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Failed Efforts At Harmonization of Securities Regulation

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ABSTRACT

This Article is based on a speech made by Professor Karmel at the Brooklyn Journal of Corporate, Financial, & Commercial Law annual symposium in May 2022 titled "Commercial Law Harmonization: Past as Prologue," analyzing the work done in the past half-century to balance commercial law. The symposium also celebrated the career of Neil B. Cohen of Brooklyn Law School for his teaching and participation in law reform efforts.

I really do not belong on this program because I am not a contracts, bankruptcy, or commercial law expert. My knowledge of these subjects has come primarily from going to Neil Cohen when I had a problem and having him generously and patiently impart what I needed to know. In one situation, where I was somewhat mistakenly hired to testify on New York contract law in a United Kingdom (U.K.) commercial court, I spent so much time being coached by Neil that I felt I should have shared my fee with him, but of course, he refused that offer. So, I agreed to participate in the "*Commercial Law Harmonization: Past as Prologue*" symposium out of my long friendship and respect for Neil and an opportunity to praise his enormous contributions as a teacher, scholar, and participant in global harmonization projects.

In contrast to Neil's successful work on the harmonization of commercial law, my topic is the harmonization of securities law. This is a topic I spent much time on in the past, but unfortunately is something of a dead letter today. In the 1980s and 1990s, stock exchanges looking to list foreign issuers and multinational companies looking for unified disclosure standards in different venues pushed to harmonize securities law.[1] The European Commission (E.C.) took on this challenge as part of its single market 1991 project,[2] and there were negotiations between European securities regulators and the United States (U.S.) Securities and Exchange Commission (SEC) to unify disclosure standards for public companies.

Most importantly, and most promising, was an effort to create and endorse international accounting standards and harmonize U.S. and European

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1. *See* Roberta S. Karmel & Mary S. Head, *Barriers to Foreign Issuer Entry Into U.S. Markets*, 24 L. & POL'Y IN INT'L BUS. 1207 (1993).

2. Roberta S. Karmel, *Securities Law in the European Community: Harmony or Cacophony*, 1 TUL. J. INT'L & COMPAR. L. 3 (1993).

generally accepted accounting principles.[3] At that time, many multinational companies had cross-listed on their home stock exchanges and the New York Stock Exchange or Nasdaq.[4] But, they were complaining about the requirements that they had to reconcile their financial statements to U.S. "Generally Accepted Accounting Principles" (GAAP).[5]

At that time, the leading securities markets were in New York and London, and the Euro securities markets in London were much more lightly regulated, if at all, than the markets in New York. Therefore, some of this harmonization effort by the New York exchanges was to compete with London. But the SEC wanted to prevent a race to the bottom. Nevertheless, there was an effort to liberalize and harmonize accounting standards for foreign issuers so that the New York exchanges could attract more listings. Also, some continental exchanges, particularly in France, Germany, and Amsterdam, wanted to get a bigger piece of the pie in securities trading, but they were more highly regulated than the London markets. So, the European Communities[6] decided to harmonize securities regulation in Europe.

In addition, there was talk about the need for a market center in Asia to foster 24-hour trading by the big securities firms. Yet, it was unclear whether this center would be in Tokyo, Singapore, or Hong Kong, leading global harmonization of securities law to become a big topic of talk between securities regulators, private lawyers, and academics. Some harmonization work was undertaken by the International Organization of Securities Commissions (IOSCO), but the disclosure framework adopted by IOSCO was very general and did not have the kind of prescriptive detail required by SEC regulations.[7]

Even organizations like the International Institute for the Unification of Private Law (UNIDROIT) began a project on securities law harmonization. I thought this was a promising idea since it provided me with a few trips to Rome, but this project only demonstrated the power of the private sector to undermine regulatory harmonization. The New York Stock Exchange was interested in harmonization in order to attract foreign issuer listings.[8] Some world-class companies from Europe and Japan did list, but they found SEC

3. *Comparability In International Accounting Standards — A Brief History*, FIN. ACCOUNTING STANDARDS BD., https://www.fasb.org/page/PageContent?pageId=/international/briefhistory.html&bcpath=ff&isStaticPage=true (last visited Sept. 5, 2022).

4. 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).

5. *See* James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58, S61 (1994); M. Elizabeth Rader, *Accounting Issues in Cross-Border Securities Offerings*, 17 FORDHAM INT'L L.J. S129, S133 (1994).

6. At this time, the European Union was still known as the European Communities.

7. *See* International Disclosure Standards, 64 Fed. Reg. 6261 (Feb. 2, 1999) (to be codified at 17 C.F.R. Parts 210, 228, 229, 230, 239, 240, 249, 260); *See also* Roberta S. Karmel, *IOSCO's Response to the Financial Crisis*, 37 J. CORP. L. 849, 900 (2012).

8. Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Restraints*, 29 INT'L L. 875, 885–86 (1995).

requirements daunting, and after the Sarbanes-Oxley Act of 2002[9] (Sarbanes-Oxley) was passed, they did not want to comply with all of the new governance, audit, and disclosure requirements in the statute. These issuers were part of the impetus behind the UNIDROIT project.

In 1993, Daimler Benz AG (Daimler) listed its stock on the New York Stock Exchange with great fanfare.[10] While it reconciled its financial statements to U.S. GAAP,[11] it continuously protested against this requirement and advocated for the harmonization of accounting standards. Then in 1998, Daimler acquired Chrysler and became DaimlerChrysler.[12] In connection with these events, the company developed a complicated global U.S. security,[13] hoping to be included in the S&P 500 index (the S&P) to attract more U.S. institutional investors. But, the proponents of this idea did not appreciate that the S&P was not a regulated entity, and despite these cosmetic changes and the importance of Chrysler to the U.S. economy, Daimler was nevertheless a German company and did not qualify for the S&P 500 index.[14] Furthermore, trading in Daimler stock on the NYSE never took off, and eventually, the company exited as an NYSE listing.[15] An influential

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

10. *See generally* Michael Gruson, *Global Shares of German Corporations and Their Dual Listings on the Frankfurt and New York Stock Exchanges*, 22 U. PA. J. INT'L ECON. L. 185, 188 (2001).

11. *Id.* at 188 n.4 (Noting that, "when Daimler Benz AG listed on the NYSE in 1993, it was required to restate its 1992 annual earnings to comply with U.S. GAAP standards. In Germany, the company had reported a profit of DM 615,000,000 to its shareholders, but it was required to restate this as a loss of DM 1,839,000,000 pursuant to U.S. GAAP").

12. Keith Bradsher, *Effective Today, Chrysler And Daimler-Benz Are One*, N.Y. TIMES, (Nov. 12, 1998), https://www.nytimes.com/1998/11/12/business/effective-today-chrysler-and-daimler-benz-are-one.html?searchResultPosition=17.

13. Gruson, *supra* note 10, at 192–96. (Noting that "German stock corporations customarily issue bearer shares (Inhaberaktien) and not registered shares (Namensaktien). However, in the U.S. market, registered shares are far more common than bearer shares, and trading, clearing, and settlement rules are based on the use of registered shares. The NYSE permits only the listing of registered shares." Thus, German regulators authorized a Global Share. "This concept is rather simple: the corporation issues registered shares as the only class of common shares worldwide. A Global Share of a German corporation is nothing but an ordinary registered share, with no par value, representing equity ownership in that German corporation which is quoted and traded simultaneously and without intermediation by receipts in several markets in the respective currencies of such markets. The form of the share certificate, dividend payment procedures, prerequisites for voting at a shareholders meeting, share register, and other features have been devised so that they meet U.S. and German legal requirements and, as much as possible, and conform with U.S. and German market practices").

14. At the time, there were only ten foreign companies in the S&P, and eight of them were Canadian (they were deemed to be grandfathered in). As a result of not qualifying for the index, the hundreds of S&P 500 index funds sold their Chrysler stock. *See* Gregory L. White & Joseph B. White, *Chrysler Loses S&P 500 Spot After Merger With Daimler*, WALL ST. J. (Oct. 2, 1998), https://www.wsj.com/articles/SB907275554572655000.

15. *Update 1-Daimler, Another German Blue Chip to Abandon NYSE*, REUTERS (May 14, 2010), https://www.reuters.com/article/daimler/update-1-daimler-another-german-blue-chip-to-abandon-nyse-idUKLDE64D15O20100514.

and well-regarded German lawyer who represented Daimler had sparked UNIDROIT's interest in securities law harmonization, but in light of these events involving Daimler and the inability or unwillingness of the SEC to negotiate exemptions from Sarbanes-Oxley for foreign issuers, this project died aborning.

A reprise of this controversy is currently happening with regard to Chinese issuers listed on U.S. exchanges.[16] These issuers are regulated by the SEC to some extent, which requires their financial statements to be examined by U.S. accountants. The Chinese government has claimed this would violate Chinese sovereignty.[17] This standoff led to the enactment of the Holding Foreign Companies Accountable Act,[18] which could result in the delisting of all Chinese issuers from U.S. stock exchanges.[19]

In implementing the single market program, the E.C. did promulgate many directives on securities regulation which served to harmonize the laws in its member states and unify the capital markets in Europe to some extent.[20] But these markets tended to be national rather than global and were not as significant as the securities markets in New York and London.

In general, the SEC applied a national treatment standard to foreign issuers rather than allowing them to follow the securities regulation standards of their home countries or continue to work on harmonized disclosure and accounting standards.[21] Nevertheless, in 2008, the SEC permitted foreign

16. Jack Denton, *NYSE Sees More Chinese Companies Listing in the U.S. and Hurdles for Stocks Like Alibaba Cleared in Months*, BARRON'S (May 23, 2022), https://www.barrons.com/articles/nyse-chinese-companies-stock-listing-alibaba-didi-tencent-51653304942.

17. Evelyn Cheng, *China is clarifying rules for overseas IPOs. Here's what we still don't know.*, CNBC (Dec. 27, 2021), https://www.cnbc.com/2021/12/27/china-is-clarifying-rules-for-overseas-ipos-us-what-we-dont-know.html.

18. Holding Foreign Companies Accountable Act, Pub. L. No. 116-222, 134 Stat. 1063 (Dec. 18, 2020).

19. Per SEC Chair Gary Gensler, around 250 Chinese companies may be delisted as soon as 2024. *See* Ben Werschkul, *SEC Chair: Roughly 250 Chinese companies could be delisted 'as early as 2024'*, YAHOO FINANCE (March 5, 2022), https://news.yahoo.com/sec-chair-roughly-250-chinese-companies-could-be-delisted-as-early-as-2024-122037497.html.

20. Karmel, *Securities Law in the European Community: Harmony or Cacophony*, *supra* note 2.

21. *See generally* Sherbet, *supra* note 8. (Noting that "The debate over the treatment of accruals and reserves has dwarfed that concerning all the other differences. Despite the fact that German GAAP yields larger accrual balances and more expense than would be permissible under U.S. GAAP, Daimler's 1993 adjustment of German accruals and reserves is a reduction of net income. This calculation demonstrates an accounting practice that is acceptable in Germany, but frowned upon in the United States. During profitable years, German firms will record larger accruals than they may truly need in the future. If subsequent years are less profitable, they will adjust for excess accruals by recording as income the excess of the liability provided in a previous profitable year over the actual settlement amount of the liability. With this method of calculation, firms more evenly distribute operating results over the course of several years. Accordingly, Daimler Benz adjusted excess liabilities downward and recorded $2.45 billion in income in 1993. Germans view this adjustment as a desirable practice designed to protect investors and creditors against short-term earnings fluctuations. In the United States, the practice is discouraged as a means of managing

issuers to report in international accounting standards rather than U.S. GAAP, although a reconciliation was necessary.[22] The SEC also created various exemptions for foreign issuers with respect to their accounting statements and corporate governance matters. For example, foreign issuers were exempted from the proxy rules.[23]

The only harmonized regime agreed upon was between the U.S. and Canada.[24] This multijurisdictional disclosure system could not be repeated with the U.K. or any other European country because it would have had to be negotiated with the E.C., but such harmonization was considered. Also, these North American markets had almost fully harmonized legal regimes.

So, in the 1990s, it seemed as if securities law harmonization would follow the commercial law harmonization efforts, which are the subject of today's conference, but for better or worse, such harmonization did not occur and was sidelined by politics and developments in the capital markets. There have been so many changes in securities regulation and trading in the global capital markets between the 1990s and today that it is hard to pinpoint all the factors that led to the demise of securities harmonization efforts. I believe, however, that the most important developments were: (1) the refusal of the SEC to fully embrace international accounting standards; (2) the shift of institutional trading into loosely regulated private (rather than public) markets; (3) the ability of institutional investors to go abroad to trade foreign securities; (4) the exit of European and other foreign issuers from the regulated U.S. markets; (5) changes in stock exchanges and trading on exchanges; (6) the rise of the People's Republic of China as a non-capitalist and non-cooperating economic power; and (7) Brexit.

A brooding presence over these developments is the internet and changes in the way in which players in the securities markets trade and communicate. For example, why trade Daimler in New York when a money manager could trade the stock in Germany, where there was a better and more liquid market? And, after a time, this did not need to be done in person, but over the phone or the internet. Yet, U.S. investment banks fanned out globally and became important financial firms in Europe and Asia and operated according to the securities law regimes there.

Regulation has always lagged behind events in the real world, but today, securities regulation is so far behind developments in the capital markets that harmonization efforts would be farcical, so they have been abandoned. In

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income or income-smoothing. Accordingly, U.S. accounting principles require the recording of accruals and reserves to more closely reflect the actual estimate of future costs").

22. *SEC Allows Foreign Private Issuers to Use Financial Statements Prepared in Accordance With International Financial Reporting Standards*, JONES DAY (Jan. 2008), https://www.jonesday.com/en/insights/2008/01/sec-allows-foreign-private-issuers-to-use-financial-statements-prepared-in-accordance-with-international-financial-reporting-standards.

23. 17 C.F.R. §§ 210, 230, 239, 249.

24. Will Kenton, *Multijurisdictional Disclosure System (MJDS)*, INVESTOPEDIA (Jan. 31, 2021), https://www.investopedia.com/terms/m/multijurisdictional-disclosure-system-mjds.asp.

addition, the SEC, like the rest of the government, is a victim of partisanship on the Commission and in the federal courts, so it is unlikely to be able to function as a global leader for securities harmonization regulation. With London similarly riven by political problems, separated from Europe, and with Hong Kong dying as a financial center in Asia, there is no world leader in a position to tame the unregulated capital markets.

Time does not allow me to take a deep dive into these developments, so I will focus on two of the most important ones: (1) the rise of private markets for offerings and trading in securities and (2) the changes in stock exchanges. When the federal securities laws were passed, and thereafter, when a company wanted to raise money from outside investors, it was required to register its securities with the SEC and make the offering in a regulated manner. The registration statement and prospectus contained all material information about the issuer, its business, and management and certified financial statements prepared according to generally accepted accounting principles. Further, after 1964, even if a company had not gone public in a registered offering, if it had over a certain amount of assets and shareholders, it was required to file and publish annual and periodic reports with the SEC and disseminate such reports to its shareholders.[25]

Although an exemption from registration for an initial offering existed for private offerings, these were limited to wealthy and sophisticated investors. In order to compete with the lightly regulated London markets, in the last quarter of the twentieth century, and thereafter, the SEC progressively enlarged the private offering exemption and also streamlined offering requirements for large actively traded issuers. Deregulation of the markets prevailed over rigorous regulation and, very importantly, civil liability for false or misleading disclosures in offering documents and annual reports.

Special exemptions for foreign issuers also relieved the pressure on the SEC to insist that foreign companies fully comply with U.S. securities regulations regarding offerings. Of particular importance was Rule 144A of the Securities Act of 1933 (Securities Act), which provided a safe harbor exemption from registration for specified sales of restricted securities to qualified institutional buyers.[26] In addition, Regulation S, which was adopted by the SEC in 1990, provided an exemption for offers and sales made outside the U.S.[27] The Supreme Court of the U.S. further incentivized foreign issuers to trade securities in private overseas markets by limiting Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) to frauds in connection with the purchase or sale of a security listed on an American stock exchange, or the purchase or sale of any other security in the U.S.[28]

25. Hugh L. Sowards, *The Securities Acts Amendments of 1964: New Registration and Reporting Requirements*, 19 U. MIAMI L. REV. 33, 36 (1964).

26. 17 C.F.R. § 230.144A.

27. 17 C.F.R. §§ 230.901–904.

28. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 273 (2010).

The SEC's insistence that foreign issuers follow U.S. disclosure and accounting standards in their annual reports, if they entered the U.S. markets by listing on a U.S. securities exchange, was a disincentive for foreign issuers to become registered and reporting companies.[29] After the passage of the Sarbanes-Oxley, foreign issuers did not wish to comply with the increased disclosure and accounting burdens of that statute. The exemptions granted by the SEC were insufficient, so they lobbied to exit from the SEC registration system. This option was granted to foreign issuers when the SEC adopted Regulation 12h-6 in 2007,[30] and many foreign issuers took advantage of the opportunity to delist their securities.[31]

In the meantime, stock exchanges, which had been serious regulators of public companies, alongside the SEC, also changed. At one time, stock exchanges promulgated and enforced corporate governance and disclosure regulations on publicly listed companies. Some of these regulations were taken over by the SEC, but some remained with the exchanges. Stock exchanges were then mutual companies, owned by the securities firms that traded on them. Then, at the behest of the large securities firms and the World Bank, stock exchanges all over the world "demutualized and became public companies."[32] They gave up their trading floors and became computers in the sky. As public companies, exchanges were vulnerable to conflicts between their shareholders and listed issuers, and so they no longer were so focused on listing only "blue chip" securities or enforcing listing standards.

29. The requirements for public companies, including all listed companies, to file and disseminate annual and periodic reports remained unchanged until 2012. Then Congress was persuaded by Silicon Valley and Wall Street to greatly liberalize the ability of companies new to the capital markets to go public without all of the rigorous requirements of the registration process, and without the necessity to file annual and period reports after they had large assets and more than 300 public shareholders. This was the so-called JOBS Act which opened the floodgates for less regulated flotations and after- market trading by some issuers that were so large—with market capitalizations of over one billion dollars— that they were denoted as unicorns. These quasi-public companies came to dominate the new issue and trading markets. The impact of this liberalization on foreign issuers is unclear.

30. 17 C.F.R. pts. 200, 232, 240, 249; *The SEC Facilitates Foreign Private Issuer Deregistration Under the Exchange Act*, LATHAM & WATKINS (Apr. 11, 2007), http://financedocbox.com/Stocks/96520343-Client-alert-the-sec-facilitates-foreign-private-issuer-deregistration-under-the-exchange-act-deregistering-equity-securities.html.

31. At least 100 companies filed form 15F to deregister within the first six months alone of the rule taking effect, perhaps surprising some at the SEC. *See* Stephen Taub, *Foreign Issuers Take Deregistration Road*, COMPLIANCE WEEK (Jan. 7, 2008, 7:00 P.M), https://www.complianceweek.com/foreign-issuers-take-deregistration-road/5697.article.

32. *See* Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges,* 1 BROOK. J. CORP. FIN. & COM. L. 355, 356 (2007); Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 368 (2002).

The failure of harmonization, even in Europe, is imperiled by Brexit.[33] Whether the U.K. will continue to follow European Union securities directives remains to be seen, and the effect of Brexit[34] on the U.K. capital markets is unclear.[35]

Why did these and the other factors I mentioned lead to the abandonment of harmonization efforts for securities regulation? Well, what is the point of harmonizing deregulated markets, other than assisting a race to the bottom? The capital markets were doing this without much objection from their regulators. Furthermore, as can be seen in other areas, such as the work of the World Trade Organization, politicians in the U.S., the People's Republic of China, and elsewhere, are not interested in being reined in by supranational powers. If harmonization can be helpful to commercial and business interests, then it can be popular, but if it is restrictive, it is unpopular.

In my work on securities law harmonization in the 1980s and 1990s, I felt that the different corporate governance regimes and capital markets in the U.S. and Europe were serious barriers to regulatory harmonization. With the exception of companies in the U.K., European issuers did not rely on the capital markets for funding, but rather relied upon bank loans and internally generated earnings. These differences resulted in certain intractable differences in accounting standards and financial statement presentations.

Further, securities regulators in Europe were not as important or powerful as the SEC, and they did not understand the legal and political constraints under which the SEC operated. They also did not fully appreciate the SEC's status as an independent agency. The harmonization efforts that were undertaken did bring these capital markets and regulators closer together, but investment activities in the capital markets were more important than law reform efforts. Because securities regulation was only harmonized in a very general way, players in the markets simply side-stepped the regulated markets and operated in the private markets. These developments went well until the financial meltdown of 2009, but the political reaction to that stock market crash led to harmonized banking regulation rather than harmonized securities regulation.

Securities regulation has only been embraced by politicians and regulators when there is scandal in the markets or a stock market crash. We will have to wait and see whether the current stock market volatility leads to

33. *See* Tom Metcalf, *U.K. Outlines Post-Brexit Changes to Capital Market Regulations*, BLOOMBERG (Mar. 1, 2022, 11:07 A.M.), https://www.bloomberg.com/news/articles/2022-03-01/u-k-outlines-post-brexit-changes-to-capital-market-regulations#xj4y7vzkg.

34. Lynn Strongin Dodds, *ICE to shift CDS clearing to Chicago from London*, MKTS. MEDIA GRP. (July 4, 2022), https://www.bestexecution.net/ice-to-shift-cds-clearing-to-chicago-from-london/ (Noting that the "Intercontinental Exchange has confirmed that it will stop clearing credit default swaps (CDS) in London next March and will shift the remaining activity to Chicago").

35. *See* Alexandra Green & Gavin Haran, *The UK's post-Brexit balancing act begins with MiFID II*, LEXOLOGY (May 14, 2021), https://www.lexology.com/library/detail.aspx?g=117814b9-72b7-4f30-a958-41ee0fc05875.

a crisis that will make re-regulation and even securities law harmonization welcome once again.