition*, in INTERNATIONAL REGULATORY COMPETITION AND COORDINATION: PERSPECTIVES ON ECONOMIC REGULATION IN EUROPE AND THE UNITED STATES 153, 172-74 (Joseph McCahery et al. eds., 1996); Romano, *supra* note 19, at 233-35.

107. See Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160-61 (1990).

108. See *id.*; see also Carney, *supra* note 106, at 167. Firms that reincorporated in Delaware to take advantage of the limited liability statute experienced positive returns, while event studies of the enactment of Delaware's limited liability statute, and of firms' charter amendments to opt into the statute, do not pick up a significant (positive or negative) price effect. See ROMANO, *supra* note 4, at 19-24.

109. See Carney, *supra* note 106, at 165, 174-75; Romano, *supra* note 19, at 235.

110. See Ad Hoc Subcomm. on Merit Regulation of the State Regulation of Sec. Comm. of the Am. Bar Ass'n, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 790 (1986) [hereinafter ABA Report]. Variation in states' approaches to securities regulation dates from the initiation of state securities laws at the turn of the century, when only a subset of the states adopted merit regulation modeled after Kansas's pioneering blue sky law (another name for state securities laws), which predated the federal legislation. See Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 377-80 (1991).

111. See ABA Report, *supra* note 110, at 823.

In addition, the import of the difference is limited because only a subset of securities are subject to state regulation; nationally traded shares are excluded, and individual exemptions are often granted.<sup>112</sup> Investors can also avoid a home state's merit review regime: If a security is not registered in their state, they can acquire it in an unsolicited secondary market transaction rather than in the initial public offering.<sup>113</sup>

The absence of competition in the securities field probably accounts for the greater variation in regulatory approach across the states than in corporate law.<sup>114</sup> But the limited applicability of the states' registration regimes is undoubtedly also a factor, for where the vast majority of investors prefer a particular regime, competition will produce incentives for regulators to choose that regime. Accordingly, if the variation in securities regulation is due, for instance, to regulators' preference for merit review differing from that of investors, in a competitive system merit regulation would not survive. In fact, even in the absence of regulatory competition, merit regulation has been on the decline, for, in addition to the expanding number of exemptions from coverage under merit regimes, several important states, such as Illinois, eliminated their merit review provisions in the 1980s.<sup>115</sup>

The empirical research on state securities laws does not provide much support for merit regulation. Studies find that securities sold in non-merit-review states have higher returns and greater risk than those sold in merit review states;<sup>116</sup> while this result is what merit regulators set out to accomplish, there is no evidence that the reduction in risk is desirable. Specifically, there is no evidence that securities risk is positively correlated with fraud, that investments in non-merit-review states are subject to more

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112. See *id.* at 796 (describing exemptions for issues traded on national exchanges or registered with the SEC); Kevin G. Salwen, *State Laws Are Often Overkill, Some Say*, WALL ST. J., July 20, 1987, at 35 (describing individual exemptions). Of course, these issues are not exempt from the states' antifraud statutes.

113. See UNIF. SEC. ACT § 402(b)(3), 7B U.L.A. 601 (1985) (providing an unsolicited offer exemption for securities resales).

114. Saul Levmore offers two explanations of variety in legal rules that suggest that differences would remain across securities regimes even in the presence of competition. Variety exists because the rules "do not much matter or . . . raise issues about which reasonable people (even in the same culture) could disagree." Saul Levmore, *Variety and Uniformity in the Treatment of the Good-Faith Purchaser*, 16 J. LEGAL STUD. 43, 44 (1987). If reasonable people can disagree over which securities regime best safeguards investors against fraud and low-quality investments, competition would not eliminate merit regulation but rather would preserve it, as investors (and hence firms) self-selected across states, choosing the regime that they considered preferable for protecting their financial interest. In addition, if the adoption of either merit review or disclosure regulation does not differentially affect the level of investor fraud, then the choice of regime would not matter and variety could be preserved, although, as Levmore notes, the commercial needs of a national market would press toward uniformity despite the inconsequential effect of variety. See *id.* at 60.

115. See, e.g., ABA Report, *supra* note 110, at 786 (reporting that Illinois and Louisiana abandoned merit review in 1983 and 1985, respectively).

116. See DAVID J. BROPHY & JOSEPH A. VERGA, THE INFLUENCE OF MERIT REGULATION ON THE RETURN PERFORMANCE OF INITIAL PUBLIC OFFERINGS (University of Michigan Sch. of Bus. Admin. Working Paper 91-19, 1991) (reviewing other studies and presenting new data).

instances of fraud than those registered in merit review states, or that investors residing in merit review states are more risk-averse, uninformed, or financially unsophisticated than those in non-merit states. The absence of a showing of significant benefits to investors from merit regulation suggests that opening state securities regulation up to competition would hasten its demise.

The probability that competition will hasten the demise of merit regulation is important because it sheds light on a potential concern over abandoning the mandatory federal system: Would investors be harmed by a subsequent loss of standardized disclosure across firms governed potentially by fifty-plus regimes? Competitive federalism does not necessarily increase variation in the legal regime. State charter competition has, in fact, produced substantial uniformity across corporate codes, preserving variety in its enabling approach to rules, an approach that permits firms to customize their charters if the default provisions of the statutes are not suitable.<sup>117</sup> This situation is likely to be true for competitive disclosure regimes, as the most desirable disclosure standards would diffuse across the states.

More important, the most significant area of standardization, firms' financial reporting, would still be controlled by the private sector under the Financial Accounting Standards Board (FASB), and thus be consistent across firms complying with its rules. States could require compliance with FASB standards to assist firms' needs for uniformity,<sup>118</sup> or stock exchanges could perform a standardizing function, as they did prior to the enactment of the federal regime, by requiring listing firms to comply with FASB or their own disclosure requirements. Even without such requirements, most firms would comply with most FASB standards voluntarily to reduce their cost of capital, just as firms at times disclose information beyond that required by regulators today.<sup>119</sup> It is important to note that although the SEC does not exercise any statutory control over the FASB, it has authority to promulgate accounting rules,<sup>120</sup> and it has thereby exerted significant influence over FASB by the threat that it would adopt its own standards if FASB would not act.<sup>121</sup> Because the market approach eliminates the SEC's prescription of accounting rules for any firms other than those voluntarily submitting to its jurisdiction, its power to influence FASB standards would be greatly reduced under the proposal.

117. See ROMANO, *supra* note 4, at 1.

118. In fact, most states currently recognize FASB as the accounting standards-setter through their regulation of public accountants. State accounting boards, which license public accountants, control accountants' activities by identifying sources of generally accepted accounting principles (GAAP) and enforcing compliance with such principles through ethics regulations, which typically recognize the FASB as the authority on GAAP. See PAUL B.W. MILLER ET AL., *THE FASB: THE PEOPLE, THE PROCESS, AND THE POLITICS* 22 (3d ed. 1994).

119. See *supra* notes 38-41 and accompanying text.

120. See 15 U.S.C. § 78m (1994).

121. See PELHAM GORE, *THE FASB CONCEPTUAL FRAMEWORK PROJECT 1973-1985*, at 18, 22 (1992).

When competition is introduced into securities regulation, specific rules will undoubtedly develop that differ from those imposed by the SEC, even under state disclosure regimes, as states experiment to find the regime most attractive to registering firms. This could be accomplished by two routes: enactment of substantively different rules from SEC rules; or application to securities laws of the enabling approach taken by corporate law, in which state securities laws (which may or may not be the same as SEC rules) would operate as default rules from which firms could opt out if they so chose. Where a majority of firms opt out of a default, the state obtains information concerning the appropriateness of that rule, and eventually the rule is revised by that state or another state that obtains new registrations (and hence increased revenue) by enacting the more desirable default.<sup>122</sup> Analogous to the states' offering of special statutes for small firms, referred to as close corporation statutes, in the chartering context, with competitive securities regulation, a state could further offer firms a menu of regimes from which to choose (such as the choice of an extensive disclosure regime, a more limited disclosure regime, and a merit review regime).

If the SEC's rules are optimal, as its supporters contend, then either firms will not opt out of SEC coverage or they will opt into state securities regimes that are identical to the SEC's regime. But if all states simply mimicked the SEC's rules, the benefits from enacting the market approach would be reduced: Although needed regime revisions would be more speedily undertaken as a state regulator would act more quickly than the SEC to update its code to meet investor preferences, investors would bear increased transaction costs under competition; firms would have to inform investors, or investors would otherwise have to learn, of the firms' securities domicile choice. The absence of empirical support for the rationales underlying federal regulation, important instances of misguided SEC disclosure policy, and persistent concerns voiced over frivolous litigation suggest, however, that the particulars of securities regulation under competition will differ significantly from the present federal regime.

#### *E. Alternative Market-Oriented Proposals*

There are two alternatives to the competitive federalism approach to securities regulation advocated in this Article that are also market-oriented: eliminating the mandatory features of the federal regime by converting the federal securities laws into default provisions from which firms could opt out,

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122. An example of a default rule change in state corporation codes is the default for preemptive rights. In the earliest corporation codes, shareholders had these rights unless a firm expressly opted out of them in its charter, whereas in modern codes these rights exist only if the firm expressly includes them in its charter. See Samuel Arshat & Walter Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 76-77 (1967).

analogous to the enabling form of corporation codes; and replacing the government regulatory apparatus with a private, exchange-based regulatory regime.<sup>123</sup> Both of these alternatives harness market-based incentives to the regulatory system. Neither is precluded by this Article's multiple-regulator approach.

### 1. *A Federal Default Regime*

In a federal default regime, firms that did not wish to be governed by particular SEC rules or statutory provisions could specify alternative provisions in their corporate charters or bylaws (or in the indenture contracts for debt securities). Congress would either specify itself, or delegate to the SEC to determine, which securities regulations, if any, a firm must opt out of by a charter, as opposed to bylaw, amendment.<sup>124</sup> A default system would clearly be more desirable than the present one-size-fits-all regime, which is difficult to change because consensus must be developed among all participants regarding a new rule, even if their needs are quite different. For example, the SEC has been surveying registrants with a view to updating its rules regulating shareholder proxy proposals, and on the question whether to retain the current voting thresholds for a proposal's resubmission, ten corporate respondents produced eight different threshold proposals.<sup>125</sup> A lack of consensus among firms on such a matter is of far lesser import under a default system because firms can obtain the threshold level most appropriate for their shareholder configuration by provision in their charter or bylaws.

Under an enabling approach, if a default rule is suboptimal (that is, the rule's compliance costs outweigh benefits to investors), the majority of firms will elect not to be subject to the rule. Assuming the SEC became informed of firms' choices, perhaps by a requirement that firms file securities "charters" with the agency so that it could track deviations from the defaults, this market response would feed back into the SEC's decisionmaking process, leading it to readjust its beliefs concerning what regulation was most appropriate and, ultimately, to alter the default rule to one more compatible with investors' needs, just as would occur with state competition. There would also be a potential benefit compared to state competition for securities regulation: Transaction costs would be reduced because investors would not have to determine which regime governs their transactions. But if the SEC is not attentive in updating its defaults, there would be little savings in transaction

123. See ROMANO, *supra* note 4, at 107.

124. The difference between charter and bylaw amendment is that state corporation codes require shareholder approval of changes to the charter, but not to the bylaws. See, e.g., DEL. CODE ANN. tit. 8, § 109 (1996) (bylaw amendment); *id.* § 242(b) (charter amendment).

125. See *Some of Surveyed Firms Show Consensus on "Cracker Barrel," Other Issues*, 29 Sec. Reg. & L. Rep. (BNA) 567, 569 (Apr. 25, 1997).

costs, because investors would have to identify whether a firm were operating under particular outdated SEC defaults or its own alternatives.

An enabling national regime would be preferable to the current mandatory one, but, in my judgment, a competitive system of securities regulation is even more preferable. State competition would not preclude a national enabling regime, as the federal government could adopt an enabling regime in competition with the states, as may any or all states. But state competition would provide an additional benefit over a federal enabling regime: There would be a straightforward mechanism by which regulators learn of firms' adoption of statutory defaults. Under regulatory competition, there would be some variety in defaults across states, even if key innovations diffuse over time across the states, as has occurred in the corporate law context. This phenomenon would accelerate regulators' identification of the rules most desired by investors, as more firms would register in the states with the more desirable default rules. This would also reduce investors' transaction costs of learning whether a firm has customized an outdated default.

A further benefit of state competition compared to a federal enabling regime would be a more rapid updating of undesirable defaults because of financial incentives. A state such as Delaware would be considerably more attentive to the need to reduce the transaction costs generated by obsolete defaults than the SEC, because of the state's financial dependence on the relevant franchise taxes. Because firms have no alternative regulator in the monopolist enabling regime, the SEC is not exposed to the same code-updating incentives as would be experienced by states—declining revenues due to declining registrations.<sup>126</sup> The pressure experienced by the SEC from global competition, whether under an enabling statute or the mandatory regime currently in effect, is quite weak because resort solely to foreign capital markets for financing is not a viable option for publicly traded U.S. firms. The best evidence that global competition is not as effective a motivator for the SEC as direct domestic regulatory competition comes from the regulation of derivative securities. In the derivatives regulatory context, where the SEC has exclusive jurisdiction over the derivatives disclosures of publicly traded domestic companies, it has been minimally responsive to issuers' concerns

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126. A regulatory monopoly affords the SEC the opportunity to implement policies favoring the interests of financial market professionals rather than investors. *See, e.g.,* PHILLIPS & ZECHER, *supra* note 33, at 22-23 (discussing disclosure policies); David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 318-30 (1987) (discussing insider-trading regulation). Market professionals benefit from receiving free information from firms under the SEC's mandatory disclosure policies, and from the absence in the market of more informed traders under the insider-trading prohibition. Regulatory capture by market professionals would be more difficult under the market approach to securities regulation because corporations would opt for the regime more congenial to investors, as the providers of capital direct their funds to firms in those regimes; correspondingly, regulators sensitive to the number of corporations subject to their jurisdiction would adapt their rules to the preferences of investors, rather than to those of market professionals.

about regulatory costs and competitiveness.<sup>127</sup> Where the SEC competes with the Commodity Futures Trading Commission (CFTC) for jurisdiction, however, it has shifted from an initial position of opposing equity derivative products to one encouraging and promoting innovation by its regulatees, stock exchanges, to facilitate their competition against the futures exchanges regulated by the CFTC.<sup>128</sup>

A final potential benefit of state competition compared to an enabling national regime turns on whether any mandatory rules are desirable in the securities context, for instance, to facilitate a firm's credible commitment to investors that it will not engage in opportunistic behavior by altering a securities default to one offering less protection after the investments are made.<sup>129</sup> Mandatory rules could not be effectuated satisfactorily under a national enabling approach. For if the national enabling regime consisted of a mix of defaults and mandatory provisions, then we would be left with the problem endemic in the current monopolist-regulator setup: There would be no

127. See SEC Derivatives Disclosure, *supra* note 54, at 6054-62 (describing minor changes made in response to comment letters on the proposal and presenting a superficial cost-benefit analysis of the proposal).

128. See Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279, 354-59 (1997) (discussing the shift in the SEC's approach to product innovation). Some might attempt to characterize the SEC's loosening of its holding period for the resale of restricted (unregistered) securities under Rule 144, see Revision of Holding Period Requirements in Rules 144 and 145, 62 Fed. Reg. 9242 (1997) (to be codified at 17 C.F.R. pt. 230), as evidence of the SEC's responsiveness to competitive pressures, since the reform is a recognition by the agency that compliance costs were too high for small businesses, see *id.* at 9243-44. In my opinion, this action does not provide evidence that the SEC is particularly responsive to competitive pressure. The holding period revision took almost two years to be adopted. Delaware, by contrast, responds to corporate complaints much more quickly. See Romano, *supra* note 107, at 1160 (discussing the enactment of a limited liability statute within one year of an insurance crisis and a controversial judicial opinion). Moreover, the change has had no effect on the disclosure obligations of the public companies that are the focus of this Article's proposal, as it is directed at easing 1933 Act offering requirements for small firms and not at easing the continuing reporting obligations of the 1934 Act. The 1934 Act disclosure obligations have, in contrast to the SEC's moves to limit 1933 Act coverage, significantly increased over time, as the SEC has come to view the 1934 Act as the centerpiece of its regulatory authority rather than the 1933 Act, in a policy referred to as "integrated disclosure." See, e.g., DAVID L. RATNER & THOMAS L. HAZEN, *SECURITIES REGULATION* 129-34 (5th ed. 1996). Finally, and most important, the SEC has sought to eliminate competition and establish its regime internationally, by identifying harmonization of regulatory standards as a central goal of its policy toward international securities regulation. See Policy Statement of the Securities and Exchange Commission on Regulation of International Securities Markets, Exchange Act Release No. 6807, 53 Fed. Reg. 46,963, 46,963 (1988) (stating that regulators should "seek to minimize differences between systems"). Although the SEC's policy statement also asserted that regulators should be "sensitive to cultural differences and national sovereignty concerns," *id.*, this is belied by the SEC's implementation of the policy at home, where it requires foreign firms to reconcile their financial statements with GAAP in order to list in the United States, see *infra* notes 190-191 and accompanying text.

129. Jeffrey Gordon has advanced this argument in the corporate law context. See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-75 (1989). I remain skeptical, however, of a justification for mandatory rules involving promoters' needs for a commitment device concerning the stability of the initial domicile choice. See Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989) (responding to Gordon's argument). A shareholder vote would be required for a change in securities domicile, as it is for a change in incorporation state, see *infra* Subsection II.B.2, and, accordingly, the need for mandatory rules as a commitment device would be minimal because the successful occurrence of an opportunistic relocation would be extremely remote.



mechanism to check whether the mandatory provisions were, in fact, the ones that investors would voluntarily choose. Multiple regulators would permit mandatory provisions without the consequent costs, as such provisions could vary across jurisdictions, and information would therefore be provided concerning which provisions were desirable through the registration decisions of firms.

## 2. *Regulation by Exchanges*

A more decidedly deregulatory approach would be to leave securities regulation to the stock exchanges on which firms list.<sup>130</sup> In such a regime, exchange-listing conditions would include the substantive content of securities laws, such as periodic disclosure requirements. Exchanges can solve free rider problems concerning information production encountered by individual firms, as well as coordination problems presented by investors' need for standardized disclosure. Thus exchanges could replace the government as the solution to a securities market failure. Indeed, much of the disclosure predating the 1934 Act discussed by Benston was an NYSE listing requirement.<sup>131</sup> Moreover, multiple exchanges compete for listings. To the extent that maximizing trading volume is a function of listings, exchanges would be subject to the same incentives as states competing for charters, leading them to adopt listing requirements preferred by investors (or to shares discounted accordingly).<sup>132</sup>

As with a national default regime, an exchange-based regime would be likely to save transaction costs compared to state competition, because investors are directly informed of which regime applies when they trade shares.<sup>133</sup> But there could still be a regulatory role for the states in an exchange-regulated system. Although the over-the-counter market for the largest stocks, NASD's Automated Quotation System (NASDAQ), is a sufficiently developed regulatory organization capable of offering its own securities regime, if the NASDAQ regime were poorly suited for the smallest

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130. For a recent article advocating this approach, see Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

131. See Benston, *Evaluation*, *supra* note 37, at 133. Paul Mahoney provides a detailed description of the NYSE's pre-SEC disclosure requirements. See Mahoney, *supra* note 130, at 1466.

132. See Fischel, *supra* note 31, at 125; Mahoney, *supra* note 130, at 1459. Amihud and Mendelson argue that exchanges would provide trading rules that benefit investors only if firms, and not exchanges, choose where a security is listed (in the context of multiple listing of shares or the trading of derivative securities). See Amihud & Mendelson, *supra* note 31, at 1442-46. The issues of interest here, however, involve issuer-shareholder transactions and not trading rules. The concerns of Amihud and Mendelson and other critics of exchange self-regulation (which focus on exchanges' mismatched incentives regarding trading rules that can exploit investors, see, e.g., Mahoney, *supra* note 130, at 1462-63), are thus not relevant to the discussion.

133. The transaction cost savings would obviously be reduced if a firm's shares were traded on more than one exchange. Even if the secondary exchange were to adopt a regime that recognized the primary exchange's rules as governing all issuer shares regardless of transaction location, investors still would have to know which exchange was the primary one.

firms traded over-the-counter ("bulletin board" and "pink sheet" issues), it might be more cost-effective for a state, rather than for the firms' market makers to organize and operate a separate securities regime.

State regulation would, however, offer some decided benefits over stock exchange regulation: a more effective mechanism of private dispute resolution for securities suits against issuers, and a public enforcement system, should the deterrent effect of criminal prosecution for securities law violations be a necessary complement to civil liability. Class action litigation is not well-suited for private arbitration,<sup>134</sup> and it is not surprising that arbitration programs currently administered by exchanges resolve individual complaints against brokers, not class complaints against issuers. As a consequence, even when courts have permitted classwide arbitration, they have retained substantial judicial involvement, including the initial determination of the certifiability of the class and review of the settlement.<sup>135</sup> Thus, state or federal courts would be required to enforce the exchanges' regulatory regime. This creates two difficulties. First, the use of tribunals not operated by exchanges externalizes the cost of their legal proceedings, which is a disadvantage from a social welfare, as opposed to investor, perspective. With state securities regulation, the fees the states earn in the registration process would defray the costs of administering securities cases.

Second, regulatory competition is most effective when the sovereign's jurisdiction includes both the court and the legislature. Canada, for instance, has not developed a vigorous charter competition across the provinces in large part because the provincial governments do not control the adjudication of corporate law disputes; securities administrators (of any province) and the national supreme court share that authority with the incorporation province.<sup>136</sup> This renders it impossible for a province to guarantee a responsive legal regime to prospective incorporators, because a securities administrator can impose obligations on firms countermending provincial laws. A similar difficulty would be experienced by exchanges that were unable to

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134. The hybrid use of courts and arbitrators in class arbitration suggests some of the difficulties. *See, e.g., Keating v. Superior Court*, 645 P.2d 1192, 1214-18 (Cal. 1982) (Richardson, J., dissenting) (describing problems with class arbitration). For a discussion of these and other difficulties by proponents of arbitration, see G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C. L. REV. 517, 551, 553-55, 561 (1989); and Note, *Classwide Arbitration: Efficient Adjudication or Procedural Quagmire?*, 67 VA. L. REV. 787, 799, 805-06 (1981).

135. *See Keating*, 645 P.2d at 1209-10 (holding that judicial involvement in class arbitration includes determination of certification and notice to class, supervision of the adequacy of counsel, and dismissal or settlement, and remanding to the trial court to determine the feasibility of the class); *Lewis v. Prudential Bache Sec.*, 235 Cal. Rptr. 69, 75-76 (Ct. App. 1986) (finding class arbitration feasible, and leaving to the trial court the determination of all issues necessary to certify the class and to provide proper notice); *Izzi v. Mesquite Country Club*, 231 Cal. Rptr. 315, 322 & n.6 (Ct. App. 1986) (remanding to the trial court to determine certifiability of the arbitration class and noting the preferability of court determination of any class action problems involving notice and discovery). None of the cases permitting classwide arbitration has involved securities law claims.

136. *See Ronald J. Daniels, Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 182-84 (1991).

adjudicate all of the disputes arising under their securities regimes. This problem is, in fact, raised in a weaker form even under the competitive federalism proposal advocated in this Article, for unless firms adopt forum clauses specifying that all securities claims are to be adjudicated in courts of their securities domicile, investors would be able to file in non-domicile courts. Although these courts would apply the law of the domicile, they might lack the expertise to adjudicate disputes as effectively as the domicile.<sup>137</sup> In sum, regulation by exchanges will at best be a dual regulatory system, with much of the enforcement of exchange rules performed by the government.<sup>138</sup>

It is important to note that state competition for securities regulation would not preclude exchange-based regulation. A state could, for instance, adopt a securities regime only for non-exchange-traded corporations, or enact no mandatory disclosure requirements at all, thereby leaving the determination of such requirements to exchanges. Because such an outcome would be within the realm of possible outcomes under competitive federalism, the prudent approach to regulatory policy reform would be to implement incremental experimentation: Replace the current monopolist regulator with state competition and permit the competitive process to reach the judgment that an exchange-based securities regime provides a set of rules as good as or more optimal than those provided by the states.

## II. IMPLEMENTING THE MARKET APPROACH TO SECURITIES REGULATION

Operationalizing a market approach to securities regulation for issuers requires two legislative reforms. The first and more straightforward reform is to make the federal securities laws optional. This could be achieved by an act of Congress. Alternatively, the SEC could cede its exclusive authority over public corporations under its newly granted exemptive power.<sup>139</sup> This solution is, however, akin to asking the agency to put itself out of business, behavior that would be decidedly out of character for an agency that has historically sought to increase, not to decrease, its jurisdictional scope.<sup>140</sup> In addition, an act of Congress expressly eliminating the SEC's exclusive regulatory authority over publicly traded firms is the preferable course of action because the statute creating the SEC's exemptive authority also preempted the states from applying registration requirements to nationally

137. See *infra* Section II.A; Subsection III.A.2.

138. Cf. Mahoney, *supra* note 130, at 1498-99 (discussing the need for government assistance in deterring exchange-regulation fraud).

139. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 105, 110 Stat. 3416, 3423 (codified at 15 U.S.C.A. §§ 77z-3, 78mm (West 1997)).

140. For an analysis of the SEC's failed effort to expand its jurisdiction to include derivative securities, see Romano, *supra* note 128, at 355-80.

traded securities.<sup>141</sup> The facial inconsistency between using the exemption to increase state authority when Congress was otherwise reducing state authority would provide opponents of the market approach to securities regulation reform the opportunity to use litigation to delay, if not defeat, its implementation.

The second major policy reform, adapting the choice-of-law rule governing securities transactions (site of sale) to one compatible with competition (issuer domicile), could be more complicated to accomplish because it would entail coordination by the states to adopt a new rule. It would therefore be more expedient for the congressional legislation making the federal regime optional also to institute the requisite change in choice of law, and this Article advocates such an approach. But because Congress has not typically legislated choice-of-law rules, this part of the Article not only explains the requisite change, but also justifies its adoption and critiques the reigning conflicts approach.

Two additional requirements for the successful implementation of the proposal are also discussed in this part: disclosure of the securities domicile to the purchaser of a security at the time of the purchase and a shareholder vote to accomplish a change in securities domicile. These refinements would ensure that the new market-oriented regime meets the stated goal of the federal securities laws: investor protection.

#### A. *An Internal Affairs Approach to the Choice-of-Law Rule for Securities Transactions*

With a market approach to securities regulation, only one sovereign's law can apply to an issuer's securities transactions. This means that only one state's securities law would govern securities transactions when the SEC option is not invoked. Similarly, when the SEC regulatory option were selected, it would preempt all state securities regulation, including antifraud provisions. The state with legislative jurisdiction<sup>142</sup> must be connected to the issuer to ensure that state competition operates properly—that one state's law governs and that it is the state chosen by the issuer. This would necessitate recrafting the reigning choice-of-law approach, which follows the site of the securities transaction and not the issuer's domicile.

141. See National Securities Markets Improvement Act § 102, 110 Stat. at 3417 (codified at 15 U.S.C.A. § 77r).

142. I adopt here terminology more commonly used in the international, as opposed to domestic, law setting: Legislative or prescriptive jurisdiction is "the authority of a state to make its laws applicable to particular conduct, relationships or status" (whether or not that state is the forum state), GARY B. BORN, INTERNATIONAL CIVIL LITIGATION IN UNITED STATES COURTS 491 (3d ed. 1996), as distinct from judicial jurisdiction, the power of a court to adjudicate a dispute, which, for U.S. courts, requires both personal jurisdiction and subject matter jurisdiction, *see id.* at 1-2. The federal securities laws confer both prescriptive and subject matter jurisdiction on federal courts.

1. *Applicability of the Internal Affairs Approach to Securities Transactions*

The prevailing choice-of-law approach to securities transactions is codified in provisions of the Uniform Securities Act: The applicable law is that of the site of the transaction, which is the state in which either the offer or the acceptance to buy the security takes place.<sup>143</sup> More than one state can claim legislative jurisdiction over a transaction under this approach, and the state whose law governs is not connected to the issuer.

The present choice-of-law rule, under which the securities law varies across a firm's stockholders based on where they purchased their shares, has a number of undesirable consequences for a legal system. These include lack of uniform treatment across similarly situated individuals and unpredictable standards of conduct for issuers, given the possible application of fifty-one (state and D.C.) statutes. These difficulties are, in fact, on occasion presented as the reason for the federal securities laws in cases involving the states' overlapping jurisdiction with the federal regime, such as the regulation of broker-dealers.<sup>144</sup> In the corporation code setting, the operational problems created by an absence of uniformity and predictability due to multistate shareholders are eliminated because the choice-of-law rule recognized by all of the states fixes one state's law, that of the incorporation state, as governing all shareholders' claims. This choice-of-law rule is referred to as the "internal affairs doctrine," because the subject matter of corporate law is characterized as the internal affairs of the corporation.<sup>145</sup>

The rationale for application of the internal affairs rule to corporate law disputes is equally applicable to the choice of law for securities transactions. In particular, choice-of-law commentators justify the internal affairs doctrine by the need for uniform treatment of shareholders. For example:

It would be intolerable for different holders of the same issue of stock to have different sets of rights and duties by reason of their stockholdings, perhaps according to the laws of the various places at which they acquired their stock. Unity of treatment is desirable, and the only single law by which it can be achieved is that of the corporation's domicile.<sup>146</sup>

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143. See UNIF. SEC. ACT § 414, 7B U.L.A. 672 (1985); see also, e.g., CAL. CORP. CODE § 25008 (Deering 1997) (codifying section 414).

144. See, e.g., *Orman v. Charles Schwab & Co.*, 676 N.E.2d 241, 246 (Ill. App. Ct. 1996) (refusing to apply state law to claims against a broker because such application would frustrate, if not destroy, the goal of federal uniformity, and stating that "if uniformity is not to prevail, neither rule 10b-10 nor the SEC would serve any function or purpose in regulating disclosure").

145. See RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 302 (1971).

146. ROBERT A. LEFLAR ET AL., *AMERICAN CONFLICTS LAW* 700 (4th ed. 1986). For a similar analysis by a choice-of-law scholar who specializes in corporate law issues, see P. John Kozyris, *Some Observations on State Regulation of Multistate Takeovers—Controlling Choice of Law Through the Commerce Clause*, 14 DEL. J. CORP. L. 499, 509-11 (1989).

The *Restatement (Second) of Conflicts of Law* similarly stresses as the rationale for preserving the internal affairs rule the need for “[u]niform treatment of directors, officers and shareholders . . . which can only be attained by having [their] rights and liabilities . . . governed by a single law.”<sup>147</sup> The Supreme Court has also followed this approach in considering whether state takeover laws violate the Commerce Clause. The Court’s validation of such statutes depends critically on a state’s exclusive legislative jurisdiction as the incorporation state (that is, on the internal affairs rule), which avoids the impermissible risk of a corporation’s encountering “inconsistent regulation by different States.”<sup>148</sup>

Application of the internal affairs rule to securities transactions should go further than covering litigation arising from initial public offerings under state registration requirements and should include secondary market trading. Fraud claims against an issuer should be uniformly adjudicated across investors. It is even more troubling to differentiate fraud claims from corporate internal affairs than to differentiate securities registration requirements from corporate law. There is no plausible rationale for distinguishing a fiduciary standard of conduct to govern an officer’s or director’s judgment concerning a corporate transaction, such as payment of a dividend or undertaking a merger, from that officer’s or director’s judgment concerning disclosure about the firm’s performance in a public document. Nor is there a rationale for permitting the differentiation of such standards across shareholders. Yet choice-of-law rules establish the application of one state’s (the incorporation state’s) standard to fiduciary duties in corporate law but leave the latter decision on disclosure to vary with the investor’s domicile, even though a duty of full and fair disclosure is at the heart of the fiduciary duties of state corporate law. Such intellectual incoherence concerning fiduciary conduct is the fallout of current choice-of-law doctrine.

The bizarre possibility of fiduciary standards differing across shareholders according to their residence (or other location of their stock purchase or sale) has not yet been the focus of legislators’ or commentators’ attention because there have not been many cases involving conflicting fiduciary standards: The vast majority of securities claims are brought in federal court and settled.<sup>149</sup> In particular, the problem of certifying a class when the standard of liability depends on the shareholder’s domicile or investment contract situs has not been raised with any frequency in the securities context, in contrast to the mass tort product liability context.<sup>150</sup> If securities cases are filed increasingly in

147. RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 302 cmt. e.

148. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987). For an analysis of the relation of the *CTS* decision to the corporate choice-of-law rule, see Kozyris, *supra* note 146, *passim*.

149. See Vincent E. O’Brien, *A Study of Class Action Securities Fraud Cases 1988-1996*, at 4 (visited Dec. 28, 1997) <<http://www.lecg.com/study2.htm#att>>; see also GRUNDFEST & PERINO, *supra* note 3, at 9, 31.

150. Cf. *Amchem Prods., Inc. v. Windsor*, 117 S. Ct. 2231, 2249-50 (1997) (affirming the appellate court’s rejection of an asbestos class action settlement for failing to meet statutory class requirements, and suggesting that the predominance of common issues that is a problem in mass tort litigation may not be

state, rather than federal, courts, whether in response to the 1995 securities litigation reform<sup>151</sup> or for other reasons, such as a more amenable settlement process,<sup>152</sup> then the class certification issue will take on a pressing importance. Beyond accomplishing this Article's immediate aim of empowering investors by creating a competitive regulatory regime, extending the internal affairs rule to state securities fraud claims would have the salutary effect of disposing of a thorny substantive law problem of varying liability standards, thereby ensuring that a class could be certified.

An additional salutary effect of following an internal affairs approach to securities regulation would be eliminating the potential problem of under-enforcement with multiple potential regulators. Without such an approach, ambiguity in regulatory responsibility can lead to regulatory free riding, as each regulator expects another regulator to be responsible. This is an increasing possibility with the expansion of Internet trading.<sup>153</sup> The internal affairs rule specifies precisely one regulator, the issuer's securities domicile, thereby removing the free-riding problem.

## 2. *Flaws in the Reigning Choice-of-Law Approach to Securities Transactions*

Conflict-of-law scholars typically rationalize the disparate choice-of-law approach to securities law that insulates state regulation of transactions in foreign corporations' shares from application of the internal affairs rule by contending that individual securities transactions do not implicate concerns

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a problem in securities fraud). In a small number of securities cases, the courts have referred to the class certification issue in passing and largely ignored it when certifying the federal class, adding, on occasion, the proviso that the class could be decertified or divided up at a later date if individual state law issues presented a problem. *See, e.g.,* *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425, 1460-61 (S.D. Cal. 1988) (holding that for purposes of the state securities claim, the federal class, if certified, would need to be divided into subclasses of California and non-California investors); *Weinberger v. Jackson*, 102 F.R.D. 839, 847 (N.D. Cal. 1984) (certifying a class despite the assertion that a need for individual determinations of state law applicable to members' claims would overwhelm the commonality of the class, by finding the assertion of a conflicts problem premature as the defendants did not show that there was a true conflict among states' interests). Moreover, when the federal suit thereafter settled, there was either no mention of the individual state law determination issue, *see, e.g.,* *Weinberger v. Jackson*, No. C-89-2301-CAL, 1991 U.S. Dist. LEXIS 3938 (N.D. Cal. Mar. 19, 1991), or the federal class was certified without any mention of the need to subdivide it for the state claims, *see, e.g.,* *In re U.S. Grant Hotel Assoc. Sec. Litig.*, 740 F. Supp. 1460, 1464 (S.D. Cal. 1990) (declaring settlement of the *Lubin v. Sybedon Corp.* litigation). *Matsushita Electric Industrial Co. v. Epstein*, 116 S. Ct. 873 (1996), in which a state court settlement disposed of federal securities claims, did not raise the multijurisdictional issue, because the state class action was a corporate law claim for breach of fiduciary duty and thus only one state's law applied to the class members. *See id.* at 882.

151. *See supra* notes 1-3 and accompanying text (discussing the impact of the 1995 Act on filings).

152. *See* Marcel Kahan & Linda Silberman, *Matsushita and Beyond: The Role of State Courts in Class Actions Involving Exclusive Federal Claims*, 1996 SUP. CT. REV. 219, 234-48 (discussing use of state courts to settle federal claims).

153. *Cf.* Clay Harris, *European Regulators Probe Defunct 'Virtual' Brokerage*, FIN. TIMES, Dec. 22, 1997, at 16 (reporting that an Internet broker that sold U.S. over-the-counter shares globally was being investigated by four nations' regulators after operations ceased).

about uniformity.<sup>154</sup> The explanation advanced for the distinction has two prongs: (1) In stock transactions, the individual purchasers are not yet shareholders (i.e., not members of the “corporate community”) and therefore the transaction can be characterized as having purely local effect, which is said to give the buyer’s domicile state an interest in regulation more significant than that of the issuer’s state; and (2) a corporation can avoid a state’s regulation by not selling its shares in that state, and thus need not be subject to inconsistent regulations.<sup>155</sup> The choice-of-law distinction between corporate and securities law is a legerdemain, but it has a certain practicality: It is more feasible for a corporation to issue fifty different disclosure statements to accompany the registration of securities than it is to operate with fifty different policies on dividend payouts and voting rights.

The flaw in the choice-of-law analysis that distinguishes corporate and securities laws is, however, easy enough to identify. The common shares of a corporation are the same in whatever state they are sold, and it is arbitrary to apply different criteria to transactions in the same securities simply because of differences in purchasers’ residences. Indeed, securities litigation between investors and issuers is not individualized litigation: Management’s defective disclosures are not differentially or personally directed at particular investors in the anonymity of modern capital markets, and the composition of the class of affected shareholders (those who entered into transactions in the relevant interval) is therefore fortuitous. In short, neither the prospective feature of the shareholder relation for a buyer of new securities nor the voluntary choice of selling securities in particular states can be characterized as individualizing the multiparty context of the corporate contract sufficiently to overcome the desirability of regulatory uniformity across security transactions for the issuer, as well as for investors, as they bear the increased cost of compliance with a panoply of regimes.

The demand for uniform and consistent treatment across investors is, in fact, recognized by the states’ voluntary refusal to exercise regulatory authority over the securities of interstate (exchange-traded) corporations. The shift in legal regime from mandatory to optional federal coverage would not alter the desirability of this approach. Just as the federal law has trumped securities choice-of-law analysis under the exemptive policy of the state statutes, where a public corporation has chosen a specific state over the SEC as its securities regulator, registration requirements should be governed by that state’s law.

Moreover, the limitation of a court’s exercise of local legislative jurisdiction by a contract’s choice-of-law clause’s selection of a foreign state

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154. See, e.g., RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 302 cmt. e (1971); Kozyris, *supra* note 146, at 520-21.

155. See Kozyris, *supra* note 146, at 521.



is well-established.<sup>156</sup> Although there are specific circumstances when courts refuse to enforce such provisions—when there are defects in contract clause formation, such as when the contracts are unconscionable adhesion contracts, or when the contracts contravene the public policy of the state that would otherwise exert legislative jurisdiction<sup>157</sup>—they are not relevant for securities law transactions. First, given the multiplicity of investment choices, securities transactions are not adhesion contracts. In addition, the proposed notice requirement concerning which state's law applies<sup>158</sup> would render highly improbable the possibility that an investor's agreement to a choice-of-law clause was fraudulently obtained. Second, securities transactions specifying the governing law of a state other than the buyer's state are also not contracts in contravention of public policy, the enforcement of which would deprive the plaintiff of an adequate remedy. Even in the remote possibility that the chosen securities domicile had no securities regulation at all, the absence of an appropriate remedy would not be an issue because a defrauded purchaser could still pursue a complaint under that state's common law fraud and fiduciary doctrines.<sup>159</sup>

The conventional conflicts-of-law objection to application of an internal-affairs-type doctrine to securities transactions, which is captured by the public policy exception to choice-of-law clause enforcement and to requirements that the chosen state have a reasonable connection to the transaction or the parties, is that the investor's domiciliary state has a more important "interest" in a securities dispute than the issuer's domicile.<sup>160</sup> The policy concern that is confusedly asserted as a state's "interest" in this instance is that the issuer's state will not provide an adequately protective regulatory regime against fraudulent sales practices because the buyers (or a majority of them) are not its citizens. This concern is founded, however, on a mistaken premise: The research on state competition for charters indicates that states that compete

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156. See, e.g., BORN, *supra* note 142, at 654-55 (stating that the contemporary approach in U.S. law regards choice-of-law provisions as presumptively enforceable); LEFLAR ET AL., *supra* note 146, at 415-19 (noting that authorities generally both approve of the right of parties to determine themselves what law governs contracts and prefer this basis for contract choice of law (citing RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 187)).

157. See, e.g., BORN, *supra* note 142, at 655, 661; LEFLAR ET AL., *supra* note 146, at 416-17; cf. The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 12-13, 15-16 (1972) (expressing similar concerns in enforcing a choice-of-forum clause).

158. See discussion *infra* Subsection II.B.1.

159. See Roby v. Corporation of Lloyd's, 996 F.2d 1353, 1365-66 (2d Cir. 1993) (upholding a United Kingdom choice-of-law contract provision over federal securities law claims, while noting the adequacy of remedies in English law). The adequacy-of-the-remedy prong of the Supreme Court's exemptions from upholding contractual choice-of-law clauses has been raised in securities law cases because the federal securities laws prohibit waiver of compliance. See 15 U.S.C. §§ 77n, 78cc(a) (1994). Were the federal statutes optional, the anti-waiver provisions would not apply to firms opting out of the federal regime, and the argument against enforcing a choice-of-law clause would be even more attenuated than it is at present.

160. See LEFLAR ET AL., *supra* note 146, at 417 n.18 (discussing the relationship between the "reasonable relation" requirement and the public policy limitation on choice-of-law clauses under the Uniform Commercial Code).

successfully for corporate charters do not enact regimes that diminish investors' wealth.<sup>161</sup> Investors would benefit from an internal affairs rule for securities regulation as well because, as occurs in the chartering market, investors' preferences drive the regulatory competition. In addition, the proposed requirement that disclosure of securities domicile must be provided upon stock purchase<sup>162</sup> would eliminate the concern of the buyer's state that its citizens were inadequately protected: Domicile notice would ensure that buyers were informed of which state's regime is applicable. If the regime of the issuer's state were less favorable to investors than that of the buyer's state, the investor would pay less for the shares or not purchase them in the first place. Consequently, a requirement of physical connection to the state to make contracting parties' choice of law effective makes absolutely no sense in the securities context.<sup>163</sup>

### 3. *Which State Should Be the Securities Domicile?*

There are three plausible candidates for the single state whose rules govern a firm's securities transactions in place of the SEC: (1) a state chosen specifically for securities regulation by the issuer; (2) the issuer's incorporation state; and (3) the issuer's principal place of business. The first approach would be implemented through a choice-of-law clause in the corporation's charter (and noticed on the security). It would create, in effect, a statutory domicile for securities law. Under a choice-of-law clause approach, the choice of securities domicile could vary across a firm's financial instruments, as well as differ from the firm's statutory domicile (its incorporation state). The other two approaches operate automatically by the firm's choice of statutory domicile or headquarters site and hence would not require independent action by the corporation to effect a securities domicile choice, unless that choice were the SEC.

The least desirable securities domicile approach is to choose the state of principal place of business. This is because a physical presence requirement introduces friction into state competition. When physical and human capital must be relocated in order to effect a change in legal regime, a firm's decision to move to a more preferable securities domicile is considerably, if not prohibitively, more expensive than when such a relocation can be accomplished by means of a paper filing. Few firms would change domicile

161. See *supra* Subsection I.B.2.

162. See discussion *infra* Subsection II.B.1.

163. The *Restatement*, see RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 187 cmt. f (1971), the Uniform Commercial Code, see U.C.C. § 1-105 (1996), and many states, see, e.g., N.Y. GEN. OBLIG. LAW § 5-1401 (Consol. Supp. 1997), recognize that geographic contacts may be unnecessary for parties' effective choice. See, e.g., LEFLAR ET AL., *supra* note 146, at 417-18 (discussing the implications of the New York provision).

to take advantage of incremental legal improvements under such a domicile approach compared to the other two approaches and, correspondingly, the incentives of states to provide securities codes responsive to investor preferences would be sharply diminished. The difference between the domicile choice of incorporation state (statutory domicile) and state of physical presence (referred to as the “*siège réel*,” the corporation’s real or effective seat, in some European nations) in corporate law is, in fact, a principal reason for the absence of charter competition across the nations of the European Union compared to U.S. states.<sup>164</sup>

Whether the most desirable approach for fostering competition over securities regulation is the choice-of-law clause or the incorporation state approach depends, in large part, on whether there are synergies from one state’s administering both the corporate and securities law regimes. This is because the incorporation state approach harnesses the in-place apparatus of charter competition to the securities context. In general, such synergies should be substantial because corporate law expertise readily transfers to securities law. For instance, with one state’s law adjudicating both corporate and securities issues, the standard for directors’ and officers’ fiduciary duties, including disclosure obligations, would be harmonized.<sup>165</sup> More specifically, all litigation relating to conduct during hostile takeovers would be governed by one state’s law. In addition, all legal issues concerning shareholder meetings would be subject to the same legal regime, eliminating the considerable confusion surrounding the SEC’s rules regulating shareholder proxy proposals, which simultaneously look to state corporate law’s allocation of authority between shareholders and managers and effectively ignore it.<sup>166</sup> Where the synergies of an incorporation state securities domicile include the expertise of the judiciary, a firm could adopt a forum clause to ensure that securities claims are filed in the incorporation state.<sup>167</sup>

164. See ROMANO, *supra* note 4, at 132-33.

165. Indeed, two Supreme Court cases interpreting the federal securities law illustrate the difficulties created by the two regimes’ being distinct. In *Basic Inc. v. Levinson*, 485 U.S. 224, 232-34 (1988), while imposing disclosure duties on managers regarding merger negotiations, the Court rejected as a valid concern the acquirer’s desire for secrecy when nondisclosure for such reasons would not obviously be a breach of fiduciary duty at state law. In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102-06 (1991), a case involving proxy statement misstatements, the Court did not find the requisite causation for a private right of action under section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1994), where the complaining shareholders’ votes were not required by state law to authorize the action subject to the proxy solicitation. The Court left open the question whether there would be sufficient causation if the shareholders lost a state remedy otherwise available because of the misstatement. See *Virginia Bankshares*, 501 U.S. at 1107-08.

166. Compare 17 C.F.R. § 240.14a-8(c)(1) & (7) (1997) (stating that firms can exclude proposals that are “not a proper subject for action by security holders” and involving “ordinary business operations”), with Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12999, 41 Fed. Reg. 52,994 (1976) (permitting, where the subject is not proper for shareholder action, proposals couched in precatory language because recommendations to the board are not improper actions at state law, and permitting proposals involving ordinary business, such as employment practices, where they implicate social policy).

167. Such clauses are presumptively enforced at federal common law and by most states. See *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 593-95 (1991); Michael E. Solimine, *Forum-Selection Clauses*

But even if the substantive law synergies were limited in number, there is a further benefit associated with the incorporation state approach. Litigation costs would be reduced because the significance of line-drawing over whether a dispute implicates securities or corporate law is reduced, as the same sovereign's rules would apply in either scenario.

Although the arguments supporting the choice of incorporation state as the securities domicile appear to be compelling, there are countervailing considerations that militate against mandating such an approach rather than leaving the choice of domicile up to the issuer (the choice-of-law clause approach). First and most important, the choice-of-law clause approach obviates the need to guess whether the potential synergies of one regime for corporate and securities law are substantial—market participants' domicile choices would provide the information. It is therefore most consistent with the market approach to securities regulation. Second, given the variety of securities issued by firms, it is possible that states would specialize in different securities, and consequently, that firms could benefit from being able to select different domiciles for different issues. This is particularly relevant for debt securities, where there are no regulatory synergies with the incorporation state because corporate law deals solely with manager-shareholder relations.<sup>168</sup> Third, permitting a self-standing securities domicile might enhance state competition, as a state could decide to compete more vigorously for securities issues than for corporate charters and thus prevent Delaware from being able to slouch on the securities regime it offers because of its success in obtaining incorporations.

#### 4. *Adapting the Securities Law Choice-of-Law Regime to the Market Approach*

Choice-of-law rules are generally creatures of judicial, rather than legislative, determination. But statutes may codify choice-of-law rules. For instance, some states have enacted the Uniform Securities Act's choice-of-law provisions, which select the most common judge-made choice, the state where the securities are offered for sale.<sup>169</sup> In addition, some states have adopted

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*and the Privatization of Procedure*, 25 CORNELL INT'L L.J. 51, 63, 69 (1992).

168. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1985) (finding that a board breached its fiduciary duty to shareholders by engaging in a takeover defensive tactic that protected noteholders, whose rights are a matter of contract); *Harff v. Kekorian*, 324 A.2d 215, 219-20 (Del. Ch. 1974) (stating that bondholders cannot bring a derivative suit), *rev'd on other grounds*, 347 A.2d 133, 134 (Del. 1975). A corporate code would be relevant for a bond contract only when a corporation is close to insolvency, for at that point some states might hold that the board's fiduciary duty encompasses creditors. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at \*108 (Del. Ch. Dec. 30, 1991) (suggesting that a board's duty shifts away from shareholders when the company enters the "vicinity of insolvency").

169. See, e.g., CAL. CORP. CODE § 25008 (West 1997) (codifying UNIF. SEC. ACT. § 414, 7B U.L.A. 672 (1985)).

choice-of-law clause statutes, which guarantee enforcement of contractual choice-of-law provisions regardless of standard conflicts rules, such as whether the contracting parties have any relationship to the state.<sup>170</sup> Coordinated statutory action by the states altering the site-of-sale rule to an issuer securities domicile rule, such as by amendment to the Uniform Securities Act, would be a more expeditious route than reliance on judicial action for implementing the new domicile choice-of-law approach.

An even more efficacious alternative than coordinated state statutory action would be for Congress to legislate the mandatory application of the issuer domicile approach as the securities transactions choice-of-law rule in the statute rendering the federal securities regime optional. Although Congress has not mandated choice-of-law rules, it could do so under its Commerce Clause and Article IV powers.<sup>171</sup> Congressional action is the preferred mechanism for implementing the securities domicile choice-of-law rule, whether the incorporation state or choice-of-law clause approach is chosen, because it is the most expeditious method for achieving that end, as it does not require coordination by fifty state courts or legislatures.

Coordination can occur—the universal recognition of the internal affairs approach to corporate law is a prime example—but it takes time. For instance, most states enforce forum selection clauses; this sea change from an earlier era when such clauses were considered presumptively invalid has occurred by a mix of state legislative and judicial action, exemplifying a policy of reciprocity (that is, the states recognize residents' contracts to litigate in another state) rather than conscious coordination through adoption of a uniform act.<sup>172</sup> But, while the gradual shift to acceptance has been led by Supreme Court decisions upholding such clauses in federal cases over the past two decades,<sup>173</sup> there are still some states that do not enforce them.<sup>174</sup> If there is a similar pattern in the securities context as in the recognition of forum selection clauses—increasing acceptance of the concept of securities domicile with an

170. See, e.g., DEL. CODE ANN. tit. 6, § 2708(c)(ii) (1993) (requiring a \$100,000 minimum contractual amount); N.Y. GEN. OBLIG. LAW § 5-1401 (Consol. Supp. 1997) (requiring a \$250,000 minimum contractual amount).

171. See LEFLAR ET AL., *supra* note 146, at 6. They note:

[A]ssuming that the local law of a particular American state permits one of its courts to act in a given instance, the only authority which can effectively say that the court may not apply the law that it chooses is that of the federal government, under the powers delegated to it by the Federal Constitution.

*Id.* Although there is a well-established judicial tradition upholding forum clauses in commercial contexts, including securities transactions, see, e.g., *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519-20 (1974); *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 18-19 (1972), to the extent there might be a question whether firms opting out of the federal regime can also opt out of the federal court system, the congressional legislation establishing the market approach should specify that federal courts are to enforce forum clauses selecting a state court.

172. See *Solimine*, *supra* note 167, at 75-76.

173. See cases cited *supra* note 171.

174. See *Solimine*, *supra* note 167, at 55, 63 & n.84 (“[A]t least four states explicitly reject . . . such clauses.”).

outstanding small number of holdouts after many years—making the federal securities regime optional would not engender successful competition in securities regulation, at a minimum in the short run, because the incentives of issuers, investors, and regulators are not aligned when the law of the issuer's selected domicile does not govern all securities transactions.

Congressional enactment of a securities domicile conflicts rule would shortcut such an evolutionary process by immediately implementing all states' adherence to the securities domicile choice-of-law approach, and would thereby preserve the advantages of the market approach. It is, perhaps, ironic that the byproduct of federal intervention in the states' securities choice-of-law rulemaking would be a greatly invigorated competitive federalism.<sup>175</sup>

### B. *Refinements to the Implementation of the Market Approach*

To ensure that the investor protection goal of the federal securities laws functions smoothly under the market approach, the congressional legislation that would render the federal regime optional and would fix an issuer domicile approach to the states' securities choice-of-law rule should contain two additional statutory mandates. These statutory requirements would establish investor safeguards at two critical transactional junctures, one occurring at the individual investor level and the other at the aggregate firm level. The first requirement is disclosure of the applicable legal regime (the firm's securities

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175. Bruce Hay has criticized adopting a non-buyer-state approach to products liability litigation, contending that state competition in choice-of-law rules is a more promising alternative approach to substantive law competition regarding such torts. See Bruce L. Hay, *Conflicts of Law and State Competition in the Product Liability System*, 80 GEO. L.J. 617, 617 (1992). He asserts that states' policies of choice-of-law rules and substantive laws are inversely correlated. Thus, when states can follow a choice-of-law rule favorable to their citizen-plaintiffs under what is referred to in choice-of-law as the "governmental interests" approach, they can adopt pro-manufacturer substantive laws to protect in-state firms without harming in-state consumers. He concludes that this scenario indicates that competition over choice-of-law rules would produce the optimal level of substantive products liability law, because it would enable states to favor consumers in the choice-of-law rule and manufacturers in the substantive law. See *id.* at 651-52.

Hay's analysis is, however, mistaken. The governmental interest approach looks to the state's substantive policy to determine a state's "interest" in a lawsuit. If a state's law favored defendant-manufacturers, then a court applying the governmental interest standard would not be able to find that the state has expressed an interest in protecting its citizen-plaintiffs. It would therefore not be able to choose a pro-plaintiff state's law to govern the dispute, as Hay expects. As a consequence, Hay's crucial assumption, that the policy underlying a state's choice-of-law rule would be the inverse of the state's substantive law, is incorrect; the two policies must be positively correlated. Hence, competition in choice-of-law rules cannot substitute for substantive law competition in the products liability setting of concern to Hay, nor in any other substantive law setting. The operation of conflicts-of-law interest analysis prevents opportunistic choices of inconsistent substantive policies and choice-of-law rules. States can, of course, compete on both choice-of-law and substantive dimensions, but the choice-of-law rule that benefits investors in the securities context, an issuer securities domicile rule, is straightforward because it fosters substantive competition, which advantages investors since their preferences dictate the competitive outcome. States would thus have an incentive to choose the issuer domicile conflicts rule. But to achieve the full benefits from competition, one state's use of the internal affairs rule must be recognized by all the other states to assure that one state's law governs all of a firm's transactions with investors. This means that the same choice-of-law rule must be uniformly applied as the choice-of-law rule across the states. Over time, states would probably do so. See *supra* text accompanying notes 172-174.

domicile) at the time an investor acquires a security; the second is a vote of the affected security holders in order to accomplish a change in securities domicile.<sup>176</sup>

### 1. *Disclosure of the Applicable Securities Regime*

For state competition to function properly, investors must know what regime will apply to a particular security.<sup>177</sup> The domicile disclosure requirement would ensure that this condition holds. To accomplish this notice function, the securities domicile should be indicated on the instrument (stock certificate or note), just as corporate law requires that restrictions on share transferability, to be effective, must be noticed on the stock certificate.<sup>178</sup> But because investors rarely receive a financial instrument even after purchase (most stock investments transfer electronically and remain physically held by the clearinghouse depository), a further mode of notice is essential. The most plausible additional means of domicile disclosure would entail a two-pronged approach, directed at both brokers and firms. First, brokers should be required to inform prospective buyers of the securities domicile at the time of purchase (or short sale). As federal broker regulation would not be transferred from the SEC under the proposed approach, such a requirement could easily be implemented by agency regulation.

Second, and more important, issuers should be required to disclose their securities domicile at the time of initial public offerings as a condition of opting out of the federal regime. The required disclosure should be permitted to take a variety of forms. Where the issuer's domicile requires use of a prospectus to sell securities, the federal requirement should be satisfied by indicating the domicile in that offering document. Where there is no prospectus

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176. Albert Breton's theory of competitive federalism offers a rationale for requiring such provisions, even though competitive securities regimes would most likely adopt the disclosure and voting requirements on their own, as a means to ensure the vitality of competition. Breton maintains that a central government can play a useful role in stabilizing competitive federalism by monitoring state activity to prevent collusion or "races to the bottom" that would undermine the benefits of competition. See ALBERT BRETON, *COMPETITIVE GOVERNMENTS: AN ECONOMIC THEORY OF POLITICS AND PUBLIC FINANCE* 251 (1996). The two statutory requirements would obviate the need for the central government to monitor actively the competition over securities regimes. But because a race for the bottom will not occur in the securities context, given the dynamics of capital markets exemplified by the corporate charter market, it is not obvious that monitoring by the central government is necessary in this context.

177. Of course, not every investor needs to know a stock's domicile; the informed investors set the price. This is the meaning of an efficient market. The best available evidence indicates that the U.S. stock market is efficient regarding publicly available information, which includes an issuer's securities domicile. See Fama, *supra* note 55, at 1577, 1607 (stating that event studies, which test the "adjustment of prices to public announcements," provide the "cleanest evidence on market efficiency"). For general models of information aggregation through prices with heterogeneously informed investors, see Alan Schwartz & Louis Wilde, *Competitive Equilibria in Markets for Heterogeneous Search Goods Under Imperfect Information: A Theoretical Analysis with Policy Implications*, 13 *BELL J. ECON.* 181 (1982); and sources cited *supra* note 21.

178. See, e.g., DEL. CODE ANN. tit. 8, § 202(a) (1996).

or other offering document requirement, the issuer should have to inform the prospective buyer of the securities domicile in writing, an obligation that could be satisfied by the issuer's contracting with the underwriting syndicate to provide the information in writing to prospective purchasers. In addition, for public offerings of a firm whose securities are already traded and whose securities domicile imposes periodic reporting requirements, disclosing securities domicile in the required documents should satisfy the issuer's federal notice requirement as long as such reports are matters of public record (i.e., filed with a state office) and thus available to prospective purchasers. Where a domicile imposes no periodic reporting requirements, voluntary disclosure of securities domicile in a public document available on a continuing periodic basis (such as in an annual financial report or proxy statement sent to shareholders for the annual meeting to elect directors, in the corporate charter on file with the Secretary of State, or in a publicly available record kept by the stock exchange on which the shares trade) should also satisfy the federal disclosure requirement. These latter forms of disclosure would also suffice for any issuer responsibility regarding domicile notice to investors who acquire securities in secondary trading markets.

Domicile disclosure would not be a costly requirement for issuers under any of the possible mechanisms that have been outlined. It would also not be costly for brokers to identify an issuer's securities domicile to prospective purchasers. But mandating disclosure of securities domicile at the time of a securities purchase is not clearly necessary to protect investors: Markets will price significant differences in securities regimes, as sophisticated investors obtain domicile information prior to their purchases, even were domicile disclosure not mandated. But, given the historical application of the federal regime to all securities, mandated domicile disclosure would go a considerable distance toward mitigating the relatively remote possibility of less sophisticated investors' not knowing that the federal regime might no longer apply. Because such confusion is most likely to occur in the initial years following the adoption of the market approach, the domicile disclosure requirement could be enacted as a sunset provision, expiring, for example, three years after the statute's effective date. For securities trading in markets where unsophisticated investors are predominant, such as penny stocks, the domicile disclosure requirement could be retained beyond such a transition period, as a protective measure for such investors.

The domicile disclosure requirement would not mandate disclosure of the substantive content of the relevant regime. Firms could, of course, provide such information to investors in their domicile disclosure, but the statutory requirement would leave acquisition of such details to investors. To the extent there might be concern that unsophisticated investors might mistakenly assume that all state regimes contain similar protections and could thereby be duped into buying penny stocks registered under a regime that institutional investors



shun, a written disclaimer could be required at the time of such securities' acquisition, in addition to the domicile disclosure, that would inform investors, in large print, that "their rights under the securities laws may differ significantly across the states." Alternatively, a requirement could be fashioned to disclose the details of a regime's significant differences. I am reluctant to advocate such an approach given the costly line-drawing questions it is likely to entail. It would, at minimum, require careful drafting to specify the norm against which differences are to be measured, such as the rules of a majority of the states, the old federal regime, and so forth. The prospect of litigation over the fulfillment of the domicile disclosure requirement under such an alternative leads me to opt for the more generic disclaimer approach, should any disclosure beyond the domicile be required.

## 2. *Security Holder Approval of Securities Domicile Changes*

A different set of concerns regarding the securities domicile choice is implicated when an issuer determines to change its securities domicile midstream than is implicated when a shareholder purchases a security with a given domicile. Namely, the price the investor paid for its shares will not reflect the value of the new domicile (unless the change was anticipated at the time of purchase). This is of concern if corporate insiders can behave opportunistically and move to a securities domicile that requires less disclosure or has a lower securities fraud standard than the original regime. Such a move could shift value away from the public to insiders' shares, assuming, of course, that outside investors did not anticipate such opportunistic behavior and paid less for the more protective domicile in the first place.

Insider opportunism regarding domicile choice could be mitigated by requiring the voting approval of the affected security holders before a domicile change can be effected.<sup>179</sup> As in the corporate law context, the federal statute would create a minimum default for the required vote of a simple majority. Firms wishing to operate under a higher, supermajority voting requirement would therefore be able to do so. The most practical means of implementing a supermajority voting requirement would be for the corporation to include such a rule in its corporate charter (and, if commitment to such a voting rule was of concern, to subject its repeal to an analogous supermajority vote). States could also establish higher voting minimum defaults in their securities codes. A supermajority voting default to accomplish changes in securities domicile, however, would not be desirable from the global perspective of competitive federalism: When exit from a regime is too difficult, the signals

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179. A change in incorporation state (the firm's statutory domicile) requires a shareholder vote because it is effected by a merger of the corporation into a subsidiary incorporated in the new domicile state. Under all state corporation codes, a merger requires shareholder approval. *See, e.g., id.* §§ 251-252.

from migration patterns concerning firms' preferred provisions are weakened, and the beneficial effects of competition stymied.

A majority voting requirement for securities domicile changes could ultimately aid insiders. In the absence of a voting requirement, it is possible that investors would expect value-diminishing moves to occur and pay less for their shares initially. The presence of a voting requirement would commit insiders to proposing a domicile change only when the new regime increases firm value, rather than when the regime disproportionately benefits their own shares, and, as a consequence, investors would not discount shares for opportunistic midstream domicile changes. To the extent that promoters value such a precommitment device, a federal voting requirement may well be unnecessary because competitive state codes would include such a requirement. Nevertheless, placing the requirement in the federal statute would create a more robust commitment device because, as an integral part of the regulatory regime, it would be difficult to rescind. It is, for example, more difficult to change congressional than state legislation.

Some commentators contend that shareholder voting is not an effective safeguard against insider opportunism because it is irrational for shareholders to vote—that is, an individual shareholder's cost of becoming informed in order to vote his or her interest outweighs the pro rata benefit he or she will receive from a correct outcome.<sup>180</sup> This contention, in my judgment, is vastly overblown.<sup>181</sup> In a capital market dominated by institutional investors holding portfolios of stock, issues are repeatedly raised across portfolio firms, reducing information costs significantly on any one vote. Moreover, the preferences of these informed voters—institutional investors—regarding securities regimes would not conflict with those of uninformed individual investors. This is because the vast majority of institutional investors, whose choices would determine the regime, do not possess private information or great skill at obtaining such information, and they would accordingly not benefit from a regime that minimizes firms' public disclosures.<sup>182</sup> It is possible that some

180. See, e.g., Gordon, *supra* note 129, at 1575.

181. In particular, it can be shown that, under plausible assumptions concerning the breakdown of stock ownership among insiders, outside blockholders, and dispersed investors, a rational strategy for an uninformed shareholder concerned about the possibility of opportunism would not be the strategy of always supporting management with "yes" votes, the strategy emphasized by commentators critical of shareholder voting, but rather a mixed strategy of voting randomly against management's proposals, or a strategy of not voting at all, leaving the decision to the informed voters. Both of these latter strategies are better than always voting "no," as well as always voting "yes." See Romano, *supra* note 129, at 1607-10.

182. Mutual funds, for instance, do not outperform the stock market. See, e.g., STEPHEN A. ROSS ET AL., CORPORATE FINANCE 348 (4th ed. 1996). This fact shows that these institutions do not have access to, or a comparative advantage in processing, private information, and there is little reason to think this circumstance would change with the switch to a competitive regime. The criticism leveled at relational investing, in which institutional investors engage in active monitoring of managers, that such investors may obtain private benefits that generate a conflict between their and other shareholders' interests, thereby reducing the value of their activism, see Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1040-41 (1994); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 989 (1994), is not applicable in our context. The posited private

institutional investors possess a superior ability to process public information; such investors would support a high level of disclosure, as that furthers their competitive advantage.

A probative example of this congruence in interest between institutional and individual investors regarding disclosure policy concerns the issues sold to institutional investors under Rule 144A, which exempts such issues from federal registration and hence the prospectus disclosure requirements of the 1933 Act.<sup>183</sup> These issues have come to include disclosures equivalent to those required in the prospectuses of registered public offerings.<sup>184</sup> Although the reason for this phenomenon could be underwriter concern over liability (the 1934 antifraud provisions still apply to such offerings<sup>185</sup>), it suggests that institutional investors find issuer disclosure more cost-effective than reliance on private information collection.

Voting rights in corporate law are often accompanied by appraisal (dissenters') rights—the right of dissenters to be cashed out of the firm at a price set by a court under statutory guidance.<sup>186</sup> Appraisal rights mitigate adverse outcomes from uninformed voting: Informed shareholders can dissent and, under the statutory standard, obtain the cash value of their shares equal to the value “exclusive” of the transaction that was the subject of the vote.<sup>187</sup> Thus, for a value-diminishing transaction such as an unfavorable domicile shift, the share's appraisal value would be the stock price before any adverse effect from the market's assessment of the value in the new domicile (the outcome of the vote). Such rights could be mandated for dissenters to a domicile change. Appraisal rights, however, come with costs, such as the potential for an unwanted cash drain if many shareholders exercise their rights, the hold-up power that comes from shareholders' exercising such rights against a non-value-decreasing proposal, and imprecise valuation of the dissenters' shares that may over- or undercompensate them.

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benefits of such investors arise most frequently from the institutions' holding preferred securities, *see, e.g.*, Rock, *supra*, at 1022, but preferred stockholders do not select the regime for common stock. More important, the number of institutions that are able to attain such preferred relational positions is quite small (there are few outside investors equal to Warren Buffett whom managements are willing to trust with the rights of relational positions), and thus they will not be the marginal investor whose tastes dictate regime choices. Accordingly, the possibility of a divergence between institutional and retail investors' preferred securities regime is remote.

183. *See* 17 C.F.R. § 230.144A note (1997).

184. *See* Luis F. Moreno Trevino, *Access to U.S. Capital Markets for Foreign Issuers: Rule 144A Private Placements*, 16 HOUS. J. INT'L L. 159, 195 (1993).

185. *See* 17 C.F.R. § 230.144A (Preliminary Notes).

186. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262 (1996) (providing appraisal rights in conjunction with mergers, which require shareholder approval); MODEL BUS. CORP. ACT § 13.02 (1992) (providing appraisal rights in conjunction with mergers, asset sales, amendments of articles of incorporation that materially and adversely affect shares by specified impact, and any actions taken pursuant to a shareholder vote where charter, bylaws, or board resolution provide for such rights).

187. *E.g.*, DEL. CODE ANN. tit. 8, § 262(h) (providing that for merger dissenters entitled to appraisal, the court should determine “fair value exclusive of any element of value arising from” the merger).

There has not been empirical research examining cross-sectionally the functioning of appraisal rights for charter amendments. Such research could provide information concerning how frequently such rights are used, what the stock price reaction is to amendments when the rights are used, and whether charter amendment proposals and voting outcomes differ systematically across firms when such rights are present. In states where appraisal rights are not statutorily provided for dissenters to charter amendments, firms do not appear to include such rights in their charters.<sup>188</sup> A plausible inference from such behavior is that appraisal costs outweigh the benefits; either they are an inadequate remedy for opportunistic amendments or insiders rarely propose opportunistic charter amendments. Indeed, if midstream opportunism were rampant, institutional investors would become aware of the practice, and promoters would have incentives—higher share prices—to bind themselves against engaging in opportunistic charter amendment by providing appraisal rights for such votes or otherwise locking in initial charter provisions. Accordingly, rather than have Congress mandate dissenters' rights in the securities domicile context, their presence should be left to the decisions of securities domiciles, which can legislate such rights, and issuers, which can place such rights in their charters or bylaws if domiciles do not mandate them.

### III. THE REGULATION OF FOREIGN (NON-U.S.) ISSUERS

The desirability of regulatory competition does not stop at national borders, for the same incentives are at work in a global setting: Financial capital is as mobile across nations as it is across U.S. states, and capital providers will require higher returns from investments governed by regimes less protective of their interests, prodding firms to seek out the securities regime preferred by investors in order to reduce their cost of capital.<sup>189</sup> The market approach to securities regulation advocated in this Article should, accordingly, apply equally to U.S. and non-U.S. issuers of securities.

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188. In the course of over a decade of research requiring examination of hundreds of corporate charters, I have not come across such a provision.

189. Although investors favor their home countries in their portfolio allocations, see Kenneth French & James Poterba, *Investor Diversification and International Equity Markets*, 81 AM. ECON. REV. 222, 222 (1991), cross-border flows of capital have dramatically increased over time and are expected to continue to do so, see ALAN C. SHAPIRO, *MULTINATIONAL FINANCIAL MANAGEMENT* 403-04 (4th ed. 1991). As financial markets have been deregulated globally, international market capitalizations have increased, and the benefits of international diversification are becoming widely recognized. See SOLNIK, *supra* note 10, at v-vi. For concise reviews in the legal literature of such investment trends, see MACINTOSH, *supra* note 8, at 6-10; and Merritt Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498, 2523-25 (1997).

A. *Applying the Market Approach to Non-U.S. Issuers*

1. *The Market Approach*

Under the market approach to securities regulation, the issuer's securities domicile controls for all securities sold in the United States, whether that domicile is a U.S. state or a foreign nation. This would be a dramatic turnabout from the SEC's current practice, which assumes jurisdiction over all transactions occurring in the United States, and until recently, asserted jurisdiction over foreign transactions involving U.S. citizens,<sup>190</sup> analogous to the states' choice-of-law rule for securities transactions that looks to the sale location or purchaser domicile.

The SEC's territorial approach to jurisdiction prevents foreign issuers who are in compliance with their home states' disclosure requirements (which are less extensive than the SEC's) from listing on U.S. stock exchanges. The principal reason that the vast majority of non-U.S. firms who could qualify for exchange trading do not list in the United States is that their disclosure costs would significantly increase, particularly with respect to accounting data, as they would have to comply with the SEC's regime.<sup>191</sup> Although the precise cost of reconciliation with U.S. generally accepted accounting principles (GAAP) is not publicly available, James Fanto and Roberta Karmel report that given compliance costs, companies find a U.S. listing worthwhile only if large amounts of equity capital (over \$300 million) are required.<sup>192</sup> Other data suggestive of the costliness of reconciliation are that the London Stock Exchange lists five times the number of foreign firms that the NYSE lists,<sup>193</sup> and that, after the SEC extended its reporting requirements to foreign firms trading on the NASDAQ, the number of such listings declined by almost thirty percent over the following seven years (after having tripled over the seven years prior to the change).<sup>194</sup>

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190. See Registration of Foreign Offerings by Domestic Issuers, Exchange Act Release No. 33-4708, 29 Fed. Reg. 9828, 9828 (1964) (stating that requirements of the 1933 Act are "intended to protect American investors"); see also Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 221 (1997) (discussing the SEC's adoption of Regulation S, governing overseas transactions, which changed the regulatory emphasis from "the protection of U.S. investors, wherever they may be located, to the protection of American capital markets").

191. See James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58, S61 (1994) (noting that there are "2,000 foreign companies eligible to go on [NYSE's] list . . . were it not for SEC regulations"); James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 3 STAN. J.L. BUS. & FIN. 51, 70 (1997).

192. See Fanto & Karmel, *supra* note 191, at 71. William Baumol and Burton Malkiel point out that beyond the time and expense entailed in the translation process for GAAP reconciliation, there are difficulties arising from the fact that GAAP requirements are not adapted to the "circumstances of the foreign firm," such as the fact that GAAP rules are tailored to U.S. corporate tax rules, which vary significantly from other nations' taxation. Baumol & Malkiel, *supra* note 42, at 41.

193. See Baumol & Malkiel, *supra* note 42, at 41.

194. See Edwards, *supra* note 7, at 63.

The market approach would open up U.S. markets to non-U.S. issuers. This is a policy shift that would not only make U.S. securities regulation more respectful of other nations' policy decisions by reaffirming a norm of international comity, but would also benefit U.S. investors. They would no longer have to incur the substantial costs of purchasing shares on foreign exchanges, as they have been doing in increasing numbers to invest directly in non-U.S. corporations.<sup>195</sup>

Under the market approach, foreign firms (firms not incorporated in the United States) would be able to choose their securities domicile for U.S. trading purposes, and therefore would not need to comply with SEC disclosure requirements in order to trade in the United States. This result has some precedent: The Multijurisdictional Disclosure System (MDS) adopted by the SEC and the Ontario and Quebec Securities Commissions in 1991 enables Canadian firms to trade in the United States by complying with Canadian disclosure requirements, although they must reconcile their financial data with GAAP.<sup>196</sup> Canada is the only nation with which the SEC has entered into such an agreement, however, because its disclosure requirements are similar to U.S. requirements.<sup>197</sup> In addition, the SEC has itself relaxed its disclosure requirements for non-U.S. firms, including eliminating certain nonfinancial items such as management compensation and related party transactions.<sup>198</sup> The market approach expands the SEC's MDS without requiring that disclosure regimes be harmonized with the SEC rules or GAAP reconciliation. But it goes still further than these precedents: It would render inapplicable to such issuers the antifraud provisions of the federal securities laws (unless they opt for SEC regulation), in contrast to the MDS, which retains U.S. antifraud liability for Canadian firms. If all nations adopt the market approach, then all of a firm's shareholders would be subject to the same securities regime, wherever they purchased their shares, and there would be uniform treatment of investors, as occurs in the corporate law context. Rather than harmonization of national securities regimes, the universal application of the market approach should be the goal of international securities regulation.

The SEC was unwilling to extend the multijurisdictional accord globally to nations with lower levels of disclosure than it requires because, in its view, investors in U.S. markets would not be adequately protected if firms traded without releasing all of the information that SEC and U.S. accounting standards mandate. There is, however, an absence of evidence that the lower levels of disclosure in other nations adversely affect investors. Studies of price

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195. *See id.* at 58-59, 63-64.

196. *See* Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Exchange Act Release No. 6902, 56 Fed. Reg. 30,036 (July 1, 1991).

197. *See* RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 1581 (7th ed. 1992).

198. *See* Fanto & Karmel, *supra* note 191, at 56.

reactions to foreign issuers' release of information reconciling their financial reports with GAAP do not consistently find any effects, leading a number of economists to conclude that the SEC's requirement that foreign firms' disclosures conform to GAAP is of no benefit to investors.<sup>199</sup> In addition, despite the lower level of disclosure required, foreign markets are not less efficient than U.S. markets.<sup>200</sup> Finally, differences in accounting systems do not appear to provide less information about firms' financial situations of importance to investors; for instance, although German accounting is considerably less rigorous than GAAP, the information it discloses provides as good a probability estimate of a German firm's bankruptcy as GAAP information does for U.S. firms.<sup>201</sup>

If the lower level of disclosure of other nations were, in fact, of concern to U.S. investors or adversely affected investments, investors would discount the shares of foreign firms or not invest in them in the first place. Because of such a reaction, many firms would voluntarily reveal more information than required by their home state, albeit less than the SEC would have required, under the market approach.<sup>202</sup> An increase in U.S. listings of non-U.S. issuers that were covered by less extensive disclosure regimes than the SEC requires would not, therefore, be harmful to investors and would instead lower the transaction costs entailed in direct foreign investment. To the extent that foreign firms chose to list in the United States—to come under the more stringent SEC disclosure requirements or to subject themselves to the more extensive U.S. liability regime—as a credible commitment to signal their quality to investors and thereby to reduce their cost of capital,<sup>203</sup> they could, of course, continue to do so under the market approach. The credibility of such firms' commitment to the U.S. regime could be sustained further by their placing a supermajority voting rule in their corporate charter in order to change their securities domicile.<sup>204</sup>

199. See, e.g., Baumol & Malkiel, *supra* note 42, at 46-50; Edwards, *supra* note 7, at 65-66 (noting, however, that more studies must be done before definite conclusions can be reached).

200. See *supra* text accompanying note 42.

201. See Jorg Baetge, *The Role of Disclosure and Auditing as Affecting Corporate Governance*, Presentation at the Symposium on Comparative Corporate Governance at the Max-Planck-Institut, Hamburg, Germany (May 16, 1997).

202. Firms currently respond to such incentives. See *supra* text accompanying notes 38-41.

203. For signaling explanations of foreign firm listings in the United States, see C. Sherman Cheung & Jason Lee, *Disclosure Environment and Listing on Foreign Stock Exchanges*, 19 J. BANKING & FIN. 347 (1995); Oren Fuerst, *A Theoretical Analysis of the Investor Protection Regulations: Argument for Global Listing of Stocks* (Feb. 17, 1998) (unpublished manuscript, on file with the *Yale Law Journal*); and Edward B. Rock, *Mandatory Disclosure as Credible Commitment: Going Public, Opting In, Opting Out, and Globalization* (1998) (unpublished manuscript, on file with the *Yale Law Journal*).

204. To the extent that the SEC requirement for deregistration of fewer than 300 shareholders, see Rock, *supra* note 203, at 11-13 (discussing exit routes under SEC rules), would no longer be applicable under the market regime because it would impede effective jurisdictional competition, firms could duplicate such an exit barrier by placing a similarly worded provision in their charters. Where the firm's home nation does not recognize a domicile approach and the firm is listed both domestically and in the United States, the firm could craft a supermajority charter amendment limited to the choice of domicile for U.S.-traded shares. In the common case in which the foreign firm uses depositary receipts for its U.S. issue, see

The securities domicile choice of foreign firms available under the market approach might be limited in practice to a firm's home country (assuming it does not choose the SEC), in contrast to U.S. firms' choices, because their home countries' choice-of-law rules might not recognize the legislative jurisdiction of a nation that is not the site of the securities transaction. For example, regarding corporate law domicile, many nations do not recognize a statutory domicile and follow instead a physical presence or "seat" rule.<sup>205</sup> If those nations were to follow this principle for securities domicile as well, then non-U.S. firms would have no securities domicile choice but their home country (or the United States as the site of the transaction). But even if the domicile choice were circumscribed because of home country practices, the number of foreign firms listed on U.S. exchanges would markedly increase under the market approach because it would eliminate the need for such firms to undertake costly expenditures to comply with the SEC's disclosure regime, such as the GAAP reconciliation.

## 2. *Securities Litigation Involving Non-U.S. Issuers*

There is a potential problem for U.S. investors who invest in firms subject to a non-U.S. securities regime should they need to seek redress for a securities law violation. Namely, the collective action problem inherent in any type of shareholder litigation—the cost of pursuing a lawsuit exceeds a shareholder's pro rata share of any recovery but not the aggregate award<sup>206</sup>—would be exacerbated by requiring prosecution of a claim in a foreign forum, both because of the expense and because of the absence of mechanisms for aggregating claims in many countries.

U.S. investors would, of course, discount the shares of foreign firms against which they could never exercise their rights under foreign securities laws or would avoid such securities entirely. Foreign firms might therefore find it in their self-interest to ensure that U.S. investors could prosecute securities claims in U.S. courts. The institutional mechanism for obtaining a foreign corporation's consent to a U.S. court's jurisdiction would not be difficult to construct: The issuer could provide such a written consent in the documentation accompanying the sale of stock to a U.S. investor. In addition,

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generally Joseph Velli, *American Depositary Receipts: An Overview*, 17 *FORDHAM INT'L L.J.* S38 (1994) (providing an overview of the depository receipts market), it might be possible for the firm to place a provision in the service contract entered into with the sponsor of the receipts (which the sponsor would enforce) either prohibiting a domicile change or requiring a supermajority vote of the American depository receipt holders to effect such a change.

205. See ROMANO, *supra* note 4, at 132 (noting that, with the exception of the United Kingdom and the Netherlands, European nations follow the real seat rule).

206. See generally John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, *LAW & CONTEMP. PROBS.*, Summer 1985, at 5 (discussing the collective action problem in shareholder litigation).



U.S. stock exchanges competing for business could require issuers' consent to jurisdiction in the United States as a listing requirement, if they thought that such a rule would enhance the value of listed shares and thereby increase trading interest.

There is, however, a question whether U.S. courts would accept jurisdiction as a forum state over a securities dispute between investors and an issuer that is subject to foreign (non-U.S.) securities law. Traditionally, in international litigation, securities law has been treated as a species of public law, over which local courts have either declined to exercise jurisdiction or accepted jurisdiction but applied their own substantive law. The distinction between public and private law is arcane, and has largely been undone by the Supreme Court in the securities context through its validation of arbitration clauses to resolve securities law disputes, reversing the prior convention that considered arbitration inappropriate for public, as opposed to private, law subjects.<sup>207</sup> Accordingly, in keeping with the contemporary trend merging the jurisdictional approach in public and private law areas, it would be appropriate for U.S. courts to apply private law jurisdictional principles to international securities transactions.<sup>208</sup> In the private law setting, forum selection clauses are presumptively enforceable,<sup>209</sup> and the exceptions to this presumption—defects in contract formation, unreasonableness, and public policy,<sup>210</sup> as well as the *forum non conveniens* doctrine—have no relevance for our context: The foreign defendant will have consented to a U.S. forum, federal policy will have expressly authorized foreign legislative jurisdiction, and the plaintiff-investor's local domicile and purchase would provide sufficient "contact" with a U.S. forum to render the local forum's retention of jurisdiction both feasible and desirable.

While U.S. jurisdiction would be readily attainable, a more important question is whether a U.S. court should exercise jurisdiction at all, or, to put it another way, is it desirable from the perspective of regulatory competition for foreign firms to choose a U.S. forum for securities suits? The adjudication of securities disputes by non-domicile courts could undermine the effectiveness of competition, as the legislating state does not control the interpretation of its laws. The problem would not be as severe as it is for Canadian provinces competing for corporate charters because the U.S. courts would be attempting in good faith to apply the domicile's law, whereas Canadian securities administrators intentionally apply their own governance standards rather than

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207. See *Rodriguez v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989); *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974) (overruling *Wilko v. Swan*, 346 U.S. 427 (1953)).

208. The Supreme Court's forum selection clause jurisprudence has especially emphasized the needs of parties engaged in international commercial transactions when sustaining parties' contractual choices. See, e.g., *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 8-18 (1972).

209. See *id.* at 17-18; see also *supra* note 167 and accompanying text.

210. See BORN, *supra* note 142, at 395.

the law of the domicile province.<sup>211</sup> But the difficulty here is not solely a matter of substantive law interpretation.<sup>212</sup> The U.S. approach that adopts the procedural rules of the forum can have a significant impact on substantive outcomes because, in addition to class action mechanisms to aggregate individual claims not prevalent in other countries, U.S. procedure—including rules on discovery, pleading requirements, contingent fees, and the absence of a “loser pays” cost rule—are far more favorable to plaintiffs than those of foreign courts.<sup>213</sup>

A powerful competing consideration in favor of a U.S. forum and against the substantive concerns raised by a non-domicile adjudicator is the significant inconvenience for a U.S. investor to prosecute a securities claim abroad. The balancing of the factors regarding the appropriateness of a U.S. forum is a calculation that is best undertaken by the foreign issuer, rather than by Congress or regulators. As long as investors were informed of the issuer’s choice-of-law and choice-of-forum selections, they would be able to price their ability to obtain relief for securities violations, and issuers would respond accordingly, trading off U.S. forum protections that facilitate securities litigation and affect the cost of capital with the substantive advantages of a foreign forum.

#### B. *Comparison with Other Reform Proposals*

The outcome of applying the market approach to non-U.S. issuers—that their shares will be able to trade in U.S. markets under a non-U.S. securities regime—is certainly not a novel idea. Several commentators have advocated

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211. See Daniels, *supra* note 136, at 182-84; see also *supra* text accompanying note 136.

212. Under current law, U.S. courts have imposed U.S. standards on foreign issuers instead of applying non-U.S. law in their role as a forum court, in a misguided attempt to protect U.S. investors. See, e.g., Consolidated Gold Fields PLC v. Minorco, S.A., 871 F.2d 252 (2d Cir.), *modified*, 890 F.2d 569 (2d Cir. 1989) (applying U.S. law to a takeover contest between foreign firms where the bid permitted U.S. residents to tender only if they did so from outside the United States); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972) (applying U.S. law to a purchase of stock in a British corporation by a U.S. corporation on the London Stock Exchange). The danger of such conduct’s continuing under the proposed regime is probably low, given that Congress will have expressly authorized the applicability of non-U.S. law to the transactions.

213. See BORN, *supra* note 142, at 4. The critical differences in litigation procedures could lead some foreign issuers to consider an alternative approach to the selection of a convenient forum for disputes, such as the use of an international arbitration clause. But it is problematic whether investors would place sufficient value on this approach to make it worthwhile for the issuer to offer arbitration, unless some features of U.S. litigation practices are retained in the arbitration agreement, such as the use of representative actions. Although arbitration is less costly than litigation to pursue an individual claim, the profitability of most securities cases comes from the ability of an attorney to aggregate claims. Despite potential difficulties in claim aggregation, in the international securities context there is a significant advantage to arbitration over litigation that may make it highly attractive to U.S. investors: It is easier to enforce arbitration awards worldwide because virtually all nations (including the United States) are signatories to the United Nations Convention recognizing arbitration awards, while there is no global treaty concerning the enforcement of judgments. See ANDREAS F. LOWENFELD, INTERNATIONAL LITIGATION AND ARBITRATION 332 (1993).

reform of the SEC's approach to foreign issuers to enable such issuers' shares to trade in U.S. markets without coming under the SEC's regulatory regime (or its more onerous components, such as GAAP reconciliation).<sup>214</sup> Some commentators have simply called for an end to the extraterritorial application of U.S. securities laws. Depending on the particular concern of the commentator, the solutions have been to permit foreign firms to list on U.S. exchanges, or, more narrowly, to permit U.S. investors to participate in foreign firms' takeovers, without having U.S. law apply,<sup>215</sup> or to advocate a strict territorial (site-of-sale) approach, regardless of the shareholders' ultimate residence or firms' domicile.<sup>216</sup> While these proposals resolve the most

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214. See, e.g., Cochrane, *supra* note 191, at S61, S63-65; Fox, *supra* note 189, at 2582; Merritt Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities* 14-15 (1997) (unpublished manuscript, on file with the *Yale Law Journal*).

215. See, e.g., Cochrane, *supra* note 191, at S61, S63-65 (criticizing applicability of SEC disclosure requirements for NYSE listing); Jill E. Fisch, *Imprudent Power: Reconsidering U.S. Regulation of Foreign Tender Offers*, 87 NW. U. L. REV. 523, 573-74 (1993) (criticizing applicability of the Williams Act); Pinto, *supra* note 5, at 73 (same).

216. See, e.g., Choi & Guzman, *supra* note 190, at 241 (reviewing possible jurisdictional rules, including site of sale and firms' choice of domicile, and concluding, "This [strict rule of territorial jurisdiction based on the connection the transaction has with the capital markets of the country] is the rule we advocate"); Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855, 1895 (1997) [hereinafter Choi & Guzman, *National Laws*] ("[W]e propose a clear and simple rule: all transactions that occur through an exchange or organized market should be considered within the exclusive jurisdictional reach of the country within which the exchange or organized market operates."). In a recent paper, Choi and Guzman's position has evolved from advocating a strict territorial (site-of-sale) approach to an approach similar to this Article's issuer securities domicile approach. See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. (forthcoming July 1998).

Choi and Guzman seek to encourage regulatory competition across nations because they believe that different rules are appropriate for different issuers and investors. One reason for their refusal in their earlier articles to advocate the logical implication of regulatory competition, an issuer domicile rather than site-of-sale approach, was that they finessed the question whether regulatory competition is for the "top" or "bottom" with respect to investor protection. They asserted that the question was complicated and did not need to be resolved because different rules were appropriate for different clienteles. See, e.g., Choi & Guzman, *National Laws, supra*, at 1876. This is an unsatisfactory position because, if the competitive race to diversity produced laws disadvantageous to investors (that is, it was a race for the "bottom"), there would be no demand for such differentiated regimes. Notwithstanding their contention, it only makes sense to advocate a policy of regulatory diversity if the competition results in regimes that benefit investors (that is, it is a race for the top).

The inconsistency in Choi and Guzman's initial position becomes more apparent when they sidestep the implications of a policy of regulatory competition for domestic regulation. Relying on the existing practice of a monopolist SEC, they contend that either investors and issuers within a single nation have homogeneous preferences regarding securities regulation or domestic markets do not value diversity produced by competition, and conclude that the desirability of international regulatory competition is distinguishable from the domestic context. See *id.* at 1882-83. Their justification of local regulatory monopolies stems from a mistaken understanding of the dynamics of competitive federalism: Competition can lead to uniformity as well as diversity in substantive law. Moreover, uniformity produced by regulatory competition is more likely to be of benefit to investors than uniformity derived from a noncompetitive regime. See Carney, *supra* note 106, at 169-72 (comparing uniform corporate law produced competitively in the U.S. with that produced by noncompetitive European harmonization process). There is, finally, little evidence that diverse securities regimes are appropriate for U.S. and non-U.S. multinationals, or for U.S. investors holding such firms, notwithstanding Choi and Guzman's conjecture. Similar product diversity arguments were hypothesized to explain the benefits of state charter competition, yet the data do not support such claims. See ROMANO, *supra* note 4, at 45-48. There is, then, simply no theoretical or empirical basis for distinguishing between domestic and international securities regulatory competition.

egregious problems in the extraterritorial application of U.S. law, to the extent that they are more restrictive than the domicile approach advocated in this Article—by limiting their reach to the takeover context or by choosing the site of sale, which issuers cannot control as easily as domicile—they are suboptimal when international issues are considered within the broader context of fostering competitive securities regulation.

In a more comprehensive effort to rationalize international securities regulation, Merritt Fox contends that an issuer nationality rule (physical presence domicile) is the rule that maximizes social welfare.<sup>217</sup> Although the substantive policy outcomes of Fox's proposal and of this Article may not be significantly different—that is, non-U.S. issuers trading on a U.S. exchange are likely to choose their home countries' securities regimes under the market approach—the rationales are fundamentally at odds. This is because Fox assumes that international regulatory competition would lead to a "race for the bottom" regarding disclosure requirements. Fox provides two reasons for this projected outcome: Firms would not voluntarily produce the desirable level of financial information because of third-party externality concerns; and U.S. stock exchanges' interest in increased listings would dominate the regulatory process, resulting in a lowering of disclosure requirements to enable them to compete for listings against foreign markets.<sup>218</sup> Fox therefore advocates a physical presence rule to stymie such regulatory competition. Not only would firms have to change their nationality in order to change regulators, which is a costly undertaking, but also exchanges would no longer have an incentive to lobby for lower local securities standards in order to increase foreign listings, as listing decisions would be independent of the regulatory regime of the stock exchange's location.

This Article's proposal for shifting to an issuer-domicile-based rule is premised on an assessment of competition that is the precise opposite of Fox's. As discussed earlier,<sup>219</sup> neither of Fox's rationales depicting destructive competition holds up to scrutiny. The need to internalize third-party externalities is a tenuous rationale for securities regulation, and such externalities are not, in any event, likely to account for the items of mandatory disclosure pursued by the SEC or the differences across national regimes. More important, there is no reason to assume that firms would list on the exchange with the lowest level of disclosure requirements. Rather, they would choose the one whose requirements lower their cost of capital, which will not be the exchange operating under the least amount of disclosure because investors place affirmative value on information. The supporting evidence against the race-for-the-bottom thesis, as already noted, is that firms the world over

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217. See Fox, *supra* note 189, at 2580-83; Fox, *supra* note 214, at 14-15.

218. See, e.g., Fox, *supra* note 214, at 34-35.

219. See *supra* Section I.B.

voluntarily release more information than their securities regulators require in order to raise capital, with the best example being the European firms listing in London, which voluntarily choose to meet higher local disclosure requirements.<sup>220</sup>

Finally, it should also be noted that Fox's concern regarding the political process in a competitive regulatory setting—the incentives of stock exchanges to lobby for lowered disclosure—is not relevant under the market approach. Whether the securities domicile is statutory, contractual, or Fox's proposed domicile of physical presence, the location of the stock exchange would not determine the issuer's securities regime; the issuer's securities domicile would. Accordingly, while Fox's proposed regulatory reform is compatible with the approach in this Article, the rationales could not be much farther apart.

#### IV. CONCLUSION

This Article has advocated fundamental reform of the current strategy toward securities regulation by implementing a regulatory approach of competitive federalism, under which firms select their securities regulator from among the fifty states and the District of Columbia, the SEC, or other nations. Competitive federalism harnesses the high-powered incentives of markets to the regulatory state in order to produce regulatory arrangements compatible with investors' preferences. This is because firms will locate in the domicile whose regime investors prefer in order to reduce their cost of capital, and states have financial incentives (such as incorporation and registration fees) to adapt their securities regimes to firms' locational decisions. This prediction of securities market participants' and regulators' responses to competition is well-grounded: There is a substantial literature examining the workings of competitive federalism in the corporate charter setting that indicates that such regulatory competition does not harm, and in all likelihood benefits, investors.

To establish competitive federalism in the securities law context, the current choice-of-law rule for securities transactions must be altered to follow the issuer's securities domicile rather than the securities' site of sale. In addition, two procedural safeguards would be required of firms opting out of federal regulation: domicile disclosure upon securities purchases and a security-

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220. See *supra* text accompanying notes 38-41. One study of foreign stock exchange listings found an inverse relation between listings and disclosure requirements, but the exchanges with the lowest level of disclosure did not have the most foreign listings (although the United States, with the highest disclosure level, did have the fewest foreign listings); more important, the inverse relation was not significant when domestic and foreign exchange disclosure levels were compared. See Shahrokh M. Saudagaran & Gary C. Biddle, *Financial Disclosure Levels and Foreign Stock Exchange Listing Decisions*, in *INTERNATIONAL CAPITAL MARKETS IN A WORLD OF ACCOUNTING DIFFERENCES* 159, 181, 184 (Frederick D.S. Choi & Richard M. Levich eds., 1994). That is, the data do not support the race-for-the-bottom hypothesis that the probability of a firm listing on a given foreign exchange is inversely related to the exchange's disclosure level when its disclosure level is higher than the disclosure level of the firm's domestic exchange. See *id.*

holder vote to effectuate a domicile change. These requirements ensure that informed investor preferences drive the regulatory competition. When competition is introduced, SEC rules and regulations that are not cost-effective or are otherwise detrimental to investors will be replaced by competing regulators with rules investors prefer, as the domicile choices of capital market participants establish a new regulatory equilibrium.

The mandatory federal securities regime has been in place for over sixty years, but the theoretical support for it is thin, and there is no empirical evidence indicating that it is effective in achieving its stated objectives. In fact, there is a developing literature pointing in the opposite direction. At a minimum, this literature suggests that the securities status quo should no longer be privileged, and that it should instead be opened up to market forces by means of competitive federalism. Corporation codes have benefited from precisely such competition. Although the current legislative trend in Congress, supported by both the proponents and opponents of the existing regulatory regime, is to seek to monopolize even further securities regulation at the federal level, this Article maintains that it would be far better public policy to expand, not restrain, state regulatory involvement. As long as only one state's law, chosen by the issuer, controls the regulation of a firm's securities transactions, regulatory competition will emerge, and there are compelling reasons to prefer such a regulatory arrangement to the mandatory federal regime.

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