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Stock Markets and the Globalization of Retirement Savings -
Implications of Privatization of Government Pensions for
Securities Regulators

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I. Introduction

The collapse of the Berlin Wall in 1989 signaled not only the collapse of Communism as an economic and political ideal, but also the collapse of the centrally planned welfare state that was conceived to bring the world economy out of the Great Depression of the 1930s. Significant privatization of state-owned assets actually began in 1984 when the Thatcher government in the United Kingdom sold off its control of British Telecom. Then privatizations on a massive scale in both developed and developing countries, and especially in former Communist countries, occurred over the past decade. Accompanying this privatization and a general transformation of the world economy to a market economy, albeit with varying degrees of government interference remaining, has been the creation of new capital markets and reform of regulatory systems governing securities issuances and financial intermediaries and markets.

Privatizations of state-owned enterprises have put a huge supply of new equity capital into the international equity markets. The next few decades are likely to witness a significant new demand for equity capital resulting from the privatization of government pensions that began in Chile in 1981 and has spread to some other developing countries. Although pension privatization has not yet spread to the G-10 countries, demographics and budgetary constraints in the United States, Europe, and Japan are likely to lead to a full or partial

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privatization of state pension programs. And although a variety of models for such privatization have been proposed and are being debated, virtually all of the models involve some private sector investment decision-making and the investment of savings into corporate equity securities.

Part II of this article will discuss the demographic, economic, and political developments that are leading to the privatization of government pensions and will set forth the most popular privatization models. This is a complex and hotly debated subject, and the author will not attempt to draw any conclusions with regard to the merits or drawbacks of a free market individually funded and directed pension system. Rather, this article will lay the foundation for a conclusion that substantial retirement savings will flow into the equity markets as a result of restructuring of government pension systems in many countries. Further, the author will argue that despite current limitations on foreign investment, future capital flows will and should go cross-border. Accordingly, capital from mature aging economies will flow into transition economies and capital from transition economies will be invested not only in privatized and new local enterprises, but also in developed foreign economies.

The remainder of Part II will discuss some of the ways in which securities regulators need to prepare for these new pools of equity investment and how capital market regulation may respond to the new pension architecture. Although the United States securities laws will be used as a model, international standards will be referenced where they exist or are developing.

Part III will discuss issuer financial disclosure and governance standards. Part IV will discuss the regulation of financial markets. Although the regulation of financial intermediaries is an extremely important subject, it will not be discussed at length in this article since in most countries this is the responsibility of banking or other regulators. However, Part IV will include some observations on the need for regulation of investment decision-making by collective investment funds and pension fund administrators, and insurance to protect against intermediary insolvency, if a state embarks upon pension privatization. Finally, Part V will touch on the need to dismantle current impediments to the cross-border investment of pension assets in order to put into place prudent investor standards.

II. Experiments with and Debates about Privatization

A. LATIN AMERICA

In 1981, General Augusto Pinochet's government, with the assistance of some American-trained "Chicago School" free market economists, radically restructured the Chilean pension system so that it was transformed from a pay-as-you-go defined benefit system to an individually directed defined contribution system. Although the Chilean government mandates deductions from workers' salaries, and guarantees a minimum pension to those who fail to accumulate sufficient savings, retirement account savings are managed by private mutual funds, not the government. Investments are divided between government-backed debt, interest bearing deposits, and stocks. The new system was established because Chile's

4. See id.
5. See id.
unfunded pension liabilities were subject to a demographic time bomb, payroll taxes were an unpopular twenty-five percent, and the pension reform meshed well with efforts to jump-start Chile's small domestic capital market.  

The Chilean experiment has been vaunted for increasing the nation's savings rate and solving the social security budgetary crisis, but stock market declines and other problems have somewhat dimmed the luster of this model for pension reform. Nevertheless, this model has been widely copied in Latin America, and also is viewed as a solution for the problems of pension programs confronting Eastern Europe.  

Although Chile has been used as a model for emulation, there are different paradigms for the features of an ideal pension system. The International Labor Organization developed a three-pillar paradigm where the first pillar is a mandatory, pay-as-you-go system, financed by taxes, providing a universal subsistence pension, and administered by the state. The second pillar is a mandatory defined benefit plan financed by employers and employees, and administered by social insurance. The third pillar is a state regulated but voluntary feature, financed by employers and employees, providing non-defined or supplementary pensions administered by private sector institutions. According to the World Bank, however, there should not be a first pillar because it might not be financially viable and could, among other things, obstruct the development of the capital market. The World Bank, therefore, offered four alternatives, each one combining a public system and a mandatory savings plan. An analysis of pension fund structural reforms in eight Latin American countries revealed considerable variations, but each of them provided at least the option of a fully funded individually defined contribution plan.  

Of importance to this article are features of private sector administration, investment diversification and yields, payout provisions, and effect on the capital markets. In Bolivia, Chile, El Salvador, and Peru, defined contribution plans are administered by private for-profit corporations and in the remaining countries there are a multiplicity of administrators including private for-profit and non-profit institutions, social security institutions, banks, insurance companies, unions, and cooperatives. There is a positive relationship between the size of the market and the number of administrators. Although the insured is given freedom to choose administrators, that latitude varies from one country to the next. Unfortunately investment yield does not necessarily drive the selection of administrators.

Investment yields generally do not include the cost of commissions (which are high) and generally reflect the performance of world stock and bond markets. Limits on the type of investments that can be made in order to accomplish a healthy diversification is a feature of all of the Latin systems. The bulk of investments in the majority of countries, however,  

6. See id.  
9. See id. at 390.  
10. See id. at 430.  
11. See id. at 431.  
12. See id. at 433.  
13. See id. at 437.  
14. See id. at 434-35.  

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is required to be made in domestic public debt instruments, a limitation the World Bank has questioned.\textsuperscript{15} Disability and death benefits are generally handled by insurance companies.\textsuperscript{16} In Chile, Colombia, El Salvador, Peru, and Uruguay, at the time of retirement the insured has three options: a life annuity paid by an insurance company; a programmed pension for a number of years; and an annuity later.\textsuperscript{17}

The World Bank, and all countries that have introduced some type of defined contribution system component, claim that it will significantly increase national savings. However, the evidence of such growth is somewhat mixed due in part to the costs of transition and administration.\textsuperscript{18} The market, private administration, and freedom to select administrators do not necessarily secure competition, compliance, and low administrative costs.\textsuperscript{19} One expert has, therefore, recommended that the establishment of securities and insurance commissioners precede pension reforms.\textsuperscript{20} Further, where reform is in place or about to begin, investment restrictions should be deregulated in order to encourage portfolio diversification and administrators should be required to publish net investment yields and conduct educational programs.\textsuperscript{21}

Latin American social security privatization is perceived as a massive business opportunity for U.S. and other investment managers and insurance companies that may be selected as administrators of these systems.\textsuperscript{22} Further, many political leaders and their advisors are in a rush to move developing economies further away from central planning and at the same time to solve the looming budgetary crisis social security programs will cause as populations age. The Chilean model therefore is touted as an appropriate model for both developing and developed economies to move the world to a global financial renaissance. One of the areas of the world copying the Chilean model is Eastern Europe.

B. Eastern Europe

Under Communism, pensions were funded by employee contributions to a state system. Demographics and fiscal problems, as well as a political desire to embrace capitalism, led to a rethinking of the role of the state providing of social security. Hungary and Poland have recently made sweeping reforms of their government pension system and opted for privatization. The new Hungarian law became fully effective on January 1, 1998, and requires participating employees to make mandatory contributions to both the state-managed fund and a private fund.\textsuperscript{23} Upon retirement, pensions will come from the state and the private fund. Private pension funds may be established by employers, labor or management organizations, professional organizations, the Pension Insurance Administration, or private

\textsuperscript{15} See id. at 436–37.
\textsuperscript{16} See id. at 424.
\textsuperscript{17} See id. at 427. Mexico, Argentina, and Bolivia have fewer options. See id.
\textsuperscript{18} See id. at 443–45.
\textsuperscript{19} See id. at 449.
\textsuperscript{20} See id. at 451–52.
\textsuperscript{21} See id.
companies. There are regulations with regard to fund governance and asset management, including diversification of investments and prohibitions against undue concentration. There also are conflict of interest provisions. The value of securities invested abroad may not exceed thirty percent of the fund’s assets.

The new Polish law has begun to be implemented in the spring of 1999, and is intended to reinvigorate a state system that was forecast to go bankrupt within the next two decades. The new system will have three pillars, the first of which closely resembles the current state-run system. The second pillar consists of about twenty private pension funds in which participation is mandatory for taxpayers under thirty years old and optional for taxpayers between thirty and fifty years old. The third pillar, which is still on the drawing boards, will encompass voluntary, private plans, including funds organized by companies of five or more people.

Although foreign insurance companies and banks have been licensed to manage some fund assets, only five percent of a fund’s assets may be invested abroad. A pension fund may invest up to forty percent of its assets in stocks, but not more than five percent in a single issuer. However, since each fund must maintain a minimum rate of return, it is anticipated that at least in the early stages most fund assets will be invested in National Bank of Poland instruments or government bonds.

C. The United States

In his January 1999 State of the Union Address, President Clinton proposed to invest hundreds of billions of taxpayer dollars in the stock market and to create government-sponsored defined contribution savings plans for the payees. A consensus in Washington on social security reform that would shift the investment of the social security fund from government bonds into other securities, including common stocks, was an unexpected shift from prior positions staked out by conservative and liberal policy makers. There is a

24. See id.

25. See id. at 30.

26. See id.

27. See id.


29. See id.

30. See id.

31. See id.

32. See id. at 23.

33. See id.

34. See id.


36. See Mary Jane Auer, Savings-Grace, INSTITUTIONAL INVESTOR, Mar. 1999, at 47. A Federal Advisory Panel on Social Security, headed by Edward M. Gramlich, that was appointed in 1994 and issued a report in January 1997 was unable to agree on one single plan for dealing with Social Security’s financial difficulties, but seven of thirteen members recommended compulsory private saving through individual investment accounts; Robert Pear, Panel on Social Security Urges Investing in Stocks, But Is Split Over Methods, N. Y. TIMES, Jan. 7, 1997, at A1. See also Jackie Calmes, Social Security Report Opens Debate, WALL ST. J., Jan. 7, 1997, at A2. Initial White House response was that any plan to put Social Security funds in the stock market raised concerns about risk no matter whether the government or individuals decide where funds should be invested; Jackie Calmes, Clinton Panel Cites ‘Risk’ in Putting Social Security Funds in Stock Market, WALL ST. J., Feb. 11, 1997, at A2. A subsequent
significant variation, however, in the ideas for social security privatization. Some proposals would raise the payroll tax and then permit the social security trust fund to invest in common stocks instead of only government bonds. An alternative would change the present social security defined benefit system to a defined contribution system. The most free market version of this concept would permit persons to invest as they choose, although perhaps only through certified financial institutions. Others contemplate that the private investment accounts would be allocated by the Social Security Administration into a menu of five to ten broad market index funds. Under any of these plans there are further issues about whether, upon reaching retirement, accumulated funds should be distributed or converted to annuities.

Although these proposals are varied, they fall within the paradigms set forth by the International Labor Organization and the World Bank and the privatizations effected in the Latin American and Eastern European countries discussed above. Implementation of any of the proposals, however, would result in the injection of huge capital flows into the equity markets that would then come under the management of either individuals, government approved fund managers, or a government agency.

The driving force behind proposals to privatize social security are the effects that demographics are likely to have on the government’s budget. Because there will be fewer workers paying taxes relative to the number of retirees drawing benefits once the 76 million baby boomers leave the work force in coming decades, social security will take in only enough revenue to pay seventy-five percent of its obligations starting around 2032. Policy


37. See Edward M. Gramlich, Is It Time to Reform Social Security? 58 (1998). It can be argued that allowing the government selectively to invest the trust fund in the private capital markets would amount to socialization of the economy. See Krzysztof M. Ostaszewski, Privatizing the Social Security Trust Fund? Don’t Let the Government Invest, in The Cato Project on Social Security Privatization, at 1 (Jan. 14, 1997). In any event, it would be difficult to insulate such investment from the political process unless investment was made into index funds. That could distort the market value of stocks comprising the index and create other problems because of the large amounts of money involved.

38. See Gramlich, supra note 37, at 60.
39. See id. at 62.
40. See id. at 64. This model is similar to that of the Thrift Savings Fund for federal employees. See 5 U.S.C. 8438 (1994).
41. See Gramlich, supra note 37, at 62.
42. See supra, notes 9–10.
43. See supra, notes 1–37.
44. See Gramlich, supra note 37, at 62. It is estimated that there could be 140 million private investment accounts if social security is privatized. Even if only a small percentage of payroll taxes is put into these accounts and only a small percentage of these funds are invested, directly or indirectly, in the public securities markets, billions of dollars would nevertheless be added to these markets. The Social Security Administration estimates that the size of its fund’s portfolio will be $1 trillion (in 1996 dollars) by 2014. See Social Securities?ECONoMIST, Dec. 14, 1996, at 28.
makers differ dramatically in their reactions to this problem, but virtually all agree that it is a problem that needs to be addressed. Further, the reluctance of politicians to raise payroll taxes or reduce entitlements, and the common mantra that common stocks have better total returns than stocks over time, make it likely that one feature of social security reform will be to allow workers to invest some social security taxes on their own.

D. WESTERN EUROPE AND JAPAN

Due to declining birth rates and increasing longevity, the share of elderly people in the G-10 countries has been growing for the past 150 years. It is probable that this trend will accelerate sharply as the post-World War II baby boom generation begins to reach retirement age. It is estimated that in the year 2010, 19.2 percent of the U.S. population over age fifteen will be over age sixty-five, in contrast to 18.9 percent in the year 1990, and that in the year 2030, that figure will increase to thirty-three percent of the population.

The prospects for a rapidly aging population in other countries are even more dramatic. In the year 2010, 32.5 percent of the Japanese population over age fifteen will be over age sixty-five, and by the year 2030, forty-four percent of the population will be over age sixty-five. By 2025 Japan will have a higher proportion of elderly people than any other country in the world. If there is no pension reform before then, either in terms of reducing benefits or increasing pension fund returns, payroll taxes in Japan will have to rise to thirty-five percent.

The prospects for many European countries are equally grim, especially since Europeans rely more heavily on government pensions in retirement than do Americans. In Germany, France, Italy and the United Kingdom, the percent of the population over age fifteen in the year 2010 will be 27.7 percent, 25.6 percent, 30.4 percent, and 25.0 percent respectively, increasing by the year 2030 to 40.4 percent, 40.1 percent, 47.9 percent and 36.5 percent.

Although these figures could change as a result of migration, disease, or a spike in fertility rates, it is clear that the populations of the world's mature economies are aging and the


48. A recent poll showed 62% of Americans favored this solution and 34% favored investment by the government of some social security funds in the stock market. See Albert R. Hunt, Gray Power Comes of Age: Senior Vote Could Decide 2000 Election, But the Bloc Can be Fickle, WALL ST. J., Mar. 11, 1999, at A9, A14.


50. See id. at 7.

51. See id.


53. See id.


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Drain on government pension programs will create a fiscal crisis absent a drastic increase in payroll taxes or some reform of the pension programs. Countries with pay-as-you-go plans are especially vulnerable. Further, although private or supplementary pension fund assets as a percentage of GDP are ninety percent in the Netherlands and sixty percent in the United States, they are only two to five percent of GDP in France, Germany, and Italy. Moreover, the composition of private pension fund assets varies significantly among G-10 countries. For example, in Belgium, the United Kingdom, and the United States, pension funds hold a majority of their assets in equities, whereas in Germany and Italy pension funds invest primarily in bonds.

An obvious conclusion from the financial consequences of an aging population, in addition to whatever other reforms might be proposed or adopted, is that savings and investment should be increased. Further, a move from traditional government mandatory defined benefit plans to mandatory defined contribution plans, in which everyone has a personal retirement savings account, has the potential for raising national saving.

Various studies and debates concerning reform of state pension systems have begun to occur in Europe and it is likely that controversies over pension reform will echo the differing points of view in the United States. Further, it is highly likely that the inexorable challenge that aging populations will present to government budgetary planners will compel some shift in pension savings from the public to the private sector. Such a shift presents some fundamental issues regarding regulation of the new pension architecture, including the adequacy of securities regulation.

The primary objectives of securities regulation are to protect investors and ensure that securities markets are fair, efficient, and transparent. While the reduction of systemic risk may also be considered an important concern of securities regulators, ensuring against such risk has traditionally been the concern of bank regulators. If governments begin to encourage or even require that their citizens invest retirement savings in the public securities markets, then those governments will become concerned about investor protection and market structure issues.

III. Regulation of Issuers of Securities Financial Disclosure

The United States federal securities laws, as administered by the Securities and Exchange Commission (SEC), require companies that offer securities to the public to comply with initial and continuing disclosure obligations. The goals of this disclosure system are to promote informed decisions by the investing public through full and fair disclosure, which includes preventing misleading or incomplete financial reporting. High quality accounting standards are a critical component of this regulatory system. Although academic com-

56. See id. at 25.
57. See id. at 27.
58. See id. at 41-42, 44.
60. Michael Taylor, The IOSCO Objectives and Principles of Securities Regulation, 13 J. Int'l Banking & Fin. L. 326, 328 (1998). Nevertheless, healthy clearance and settlement systems and the capital adequacy of securities firms in the market are matters of concern for securities regulators. Their focus, however, is investor protection rather than systemic protection. See id.
mentators have disagreed about the need for, and value of, a mandatory disclosure system, this system is well established and extensively copied by securities commissions around the world. Nevertheless, substantive disclosure provisions and procedural requirements have developed in a sufficiently different fashion as to make harmonization and mutual recognition of disclosure regimes difficult.

As pointed out by a former SEC Commissioner, globalization of the capital markets has real challenges for regulators. Some international cooperative measures are necessary if domestic regulators are to be able to continue effectively to regulate their own capital markets. However, "the world's securities markets are beset by a maze of contradictory and incompatible regulatory requirements that often serve no real purpose." Further, nations may legitimately wish to adopt different approaches to some regulatory standards. The SEC has been well aware of these challenges, especially in the area of financial reporting, where comparability is an important value. The SEC's policy, as well as that of securities regulators in Japan, Canada, and some other countries, has been not to adopt a mutual recognition approach or eliminate disclosure requirements that assure the availability of information comparable to that required from domestic registrants.

Nevertheless, the SEC has been working over the past decade with the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC) to develop adequate internationally acceptable disclosure standards. In 1990, IOSCO endorsed development or recognition of standards that would facilitate the evolution of a single disclosure document for cross-border offerings and listings. In 1994, IOSCO completed a review of international accounting standards issued by the IASC, and in the next year IOSCO agreed that a work program prepared by IASC would, upon successful completion, result in a comprehensive core set of standards. These core standards would then be considered by IOSCO as a basis for preparation of financial statements used in cross-border offerings and listings. Despite the difficulties, work on the core standards has gone forward.


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expeditiously, and at the end of 1998, IASC's project was presented to IOSCO for review.\textsuperscript{73}

In the meantime, in September 1998, IOSCO endorsed the Technical Committee's Disclosure Standards to Facilitate Cross-Border Offerings and Listings By Multinational Issuers.\textsuperscript{74} These international disclosure standards consist of ten core disclosure items as follows: identity of directors, senior managers, and advisors; offer statistics and expected timetable; key information including selected financial data, the reasons for the offer, and the expected use of proceeds; description of the issuer's business and properties; operating and financial review and prospects; compensation and shareholdings of directors and senior managers; major shareholders and related party transactions; financial information; description of the offering including plan of distribution, trading markets, selling shareholders, dilution, and expenses; and additional information about the issuer's capital, articles of incorporation and by-laws, material contracts, and applicable taxes.\textsuperscript{75}

The IOSCO and IASC financial and disclosure standards have been developed primarily for use in multi-jurisdictional securities offerings. Nevertheless, they should establish a benchmark for financial disclosure by public companies in emerging as well as mature market economies. Once governments permit and even encourage a shift of pension fund savings from government obligations into corporate equities, they should take on the responsibility of assuring minimum standards of investor protection. The most fundamental of these protections is financial disclosure requirements. Greater transparency is a critical factor in sustaining cross-border flows of pension fund investments from industrial countries into emerging markets.\textsuperscript{76} The converse should also be the case. The IOSCO disclosure standards and IASC core financial standards should serve to make issuer disclosure better and more uniform worldwide.

IV. Corporate Governance

Corporate governance concerns the distribution of power among shareholders, directors and officers, and the extent to which other constituencies, such as employees and creditors, have claims on the directors and the firm.\textsuperscript{77} In different countries, the claims of these various constituencies are ordered differently. In the United States and the United Kingdom, where the financing of enterprise has traditionally been through the public securities markets, directors' duties are owed to their corporations and the shareholders as a body.\textsuperscript{78} Generally, the claims of creditors are paramount only if a company is facing insolvency.\textsuperscript{79} The claims of other constituencies may be taken into account in change of control transactions, but shareholder interests are difficult for public corporations to disregard.\textsuperscript{80}

\textsuperscript{73} See Denny Beresford, The Race Has Just Begun, FIN. TIMES (London), Feb. 11, 1999 at 14; Peta Firth, IASC to Complete Core Standards on Cross-Border Offerings Soon, 30 SEC. REG. & L. REP. 1729 (BNA) (1998).
\textsuperscript{75} See id.
\textsuperscript{76} Implications of Aging, supra note 49, at 32.
\textsuperscript{77} See Arthur R. Pinto, The United States, in THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS 262 (Arthur R. Pinto and Gustavo Visentini eds., 1998) [hereinafter CORPORATE GOVERNANCE].
\textsuperscript{78} See Goodwin v. Agassiz, 186 N.E. 659, 660 (1933); Percival v. Wright, 2 Ch. 421 (1902); Hutton v. West Cork Ry. Co., 23 Ch. D. 654, 671 (1883).
In Germany and Japan, by contrast, bank creditors and employees have stronger claims on the board of directors than in the United States, although this does not mean that shareholder interests are unimportant or neglected. In Italy and the Netherlands, managers tend to have more autonomy and to be self-perpetuating. In France, the state has had a strong influence on corporate governance.

Nevertheless, globalization of the capital markets and the shift to equity based finance has been influencing corporate governance so that shareholders are becoming more influential everywhere. Government policies in France and Italy, for example, have been tilting in the direction of shareholder rights. An important force for greater emphasis on shareholder rights in corporate governance matters is U.S. institutional investors, who have been quite active in the United States with regard to corporate governance reform, and who have begun to export this activism to countries where they become investors. U.K. pension funds have joined in this effort to some extent, and the push for protection of minority shareholders has been felt in Chile, some Asian markets, and elsewhere.

Pension privatization is more likely to result in the management of private accounts by professional money managers than individually self-directed savings accounts. Governments will have too big a stake in the success of privatization not to limit investor choice and encourage, if not require, that pension savings be professionally managed. This means that the ideas that institutional investors have about corporate governance are likely to become official policy. To some extent this is already happening.

The last decade has seen a flurry of reports by committees in different countries concerning corporate governance, which have a surprising degree of convergence. The United States undoubtedly heads the list. In the 1970s, the SEC spearheaded corporate governance reform, but debates about corporate governance then moved to the private sector and focused particularly on the American Law Institute's Corporate Governance Project. Then, such organizations as the Business Roundtable and the National Association of Corporate Directors, and institutional investors, such as Calpers, came out with corporate governance principles. Currently, the SEC is back in the corporate governance act, high-

81. See Birk, Germany, in CORPORATE GOVERNANCE, supra note 77, at 64; Hideki Kanda, Japan, in CORPORATE GOVERNANCE, supra note 77, at 115. See also Klaus J. Hopi, Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe, 14 INT'L REV. LAW & ECON. 203 (1994).
82. See Eugenio Ruggerio, Italy, in CORPORATE GOVERNANCE, supra note 77, at 86; Martijn van Empel, The Netherlands, in CORPORATE GOVERNANCE, supra note 77, at 136.
83. See James A. Fanto, France, in CORPORATE GOVERNANCE, supra note 77, at 7.
84. See id. at 47-48; Ruggerio, supra note 82 at 108-110.
86. See Paul M. Sherer, Raising Their Voices, WALL ST. J., April 26, 1999, at R15.
lighting the role of directors on audit committees. Although there are differences in emphasis and detail in these initiatives, all of them emphasize the need for and importance of independent directors as a check on the CEO. The role of such directors with regard to compensation and audit issues is particularly emphasized.

In Europe, reports recommending corporate governance reform also have been roiling business interests. In the United Kingdom, the Cadbury Committee published a code of best practices, which was then followed by the Greenbury and Hampel reports. In France, similar reform proposals have caught the attention of the legal and business communities. A report to the Organization for Economic Cooperation and Development (OECD) stressed the basic themes of these reports. The OECD Advisory Group set forth an agenda for corporate governance modernization that addressed defining the mission of the corporation in the modern economy as generating long-term economic gain to enhance shareholder (or investor) value; ensuring the adaptability of corporate governance arrangements to allow competition and market forces to work; protecting shareholder rights; enabling active investing; aligning the interests of shareholders and other stakeholders; and recognizing societal interests. With regard to protecting shareholder rights, the OECD report expressed the view that regulatory safeguards should emphasize fairness, transparency and accountability, and take institutional investors into account. Further, there should be a focus on investor access to performance-related information, shareholder exercise of voting rights, and the promotion of active and independent (non-executive) members of boards of directors.

Following receipt of this report, the OECD formed an Ad-Hoc Task Force on Corporate Governance to develop a set of principles that embody the views of member countries on corporate governance standards and guidelines. The OECD then published principles covering the rights of shareholders, equitable treatment of shareholders, including minority and foreign shareholders, the role of stakeholders, disclosure and transparency, and board responsibilities. With regard to board structure, the OECD principles recommend that boards consider assigning non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflicts of interest, such as financial reporting, nomination, and executive and board remuneration.

Corporate governance is both cultural and political. In post-industrial economies, organized labor is weaker than it was formerly and sometimes exerts power as an institutional

93. See Fanto, supra note 83, at n.3.
94. See BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS: A REPORT TO THE OECD (Apr. 2, 1998).
95. See id. at 17-18.
96. See id. at 17.
97. See id.
98. OECD PRINCIPLES OF CORPORATE GOVERNANCE, SG/CG (99) 5, Apr. 16, 1999, at 3.
99. See id. at 6-11.
100. See id. at 10.
As post-industrial societies age, there will be further shifts in the policies exerted upon corporations. In the past, governments and labor have been most interested in the capability of corporations as employers of large numbers of people. In the future, if government pensions are fully or partially privatized, governments and labor will become more interested in corporate profitability and investment returns.

V. Securities Market Structure and Regulation

A. Regulation of Exchanges and Trading Transparency

The transaction costs of privatized pension arrangements are a significant issue. These costs include not only management fees, but also the costs of trading securities. Generally a broker-dealer has a duty to seek to obtain best execution for a customer's order, which is understood to mean that a broker-dealer must obtain the most favorable terms available under the circumstances for a customer's transaction. In today's markets, however, it is frequently difficult to measure best execution. This is because trading markets have become complicated and fragmented.

Until recently, stock exchanges were floor-based membership organizations that traded primarily domestic securities. Today, however, secondary securities market trading is a global business and there is competition among exchanges for listings. Further, stock exchanges around the world, with the notable exception of the New York Stock Exchange (NYSE), have become electronic markets and no longer have floors. The problems of regulating such cyber-markets have only begun to be addressed. Further, the orientation of regulators in different countries concerning trading transparency differs.

The SEC mandate regarding securities market structure is driven by the national market system mandate added to the Securities Exchange Act of 1934 (Exchange Act) in 1975. The critical features of such a system according to the statute are: economically efficient executions; fair competition among brokers and dealers, among exchange markets, and between exchange and non-exchange markets; the availability to brokers, dealers, and investors of information regarding quotes and trades; the practicality of best execution; and the opportunity for investors' orders to be operated without the participation of a dealer. In addition, the statute advocates market linkages.

101. The Teamsters Union, for example, is an active institutional shareholder. State pension funds such as Calpers and the New York City Teachers have a more activist agenda than, for example, the General Motors Pension Fund. See Proposals on Director Independence Get Record Proxy Votes, DIRECTOR'S ALERT, June 1998, at 2; AFL-CIO Steps up Board Power Struggle, supra at 1.


103. See Good-bye to All That, ECONOMIST, Jan. 30, 1999, at 67.


105. See Good-bye to All That, supra note 103.

tional market system by the establishment of a consolidated tape, composite quotation and last sale reporting system, and the development of integrated clearing and settlement rules. Anticompetitive trading rules and practices by exchanges have been attacked if not completely eliminated. The SEC also has attempted to foster fair competition and best execution through the imposition of order execution rules.

In Europe, debates about market structure have centered on the adoption of the Investment Services Directive (ISD) and its implementation. Among other things, the ISD establishes minimum standards for the regulation of stock exchanges. It does so through its provisions relating to "regulated markets." These include a requirement for listings to be conducted in accordance with the listing directive, a reporting requirement to a competent authority for transactions, whether effected on or off a regulated market, transparency requirements, an optimal concentration requirement, and provision for cooperation among the regulated markets. Due to the inability of the European stock exchanges and governments to agree to a market structure model, the ISD almost failed approval and required so much flexibility of implementation to gain approval that it does not provide a standard for pan-European exchange trading. In large part, these disagreements were the product of competition between SE AQ International in London and continental exchanges for trading volume in non-U.K. stocks, but the continental exchanges have reclaimed some of this trading volume, and the advent of remote membership and electronic trading may make this rivalry moot.

In addition to its failure to come to grips with transparency requirements, the ISD does not provide a comprehensive approach to many issues that arise in the regulation of markets. Some issues not addressed are the need for an exchange to be licensed, to have adequate financial resources, to run proper markets, to have adequate monitoring and enforcement, to provide satisfactory arrangement for clearance and settlement, and to cooperate with regulators. In addition, the ISD does not address the very difficult question of when a securities firm or facility should be required to register as a "regulated market."

In the United States, these issues have been addressed in the context of the regulation of alternative trading systems (ATSs). In general, the SEC has been concerned about the lack of transparency of hidden or fragmented markets created by institutional investors in cyber-space. However, regulation of ATSs has focused on defining an "exchange." Rulemaking to this end began with a Concept Release proposing a new regulatory regime that would either require ATSs to register with the SEC as exchanges or impose new obligations that would permit ATSs to continue to be regulated as broker-dealers, but would require them to comply with rules designed to improve their transparency and surveillance, as well as their systems capacity, integrity, and security.  

The SEC asserted that ATSs were handling almost twenty percent of orders in over-the-counter stocks and four percent of orders in NYSE listed securities and, therefore, they needed to be better integrated into the national market system.  

The particular concerns highlighted by the Concept Release as a justification for increased regulation of ATSs were market access and fairness, market transparency and coordination, market surveillance and market stability, and systemic risks. In general, comments opposed the "exchange-lite" concept and suggested that ATSs be permitted to remain registered as broker-dealers as they have been historically. The SEC then proposed rules and requested comment on a framework that would allow ATSs to choose to be a market participant and register as a broker-dealer, or to be a separate market and register as an exchange. The thrust of these proposals was to integrate ATSs into the national market system. Although the proposals were controversial and generated a fair amount of negative comment, the SEC adopted its proposed framework with only minor modifications.

The SEC's objective of bringing ATSs into the national market system has been accomplished by a new and expanded definition of the term "exchange" that captures most ATSs, and a rule exempting ATSs from exchange registration if they register pursuant to Regulation ATS and undertake certain new obligations as to the transparency of their quotes and trades, fair access and systems capacity. The SEC's new rule interprets the term "exchange" to include "any organization, association or group of persons that: (1) brings together the orders of multiple buyers and sellers; and (2) uses established non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade." The SEC justified its revised interpretation by asserting that although traditional exchanges still provide liquidity through two-sided quotations and raise an expectation of liquidity at the quoted price, this is no longer the essential characteristic of a securities market. Today's technology enables market participants to tap simultaneous and multiple sources of liquidity from remote locations. Europe has not been as troubled
as the United States by the proliferation of ATSs because securities regulators generally leave market structure issues to exchanges for their self-regulation. An argument can be made that market structure issues should be left to the competition of the market because competition will assure that pricing mechanisms are sound and fair. Therefore, the only market structure issues that should be the concern of securities regulators are the suppression of manipulation and insider trading.

Nevertheless, the ability of investors in one country to access electronic exchanges in other countries raises serious issues about how secondary securities marketplaces should be regulated and by whom. Although the SEC has adopted new rules for the regulation of ATSs in the United States, it has been unable thus far to propose or adopt regulations pertaining to foreign stock exchanges wishing to provide trading screens to U.S. investors. If social security savings begin to flow into the equity markets and begin to be invested across national borders in cyber-space, these issues will have to be addressed. Should Chilean or Hungarian trust funds, to the extent they can invest internationally, be limited to doing so on "regulated" exchanges or markets? Similarly, if the United States or Germany privatize social security, will their governments allow pension fund assets to be invested in unregulated markets abroad?

Securities regulators have begun to focus on the need to address market structure issues because of the impact of technology and globalization on domestic exchanges. At its 1996 meeting, the Council of Securities Regulators of the Americas (COSRA) issued agreed upon Principles of Market Structure to provide guidance to regulators. Participants at the COSRA meeting acknowledged that in light of the diversity and evolving nature of market structures, it was impossible to imagine a single structure or set of rules well suited for all countries and markets. Nevertheless, regulators were exhorted to concentrate their efforts on pursuing fundamental goals, such as investor protection, full disclosure, fair, orderly, and efficient markets, and the facilitation of venture capital. It was agreed that regulators could lessen the effects of fragmentation across multiple markets and preserve the benefits of competition by promoting best execution, information transparency, and adequate mechanisms for the free flow of information and access to bids and offers simultaneously quoted in different markets.

If social security is privatized, more efficient and better executions of secondary market transactions will have to become a matter of government policy. Whether retirement savings are invested directly by individuals or by collective funds, execution costs will adversely

126. See id. at 308–09.
129. See id.
130. See id.
131. See id. at 854.
affect the return earned on these savings. While some advocates of privatization may argue that equity investment returns are superior to returns on government bonds, these returns are subject to transaction costs. Although these costs may be minimal in relation to other costs of administering a privatized social security system, they could become large enough in the aggregate to attract the attention of government regulators.

The International Federation of Stock Exchanges (FIBV) has recognized that exchanges may offer different degrees of transparency depending upon their resolution of the balance between transparency and liquidity. Nevertheless, the FIBV also recognizes that market transparency is an important element of fairness and, therefore, transactions should be reported promptly, and in detail, as to price and volume to the exchange. The FIBV also has defined the duty of best execution for its members. This involves executing agency orders promptly, and at the best available price for market orders, and charging an agreed-upon, fully disclosed commission. This also involves executing principal orders at a price reasonably related to the market price.

The sheer enormity of the funds that would flow into the equity markets under social security privatization would likely change those markets in unpredictable ways. Whether social security funds are invested through index funds, other types of funds, or through individualized decision making, governments would have a much greater stake in the continued buoyancy of the stock markets than they have today. At the same time, governments would have to be concerned about the efficiency and fairness of those markets.

VI. Continuous Disclosure, Insider Trading, and Manipulation

The prevention and suppression of fraud is a major objective of any securities regulator. If investors do not have confidence that the public securities markets are fair and honest, they will be disinclined to trade in those markets. The preamble to the Exchange Act provides that it is an "Act to provide for the regulation of securities exchanges and of over-the-counter markets" to prevent inequitable and unfair practices on such exchanges and markets. The necessity for SEC regulation, as spelled out in section 2 of the Exchange Act, refers to the national public interest in securities transactions conducted upon public securities markets, the importance of prices established in such transactions, and the need to secure the maintenance of fair and honest securities markets.

The SEC's scheme of mandated public disclosure concerning the business affairs and financial condition of public companies is carried out not only through the registration provisions of the Securities Act, applied when companies sell their securities to the public, but also through the continuous reporting obligations of the Exchange Act. Disclosure requirements are established by the SEC pursuant to the Securities Act of 1933 (Securities Act) and the Exchange Act. The Securities Act is primarily concerned with initial dis-
tributions of securities. It requires that securities issuances either be registered with the SEC prior to sale or that an appropriate exemption from registration exists. The registration statement must contain specified information about the security, the issuer, and the underwriter.

The Exchange Act is primarily concerned with post-distribution trading in securities. It requires publicly held companies to file annual and periodic reports with the SEC, including audited annual financial statements. Under the SEC's integrated disclosure regulations, material in Exchange Act reports can be incorporated by reference in Securities Act registration statements. From 1934 until 1964, when section 12(g) was added to the Exchange Act, only companies listed on national securities exchanges were subject to the registration provisions of the Exchange Act. Under section 12(g), all publicly traded companies of a certain size became subject to the reporting provisions of the Exchange Act.

Today, any corporation with 500 shareholders and $10 million in assets must register its securities under section 12(g) and, therefore, must file an annual report with the SEC containing audited financial information within ninety days of the company's year-end. Information in the annual report, including the year-end financial statements, must be sent to shareholders in order to solicit proxies for the corporation's annual meeting. Exchange Act reporting companies also must file unaudited quarterly earnings reports.

The Exchange Act's regime for corporate disclosure is frequently referred to as a continuous disclosure system. However, corporations are not, in fact, required to make continuous disclosure of material information, although in addition to the annual and quarterly reports that the Exchange Act requires companies to file, they are also required to report certain material events on Form 8-K. The events that trigger a mandatory filing are limited to: changes in control; the acquisition or disposition of significant assets not in the ordinary course of business; bankruptcy or receivership; a change of accountants; resignation of directors; and a change in fiscal years. These are watershed events in the life of a corporation, not events of routine materiality that nevertheless can move stock prices significantly.

Part of the continuous disclosure regime, therefore, is stock exchange policies that affirmatively require the continuous disclosure of material information. For example, the New York Stock Exchange Listing Manual provides that a listed company "is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities." The Securities Act Amendments of 1964,
imposing continuous reporting on all public companies, was patterned after the disclosure obligations in such stock exchange listing requirements.\textsuperscript{153} Congress believed that a system of mandated public disclosure under federal law was necessary to reinforce the essentially voluntary obligations set forth in exchange listing agreements.\textsuperscript{154} By 1964, Congress felt that all public companies, not only listed issuers, should be required to provide shareholders with current information after going public.\textsuperscript{155}

Due to the gaps that exist in the continuous disclosure system, the SEC and the courts also have developed the ban against trading on inside information by public companies, their officers and directors, and their advisors and tippees.\textsuperscript{156} This doctrine was developed pursuant to Section 10(b) of the Exchange Act\textsuperscript{157} and Rule 10b-5\textsuperscript{158} thereunder, a catchall antifraud provision generally used by the SEC to police the public securities markets. These provisions also are the basis for civil liability under the Exchange Act in actions for fraud against issuers, financial intermediaries, and individuals.\textsuperscript{159}

In addition to providing for a continuous disclosure system for public companies and banning trading on inside information, the Exchange Act outlaws the manipulation of securities prices.\textsuperscript{160} Other provisions of the Exchange Act, giving the SEC authority with respect to the regulation of short selling,\textsuperscript{161} options trading,\textsuperscript{162} and securities margins,\textsuperscript{163} are related to the statute’s overall objectives of making the public securities markets fair and efficient and free from inequitable practices and undue speculation. Globalized trading of derivatives has undercut the SEC’s powers in these matters to a significant extent, and created the kind of market volatility that threatens the security markets periodically.\textsuperscript{164}

Countries other than the United States, even those with mature and sophisticated financial markets, do not have such an elaborate regulatory system mandating continuous disclosure and outlawing manipulation of securities prices. The European Union has directives that establish disclosure standards for public offerings and listings of securities,\textsuperscript{165} including the Interim Reports Directive that imposes an ongoing requirement on stock exchange

\textsuperscript{154} See id.
\textsuperscript{155} See id. at 601–605.
\textsuperscript{158} 17 C.F.R. § 240.10b-5 (1998).
\textsuperscript{159} See Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983). Rule 10b-5 has given rise to great quantities of cases and commentaries too numerous to cite.

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listed companies to publish semi-annual profit and loss reports and developments of significance to investors.\textsuperscript{166} The ISD is the only directive relating to trading in the secondary markets and it does not address market manipulation. The new Financial Services Authority (FSA) in the United Kingdom intends to promulgate a Code of Market Conduct that will prohibit market manipulation.\textsuperscript{167} Further, the draft Code proposes a concept of relevant information that should be made available to all users on an essentially equal basis.\textsuperscript{168}

The prohibition against trading on inside information, however, is a concept that has gained widespread acceptance. In the European Union, an Insider Trading Directive\textsuperscript{169} was adopted in order to harmonize insider-trading laws, which previously were not uniform throughout Europe.\textsuperscript{170} All of the EU countries have now implemented this directive, the last of which to do so being Germany in 1994.\textsuperscript{171} In addition, the Council of Europe in 1990 adopted a convention on Insider Trading, condemning it and committing signatories to a regime of mutual assistance in combating it.\textsuperscript{172}

In September 1998, IOSCO issued Objectives and Principles of Securities Regulation\textsuperscript{173} that included five (out of thirty) principles for secondary market trading. The first two were that the establishment of trading systems, including exchanges, should be subject to regulatory authority and oversight, and to ongoing supervision, to ensure that the integrity of trading is maintained through fair and equitable rules. In addition, IOSCO recommended that regulation should promote trading transparency, and detect and deter manipulation and other unfair trading practices.\textsuperscript{174}

The FIBV has been more pointed and more specific regarding anti-manipulation standards. The FIBV believes that its members should refrain from any action that would hinder or disrupt the fair and orderly functioning of the market and give consideration to outlawing specific manipulative conduct, such as trades that involve no change of beneficial ownership or give a false appearance of activity.\textsuperscript{175}

Maintaining sound secondary trading markets are just as important in protecting investors and facilitating capital formation as the establishment of a mandatory disclosure system


\textsuperscript{168} \textit{See id.} at Pt. 1, 19–20.


\textsuperscript{174} \textit{See id.} at 287–88. The remaining principles dealt with regulation of large exposures and clearance and settlement systems. \textit{See id.}

\textsuperscript{175} FIBV Principles, \textit{supra} note 132.
for primary offerings of securities. Before a state privatizes social security, it is essential that it examines the functioning and regulation of domestic trading markets and the markets in other jurisdictions where investment will be permitted to assure that pension savings will not be dissipated in market manipulations or fraud.\textsuperscript{176} In transition economies where capitalism and private law are immature and trading markets are illiquid, it may be difficult to prevent the kind of volatility and speculation that destroys investor savings and confidence.\textsuperscript{177} Realistically, however, the state is the social welfare insurer of last resort. Further, the capital provided by privatized pension funds can assist a transition economy in raising the standard of living in the country. It, therefore, behooves privatizers to insist upon rigorous securities regulation.

Such regulation should include provisions mandating annual and periodic disclosure by public companies in addition to any disclosure requirements pertaining to offerings. Further, administration and enforcement of insider trading prohibitions should emphasize that prompt disclosure of material events by issuers can prevent violations. Also, anti-manipulation provisions in addition to those involving insider trading need to be formulated and enforced. IOSCO and other international organizations have been and can continue to be helpful in formulating international standards in this area.

VII. Regulation of Intermediaries

Although social security privatization sometimes is debated in the United States as if this were a unique and novel idea, the United States already has a mixed pension system. In addition to government-provided pensions commonly known as social security, there are employer provided pensions and individual pensions. Employer pensions may be provided by governmental or private-sector employers, and they may be defined benefit plans or defined contribution plans. The individual plans may be investment retirement accounts or some other type of tax-advantaged plans.\textsuperscript{178}

There are two kinds of risk to which all of these plans are subject: investment risk (in that the fund manager may make investments that decline in value) and credit risk (in that the trustee holding the assets of the pension plan may become insolvent). There are a number of models of intermediary regulation that are designed to mitigate against these risks. One model can be found in the Investment Company Act of 1940,\textsuperscript{179} an important model because a significant proportion of retirement savings is invested in such pooled-investment vehicles. Further, the privatized pension plans of Chile and other countries employ similar funds in their regulatory schemes.\textsuperscript{180}

Investment companies are heavily regulated by the SEC. They must have independent


The membership of a board of directors of an SEC registered investment company may not include more than 60% of members who are "interested persons" of the investment company. Investment Company Act, § 10(a), 15 U.S.C. § 80a-10(a) (1994). The SEC staff believes that the number of independent investors should be increased to a majority. Protecting Investors, supra note 178, at 253–54.

The Pension Benefit Guaranty Corporation (PBGC) insures defined pension plans against employer insolvency. An employee in a participant-directed defined contribution plan has no such PBGC safety net. However, if the plan assets are maintained at a broker-dealer or bank, other government insurance would give the plan some protection against intermediary insolvency. The Federal Deposit Insurance Corporation (FDIC) insures the deposits of banks and savings associations and provides insurance not to exceed $100,000 for each depositor at every insured depositary institution. Customers of brokerage firms...
also enjoy federal deposit insurance. The Securities Investor Protection Corporation (SIPC), a federal insurer similar to the FDIC, is authorized to pay up to $500,000, but not more than $100,000 for a cash claim, to satisfy the net equity claims of customers.196

If plan assets are maintained at a mutual fund, FDIC or SIPC insurance also covers such assets because SEC registered investment companies are required to maintain their securities at banks or broker-dealers.197 Employee benefit plans may also be managed by insurance companies subject to state regulation where plan assets are protected by state insurance guaranty funds.198

To protect the FDIC and SIPC insurance funds, there are capital adequacy rules that cover banks and broker-dealers. Risk-based capital adequacy rules promulgated by the FDIC199 are designed to protect depositors and prevent bank insolvencies. The SEC imposes capital adequacy rules on broker-dealers.200 These regulations differ in that bank regulators calculate capital adequacy on a going concern basis, and securities regulators calculate capital on a liquidation basis.201 Capital standards for insurance companies are established by state regulators to insure long-term viability and to protect policy holders, and capital is calculated on a going concern basis.202 Open-end investment companies are regulated to assure that their shares are redeemable on a daily basis, but there is no federal insurance program designed to pay off mutual fund shareholders if that proves impossible.

The purpose of this analysis is not to point out the complicated and inconsistent nature of the safety net for pension assets in the United States, but to explain that there is a safety net that protects private sector plan assets against intermediary insolvency. The dangers of failing to provide such a safety net were dramatically illustrated in the United Kingdom when Robert Maxwell stole £420 million from the pension schemes under his control.203 This led to an investigation by the Pension Law Review Committee and the adoption of legislation to protect retirement savings against such problems.204

The regulation of investment decision-making to ward off pension losses due to investment risk exists to some extent in the United States, but such regulation is difficult, and as the foregoing suggests, it does not apply to self-directed pension plans. Moreover, as the next part will argue, regulation of investment decision-making by pension plan trustees in the United States and elsewhere often does not accord with modern portfolio theories regarding prudent investment. Further, it frequently outlaws or at least inhibits cross-border capital flows.

VIII. Prudent Investment and Cross-Border Flows

The prudent investor rule is a legal standard prescribed for investment trustees and other financial fiduciaries. The traditional prudent man rule as set forth in the Second Restate-

201. Risk-Based Capital, supra note 198, at 5, 42-43, 54-58.
202. See id. at 64-67.
204. See id.
ment required a trustee to make such investments and only such investments as a prudent man would make of his own property having in mind the preservation of the estate. As narrowly interpreted by the courts, this rule discouraged trustees from making many types of investments and diversifying assets. The core of the prudent man standard was the distinction between prudence and speculation. This narrow conception of safety and risk was not in accord with modern portfolio theory which posits that the risk of owning any particular asset is best measured in terms of the risk that the asset adds to a well-diversified portfolio of assets. Nevertheless, traditional trust law supplemented the duty of prudence with a duty to distribute the risk of loss through reasonable diversification. Thus, trust assets were required to be both diversified and individually prudent.

In 1990, the Third Restatement replaced the prudent man rule with a new prudent investor rule to be applied to investments not in isolation, but in the context of the trust portfolio and as part of an overall investment strategy. This endorses the mitigation of the unique risk of the asset by offsetting that risk against the unique risk of another asset through diversification. The new Uniform Prudent Investor Act similarly embraces modern portfolio theory.

ERISA was enacted in 1974 and imposed the standard of the Second Restatement on trustees. This required them to invest prudently and to diversify. The only negative prohibitions on portfolio selection in ERISA are that no more than ten percent of plan assets may consist of employers' securities or real property. However, as interpreted by the courts, an ERISA fiduciary has no obligation to diversify individually prudent investments even where associated risks could be reduced through diversification. This application of the ERISA prudence standard has been criticized and it has been suggested that ERISA's investment rules should adopt the principles that fiduciaries must make all reasonable efforts to eliminate diversifiable risks.

In the case of participant-directed defined contribution plans, the ERISA prudence rule may become subsumed by broker suitability restrictions. A good argument can be made

205. Restatement (Second) of Trusts § 227(a) (1959).
207. See id. at 66.
208. See id. at 54; see also Deborah M. Weiss, The Regulation of Funded Social Security, 64 Brook. L. Rev. 993, 995–96 (1998).
211. Weiss & Sgaraglino, supra note 209, at 1188–90.
215. ERISA, supra note 214, § 407(a)(2).
216. Weiss & Sgaraglino, supra note 209, at 1192.
217. See id. at 1199. Professor Weiss also has recommended that privatized social security accounts be actively managed by investment professionals. See id. at 1015.
218. In some plans, participants may choose between a menu of mutual funds. It may also be possible for the participant to choose to maintain an account at a broker-dealer and personally select investments. See

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that the suitability doctrine should be informed by modern portfolio theory. Further, modern portfolio theory has been endorsed by many commentators in academia, in practice, and in government, and is utilized in pension and international investment.

Neither ERISA nor any other U.S. law prevents pension assets from being invested internationally. Nevertheless, investors have a preference for domestic investment, even though modern portfolio theory would dictate international diversification. In other countries, there are constraints on the cross border-investment of corporate pension fund assets, and in countries where state pensions have been privatized, such constraints have been imposed.

The pension asset regulations of the principal European countries where pension funds are established reflects a strong bias against equity investments, real estate investments, and foreign investments, with frequent requirements for investment in domestic or EU government bonds. For example, France requires assets of supplementary pensions to be invested fifty percent in EU government bonds; Denmark requires sixty percent to be invested in government debt. The German formula of maximum guidelines—thirty percent EU equity, twenty-five percent EU property, six percent non-EU shares, six percent non-EU bonds, twenty percent overall foreign assets, and ten percent self-investment—discourages both equity and foreign investment. As a critic of these restrictions has pointed out, although the ostensible aim of the regulations are to protect fund beneficiaries, motives such as insuring a steady demand for government bonds may also play a part. However, these regulations prevent funds from reaching an optional trade-off between risk and return. Further, these restrictions may violate the Treaty of Rome.

The European Commission has reached similar conclusions. It has pointed out that with the exception of the United Kingdom and Ireland, EU pension assets are invested primarily in bonds, and equity and foreign holdings are small. For example, only eleven percent of German and fourteen percent of French assets are invested in equities, and member states invest less than ten percent in foreign assets. The commission has criticized and tried to end restrictions against investment diversification by pension funds, but thus far has been unsuccessful in doing so. However, the commission has proposed that a sound policy objective for pension funds would be freedom to invest under the prudent man principle and diversification of assets, including the removal of restrictions requiring or prohibiting

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219. See id. at 256, 270–71.
220. See id. at 253–54.
223. See id.
224. See id.
225. See id. at 193.
226. See id. at 216.
227. See id. at 219.
229. See id. at 11.
Countries privatizing their social security systems have not chosen international diversification. From 1981 to 1991, Chilean privatized funds were barred from investing abroad. Restrictions have been justified as spurring domestic development and helping to cover the costs of shifting from a government-run pay-as-you-go system to a privately managed system, although these justifications have been questioned. Chile had a negative experience with its investment restrictions, which resulted in ninety-seven percent of funds being invested in domestic monetary instruments. After a monetary crisis in 1981-82 threatened the collapse of the pension system, the law regarding diversification was changed to reduce risks and diversify the portfolio of the private pension administrators. By 1996, the legal ceiling for virtually all investments was fifty percent, except for a nine percent ceiling on investment abroad. Nevertheless, only 0.7 percent was invested in foreign instruments by June of 1997. When an economic and financial crisis led to a sharp decrease in local investment, foreign investment increased to only 5.3 percent by October of 1998.

Other Latin American countries also prohibit or limit foreign investment by their privatized pension funds on the theory that capital needed for domestic development should not be exported. Investment in foreign instruments is prohibited in El Salvador, Mexico, and Uruguay, and subject to a legal ceiling of five percent in Peru, nine to ten percent in Argentina, Colombia, and Chile, and fifty percent in Bolivia. Yet actual foreign investment is much lower than these limits, if it exists at all, perhaps due to a fear that short-run volatility may adversely affect the annual minimum yield demanded. The recent privatizations of state pension systems in Hungary and Poland have similarly restricted foreign investment. Hungary limits investment in foreign instruments to thirty percent; Poland to five percent.

Pressure from international organizations such as the OECD and the World Bank are likely to undo, or at least liberalize, the restrictions on foreign investment and the bias against equity investment in the future. Such cross-border capital flows are likely to be encouraged by U.S. pension managers, who are frequently selected to manage privatized pension assets and who are accustomed to investment on a worldwide basis. Further, crises such as the 1981-82 Chilean crisis, may demonstrate the wisdom of utilizing modern portfolio theory in investing pension fund assets.

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230. See id. Switzerland, a non-EU country, recently tried to improve the performance of its state pension fund by expanding stock market investments until they reach 25% of the funds' value. However, only Swiss equities have been selected. See Margaret Studer, Swiss Embrace Stocks to Buoy Social Security, WALL ST. J., Jan. 25, 1999, at A15.
232. See id.
233. See Mesa-Lago, supra note 8, at 435.
234. See id.
235. See id.
237. See id. at 788-89.
238. See Mesa-Lago, supra note 8, at 436.
239. See id.
240. See id.
242. Arend, supra note 22; Millman & Torres, supra note 22; Wayne, supra note 85; Sesit, supra note 85; Paefgen, supra note 85; Speeckaert, supra note 85.
IX. Conclusion

A trend toward social security privatization, or the transformation of state pension systems to private sector systems, is ongoing in transition economies and is likely to spread to mature economies with aging populations. Further, such privatization will involve a shift of pension investments from government bonds to private sector debt and equity securities. The prudent investor standard, which should be applied to pension investments, in conjunction with modern portfolio theory, dictates that the investment of pension fund assets be diversified, and such diversification should result in cross-border investment flows. Currently, there are restrictions against such cross-border investment flows in many countries. However, these restrictions are likely to give way because they do not accord with prudent investor standards, and even if some restrictions remain, the amounts of money involved in pension privatization is so huge that cross-border investment flows will be sizeable.

One of the many complex public policy issues that will have to be confronted when state pension systems privatize is what type of investment restrictions should be imposed on the managers of private pension funds. If the state remains a last-resort provider of social security, the safety of pension funds is a significant issue and concern. In this regard, the development of sound workable international standards for securities regulation is an important objective so that private sector investment management can be incorporated into privatization plans.243

This article has discussed some of the most important components of securities regulation that international regulators and securities regulators should consider in order to promote cross-border capital flows. The topics selected were issuer disclosure, corporate governance, secondary trading transparency and efficiency, market fraud and manipulation, regulation of investment managers, and insurance against intermediary insolvency. All of these topics deserve more attention than time and space permitted for this article. Further, others might have selected different or additional topics as key measurements of good securities regulation.

The author has not cited provisions of the U.S. federal securities laws to promote U.S. hegemony in securities regulation, but because this is the legal standard with which she is most familiar and comfortable. It is important, in this regard, that international organizations such as IOSCO, COSRA and the FIBV, whose standards have been discussed in this article, continue to develop and amplify international benchmarks of good securities regulation, so that the views of many countries can be heard and incorporated into international standards. Organizations such as the World Bank and the OECD should continue advocating and assisting privatization of state pension systems, with a focus on the legal and business infrastructures necessary for such pension funds to be prudently invested. Social security privatizations could become a keystone of the new financial architecture envisioned by those who foresee a new golden age of worldwide capitalism. Stock market crashes, scandals, and corruption could, however, imperil the realization of such a vision.

243. The case against government or employer management has been argued in Weiss & Sgaraglino, supra note 209, at 999–1002.