The S.E.C. and Regulation of Foreign Private Issuers: Another Missed Opportunity at Meaningful Regulatory Change

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I. INTRODUCTION

The observation that world financial markets have and
continue to become more internationalized is no longer novel.
However, a few statistics will illustrate the continued broaden-
ing of the phenomena. Near the end of 1993, U.S. investors
were purchasing approximately $2 billion of foreign securities
per week or engaged in a total of $560 billion in gross trades of
foreign securities for the year.¹ In contrast, U.S. investors
purchased approximately $2 billion of foreign securities per
year from 1985 to 1990.² By 1996, total purchases and sales of
foreign securities by U.S. investors totaled $12.4 trillion.³ To
date, there is little evidence to show that the trend is abating.
Yet, while United States capital markets are the model of
“size, sophistication [and] liquidity,” which explains much of
their attraction to domestic and foreign investors and issuers,
these actors do have the option of looking to competing capital
markets to satisfy their economic needs.⁴ Moreover, financial
economists posit that investors and issuers will not utilize
markets where the marginal costs of additional regulation
exceed the marginal benefits of such regulation.⁵ Because in-
ternationalization has facilitated a network of different regulatory regimes from which investors and issuers all over the

¹. See Todd Cohen, The Regulation of Foreign Securities: A Proposal to
Amend the Reconciliation Requirement and Increase the Strengths of Domestic Mar-
kets, 1994 ANN. SURV. AM. L. 491.
². See id.
³. See Uri Geiger, Harmonization of Securities Disclosure Rules in the Global
⁴. See Nicholas G. Demmo, Comment, U.S. Securities Regulation: The Need
for Modification to Keep Pace with Globalization, 17 U. PA. J. INTL ECON. L. 691,
691-92 (1994).
⁵. See James D. Cox, Rethinking U.S. Securities Laws in the Shadow of
International Regulatory Competition, 55 LAW & CONTEMP. PROBS. 157, 159-65
globe may choose, the economic implication of a regulator's decision is important with regard to the competitiveness of its capital markets.6

As the nature and breadth of the international securities markets continues to change in radical ways, U.S. regulators have accomplished little to address issuer informational disclosure requirements implicated by these changes.7 The United States Securities and Exchange Commission (S.E.C.) has had ample opportunity to view the foreign issuer component of its mandatory disclosure regime as a template from which to experiment with policy change. On February 2, 1999, however, the S.E.C. perhaps recognized that regulatory change is inevitable in order to maintain the United States' position as the globe's preeminent securities market. On this date, the S.E.C. announced proposed rulemaking with respect to disclosure requirements of international issuers offering securities in the U.S.8 The S.E.C. announced these rulemaking proposals in reaction to the phenomenal internationalization of securities markets while touting the broad policies of protecting investors, decreasing the cost of capital to foreign issuers, and facilitating the cross-border flows of capital.9

One result of the internationalization of securities markets has been increased competition among the various national markets for the attraction of both foreign investors and issuers.10 How a given jurisdiction chooses to regulate its markets is critical because capital ultimately flows to the market with "the least government intervention, the highest liquidity, the lowest transaction costs . . . and the lowest tax burden."11 The S.E.C. has recognized that overprotection of investors could result in the lessening of the competitiveness of U.S. capital

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6. See Demmo, supra note 4, at 706-08.
7. See Geiger, supra note 3, at 1786.
11. Id.
markets at the same time emphasizing that it will not engage in a regulatory "race to the bottom"\textsuperscript{12} of reporting standards in attempt of improving the attractiveness of the U.S. markets to foreign issuers.\textsuperscript{13} Thus, herein lies the dilemma: does the S.E.C.'s concern of a regulatory race to the bottom preclude the U.S. securities markets from maintaining their hegemony or shall the S.E.C. adapt its rules to the dynamics of an ever changing world market for securities?

Part II of this Note will discuss the history of how the S.E.C. and other regulators have approached the phenomena of increasing internationalization of securities markets and the current state of the law in the U.S. Part III of this Note argues that although the S.E.C.'s proposed rulemaking is an appropriate method to address the dynamics of the internationalization of the securities markets, economic information theory suggests that the S.E.C.'s rulemaking effort falls short of optimizing the goals of protecting investors, decreasing the cost of capital to foreign issuers, and facilitating the cross-border flows of capital. Part IV of this Note proposes an alternative that would more effectively protect investors' interests, decrease the cost of capital to foreign issuers, and facilitate the cross-border flows of capital.

II. BACKGROUND/HISTORY OF THE REGULATION OF INTERNATIONAL ISSUERS

A. Basic Tenets of United States Securities Laws.

The law governing securities in the U.S. is primarily governed by the Securities Act of 1933\textsuperscript{14} (Securities Act) and the Securities and Exchange Act of 1934\textsuperscript{15} (Exchange Act). These two Acts are supplemented by the individual states' "blue-sky"\textsuperscript{16} laws. The Security Act and Exchange Act serve to pro-

\textsuperscript{12} See Stephen J. Choi & Andrew T. Guzman, \textit{National Laws, International Money: Regulation in a Global Capital Market}, 65 \textit{FORDHAM L. REV.} 1855, 1872-1874 (1997) (describing how nations will have a continuing incentive to lower disclosure standards as a result of competing with other nations to attract more capital into their securities markets).

\textsuperscript{13} See Roquette, \textit{supra} note 10, at 570.

\textsuperscript{14} Securities Act of 1933, 15 U.S.C. \textsection\textsection 77a, et seq. (1994).


\textsuperscript{16} The term "blue-sky" is in reference to speculative schemes which have no basis other than to so many feet of the blue sky. \textit{See BLACK'S LAW DICTIONARY}
ect investors by focusing on issuers' responsibility to disclose material information bearing upon an investor's transactional decision. A primary purpose of the Exchange Act is to make available to investors firm-specific information, known only by firm's management. This purpose is served by requiring historical disclosure of company-specific information, imposing administrative oversight by the S.E.C. of such disclosure, and potential heightened fraud liability. Another purpose of the Exchange Act is to require similar disclosure from registered issuers on a continual basis under S.E.C. oversight. While debate about the importance of information disclosure began in the early 1900's, it was the pall of the stock market collapse and subsequent Great Depression that provided the "political momentum" necessary for Congress to enact the Securities Act in 1933, and the Exchange Act in 1934.

From these landmark pieces of legislation emerged the cornerstones upon which securities laws in the United States rest. These cornerstones are the notions of registration, full and fair disclosure of material information, and the prevention of fraud in relation to the offerings and sales of securities. Securities law scholars often group registration and full and fair disclosure of material information into the general concept of "mandatory disclosure" which refers to information required of issuers offering new securities and information required of registered issuers when making various reports to shareholders. Securities law scholars additionally posit that United

166 (7th ed. 1999).
18. See SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1968) (positing that one purpose of the regulatory scheme of the Exchange Act is to essentially solve the problem of information asymmetry when the investor is making a purchase or sale decision).
20. See Cohen, supra note 1, at 497.
22. See Steinberg & Michaels, supra note 17, at 210. One might argue that the prevention of fraud in relation to the offering and sales of securities and full and fair disclosure are corollaries.
States securities laws have generally gone through a slow evolutionary process shadowing changes in the economy, finance theory, and the costs of mandatory reporting requirements upon entities seeking access to capital markets.\(^4\) However, as growth of foreign capital markets and the Internet continue to challenge the hegemony of the United States capital market, United States regulators must be aware that this slow evolutionary process in relation to foreign issuers seeking access to the U.S. capital markets may not be proper.

### B. History of Domestic Regulation of Foreign Issuers

Until 1974, the S.E.C. did not perceive a need to adopt new reporting forms or rules in response to offerings by foreign private issuers of securities.\(^5\) Prior to 1974, however, as U.S. investors' interest in foreign investment began to pique, S.E.C. Chairman Manuel F. Cohen foresaw that the time would soon come to recognize the notion of an international securities market.\(^6\) Subsequently, the S.E.C. approached the internationalization of securities markets in view of the traditional policy of protecting investors while balancing the competing consideration of facilitating transnational flows of capital.\(^7\) Recognizing the latter competing goal, the S.E.C. acknowledged that building flexibility into the reporting requirements of foreign issuers was the order of the day.\(^8\) Moreover, the S.E.C. has conceded that it has historically treated foreign issuers in a different manner than U.S. issuers.\(^9\) The S.E.C.'s explanation as to its seemingly favorable treatment of foreign issuers, when compared with seasoned U.S. issuers, has not been adequately explained and arguably runs afoul of the

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\(^{24}\) See id. at 245.


\(^{28}\) See id.

S.E.C.'s general statements of policy.\footnote{30}

Although the S.E.C.'s proactive approach to regulating foreign private issuers in light of the internationalization of securities markets is a relatively recent occurrence, U.S. investors had access to foreign equity investments in the form of American Depository Receipts\footnote{31} (ADRs), which have been available on U.S. exchanges since 1927.\footnote{32} ADRs are available to U.S. investors on the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automatic Quotation System (NASDAQ), the American Stock Exchange (AMX) and over-the-counter in the “pink sheet” market.\footnote{33} During the late 1970's, the S.E.C. created forms F-1,\footnote{34} F-2,\footnote{35} F-3,\footnote{36} F-

\footnote{30. See Palmiter, supra note 19, at 48-49. Palmiter presents the following syllogism of mandatory disclosure and ultimately argues that if the syllogism does not apply to foreign issuers, it ought to be reexamined with respect to U.S. issuers:

Premises
1. Management knows more about the issuer and its prospects than do investors.
2. Disclosure by management enables investors to more accurately price expected returns and risks, and thus distinguish between good and bad investments.
3. Disclosure cannot be left to private contracting since managers cannot be counted on to voluntarily disclose price-sensitive information, particularly bad news or revelations embarrassing to management; investors cannot be expected to demand the information they need.

Conclusion
Therefore, to ensure accurate pricing and proper capital allocation, disclosure must be compelled through a system of ex-ante government mandates and supervision, as well as heightened ex-post liability and government enforcement.

\textit{Id.} at 16-17 [footnotes omitted].

\footnote{31. ADRs are documents that represent ownership of either a share or shares of a foreign issuer which a foreign branch of a U.S. bank holds on behalf of an investor. See Ian J. Giddy, \textit{GLOBAL FINANCIAL MARKETS} 439 (1994). The foreign analog to ADR's are coined as international depository receipts (IDR's). \textit{Id.}


\footnote{33. See Mark A. Saunders, \textit{American Depository Receipts: An Introduction to U.S. Capital Markets for Foreign Companies}, 17 \textit{FORDHAM INT'L L. J.} 48, 57 (1993). Before 1971, generally all over-the-counter (OTC) orders were recorded manually on so-called "pink sheets." After 1971, the National Association of Security Dealers created the automated trading system known as NASDAQ and thereby significantly reduced the amount of over-the-counter activity recorded by "pink sheets." See Zvi Bodie \textit{et al.}, \textit{INVESTMENTS} 84 (3rd ed. 1996) [hereinafter \textit{Bodie \textit{et al.}}].

\footnote{34. 17 C.F.R. § 239.31 (1999).}}
and F-6\textsuperscript{38} (applicable to ADR's) by which foreign private issuers could register their securities in the U.S. capital markets pursuant to the Securities Act.\textsuperscript{39} Furthermore, the S.E.C. created Form 20-F,\textsuperscript{40} pursuant to the Exchange Act, which served the purpose of implementing a mandatory periodic disclosure requirement for private foreign issuers.\textsuperscript{41} When originally created, forms F-1 through F-4, F-6, and 20-F were essentially simplified versions of the forms that the S.E.C. required U.S. firms to file and reflected subtle differences as a result of different accounting practices in other countries.\textsuperscript{42}

ADRs facilities fall under two different types: sponsored and unsponsored.\textsuperscript{43} A sponsored ADR facility is one in which the issuer actively participates with the depositary (i.e., foreign branch of U.S. bank) in the issuance of the ADRs.\textsuperscript{44} On the other hand, in an unsponsored ADR facility, the foreign issuer does not actively participate with the depositary in the issuance of the facility.\textsuperscript{45} In an unsponsored ADR facility, the depositary submits form F-6 to the S.E.C. and is subsequently authorized to issue ADR's to interested investors while the foreign issuer in a sponsored ADR facility signs the F-6.\textsuperscript{46} Most foreign issuers seek unsponsored facilities while obtaining an exemption to the periodic reporting requirements of the Exchange Act pursuant to Rule 12g3-2(b)\textsuperscript{47} rather than registering its securities under Section 12(g)\textsuperscript{48} of the Exchange Act.\textsuperscript{49} Foreign issuers have relied upon the Rule 12g3-2(b) exemption but may only trade in the NASD pink sheet market—that is, these issuers' securities may not trade on national

\textsuperscript{35} 17 C.F.R. § 239.32 (1999).
\textsuperscript{36} 17 C.F.R. § 239.33 (1999).
\textsuperscript{37} 17 C.F.R. § 239.34 (1999).
\textsuperscript{38} 17 C.F.R. § 239.36 (1999).
\textsuperscript{40} 17 C.F.R. § 249.220f (1999).
\textsuperscript{41} See Peters, supra note 39, at 232.
\textsuperscript{42} See id.
\textsuperscript{43} See Saunders, supra note 33, at 54.
\textsuperscript{44} See id. at 55-56.
\textsuperscript{45} See id.
\textsuperscript{46} See id.
\textsuperscript{47} 17 C.F.R. § 240.12g3-2(b)(1) (1999).
\textsuperscript{49} See Saunders, supra note 33, at 55.
securities exchanges such as the NYSE or NASDAQ. Moreover, foreign issuers wishing to tap the U.S. capital market will typically establish a secondary trading market for their ADRs, if an active market exists, before proceeding with primary offerings of ADRs. Today, the ADR remains the most popular vehicle for foreign issuers to access the U.S. capital markets.

The year 1989 marked the first significant period of rulemaking for the S.E.C. as it attempted to attract private foreign issuers and appease U.S. investors' appetites for foreign securities. On April 24, 1990, the S.E.C. introduced Regulation S and Rule 144A. The purpose of Regulation S is to make clear the extraterritorial impact of Section 5 of the Securities Act upon foreign issuers. The purpose of Rule 144A is to provide a safe harbor from Securities Act reporting requirements involving the resale of securities to qualified institutional buyers ("QIBs") holding assets totaling at least $100 million. The ultimate effect of these provisions is that the reporting requirements of foreign private issuers using the provisions' safe harbors have been reduced when compared to issuing securities under other provisions of the U.S. securities laws.

51. See Saunders, supra note 33, at 58.
52. See id. at 50.
53. See Roquette, supra note 10, at 584-86.
57. In the parlance of the Securities Act, QIBs are defined differently than an "accredited investor" pursuant to Regulation D. One legal scholar has criticized the apparent inconsistency between the definitions. Under Regulation D, an "accredited investor" can be an institution with $5 million in assets or an individual with significantly less assets. To qualify as a QIB, an institution must hold $100 million in assets. See Lawrence R. Seidman, SEC Rule 144A: The Rule Heard Round the Globe—Or Sounds of Silence?, 47 BUS. LAW 333, 349 (1991).
58. See Karmel & Head, supra note 50, at 1208-09.
59. See Roquette, supra note 10, at 585.
C. Alternative Approaches to the Regulation of Private Foreign Issuers

The last two decades have witnessed alternative methods of mandatory disclosure schemes which regulators in different nations, including the U.S., have adopted in order to deal with the special problems posed by private foreign issuers.60 There have been two basic approaches by which regulators have attempted to reduce the inefficiencies that result from the traditional national regulatory schemes. These two approaches are "reciprocity" and "commonality" harmonization, which encompass the approaches of the European Union, and the Multijurisdictional Disclosure System (MJDS) adopted by the U.S. and Canada in 1991.61

As early as 1980, the European Union (E.U.) had been discussing the proposal of harmonizing the disclosure rules of firms offering securities on a transnational basis within its members' capital markets.62 The policies of the E.U. harmonization plan were threefold: first, investors were to receive sufficient information from which they could assess the risks of their investment; second, all investors were to receive equal access to such information; and third, that the proposed regulations eased the access of foreign issuers to other markets as a function of treating the European Community as a single capital market.63 The E.U. approach to the regulation of private foreign issuers is accomplished by the operation of "directives" and regulations which the European Community authority promulgates.64

Harmonization traditionally takes the form of either the

60. See Geiger, supra note 3, at 1788.
61. See Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 6902, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,812, at 81,860 (July 1, 1991) [hereinafter MJDS Release]. Reciprocity implies that an issuer must comply with its home nation's regulations and the foreign nation's regulations. Commonality implies that an issuer must comply with a single norm agreed upon by two or more nations.
62. See generally Proposal for a Council Directive Coordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Prospectus to be Published When Securities are Offered for Subscription or Sale to the Public, 1980 O.J. (C 355) 39-40, 46.
63. See Peters, supra note 39, at 232.
64. See Steinberg & Michaels, supra note 17, at 214.
“reciprocity” or “commonality” models. Reciprocity refers to the type of harmonization in which regulators of different nations agree to follow the informational reporting standards of other nations while commonality is characterized by nations changing their informational reporting standards to reflect a universal standard. The essence of the E.U. harmonization plan is that all firms wishing to issue their securities on a transnational basis have to disclose specific information on a general form controlled by “mutual recognition” of disclosure standards. Thus, the E.U. harmonization plan follows the reciprocity model since each member nation must agree with the other members that any issuer’s offering document will be accepted in all nations as part of their agreement. While the SEC has been reluctant to accept the reciprocity approach to harmonization beyond its MJDS plan with Canada, the approach is widely accepted throughout much of the world.

In July of 1991, the S.E.C. adopted the MJDS plan which marked the first time that the S.E.C. accepted disclosure documents prepared according to foreign regulations for purposes of securities offerings in the U.S. Pursuant to the MJDS plan, the U.S. and Canada agreed to accept disclosure documents of issuers if they satisfy the reporting standards of the issuer’s domestic regulations. The S.E.C. announced that the MJDS plan was the “first step in meeting the needs of transnational securities transactions.” While the S.E.C.’s adoption of MJDS was a “first step” in that it accepted the reciprocal form of harmonization, the largest single reason explaining the S.E.C.’s decision is most likely the similarity of the Canadian and U.S. mandatory disclosure rules. Because most nations'
disclosure rules are significantly different from those of the United States, it is not likely that the S.E.C. will extend the MJDS plan to other countries in the near future.\textsuperscript{74}

**D. Current Trends in the Law Affecting Private Foreign Issuers**

Perhaps the most important development addressing the special problems raised by transnational securities offering is that of the emergence of the Inter American Association of Securities Commissions (IOSCO). Several nations in the Western Hemisphere founded IOSCO in 1974 for the purposes of providing a forum for regulators of member nations to discuss securities issues and to assist capital formation primarily in the Western Hemisphere.\textsuperscript{75} The S.E.C. is a member of IOSCO and serves as a member of IOSCO's Technical Committee which reviews "major regulatory issues related to international securities . . . transactions and to coordinate practical responses to these concerns."\textsuperscript{76}

In 1987, the IOSCO Technical Committee initiated a study which addressed methods and emergent issues related to the increased levels of transnational securities offerings.\textsuperscript{77} As a result of this study, IOSCO recommended in a report entitled "International Equity Offers" that "regulators [should] be encouraged . . . to facilitate the use of single disclosure documents, whether by harmonization of standards, reciprocity or otherwise."\textsuperscript{78} However, regulators had accomplished little in line with IOSCO's recommendation largely by reason of differing accounting practices among member nations.\textsuperscript{79} It was not until 1995 that IOSCO and the International Accounting Standards Committee (IASC), a body not part of IOSCO, reached an agreement with respect to accounting practices to be applied to the new standards among member nations.\textsuperscript{80} The S.E.C., although applauding the efforts of IOSCO and the IASC, reserved its acceptance of international accounting stan-

\textsuperscript{74} See Demmo, supra note 4, at 706.
\textsuperscript{75} See Steinberg & Michaels, supra note 17, at 238.
\textsuperscript{76} International Disclosure Proposals, supra note 8, at 4.
\textsuperscript{77} See Steinberg & Michaels, supra note 17, at 238.
\textsuperscript{78} International Disclosure Proposals, supra note 8, at 4.
\textsuperscript{79} See Steinberg & Michaels, supra note 17, at 242.
\textsuperscript{80} See id. at 243.
 standards upon their “generally accepted basis of accounting . . . [which] would result in compatibility and transparency, provide full disclosure, and [be] rigorously interpreted and applied.”

On February 2, 1999, the S.E.C. proposed to “revise [its] disclosure standards for foreign private issuers to incorporate the international disclosure standards in their entirety.” The S.E.C. concluded that investor protection would not be jeopardized by incorporating the new international disclosure standards since it did not perceive a “change in the quality of disclosure that investors [would] receive.” Acceptance of the new IOSCO disclosure standards would require the S.E.C. to: amend Forms 20-F, F-1, F-2, F-3, F-4; revise Regulation S-X; and change the definition of a “foreign private issuer” under both the Securities Act and Exchange Act.

Then, on September 28, 1999, the S.E.C. announced that the proposed rules changes it announced on February 2, 1999 would become effective on September 30, 2000. While the S.E.C. encountered little objection to the adoption of the IOSCO standards, the primary advantages and disadvantag-

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82. International Disclosure Proposals, supra note 8, at 7.
83. Id. IOSCO developed and recommended the following ten “core” disclosure items for cross-border offerings: (1) identity of directors and senior management; (2) offering statistics and timetable; (3) essential financial data, reasons for offering, anticipated use of proceeds from offering, information regarding risk factors; (4) information about the issuer’s business and properties; (5) management discussion of financial condition and operating results of issuer; (6) compensation and equity holdings of issuer’s employees; (7) majority shareholders and related party transactions; (8) presentation of financial statements and contingent liabilities; (9) description of offering and listing; and (10) other relevant information. Id. at 5.
85. 17 C.F.R. § 239.31 (1999).
86. 17 C.F.R. § 239.32 (1999).
92. Id. at 3. “All of the comment letters expressed support for increasing in-
es of the harmonization effort in light of increased internationalization of securities markets are clear. A primary advantage of the adopted rule changes is that implied within them is a signal of the S.E.C.'s willingness to work with the commonality model of harmonization. However, the rule changes incorporate the commonality approach to harmonization only to the extent of adopting common accounting standards for multinational offerings while each nation retains its own minimum standards of disclosure for domestic offerings. A primary disadvantage of the S.E.C.'s adoption of the IOSCO standards is that IOSCO's power is limited by its "inability to impose its mandates and the diversity among [IOSCO's] members which . . . leads to disagreements concerning standards." Therefore, much of IOSCO's success might be measured by the S.E.C.'s willingness to remain flexible and follow the lead of IOSCO's mandates in the future.

Clearly, the S.E.C.'s choice of adopting the IOSCO commonality approach of harmonizing mandatory disclosure at the international level was the optimal choice for the S.E.C. since the advantages of commonality outweigh the advantages of reciprocity. The commonality approach make possible the realization of economies of scale since practitioners, investors, and issuers only will have to learn and use a single set of rules as opposed to multiple sets under the reciprocity approach. Moreover, a single common prospectus will make possible more

ternational harmonization of disclosure standards and many expressed support for the proposed amendments . . . ." Id.

93. See Geiger, supra note 3, at 1796-97.
94. See id. at 1797. Geiger argues that the commonality approach to harmonization should be extended to its logical conclusion. That is, there should be a formation of a global prospectus and global coordinator to facilitate international harmonization. The S.E.C.'s rule changes incorporate both commonality and reciprocity approaches in that IOSCO accounting standards follow commonality, but in the end, the changes still follow the reciprocity approach since foreign private issuers must satisfy minimum U.S. reporting standards contained in Form 20-F. Geiger's argument with respect to the benefits of creating an ultimate global regulator is beyond the scope of this Note. Rather, this Note focuses on what information should be disclosed, not upon who should be overseeing the mandatory disclosure requirements.

95. Steinberg & Michaels, supra note 17, at 266.
97. See Geiger, supra note 3, at 1796.
efficient comparison of alternative investments from different markets. Unfortunately, the IOSCO standards merely accommodate differing accounting regimes across nations. These standards still fail to address what type of information is important to investors and, thus, private foreign issuers will continue to incur costs that exceed the benefits of IOSCO changes.

III. ECONOMIC DECONSTRUCTION OF THE IOSCO/S.E.C. PROPOSAL

While the S.E.C.'s recent change in policy impacting foreign private issuers is likely to be the most appropriate method to address increasing internationalization of the securities markets, economic information theory suggests that its effort falls short. The relevant issue has long been not whether the S.E.C. should engage in such regulatory reform, but rather the appropriate depth and nature of that reform. Efficient Markets Hypothesis (EMH) and Modern Portfolio Theory (MPT) imply that the S.E.C. should focus disclosure rules of foreign private issuers primarily upon the dissemination of market risk factors in order to achieve the goals of maintaining the hegemony of the U.S. equity markets, protecting investors, decreasing the cost of capital to foreign issuers, and facilitating the cross-border flows of capital. Moreover, modern economic theories such as chaos theory and noise theory

98. Id.
101. See generally Harry M. Markowitz, Portfolio Selection, 7 J. OF FINANCE 77 (1952). MPT holds that investors may eliminate almost all of the firm specific risk of assets held in their portfolios by the addition of less than perfectly correlated assets to their portfolios. Id. See also generally HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1959).
102. See generally Palmiter, supra note 19. Palmiter recommends that the S.E.C. give issuers the alternative of "opting out" of the disclosure rules. The main thrust of this piece is that investors and issuers may reach a more effective midpoint wherein the issuer discloses an "ex-post" beta plus additional relevant market risk factors that are not easily quantified. While this piece argues that these recommended disclosures should be exempt from the fraud provisions of U.S. law, disclosures with respect to firm-specific information would remain under the fraud provisions. Id.
103. See generally Lawrence A. Cunningham, From Random Walks to Chaotic
can serve to augment the thesis advanced in this Note.\footnote{105} While legal and economic scholars have previously advanced the argument that EMH and MPT explain away the need for mandatory disclosure, this Note argues that these theories better explain what information foreign private issuers should disclose to assist investors when making their transactional decisions.

A. The Economics of Information

The notion of EMH posits that the price of a given stock reflects all available information.\footnote{106} What "all information" means turns on upon whether one refers to either the "weak-form," "semistrong-form," or "strong-form" of EMH.\footnote{107} Weak-form EMH implies that a stock's price reflects such information as the history of past prices, short interest, and trading volume.\footnote{108} Semistrong-form EMH proposes that a stock's price reflects all publicly available information.\footnote{109} Finally, strong-form EMH proposes that a stock's price reflects all information about the firm; even information only available to


\footnote{104} For the seminal work on "noise theory," see Fischer Black, \textit{Noise}, 41 J. OF FINANCE 529 (1986). \textit{See also} Stephen F. LeRoy, \textit{Efficient Capital Markets and Martingales}, 27 J. ECON. LIT. 1585, 1611-12 (1989). Noise theory, in essence, holds that some investors in the capital markets make trading decisions on the basis that they are able to "outwit" other investors. \textit{Id}.

\footnote{105} While economic and legal scholars generally deploy the chaos theory to deconstruct EMH, it seems that the theory better explains "chaotic" stock market events such as the October 1987 crash, as opposed to outright disproving EMH. Noise theory tends to directly support this Note's argument.

\footnote{106} \textit{See BODIE ET AL., supra} note 33, at 340. The EMH is an outgrowth of work done by the French mathematician Louis Bachelier in which he elaborated on a 1900 model which explained that prices of certain assets on the French Bourse over time behaved in a random manner (\textit{ergo}, "random walk"). \textit{See Louis Bacheleir, Theory of Speculation, in THE RANDOM CHARACTER OF STOCK MARKET PRICE 17} (Paul H. Cootner ed., rev. ed. 1964).

\footnote{107} \textit{See BODIE ET AL., supra} note 33, at 341.

\footnote{108} \textit{See id}.

\footnote{109} \textit{See id}.
insiders. Neither financial economists nor legal scholars give much weight to strong-form EMH, but generally agree that markets are very efficient.

Harry M. Markowitz's development of MPT in 1952 dramatically changed the way in which investors viewed the concepts of risk and return. One of the important principles derived from MPT is that a stock's risk is composed of two components. Each firm's risk profile is composed of "unique risk," or alpha, which relates solely to how the firm's stock reacts to factors internal to the firm and "market risk," or beta, which relates to how the firm's stock reacts to market variation. MPT holds that from a starting point of a single asset, as investors add assets to their portfolios at random, average portfolio risk drops appreciably. Alternatively, so long as investors can continue to add less than perfectly correlated stocks to their portfolios, they can continually reduce the unique risk component of each individual stock contained in their portfolios. Since investors may diversify away unique risk, competitive stock markets should not reward investors for taking on such risk. Therefore, the ultimate implication of MPT is that a diversified investor need only be concerned with how his or her portfolio reacts with movements in the underlying market as measured by portfolio beta. In other words, diversified investors should be indifferent to the unique

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110. See id.
111. See id. at 377 (concluding that while markets are very efficient, informational based rewards are available to those who are extremely diligent, smart and creative). Id.
112. Supra note 92 and accompanying text.
114. See id.
115. Id.
116. See Bodie et al., supra note 33, at 194.
117. See id. at 197. The primary lesson of diversification is that investors may actually achieve higher expected returns for less overall risk since unique risk is virtually eliminated. Id. This is achieved because expected portfolio return is a function of the weighted average of each stock's expected return while portfolio volatility (standard deviation) is less than the weighted average of each stock's standard deviation. Id.
118. See Brealey & Myers, supra note 113, at 129-140.
119. See id. at 143. Beta forms the critical slope element of the Capital Asset Pricing Model (CAPM). Id. at 161. CAPM holds that the expected rate of return on a stock is equal to the risk-free rate of return plus the product beta multiplied by the market risk premium; i.e., E(r) = r_f + \beta[E(r_m) - r_f].
risk of the individual stocks contained in their portfolios.

As a result of the market crash that occurred on October 19, 1987, in which the Dow Jones Industrial Average plummeted 23 percent, EMH and its logical outgrowth, MPT, have been called into question by behavioral scientists and economists.\(^1\) Behavioral scientists and economists have attacked EMH and MPT with noise theory; which basically holds that some investors buy and sell stocks, thus affecting prices, based on irrational decisions as opposed to fundamental values.\(^2\) Furthermore, noise theory makes a distinction between "informational" and "fundamental" values of assets which reflects the import of its rationale.\(^3\) The theory is best explained with the following illustration: investors may buy or sell based merely upon what other investors do, which is an informational dimension of value, yet the prices paid for assets may not reflect their fundamental or intrinsic value.\(^4\) Therefore, noise theory suggests that markets may be efficient in incorporating all publicly available information under the semi-strong form of EMH, but that prices of some assets may not be based on rational fundamental values.\(^5\)

Chaos theory is a relatively modern economics of information theory which directly challenges the assumptions of EMH in light of EMH's purported inability to explain market crashes.\(^6\) Simplified, chaos theory holds that minute changes in original conditions can portend large changes in ultimate outcomes.\(^7\) Alternatively, EMH rests upon the assumption that changes in stock prices are purely random whereas chaos theo-

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1. Id. at 297-300. However, Brealey and Myers point out that "Black Monday" did not necessarily disprove EMH, but that the crash merely reinforced the notion that EMH explains relative values of stock prices while EMH's ability to prove the intrinsic value of a security is often labored. Id. The reader should be aware of the fact that the precipitous decline in stock values was not limited to the 30 stocks that make up the DJIA or U.S. stock on a whole; the crash of October 1987 was a world-wide phenomena. See generally PETER S. ROSE, MONEY AND CAPITAL MARKETS 536-37 (5th ed. 1994).
2. See Cunningham, supra note 103, at 565-66.
3. Id. at 563.
4. See id. at 564. Fundamental value of an asset is equal to the net present value of all expected future cash flows. Id.
5. See id. at 563.
6. See id at 593-98.
aly holds that changes in stock prices "thought to be . . . random are not random but exhibit significant pattern." 127 While there is presently no conclusive proof that capital markets follow chaotic behavior, legal scholars and financial economists have opined otherwise. 128 Given a brief description of the various economic models that legal and economic scholars have brought to bear upon the issue of mandatory disclosure, this Note turns to how these models have influenced the S.E.C. in their policy making decisions.

B. Implications of Economics of Information upon Mandatory Disclosure

The EMH and MPT theories have been used to critique the adequacy of the S.E.C.'s corporate disclosure system since the early 1960's. 129 Moreover, EMH and MPT have had a significant influence upon the policy making of the S.E.C. with respect to mandatory disclosure issues since the late 1960's. 130 On the other hand, the noise and chaos theories are relatively new in the legal community as bearing on the topic of mandatory disclosure and are being marshaled to critique the EMH's position as the fundamental model from which policy makers base their disclosure policies. 131 The purpose of this section is to delineate how EMH and MPT have affected the various policies of the S.E.C., and to address how these theories cast doubt on the necessity of mandatory disclosure.

EMH "has served as the intellectual premise for . . . major revision[s] of the disclosure system administered by the S.E.C. . . . ." 132 The S.E.C. expressly invoked EMH in its adoption of integrated disclosure 133 and "shelf regulation"
pursuant to Rule 415\textsuperscript{134} of the Securities Act. Moreover, the Supreme Court's adoption of EMH to support its "fraud-on-the-market" theory in \textit{Basic Inc. v. Levinson},\textsuperscript{135} to satisfy the reliance element in certain securities-fraud cases, served to illustrate the influence EMH has had on the legal community.\textsuperscript{136} While it appears that the S.E.C. and the courts have taken an incremental approach in adapting regulations to the implications of the EMH, the argument has been made that EMH's implications be extended to their logical conclusion.

Since the early 1960's, economic and legal scholars have brought EMH to bear on the question of whether mandatory disclosure is worth the costs it imposes on firms.\textsuperscript{137} Opponents of mandatory disclosure have advanced the following argument: if market professionals acting as arbitrageurs compete for purchasing and selling opportunities by obtaining valuable information upon which to base their transactional decisions, securities will be appropriately priced by operation of such arbitrage activity and, therefore, "the core of the SEC's regime of regulatory mandate, is simply unnecessary."\textsuperscript{138} On the other hand, proponents of the S.E.C.'s mandatory disclosure regime suggest that it might be necessary to protect a

\footnotesize{6383 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982). When an issuer that is subject to the disclosure requirements of the Exchange Act, it may incorporate certain disclosure forms when issuing pursuant to the Securities Act. \textit{Id.} See also \textit{COX ET AL., supra}, note 21, at 245-63 (2d ed. 1997).


135. 485 U.S. 224 (1988). A majority of the Court accepted the notion that in efficient markets, if there is fraud, the cost of such fraud should be reflected in the price of the security in question. Thus, relying on price, is in essence justifiably relying on the fraud. \textit{Id.} at 245-50.


137. \textit{See SELIGMAN}, \textit{supra} note 23, at 195. While the critique of the S.E.C.'s mandatory disclosure system began in the early 1960's, the S.E.C. did not even venture to repudiate the various critiques based upon the EMH theory until 1977. \textit{Id.} As suggested in this Note, the S.E.C. eventually withdrew much of its repudiation. For the primary arguments that mandatory disclosure is obsolete, see generally George J. Benston, \textit{Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934}, 63 AM. ECON. REV. 132 (1973); George J. Stigler, \textit{Public Regulation of the Securities Markets}, 37 J. BUS. 117 (1964).

group of irrational market participants known as "noise traders." However, just because investors choose to participate in trading markets on an uninformed basis is not necessarily an irrational act since the costs of relying on market professionals' role as price makers might be less than the opportunity costs of self-education. Moreover, if it is assumed that noise traders are truly irrational in their decisions because they do not act on fundamental information, such reasoning also supports the conclusion that mandatory disclosure is "irrelevant." Therefore, while noise theory addresses the topic of mandatory disclosure from a different angle, it may be employed to arrive at the same conclusion as does EMH.

Additionally, proponents of mandatory disclosure also raise chaos theory to counter the assumptions of EMH and its conclusion that mandatory disclosure is unnecessary. Chaos theory advocates that the "linear frame of reference" which EMH rests upon is insufficient to explain market behavior. Moreover, chaos theory criticizes EMH's simplistic informational approach by suggesting that other factors such as firm fundamentals, macroeconomic factors, and differentiated time dimensions affect prices of securities. Because EMH does

139. Id. at 929. "The possibility that human beings behave irrationally has been resisted by economists for centuries, and is 'assumed out' of ECMH model." Cunningham, supra note 103, at 565. Cunningham points out that economists, to save face, interchanged the term "irrational" with "noise." See id.

140. See Macey, supra note 138, at 930-31. One may advance the argument that it is not the responsibility of the S.E.C. to protect individuals who opt to act irrationally in the first place, assuming that noise traders are indeed irrational.

141. Donald C. Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. PA. L. REV. 851, 881 (1992). Langevoort advances the argument that much of the revision the S.E.C. has adopted in view of the positive norm of EMH can be justified independently of that economic theory. See generally id.

142. See generally Cunningham, supra note 103.

143. See id. at 603. Chaos theory attacks EMH as being a linear or two-dimensional model, while chaos theory is a multi-dimensional model which explains various behaviors beyond the financial markets.

144. See id. Multi-factor models which attempt to explain market behavior are not the exclusive domain of chaos theory. Arbitrage Pricing Theory (APT) is arguably an earlier attempt to introduce the notion that various factors such as industrial activity, short and long-term inflation and interest rates, interest rate spreads, and default risk have some affect on price. See BREALEY & MYERS, supra note 113, at 169-73. For a discussion of the implications of APT, see generally Steven A. Ross, The Arbitrage Theory of Capital Asset Pricing, 35 J. OF ECON. THEORY 341 (1976). The difficulty in applying APT, however, lies in deciding what factors to include in the model from which to derive an expected return on any
not incorporate the factors which chaos theory recognizes, chaos theory "implies a possible justification for expanded disclosure of information concerning price discovery in the market microstructure." 145 However, as its name implies, economic and legal scholars predominately employ chaos theory only to explain chaotic events—typically, stock market crashes such as the one that occurred in October 1987. 146 The chaos theory has an intuitive appeal as an explanatory model, yet its weakness lies in its inability to explain overall market behavior. This Note does not suggest, however, that the model be discounted as having no value as the basis of a positive norm. Therefore, this model should remain as one of the guiding factors for the development of S.E.C. policy. 147

It is obvious that the S.E.C. is nowhere near the point at which it will accept the argument that mandatory disclosure is irrelevant. 148 Various arguments have been advanced for the S.E.C.'s reluctance to introduce radical change to the structure of the Securities Act and Exchange Act. For example, the S.E.C. has been accused of extending its regulatory reach and manufacturing crises for purposes of maintaining its relevance. 149 Alternatively, the S.E.C. must become "less . . . at-

given asset. See BREALEY & MYERS, supra note 113, at 171.
145. Cunningham, supra note 103, at 604.
146. See generally id. See generally Lawrence A. Cunningham, Capital Market Theory, Mandatory Disclosure, and Price Discovery, 51 WASH. & LEE L. REV. 843 (1994). An additional disadvantage of chaos theory seems to be its intellectual appeal to the legal community. Unfortunately, legal scholars give short shrift to many of the other explanatory theories of market crashes. For example, one popular theory posits that the October 1987 market crash was largely a result of professional investment managers employing portfolio insurance strategies which created a prime condition for a "cascade" downward of securities prices. See G.J. Santoni, The October Crash: Some Evidence on the Cascade Theory, in THE FINANCIAL DERIVATIVES READER 461, 463-67 (Robert W. Kolb ed., 1992).
147. As a general observation, chaos theory appears to be a favored topic in the legal scholarly literature but does not yet appear to have been accepted as a policy tool of the S.E.C.
148. For example, the S.E.C.'s insistence on protecting investors by demanding disclosure of information is reflected in the following S.E.C. policy statement: The Commission historically has sought to balance the informational needs of investors with our awareness that the interest of the public is served by opportunities to invest in a variety of securities . . . In our 1988 policy statement, we noted that '"the goal in addressing international disclosure and registration problems should be to minimize regulatory impediments without compromising investor protection.' International Disclosure Proposals, supra note 8, at 3 (emphasis added).
149. See Macey, supra note 138, at 936-37.
tached to some of the sacred cows of the United States disclosure system and recognize the merits of different regulatory approaches. On the other hand, if the S.E.C. were to compromise its reporting standards for the sake of foreign private issuers, its position with respect to domestic reporting requirements would come under political regulatory arbitrage pressure, thus creating an environment ripe for a regulatory race to the bottom. Yet, the purpose of this Note is not necessarily to advance the obsolescence of mandatory disclosure argument, but merely to advance the proposition that EMH supports the conclusion that the S.E.C. should have adopted a "less is more" strategy when formulating its recent revisions to the reporting requirement of foreign private issuers.

As introduced above, the key lesson of MPT is that the risk inherent in owning a basket of securities is market risk since firm specific risk may be eliminated through the process of diversification. Therefore, there should be less demand for mandatory disclosure since it focuses on firm-specific risk and does not adequately explain how a given security reacts to "overall market" factors. Consequently, MPT suggests that the S.E.C. should concentrate on requiring issuers to disclose market factors that might have an effect upon the price of the securities they offer to investors. The following question then logically follows: what factors are material to an investor making the transactional decision with respect to market risk?

There are a number of factors, both ex-ante and ex-post, that an investor should use in deciding whether to make any

150. Karmel, supra note 56, at 17.
152. Perhaps the strongest argument for maintaining the current disclosure regime with its attendant focus on historical information is that history serves as an imperfect proxy for the future. That is, "facts of the existing situation enter, in a sense disproportionately, into the formations of our long-term expectations; our usual practice being to take the existing situation and to project it into the future . . . ." See JONATHAN M. KEYNES, GENERAL THEORY 148 (1936). It seems that Keynes suggested that forward looking information is what is truly relevant, but without some sense of the past, expectations might converge on the irrational.
153. See discussion, supra part III.A.
154. See id.
155. KRIPKE, supra note 130, at 92.
given security investment. The first and primary market risk factor an investor should be concerned with is a specific investment's beta (β). 156 β is critical to the investment decision since "[t]he risk of a well-diversified portfolio depends on the market risk of the securities included in the portfolio." 157

Because evidence suggests that the historical returns of the U.S. and foreign security markets are not directly correlated, 158 additions of foreign securities to a domestic portfolio increase the reward-to-volatility ratio to investors. 159 Therefore, foreign firms wishing to issue their securities in the U.S. should be required to report their firm's β (as derived against some U.S. market proxy such as the Standard & Poor's 500) and their domestic market's correlation of annual returns with that of the U.S. market proxy. 160 While β and correlation coefficients would serve as useful ex-ante disclosure, the S.E.C. should require firms to disclose certain forward looking information which could be treated in a similar fashion as other "soft-information" disclosures within the Exchange Act's fraud rules. 161

Since international investing lends itself to multi-dimensional models of deriving securities returns such as the Arbitrage Pricing Theory 162 (APT), 163 the S.E.C. should mandate that foreign firms issuing securities in the U.S. market release information with respect to various forward looking factors which might affect the price of those securities. For example,

156. See discussion supra, part III.A.
157. BREALEY & MYERS, supra note 113, at 143. Critics of the argument presented in this piece may note that beta is important only if one assumes that all investors are well diversified. The counter to this argument is that even though not all investors are well diversified, the market still only compensates them for non-diversifiable risk. See generally William A. Sharpe, Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk, 19 J. FIN. 425 (1964).
158. See GIDDY, supra note 31, at 428.
159. See BODIE ET AL., supra note 33, at 833.
160. Such information could easily be tested against the fraud provisions of the securities laws since both beta and correlation coefficients are derived from ex-ante return data.
161. For example, Palmiter suggests that 10b-5 liability under the Exchange Act is both a flexible doctrine and sufficient rule to ensure adequate disclosure in most circumstances. See Palmiter, supra note 19, at 130-31. Rule 10b-5 provides the cause of action for fraud in connection with the purchase or sale of any security in the secondary market. See 17 C.F.R. 240.10b-5 (1999).
162. See supra note 144.
163. See GIDDY, supra note 31, at 427.
foreign firms should be required to release forward looking information such as anticipated levels of industrial activity, anticipated changes in inflation, anticipated short and long-term interest rate spreads, and anticipated default risk spreads between low and high-risk corporate bonds.\textsuperscript{164}

Finally, the justification for such disclosure as recommended above rests upon the premise that the addition of international assets into a diversified portfolio is a rational risk reducing decision.\textsuperscript{165} As the discussion above illustrates, detailed firm-specific information is not necessary to investors when making the decision to reduce risk while at the same time maximizing return. Therefore, if the marginal costs to international issuers in meeting mandatory disclosure requirements exceed the benefits of reaching into the foreign market, the S.E.C.'s goals of protecting the interests of investors and facilitating the notion of freely mobile capital will not be realized.

C. Economic Theories Applied to Amended Form 20-F

On September 28, 1999, the S.E.C. announced as a final rule that it was “revising the registration statements used by foreign private issuers under the Securities Act of 1933 to reflect the changes in Form 20-F.”\textsuperscript{166} The S.E.C.'s final ruling with respect to the new international disclosure rules provides that “[a]ny foreign private issuer” may use Form 20-F as a registration statement under the Exchange Act.\textsuperscript{167} Amended Form 20-F requires a foreign private issuer opting to use it for mandatory disclosure requirements to report numerous “items” or “standards.”\textsuperscript{168} This part of the analysis will address the


\textsuperscript{165} See GIDDY, supra note 31, at 446. The implication of this premise is clear: if the S.E.C. truly wishes to protect investors (which includes facilitating the ability to maximize return while minimizing risk) and facilitate cross-border flows of capital, it should construct rules which assist investors and issuers rather than unnecessarily adding costs.

\textsuperscript{166} See Final Ruling, supra note 91, at I.

\textsuperscript{167} Id. at 26. The Final Ruling also amended 17 CFR § 230.405 which now provides that a “foreign private issuer” is any issuer other than: (1) an issuer with greater that 50% of its voting shares held by U.S. investors; (2) an issuer with a majority of officers or directors who are U.S. citizens; (3) an issuer maintaining over 50% of its assets in the U.S.; and (4) an issuer predominantly doing business within the U.S. Id. at 19-20.

\textsuperscript{168} See generally id.
core items which deal with what foreign private issuers must or should disclose. This part also provides the foundation of this Note's contention that while the S.E.C. should be applauded for accepting IOSCO standards, modern economic theory suggests that the S.E.C.'s rule making falls short of realizing the opportunity of truly achieving the goals of protecting investors, decreasing the cost of capital to foreign issuers, and facilitating the cross-border flows of capital. The rule making falls short simply because the S.E.C. has once again failed to sufficiently address what information is important to investors.

The first Item (Item 1) required on revised Form 20-F is the identification of company directors, senior management, and other persons related to the firm's registration of listing. As suggested by EMH, a security's price should already reflect this basic historical information, and therefore, requiring foreign private issuers to disclose such information does not necessarily protect investors but increases the firm's cost of raising capital. Item 2 on revised Form 20-F requires the foreign private issuer to report "key information regarding the conduct of any offering and the identification of important dates relating to [the] offering." While EMH would suggest this information may not be necessary, if in fact the foreign private issuer is filing a registration statement pursuant to the Securities Act, information such as "[t]he time period during which the offer will be open . . . " is obviously indispensable with respect to whether an investor can even enter into a transactional decision.

The purpose of Item 3 is "to summarize key information about the company's financial condition, capitalization and risk factors." The "key" information required under this standard generally includes five years of income statements, balance sheet items, and statements of capitalization and debt levels. While some legal and economic scholars have ar-

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169. See id. at 30-31.
170. See Parts IIIA & B, supra.
171. See Final Ruling, supra note 91, at 31. If the foreign direct issuer is filing a registration under the Exchange Act, then it does not have to report Item 2. On the other hand, if the foreign issuer is filing a registration statement under the Securities Act, then the information is required. See id.
172. Id. at 31.
173. Id. at 32.
174. See id.
argued that such firm specific information is exactly what EMH explains away, 175 history is often the best proxy for the formation of expectations, 176 and thus, this information should be required of foreign issuers. Item 3 should serve as the centerpiece of Form 20-F since many of its other provisions merely repeat the information it generates. 177 Moreover, investors may use much of the information in Item 3 as a proxy for comparing their expectations with the firm's management with respect to forward looking market risk factors required in Item 5. 178

The purpose of Item 5 of the new Form 20-F is to provide "management's explanation of factors that have affected the company's financial condition . . . and . . . assessment of factors and trends which are anticipated to have a material affect on the company's financial condition." 179 The key risk factors included in Item 5 include inflation, foreign currency fluctuations, and political risk. 180 Requiring firms to disclose such factors would serve as a basis from which private and institutional investors could make comparison as to their own future expectations. These investors could compare their expectations with the firm's management drawn not only from historical information disclosed under Item 5 but also from management's forward-looking projections. 181 Thus, Item 5 serves a material function for investors since it provides them with valuable information from which to make a rational transactional decision.

Items 6 and 7 of Form F-20 deal with firm-specific information since they address corporate governance issues. 182 MPT posits that investors are not rewarded for taking on risk

175. See Parts III.A & B, supra.
176. See KEYNES, supra note 152 and accompanying text.
177. See generally Final Ruling, supra note 91.
178. See Final Ruling, supra note 91, at 37-40.
179. Id. at 38.
180. See id.
181. Instructions to Item 5 provides that management "should" supply forward-looking information, but that it is not required. Id. at 39. Whether the S.E.C. "should" require firms to provide forward-looking information is reserved for Part V, infra.
182. Item 6 requires disclosure of information with respect to directors, executive management and employees. See Final Ruling, supra note 91, at 40. Item 7 requires disclosure of major shareholders and firm transactions with such affiliates. See id. at 41.
with respect to management and majority shareholder conduct (i.e., firm-specific risk). MPT further implies that such disclosures could only be of marginal value to a diversified investor\textsuperscript{183} since portfolio risk is a function of multiple securities and their correlations.\textsuperscript{184} Moreover, one could argue that the corporate law doctrines of the “business judgment rule”\textsuperscript{185} and various director and majority shareholder duty rules provide investors with a sufficient insurance contract protecting against firm-specific risk. Because the marginal cost of requiring foreign private issuers to report information with respect to their management structure and purported interested transactions likely exceeds the risk reducing benefits conferred upon shareholders, the S.E.C. has failed in its goals by insisting on disclosure of these Items.

Moreover, Item 10 requires the disclosure of statutory information which does not necessarily relate to market risk factors for which the financial markets would reward an investor. Item 10 requires the reporting of such information as follows: (1) share capital reflected on the balance sheet; (2) the firm’s corporate charter; (3) material contracts outside the normal course of business; (4) governmental currency exchange controls; (5) tax regime; and (6) dividend restrictions.\textsuperscript{186} EMH and MPT might suggest that requiring disclosure of the firm’s corporate charter and material contracts outside the normal course of business are irrelevant with respect to investors’ expected returns since the market only rewards a given investor for taking on market risk. On the other hand, future government exchange controls and tax regimes probably have an effect on market pricing of assets. Additionally, it is reasonable to require disclosure of dividend restrictions since rational investors require some information on dividends from which to build expectations of future dividend cash flows to incorporate into an asset valuation model.\textsuperscript{187}

Item 12 addresses a foreign private issuer’s disclosure

\textsuperscript{183} This argument does not fail in its assumption that all investors are well diversified since the market, in theory, only rewards investors for market risk. Hence, it should be of no moment whether an investor is well diversified or not.

\textsuperscript{184} See Parts III.A & B, supra.

\textsuperscript{185} See, e.g., Smith v. Van Gorkom, 488 A.2d 858, at 872 (Del. 1985).

\textsuperscript{186} See Final Ruling, supra note 91, at 51-53.

\textsuperscript{187} See GARY SMITH, FINANCIAL ASSETS, MARKETS AND INSTITUTIONS 257-59 (1993).
obligations when "registering debt securities" or ADRs.\textsuperscript{188} Item 13 addresses information about unpaid dividends and default.\textsuperscript{189} All of the disclosure with respect to these items contains ex-ante data and is essentially irrelevant, as suggested by MPT. However, critics of MPT point out that investors require firm-specific data when any issuer offers securities in a primary offering because management has an incentive to not fully disclose unfavorable information.\textsuperscript{190} Yet, in the current intermediated securities markets and given an underwriters' reputation concern, before a foreign issuer's securities have hit the market, management has had sufficient incentive to disclose such unfavorable information well in advance of any offering.\textsuperscript{191} Thus, the S.E.C. in requiring the disclosure of information under Items 12 and 13 has imposed a double cost upon the issuer. There is little doubt that such costs outweigh any presumed benefit considering the fact that intermediaries have already priced such information into the foreign private issuer's securities.

Upon an analysis of the S.E.C.'s Final Ruling on amending Form 20-F, it appears that the S.E.C. has missed the opportunity to address the reality that a significant portion of the disclosure required might be marginally important to investors as suggested by the economics of information. Furthermore, the S.E.C. has turned a blind eye to the fact that much of the disclosure required of issuers is otherwise previously disclosed under normal market pressures brought to bear by institutional investors and investment professionals.\textsuperscript{192} Although the great bulk of scholarship on the benefits and costs of mandatory disclosure continues to argue against the "paternalistic tendencies"\textsuperscript{193} of the S.E.C., whether the S.E.C. will ever "let go" of its assumption that market failure\textsuperscript{194} would be the inevitable result of the absence of mandatory disclosure remains unclear; further, it is another question altogether. Nonetheless, the S.E.C. should view the international component of securi-

\textsuperscript{188} Final Ruling, supra note 91, at 54-57.
\textsuperscript{189} See id. at 57.
\textsuperscript{190} See id.
\textsuperscript{191} See id. at 129.
\textsuperscript{192} Cohen, supra note 1, at 512.
\textsuperscript{193} See id. at 128-29.
ties regulation as a prime experimental ground for well-reasoned changes in policy.

IV. RECOMMENDATIONS

While amended Form 20-F incorporates some disclosure with respect to market risk in its provisions, much work remains to be completed to sufficiently provide valuable market risk information to investors in international securities. It is the purpose of this section to introduce some elements of market risk that the S.E.C. has overlooked. Moreover, given the concession that certain ex-ante disclosure is useful and that the S.E.C. failed to make adequate provisions for market risk in amended Form 20-F, this analysis turns to recommendations for future change. Foreign private issuers should be further required to disclose management's forward-looking positions on β, inflation, foreign currency risk, political risk, and domestic market correlation with other markets in which the foreign issuer offers its securities.

This argument rests upon a number of premises. First, since § 27A of Securities Act provides safe harbor for forward-looking statements, the S.E.C. should not merely recommend such disclosure, but make it mandatory. Second, MPT holds that investors are rewarded by their willingness to take on market risk which is derived from information independent of firm-specific information. Third, EMH holds that all publicly available information should be reflected in a given security's offering price. That is, securities should reflect their fair value at all times. Thus, investors making a transactional decision should base their decision upon whether

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196. Id. § 27A(i)(1)(F) provides: "[a] forward-looking statement' means—a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission." Since β and correlation coefficients are not required by Form 20-F, this definition implies that the S.E.C. could further amend Form 20-F to require these types of forward-looking information provided by a firm's management.
197. Such information should be included in mandatory disclosure since it is of true value to rational investors—"noise traders" have no use for fundamental information. Thus, noise theory has no bearing on the argument.
198. See Parts III.A & B, supra.
199. See id.
200. See id.
their future expectations as to market risk differ from that of the market's.

Form 20-F should contain an Item requiring the issuer to report its position on possible future directional movements in their security's P. Inclusion of this information would give investors the valuable information of how the firm's management perceived its security to be affected by changes in the market in the future. Investors would be given additional market risk information on which a comparison with other securities could be based. Moreover, investors might be able to arrive at a more reasoned decision as to whether the addition of the security to their portfolio would have any expected return effect.

Perhaps the most important forward-looking information the S.E.C. should require of foreign private issuers is that of management's opinion regarding how its domestic market may be correlated with movements in the U.S. market. As noted above, investments in less than perfectly correlated assets have the effect of reducing overall portfolio risk while increasing an investor's expected portfolio return. While the S.E.C. states that foreign private issuers may provide forward-looking information with respect to "trend information," this information is limited to firm-specific information which should be of little concern to the well-diversified investor—or for that matter, "noise traders."

V. CONCLUSION

While the S.E.C. should be lauded for integrating IOSCO's international disclosure standards into Form 20-F, it missed the opportunity to further liberalize mandatory disclosure for foreign private issuers in view of the Commission's goals of protecting investors, decreasing the cost of capital to foreign issuers, and facilitating the cross-border flow of capital. No doubt, policy makers and scholars will continue to closely watch the increasing internationalization of securities markets. Also, it follows that there will be a common refrain to the basic argument that the S.E.C. must let go of dated assumptions underlying mandatory disclosure. The fact that the U.S. securities market remains the most attractive market for raising

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201. See GIDDY, supra note 31, at 432-33.
capital can no longer remain as an excuse for letting such regulation stand. As the costs to foreign issuers in raising capital in the U.S. continue to increase in relation to other world capital markets, it will soon be a rational decision for those issuers to turn to less costly alternatives.

The S.E.C. should continue to view foreign issuers as a prime experimental group on which to test regulatory reform. Moreover, it would be best to experiment with mandatory disclosure reform now. Concern about a regulatory "race to the bottom," moreover, is a misplaced conception. Nations which have less stringent disclosure regimes have been pursuing policies to increase the level of disclosure while the U.S., concededly, has been on a track of shedding regulation. Clearly, some level of international convergence is at hand. Should not the S.E.C. attempt to accept its leadership role in discovering regulatory equilibrium? At the very least the S.E.C. should continue its efforts to discover what information is now of true value to the "modern investor."

Trig R. Smith*

203. Relying on the fact that foreign investors have been increasingly accessing the U.S. market to raise capital in order to support the current regulatory environment might prove dangerous to the hegemony of the U.S. capital market. As foreign markets grow in size and efficiency, the costs of U.S. mandatory disclosure could become a significant barrier to entry.

204. "[T]he prototypical investor is no longer our helpless and guileless grandmother, but has instead become our connected and savvy rich uncle." See Palmiter, supra note 19, at 3.

* The author would like to dedicate this Note to his mother, Carla, without whom his life-long ambitions would not have been possible.