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A System of Selective Substitute Compliance

Howell E. Jackson*

In the field of securities regulation, there is something of a tradition for senior SEC officials to float major new initiatives in the pages of law reviews. The classic example is Milton Cohen's *"Truth in Securities" Revisited*, which appeared in the *Harvard Law Review* in 1966 and laid the conceptual groundwork for the integration of disclosure standards under federal securities laws and eventually the now-familiar practice of incorporation by reference.[1] Ethiopis Tafara and Robert Peterson's *Blueprint for Cross-Border Access to U.S. Investors* may someday be seen as having a similar impact on the application of federal securities law to foreign entities.[2]

The idea underlying their new framework is what they call a "system of substituted compliance," which I amend in the title of this comment by inserting the crucial concept of selectivity.[3] Despite its bland formulation, their proposal would constitute a major change in U.S. policy. Historically, the SEC has taken the position that when foreign entities intentionally enter U.S. markets (and sometimes even when the entrance is unintentional), federal securities laws apply in the same manner as our rules apply to U.S. domestic entities.[4] While some small accommodations for some foreign entities have long been permitted—especially in the case of foreign private issuers[5]—the over-

* James S. Reid, Jr., Professor of Law, Harvard Law School. Several of the themes explored in this comment are based on issues covered over the past six years in the International Finance Seminar that Professor Hal Scott and I have been teaching at Harvard Law School. Also helpful were discussions with European and American academics and regulators at a Roundtable Discussion on the EU-US Transatlantic Dialogue on Financial Services Regulation held at Cambridge University under the auspices of the Centre for Corporate and Commercial Law in September 2005.

1. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340 (1966). Prior to writing this piece, Cohen was the Director of the SEC's Special Study on Securities Markets.

2. Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 Harv. Int'l L.J. 31 (2007).

3. Selectively incorporating foreign regulatory structures into the law of developing countries is an idea I explored a number of years ago in Howell E. Jackson, *Selective Incorporation of Foreign Legal Systems to Promote Nepal as an International Financial Services Center*, *in* Regulation and Deregulation: Policy and Practice in the Utilities and Financial Services Industries 367 (Christopher McCrudden ed., 1999).

4. This policy—a form of national treatment—has an intuitive appeal. As SEC Commissioner Roel Campos once justified the U.S. position: "foreign exchanges are more than welcome in our markets—under the same terms that apply to U.S. exchanges." Roel C. Campos, Convergence and Beyond, Speech to the U.S.-Europe Symposium, Program on International Financial Systems (Nov. 15, 2003), available at http://www.sec.gov/news/speech/spch111503rcc.htm. But the SEC has, over the years, recognized a number of exceptions to this policy. *See infra* note 20 (reviewing accommodations for foreign private issuers).

5. *See infra* notes 17–18 (discussing current SEC accommodations for foreign firms).

all SEC approach to its jurisdiction over foreign entities has been profoundly territorial. Enter our capital markets and you must comply with our rules.

Under the Tafara and Peterson Blueprint—at least with respect to foreign exchanges and broker-dealers—the SEC would for the first time exempt a broad group of foreign firms from Securities Exchange Act of 1934 registration requirements (but not anti-fraud rules),[6] provided the Commission can satisfy itself that the applicants' supervisory oversight in their home markets is substantially similar to the oversight the SEC imposes on U.S. domestic firms. The Blueprint outlines a variety of procedural mechanisms for ensuring comparability, but the heart of the proposal is the proposition that the SEC should accept at least some systems of foreign regulation and supervision as adequate substitutes for direct SEC supervision under the same legal regime applicable to domestic firms. And that idea is revolutionary.

At the outset, I should acknowledge that I recently co-authored an article analyzing the SEC's treatment of foreign trading screens and recommended the Commission liberalize its rules governing the placement of these screens within U.S. borders.[7] While our recommendations are fully consistent with the Blueprint's proposal, the Tafara and Peterson Framework goes well beyond what we had suggested in our paper. Not only does their proposal take on broker-dealers in addition to exchanges, but it advances a conceptual framework that should arguably apply to all areas of SEC oversight and not just the Commission's supervision of financial services providers. By temperament, academics like to think of themselves as being well in the forefront of government bureaucrats. But here I find myself in the uncomfortable posture of having to play catch-up with senior SEC staff who have advanced a far more ambitious program than my own.

My comments touch upon four points. First, I outline one of the most striking aspects of the Tafara and Peterson Framework: it focuses on the SEC's oversight of secondary market linkages in global markets and not its more commonly discussed direct regulation of disclosures and accounting for foreign corporations seeking access to U.S. markets. I next offer my perspective on why the theoretical foundation of their proposal—and particularly its analysis of the needs of individual investors—constitutes a major shift in SEC thinking, likely to have important implications in other areas of the Commission's jurisdiction. I then touch upon several pragmatic considerations that the SEC and its staff would need to address if they were to put the Blueprint into practice. Finally, I sketch out potential implications of the Tafara and Peterson proposal for other areas in which the SEC oversees foreign entities and suggest several lines of additional academic work that might assist the

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6. Under Rule 15a-6 of the 1934 Act, 17 C.F.R. § 240.15a-6, the SEC currently allows foreign broker-dealers to have limited contact with U.S. institutional investors without having to register under the 1934 Act, but the Tafara and Peterson proposal would be substantially broader. *See* Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, *Foreign Trading Screens in the United States*, 1 Cap. Markets L.J. 54 (2006) (describing Rule 15a-6). Rule 15a-6 does not apply to foreign exchanges.

7. *See* Jackson et al., *supra* note 6.

Commission in deciding how far to extend the logic that underlies the Tafara and Peterson proposal.

I. Secondary Market Linkages as Opposed to Foreign Private Issuers

For more than a decade, the debate over international securities markets has focused on cross-market listings and public offerings of foreign companies seeking capital in the United States and a handful of other leading financial centers, such as London or perhaps Luxembourg. Of critical interest to academics has been understanding the benefits to issuers of raising capital in foreign markets.[8] For national stock markets, the chief concern was gaining the largest possible market share of foreign listings while losing the smallest number of domestic issuers to foreign markets.[9] For regulators, the central issue has been deciding which domestic regulations—that is, host country requirements—should be applied to foreign issuers that seek to gain access to local capital markets.[10] While the key players had different perspectives, the cross-market listing decisions of foreign issuers have traditionally been at the center of attention.[11]

But issuers are not the only entities with mobility in modern capital markets: investors, exchanges, brokerage houses, and a wide range of professional service providers can and do move around the world. Strikingly, the Tafara and Peterson proposal does not directly address the perennial hot button issue of foreign-issuer regulation, but rather deals with the less frequently discussed topic of SEC oversight of financial service providers. Before turning to the merits of the Tafara and Peterson Framework, I think it is important to explore some of the ways in which the mobility of other market participants—investors as well as financial services firms—has altered the structure of global capital markets and contributed to the logic underlying the Tafara and Peterson recommendations.

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8. *See* John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 Colum. L. Rev. 1757 (2002). For an overview of the debate in the late 1990s amongst legal academics over the value of regulatory competition in international securities markets, see Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 Theoretical Inquiries in Law 649 (2001). For an overview of financial economic analysis of the benefits of cross listings, see George A. Karolyi, *The World of Cross-Listings and Cross-Listings of the World: Challenging Conventional Wisdom* (Dice Ctr., Working Paper No. 2004-14, 2004), *available at* http://ssrn.com/abstract=577021.

9. *See, e.g.*, Yalman Onaran, *Sarbanes-Oxley Brings American Firms Record IPO Earnings Abroad*, Bloomberg.com, Oct. 30, 2006, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aV7_9zTtcL9s. ("NYSE Group Inc. CEO John Thain said in September that the stampede of IPOs to foreign markets is a 'major problem.'"); *see also* Jackson et al., *supra* note 6, at 68–69.

10. *See infra* text accompanying note 20 (describing SEC accommodations).

11. To some degree, this issuer-centric perspective still exists, as evidenced by ongoing debates over the stringency of the Sarbanes-Oxley Act and its role in the declining number of foreign private issuers that are choosing to list their securities on U.S. markets. *See, e.g.*, R. Glenn Hubbard & John L. Thorton, *Is the U.S. Losing Ground?*, Wall St. J., Oct. 30, 2006, at A12 ("In the universe of global IPOs, the fraction of non-U.S. IPOs listed in the U.S. has fallen to under 10% so far in 2006 from 37% in 2000.").

Start first with the globalization of institutional investors. Time was, if a foreign issuer wanted to sell securities to Fidelity or other major U.S. institutions, the best way to reach those investors was to come to the United States and establish a trading vehicle, such as an American Depository Receipts ("ADRs"),[12] on a major U.S. exchange. Increasingly, however, major institutional investors have established offices overseas in key financial centers, like London and Tokyo, and prefer to trade their foreign securities in the home market of issuers, where there is likely to be greater liquidity and market depth. Institutions that lack foreign offices also prefer off-shore trading venues for foreign securities and can effect trading on these markets through relationships with foreign brokers, who have considerable latitude in bringing foreign offerings to the attention of these U.S.-based clients.[13] The forward positioning of U.S. institutional investors into foreign markets has two important (and somewhat surprising) implications for U.S. domestic securities regulation. First, as the Blueprint suggests,[14] when institutional investors go off-shore at least some retail investors will get it in their minds to follow. Though direct investment in foreign markets may be cumbersome for individuals, it can be done and there is mounting evidence that an increasing number of retail investors are making direct investments in foreign markets, albeit often at unnecessarily high costs or without any SEC oversight.[15]

A second implication of the direct linkages between U.S. institutional investors and foreign markets is a reduced need for foreign private issuers to list their securities on foreign exchanges. While foreign private issuers once had to enter U.S. markets in order to gain access to U.S. institutional investors, they no longer need to do so, at least for much of the market, most of the time. Although many have pointed to the passage of the Sarbanes-Oxley Act of 2002 as damaging the ability of U.S. exchanges to compete for foreign cross-listings, there is ample evidence that the erosion of U.S. market power for foreign listings was already underway well before 2002.[16] Increasingly,

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12. American Depository Receipts, Exchange Act Release No. 29,226, 48 S.E.C. Docket 1,440 (May 23, 1991).

13. The limitations on solicitations that Tafara and Peterson describe in their proposal apply only to solicitations of retail investors. *See* Tafara & Peterson, *supra* note 2, at 48. Foreign brokers selling 144A securities have a free hand to access U.S. institutional investors. The current rule governing foreign broker-dealers—rule 15(a)(6) of the Exchange Act of 1934, 17 C.F.R. § 240.15(a)(6) (2006)—was adopted in the late 1980s and reflected an early (albeit narrow) accommodation of foreign broker-dealers. *See* 54 Fed. Reg. 30,031 (July 18, 1989). For an overview of the application of these rules to U.S. institutional investors, see Jackson et al., *supra* note 7, at 70–72.

14. *See* Tafara & Peterson, *supra* note 2, at 41.

15. *See* S. Eric Wang, *Investing Abroad: Regulation S and U.S. Retail Investment in Foreign Securities*, 10 U. Miami Bus. L. Rev. 329, 349 (2002).

16. It is beyond the scope of this Commentary to evaluate the relative importance regulatory burdens and the internationalization of U.S. institutional investors has contributed to the decline of foreign listings on U.S. capital markets. I would note, however, that if one takes a broader perspective, a case can be made that the regulatory barriers for foreign private issuers entering U.S. public markets today are lower than they were ten years ago when the foreign offerings were flooding the U.S. markets. The distance between U.S. and foreign accounting standards has narrowed a good bit over this period and—beyond a doubt—the level of familiarity of legal, investment, and accounting professionals in the cross-listing

foreign issuers—particularly those that were already raising capital in major financial centers like London or Hong Kong—do not have to leave their home markets to reach the vast majority of investable U.S. funds.[17] So, while U.S. retail investor demand for foreign securities may be on the increase, the supply of those securities onto public U.S. markets is on the decline.

Against this background, the premise of the Tafara and Peterson proposal—that the SEC should see what it can do to make it easier for U.S. retail investors to gain access to foreign secondary markets as opposed to trying to make it easier for foreign private issuers to access U.S. public markets—strikes me as a sensible response to the changing reality of globalization in capital markets. Improved secondary market linkages as opposed to improved issuer access may be the key.

II. A New Perspective on the Interests of Investors

The centrality of competition over cross-listings for foreign issuers has also framed the way in which the SEC has approached the issue of globalization in the past. In evaluating whether certain domestic rules—for example, U.S. GAAP accounting standards—should apply to foreign private issuers, analysis has usually been framed in terms of whether the SEC should provide special accommodations to foreign entities from potentially redundant U.S. rules. As foreign firms typically comply with analogous regulatory requirements in their home jurisdictions, subjecting them to additional U.S. requirements is inherently duplicative. Accommodations for foreign entities have been most easily justified where home rules were directly inconsistent with U.S. requirements, for example in tender offers.[18] In other contexts, where redundancy was simply costly, policy analysis typically balanced these extra costs against the presumed interests of U.S. investors in having the same set of U.S. rules apply to all firms.[19] In other words, the interests of U.S. investors, particularly

process has improved dramatically. To be sure, Sarbanes-Oxley and its 404 certifications points in the opposite direction, but even there much of the costs may be transitory and annual compliance costs that can be expected to decline over time. In any event, the decline in public listings in U.S. markets was evident among European issuers well before the passage of Sarbanes-Oxley. *See* Howell E. Jackson & Eric Pan, Regulatory Competition in International Securities Markets: Evidence from Europe—Part II (Apr. 2002) (unpublished manuscript on file with author).

17. *See, e.g.*, Erica Fung, *Regulation Competition in International Capital Markets: Evidence from China in 2004–2005*, 3 N.Y.U. J. L. & Bus. (forthcoming 2007) (reporting evidence of Hong Kong rising as the principal listing market for Chinese issuers); *see also* Norman Cappell, European Issuers in the American Capital Markets: Empirical Evidence and Implications for the Issuer Choice Debate (May 8, 2002) (unpublished paper, Harvard Law School Program on International Financial Systems), http://www.law.harvard.edu/programs/pifs/pdfs/norman_cappell.pdf (expanding data presented in Jackson & Pan, *supra* note 16).

18. For a recent overview of SEC rules on cross-border tender offers, see John M. Basnage et al., *Cross-Border Tender Offers and Other Business Combination Transactions and the U.S. Federal Securities Laws: An Overview*, 61 Bus. Law. 1071 (2006).

19. An example of such a balancing can be seen in the Commission's 2000 decision to exempt foreign private issuers from the application of Regulation FD. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 65 Fed. Reg. 51,716 (proposed Aug. 24, 2000).

retail investors, were seen as being compromised by, and in tension with, accommodations of foreign firms. While the SEC has found its way to make a reasonable number of accommodations for foreign private issuers by applying this sort of cost-benefit analysis,[20] the accommodations have typically been extended grudgingly and in small increments.

What is novel about the Tafara and Peterson Blueprint is the way in which it reframes the debate by focusing on the disadvantages to investors, particularly retail investors, of barriers to foreign investment under current SEC rules and, conversely, the benefits that individual investors could derive from reforms that would make it easier for individual investors to reach foreign markets. This shifting of the frame of debate is critical. Deep within the regulatory DNA of SEC commissioners and staff is a primal urge to protect investors and advocate for their interests. Prior debates over reforming the extraterritorial application of SEC rules—where the issue was presented as sacrificing the interests of investors to reduce industry costs—invariably lacked traction among SEC staff. What is innovative about the Tafara and Peterson Framework is that it represents, for the first time, the clear recognition on the part of a senior SEC official that individual investors could in many ways benefit from greater and more transparent access to foreign markets.

In brief, I see five principal benefits from improved retail investor access to foreign markets, the first four of which are touched upon in the Tafara and Peterson Blueprint but the fifth also deserves consideration.

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20. Stretching back over several decades, the SEC has done rather a lot to relieve regulatory burdens on foreign private issuers. One of the most notable accommodations, mentioned in Tafara & Peterson, *supra* note 2, at nn.49–50 and accompanying text, are accounting rules which allow foreign private issuers to reconcile their financial statements to U.S. GAAP rather than prepare full U.S. GAAP compliant statements. But also important are exemptions from full 1934 Act reporting requirements for foreign private issuers that do not deliberately access public U.S. capital markets, see rule 12(g)(3)(b)(2) under the 1934 Act, 17 C.F.R. § 240.12(g)(3)(b)(2) (2006), as well as the exemptions from proxy rules, short-swing profit rules, aspects of Regulation FD; and certain tender offer regulations. *See* Rule 3a12-3, 17 C.F.R. § 240.3a12-4 (2006) (exemptions from proxy rules and short-swing trading restrictions); 17 C.F.R. § 243.101(b) (2006) (exemption from Regulation FD); Basnage et al., *supra* note 18 (overview of exemptions from tender offer regulation for cross-border transactions). Though much has been written about the adverse consequences of the Sarbanes-Oxley Act for foreign private issuers, the Commission has actually been reasonably active in ameliorating the effects of that legislation on foreign private issuers, in terms of making accommodations in the Act's audit committee requirements, delaying the application of section 404 compliance for certain foreign issuers, and proposing a liberalization of the deregistration rules under the 1934 Act. *See* Press Release, SEC, SEC Offers Further Relief from Section 404 Compliance for Smaller Public Companies and Many Foreign Private Issuers (Aug. 9, 2006), *available at* http://www.sec. gov/news/press/2006/2006-136.htm; Press Release, SEC, Extension of Compliance Dates for Non-Accelerated Filers and Foreign Private Issuers Regarding Internal Control Over Financial Reporting Requirements (Mar. 2, 2005), *available at* http://www.sec.gov/news/press/2005-25.htm; Termination of a Foreign Private Issuer's Registration, Exchange Act Release No. 53,020, 70 Fed. Reg. 77,688 (proposed Dec. 30, 2005). Another major, albeit narrowly focused exception, is the MJDS, which allows qualifying Canadian issuers to make use of Canadian disclosure rules when accessing U.S. capital markets. *See* Roel C. Campos, Comm'r, SEC, The Global Marketplace and a Regulatory Overview, Speech Before the Mentor Group in Amsterdam (Sept. 17, 2004), *available at* http://www.sec.gov/news/speech/spch091704rcc.htm.

A. *Increased Diversification*

Most likely the principal benefit of the proposed Blueprint would be to increase the ability of U.S. retail investors to diversify their portfolios, particularly to potentially attractive securities of firms located in fast-growing markets in the developing world. While individual investors currently have ways to make direct investments in foreign markets, the paths are limited and require considerable effort. Aside from technical barriers, U.S. retail investors face serious problems receiving information about foreign investment opportunities. Most notably, foreign broker-dealers are prohibited from soliciting most U.S. retail investors unless those firms comply with SEC registration and compliance requirements. Although there are few good studies on the subject, most experts believe that individual investors have substantially less international exposures in their investment portfolios than financial theory suggests is appropriate.[21] While opportunities now exist for making international investments through registered investment companies, not all individuals take advantage of these opportunities and it seems plausible to assume that liberalization of foreign exchange and broker-dealer access to U.S. retails would materially increase diversification of U.S. retail investors.[22]

B. *Reduction of Transaction Costs*

A second benefit of liberalization for retail investors would be a reduction in transaction costs. This benefit is particularly important for those U.S. investors who currently do make investments overseas, but now have to effect their transactions either through two layers of intermediaries or through unsupervised interactions with unregistered foreign broker-dealers that can only provide a limited range of services.[23] The Blueprint would offer transparent and one-stop shopping for direct foreign investments, either through a foreign broker-dealer with floor privileges on the relevant foreign exchange or through a domestic U.S. broker-dealer with remote access to that same exchange. By increasing the number of eligible intermediaries and providing more competition for order-flow to foreign markets, retail investors would gain.

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21. For a useful overview of recent research on the diversification in household portfolios, including a discussion of international diversification by Swedish investors, see John Y. Campbell, *Household Finance*, 61 J. Fin. 1553, 1570–77 (2006). *See also* Howell E. Jackson, *To What Extent Should We Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Individual Investor Returns*, 28 J. Corp. L. 671 (2003).

22. A nice question of public policy is whether the SEC should also promote international diversification through investment companies or, as discussed below, liberalize rules governing foreign investment companies to make it easier for U.S. retail investors to reach these vehicles. *See infra* text accompanying notes 28–29.

23. *See* Jackson et al., *supra* note 6, at 73–75 (discussing these costs).

C. Reduction of Spillover Risks from Foreign Market Failures

An interesting challenge in the regulation of foreign investments is the possibility of spillover effects in the United States when things go wrong overseas, like the Parmalat scandal or the Asian financial crisis of 1997. These spillover effects, as suggested in the Tafara and Peterson Blueprint, could take the form of either a run of some sort on domestic capital markets stimulated by offshore events or a slight increase in the cost of capital for U.S. issuers (resulting from investors being unable to easily distinguish between the risk associated with investments in U.S. companies and the higher and less predictable risks associated with some foreign markets). To some degree both of these risks exist under the status quo; some U.S. investors are already investing overseas and, notwithstanding the machinations these investors need to perform to effect such investments, it is not entirely clear they all understand they are purchasing securities in markets that are not subject to SEC oversight.[24] But the disclosures that the Tafara and Peterson proposal contemplates—clear statements from both foreign brokers and foreign exchanges—would do a better job establishing a clear and transparent firewall between foreign investments subject to substitute compliance and U.S. investments subject to direct SEC oversight. Moreover, to the extent that the proposal's system of selective approvals has the effect of steering U.S. investors toward better regulated foreign markets, its adoption could limit individual investor exposures in more volatile off-shore trading environments.

D. Indirect Benefits from Market Competition

A fourth benefit to consumers is the indirect benefit of increased competition; not just in the form of enhanced competition among exchanges for the listings of foreign firms but enhanced competition among a wider range of broker-dealers seeking to market foreign securities to American investors. It is possible to imagine that this latter form of competition will be of even greater significance, particularly in terms of educating American investors of the advantages and options for off-shore investments. As Tafara and Peterson acknowledge, current SEC rules discourage foreign brokers from supplying information to U.S. investors—particularly retail investors—lest they run afoul of prohibitions on solicitations, and—under Regulation S—foreign private issuers themselves are severely limited in their ability to market their securities to retail investors in the United States.[25]

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24. *But see* Tafara & Peterson, *supra* note 2, at 41–42 (suggesting that these convoluted methods of accessing foreign markets put U.S. investors on notice of the lack of regulatory oversight).

25. *See* Rule 901 et seq. under the 1933 Act, 17 C.F.R. § 230.901 et seq. (2006).

E. Freeing the SEC To Target Linkages with Unsuitable Markets

A final advantage of the Blueprint for consumers is the capacity of this reform proposal to free the SEC to more rigorously police the marketing of securities from truly unsuitable foreign markets to U.S. investors. Currently, the SEC posture with respect to foreign investments by individual investors is characterized by an element of benign neglect. As the Tafara and Peterson proposal explains, industry experts and SEC officials are aware that some retail investors are investing overseas and the lines surrounding permissible off-shore access and impermissible solicitations from abroad is sometimes blurred. This ambiguity has the advantage of scaring off disreputable firms and allowing the SEC latitude when it chooses to bring enforcement actions. But it also discourages some foreign broker-dealers from accessing U.S. investors and casts something of a pall on many cross-border investments. Moreover, the SEC itself must now be somewhat circumspect in how it approaches its oversight of foreign investment lest it discourage retail investors from making legitimate purchases in sound markets.

The beauty of the Tafara and Peterson proposal is that it would offer a clear and legitimate path for off-shore investments. Once an appropriate number of foreign entities are granted exemptive relief under the Blueprint, the SEC enforcement staff would then be free to be more aggressive in sanctioning firms and exchanges from unsuitable markets or intermediaries in acceptable markets that have not complied with the Commission's exemptive procedures. In other words, the proposal offers a mechanism for the Commission to clearly distinguish between acceptable paths to foreign markets and unacceptable paths and target its enforcement efforts appropriately.

III. Practical Concerns in Applying the Framework

I now turn to some more practical considerations the Commission may face in applying the Tafara and Peterson Framework. I start first with the issue of selectivity and then consider more technical aspects of the proposed exemptive procedures.

A. Selectivity in Theory and Practice

The fact that the Blueprint postulates a "selective" system of substitute compliance is of critical importance to the merits of the proposal from the perspective of advancing the interests of retail investors. In the past, the SEC has generally preferred to proceed multilaterally, granting its accommodations to foreign entities in all jurisdictions. While universalism has its advantages, it does complicate policy analysis and forward progress. Some jurisdictions will have woefully inadequate supervisory standards and, absent heroic assumptions about the power of market discipline,[26] one has to regard

26. In the academic debate over regulatory competition, a principal point of disagreement has been

many universal accommodations for foreign firms as being a mixed blessing for individual investors. Some foreign regulatory systems will provide adequate mechanisms of investor protection and others will not. By insisting on stringent prior approval standards coupled with acceptance of U.S. service of process for future enforcement efforts and buttressed by bilateral cooperation from home market supervisors, the Tafara and Peterson proposal offers a credible screen for weeding out Barbary Coast jurisdictions from those that maintain regulatory standards roughly equivalent to our own. Selectivity, in other words, is what elevates the Framework into a reform that can unambiguously advance the interests of retail investors.

Having lauded the framework's selectivity provisions, let me now add a few words of caution about their difficult application in practice. Only rarely in the past has the SEC distinguished among the quality of regulation in foreign jurisdictions, and when it has made such distinctions, the Commission has tended to accept just about everybody or almost nobody (aside from Canada).[27] And there are good reasons why federal agencies do not like to get in the business of picking favorites among foreign governments. While it is possible to develop short blacklists of off-shore havens that clearly have substandard controls over money laundering and tax reporting, it is a more difficult task to distinguish between major jurisdictions, some of which will be valued political allies, on the basis of whether their regulatory controls are acceptable substitutes for U.S. oversight. Official government distinctions of this sort tend to generate reactions from the State Department and one can imagine the complexities that will arise when the first Turkish broker-dealer seeks an exemptive ruling while renegotiation of military basing rights are pending elsewhere in the government.[28]

A similar set of problems will arise when applications come from exchanges and broker-dealers that are spread across regions—such the European Union—and are bound together by complex treaty structures and harmonized regulations. While there may be substantial variation in the quality of

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the extent to which capital markets can efficiently discriminate between good and bad systems of regulation. Proponents of regulatory competition tend to have greater confidence in the capacity of markets to price regulatory risks. *Compare* Merritt B. Fox, *Optimal Regulatory Areas for Securities Disclosure*, 81 WASH. U. L.Q. 1017 (2003) (suggesting efficient securities regulation should be based on territorial principles) *with* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (arguing that efficiency can be achieved through a greater degree of issuer choice). *See also* Hal S. Scott, *Internationalization of Primary Public Securities Markets*, 63 LAW & CONTEMP. PROBS. 71 (2000).

27. An example of SEC selectivity applying to just about everyone can be found in Regulation S's expansive definition of a "designated offshore securities market," which extends a limited amount of regulatory relief under the 1933 Act to a quite large number of exchanges. *See* 17 C.F.R. § 230.902(b) (2006). The MJDS, *see supra* note 20, as well as 17 C.F.R. § 240.12g3-2(d)(3)(iii), are examples of accommodations for just Canadian issuers.

28. An analogous problem has arisen under the Federal Credit Reform Act of 1990, which requires congressional budget officials to estimate the cost of extending credit to a foreign government. As these estimates implicitly turn on the default risks of foreign sovereigns, their publication has diplomatic ramifications. *See* Michael Pompeo, *Accrual Accounting for Federal Credit Programs: An Evaluation of the Federal Credit Reform Act of 1990,* 95 TAX NOTES TODAY 2–89 (1995).

regulatory oversight between London and Vilnius, both formally operate under EU directives designed to generate a unified and harmonized European capital market. If the SEC wants to grant exemptive relief for the London Stock Exchange (as is most probable), is the Athens Exchange entitled to similar treatment? And, in reviewing an application from Frankfurt, what should the Commission make of the fact that the EU's passporting rules allow issuers located in Portugal to list on German exchanges while abiding by Portuguese reporting requirements based on IFRS accounting standards implemented in Portugal and audited by a Portuguese accounting firm?[29] Can the Commission's review of supervisory controls be limited to German rules, or must it extend its analysis to the entire EU internal market?[30]

Neither of these concerns should, in my view, dissuade the SEC from implementing the Framework as proposed. But they do suggest that the Commission needs to appreciate the difficulties it will likely confront in making distinctions among national regulatory systems and take steps—perhaps reliance on an outside body of independent advisers—to assist in making these determinations and to provide some insulation from the inevitable blowback that will come from overseas and Foggy Bottom.

B. Proposed Standards for Exemptive Relief

For the most part, I think the structure that Tafara and Peterson propose for exemptive relief is sensible and well-conceived. Uncoupling review of national supervisory systems from consideration of particular applicants strikes me as a reasonable division of labor, and their respective evaluation of the exemptions also seems sound. I do, however, have several modest suggestions for refining their program.

The first concerns the aspect of their proposals that entails the review of national regulatory systems. Most of their review procedures focus on the formal structure of legal requirements as opposed to their application in practice. As it turns out, countries with quite similar regulatory systems may expend very different amounts of resources on supervisory oversight. Within the EU, for example, regulatory requirements are harmonized along many dimensions, but regulatory budgets and staffing levels vary a good deal from country to country.[31] Moreover, even countries with similar staffing and budget

29. As this question suggests, allowing foreign brokers to enter U.S. markets is, in certain respects, a more far-reaching initiative. While exchanges list a limited and well-defined number of securities, foreign broker-dealers offer their clients an open-ended and often changing range of investment options. In approving foreign broker-dealers under the Tafara and Peterson proposal, would the Commission authorize the firms to offer U.S. customers whatever investment products the firm offers in its home market or would the SEC authorization cover only some subset of those products? If the latter, how would the subset be defined?

30. For a discussions of the development of cross-market linkages within the EU, see Howell E. Jackson & Eric Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 Bus. Law. 653 (2001).

31. Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* (John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 521, 2005), *available at*

levels, can have quite different levels of enforcement activity.[32] While many factors contribute to the creation of an effective system of financial regulation, I think the proposal's exemptive procedures might be expanded to include consideration of the level of actual resources committed to regulatory oversight and the extent of actual enforcement activity within each jurisdiction.

Another aspect of the framework that might benefit from further refinement is the preservation of anti-fraud provisions from exemptive relief. Within the field of securities regulation, it is relatively common for the SEC to exempt firms or transactions from registration or reporting requirements but at the same time preserve authority to bring enforcement actions for violations of anti-fraud rules.[33] The distinction is quite sensible as it allows the Commission latitude to deal with occasional problems on a case-by-case basis, while not subjecting a large class of firms or activities to continuous and costly oversight. The problem, however, comes with the existence of robust private rights of action and generous class action certification procedures for the enforcement of federal securities. While numerous factors constrain the Commission's enforcement staff from bringing unnecessary enforcement actions, similar constraints do not apply to private litigation, especially litigation driven by the interests of counsel. In order to encourage foreign firms to take advantage of the proposed exemptive rules, some additional thought may be needed to ensure that the benefits of exemptive relief are not undercut by opportunistic private litigation.

Finally, the Commission staff may wish to give some additional consideration to the interaction between its proposed liberalization of regulation of foreign exchanges and broker-dealers and its approach to off-shore offerings of securities under Regulation S. To qualify for Regulation S exemptions, foreign issuers must refrain from making solicitations to U.S. residents.[34] Presumably these restrictions would not inhibit foreign brokers from disseminating information into the United States, but some clarification of this matter may be needed, especially for foreign brokers that may be affiliated with major distributors.

IV. Implications for the Future

While the Tafara and Peterson proposal limits itself to foreign exchanges and broker-dealers, its logic could well be extended more broadly, and so I

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http://papers.ssrn.com/so13/papers.cfm?abstract_id=839250.

32. Howell E. Jackson, Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches (2005), http://www.tfmsl.ca/docs/V6(2)%20Jackson.pdf.

33. *See, e.g.*, Preliminary Note 1, Regulation S, 17 C.F.R. § 230.901 (2005) ("The following rules relate solely to the application of Section 5 of the Securities Act of 1933 (the "Act") and not to antifraud or other provisions of the federal securities laws.").

34. *See, e.g.*, 17 C.F.R. § 230.903(b)(ii) (2006) (placing limitations on directed selling efforts into the United States). Consideration of the imposition and monitoring of Regulation S's offering restrictions for Category II and Category III issuers may also be important.

will conclude my comments with some speculation as to where the path set forth in the Blueprint might lead and the role that future academic work might play in assisting the Commission in deciding how far to push the logic of the Tafara and Peterson proposal.

First, almost certainly, the Commission will be invited to extend the logic of the Framework to foreign private issuers and to consider whether the disclosure and accounting standards of certain jurisdictions might also constitute acceptable substitutes for U.S. requirements. Arguably, the Blueprint begins this process to the extent that it would require the SEC to consider the issuer disclosure standards on foreign exchanges seeking exemptive release.[35] Experience under the Framework will allow the Commission to develop additional expertise in evaluating the quality of issuers' disclosure and accounting oversight in other markets. Many constituencies can be expected to push the Commission in this direction. First, major U.S. exchanges will likely complain that the Blueprint further undermines their capacity to attract new foreign listings, as there will be even less reason for foreign firms to list on public U.S. exchanges when retail investors in this country have improved access to foreign exchanges and broker-dealers. To achieve competitive equality, exchanges may well argue, selective exemptive relief along the lines proposed in the Blueprint should also be available for foreign issuers.[36]

Another source of pressure with respect to foreign private issuers is likely to be foreign jurisdictions themselves, particularly in the European Union. The EU and the United States are currently in the midst of an elaborate process designed to push the two jurisdictions toward a convergence of U.S. and international accounting standards.[37] By 2009, officials are supposed to decide whether the two systems have become sufficiently equivalent to warrant mutual recognition, at least among certain jurisdictions. While the discussions have been couched in the language of diplomacy, there has been at least an implicit threat on the part of European authorities that if the SEC cannot see its way to accepting international accounting standards for European issuers, then the EU may need to revisit the question of whether U.S. GAAP should remain acceptable for U.S. firms raising capital in public European markets. If the Commission can make progress in implementing the Blueprint for ex-

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35. *See* Tafara & Peterson, *supra* note 2, at 61; *see also* Jackson et al., *supra* note 6 (explaining how the allowance of foreign trading screens into the United States facilitates direct U.S. purchase of foreign issuers that do not comply with U.S. reporting standards).

36. Of course, there is considerable doubt whether foreign issuers—at least those from countries with developed markets—will see any need to return to U.S. listings once seamless secondary market linkages are in place. Moreover, if the consolidation of exchange ownership continues, the NYSE Group may be perfectly content to list foreign issuers on its affiliated offshore exchanges where market depth and liquidity is likely to be greater. Again, investor mobility rather than issuer mobility may be the dominant factor in the globalization of financial markets.

37. *See* SEC Press Release, SEC, SEC and CESR Launch Work Plan Focused on Financial Reporting (Aug. 2, 2006), *available at* http://www.sec.gov/news/press/2006/2006-130.htm; *see also* Kern Alexander, Eilis Ferran, Howell Jackson & Niamh Moloney, *Transatlantic Financial Services Regulatory Dialogue*, 7 EUR. BUS. ORG. L. REV. (forthcoming 2006).

changes and broker-dealers in the next few years, its extension to foreign issuer disclosure and accounting standards could offer an attractive and principled way out of a potential confrontation with EU officials in 2009.

Of course, SEC jurisdiction covers foreign entities in many other areas, including, for example, investment companies and (perhaps someday) hedge funds. Similar issues arise with regard to the oversight of foreign auditing firms and investment advisers. Arguably, the logic of the Framework could be extended to these other areas. Just as U.S. investors would benefit from having better and cheaper access to appropriately regulated foreign exchanges and broker-dealers, so too might they benefit from better access to collective investment vehicles policed by adequate foreign laws. Once the Commission accepts the theoretical underpinnings of the Tafara and Peterson Blueprint, U.S. investors may gain access to a wide range of new investment opportunities.

Deciding where and how far the logic of the Tafara and Peterson proposal should be extended will require the Commission to make a number of difficult determinations as to which accommodations most effectively advance the interests of U.S. investors. To a large degree, these are empirical questions to which additional academic work might provide helpful guidance. To date, most economic research on globalization of capital markets has explored the benefits of cross-border financings to issuers. Hence, a common measure of the benefits of globalization is the reduction in the cost of capital for issuers.[38] While lower capital costs presumably benefit consumers through higher economic growth, the benefits are not entirely obvious to the consumers in countries like the United States where foreign issuers come to raise their capital. Indeed, foreign issuers could end up competing with domestic firms for scarce domestic capital and forcing local firms to pay more for their capital. It would be quite useful to see more economic analysis of the benefits to local investors from cross-listings of foreign issuers or secondary market linkages of the sort at issue in the Blueprint, either from diversification benefits, from reduced transactions costs, or from increased competition.[39] It should, in theory, be possible to quantify many of the benefits for individual investors suggested above. Such work could guide the Commission and its staff as they move ahead with the Blueprint's proposal or consider extending the framework to other areas. Useful work might also be done to consider whether other mechanisms, such as consumer financial education, might also be needed to encourage consumers to increase the diversification of their portfolios. Similarly, further work might be done into the potential benefits of increasing U.S. retail investor access to foreign investment funds and related products.

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38. *See* Karolyi, *supra* note 8; *see also* Luzi Hail & Chistian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. ACCT. RES. 485 (2006).

39. To be sure, some leading economists have already identified this as an important issue and the need for diversification in the pension plan savings of developing countries has received particular attention in recent years. *See* Campbell, *supra* note 21; *see also* Jhon Carmona, Revisiting Legal Limitations on Foreign Investing by Pension Funds (May 2006) (unpublished LL.M. paper, Harvard Law School), *available at* http://www.law.harvard.edu/programs/pifs/LLMpapers/Jhon%20Carmona%20Final%20Paper.pdf.

Conceivably reforms in these other areas may be even more valuable to retail investors than providing greater access to foreign exchanges and broker-dealers.

V. Conclusion

The Tafara and Peterson proposal represents, in my view, the beginning of a new chapter in the relationship between the SEC and its sister agencies around with the world. For much of the twentieth century, the Commission justly considered itself to be the world's premier securities market regulator. But with the passage of time, the capital markets of many other countries have developed and the supervisory capabilities of many jurisdictions have expanded—often with the assistance of advice from the SEC or the International Organization of Securities Commissions. Today, a number of these jurisdictions provide capital market oversight that is substantially equivalent to SEC supervision. The Tafara and Peterson proposal recognizes this new reality and offers concrete steps that will allow the Commission to take advantage of the expanded supervisory capabilities of many jurisdictions and that will bring new and beneficial investment opportunities to the American public.