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Progress Report on Securities Law Harmonization

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of the international standard is good, but it depends on definitions of purchase accounting that are determined by other international standards.

The SEC has proposed to use IAS 7 because it can stand alone. You do not need to refer to any other standard to determine what ought to show up on the cash flow statement. From the SEC's perspective, it is the quality of the information that the international accounting standards produce that will determine how usable they are. The SEC has spent a lot of resources and time working with IASC and IOSCO. The Commission really believes that international standards have the potential to lower costs for issuers by allowing the same financial statements to be used worldwide. The SEC also believes that international standards have the potential to lower costs for investors because people will be reporting information on a comparable basis around the world.

Mr. WAITZER: I do not disagree with anything just said. When I spoke to process, as I said, I think the market will dictate appropriate standards. There was a tremendous resistance initially to Canadian issuers reconciling to U.S. GAAP in order to get access to the U.S. market. Although there has been an ongoing discussion about dropping the reconciliation requirements under MJDS, what is interesting to me is that, over time, the demand for that, amongst Canadian issuers, has fallen away. They are used to reconciling. Some of them will even acknowledge that it may have some merit.

What we are struggling with are the pitfalls presented by the tyranny of unanimity. Indeed, the logjams in the international standards-setting process can disappoint expectations and frustrate people. I was suggesting focusing on process and on noncoercive but appropriate market-driven standards. Those who want to adopt them will, and those who do not, will not. Over time, there should be a congruence between the level of standards you are describing and the demand for appropriate information among investors.

PROGRESS REPORT ON SECURITIES LAW HARMONIZATION

*By Roberta S. Karmel**

Capital is likely to flow to its highest and best use unless it is diverted or restrained by law or cultural biases. Although we often give lip service to the importance of free capital flows in the United States, because this is one of the keystones upon which capitalism rests, frequently we set up legal and structural impediments to the free flow of capital. So do other countries. The fear that an outflow of jobs will follow an outflow of capital to another country is as strong an influence on political decision makers as the fear that foreign investment will place natural resources and productive assets under the control of foreign nationals. A narrow parochialism can easily make national laws the enemy of freedom of capital movements.

Transnational capital flows are not a recent phenomenon. What is more recent is the growth and development of international equity markets, where issuers from one nation sell common stock issues to investors from many nations and thereafter such securities enjoy a secondary trading market. This international market is

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large.[1] In the future, internationalization of the equity markets probably will continue to expand because investors have become persuaded that their portfolios should be global.[2] Individual investors also are interested in diversifying their portfolios globally if they can do so in a cost-effective way. Unfortunately, national economic and regulatory structures pose serious obstacles to international equity investment. Further, there is only very limited international regulation of the securities markets and what international regulatory standards exist are entirely voluntary.

There are essentially four approaches that can be utilized by national securities regulators with regard to international stock market activity. These are national treatment, special rules for foreigners, harmonization and mutual recognition. National treatment is a parity of treatment between foreign and domestic investors, financial products and financial institutions in like circumstances. The United States historically has been a strong advocate of national treatment and the free international movement of goods, services and capital. The EU is committed to the free movement of goods, persons, services and capital—but only within the EU as a trading block. Nevertheless, many discriminatory barriers against foreign firms, both direct and structural, remain both in U.S. law and the laws of EU member states. Accordingly, it can be seen that, at best, national treatment means permitting foreign-owned firms to do business in a country on the same terms and conditions as domestic firms to create a branch or subsidiary in the host country. It may not remove structural impediments to competition by the foreign firm with domestic enterprises. Although national treatment is a mechanism for removing protectionist barriers, it will not necessarily foster free capital flows.

Foreigners clamor for national treatment when domestic laws discriminate against them. However, foreigners may also clamor for exemptions from domestic law or favored treatment pursuant to special rules. As a general matter, the SEC has insisted that foreign issuers comply with the registration provisions of the federal securities laws, including financial presentation according to generally accepted accounting principles ("GAAP") in the United States. Nevertheless, various exemptions and special rules have been designed for securities offerings by foreign issuers.

Regulation S under the Securities Act of 1933 ("Securities Act") permits U.S. investors to purchase unregistered foreign securities abroad.[3] Also, institutional investors are able to resell such securities immediately to qualified institutional buyers in the United States pursuant to Rule 144A.[4] Although these exemptions may be utilized by both U.S. and foreign issuers, they were designed for offerings by foreign issuers.

A different and more longstanding exemption only for foreign issuers is con-

[1] In 1992, there were purchases and sales of foreign stocks totaling $347 billion in the United States. Yet, purchases and sales of foreign companies on the New York Stock Exchange accounted for only 6.8 percent of average daily turnover. The comparable figure for NASDAQ trading was 3.6 percent. By contrast, the purchases and sales of foreign companies on the London Stock Exchange in 1992 accounted for 43.2 percent of trading volume. James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, Int. L. J. (forthcoming, 1994).

[2] *Id.* In 1992, foreign stocks represented 6.5 percent of the portfolio holdings of corporate pension funds, 4.4 percent of public pension funds and 5.3 percent of endowment funds. Greenwich Associates estimates that by 1995 these percentages will increase to 8.6 percent for corporate funds, 7.3 percent for public funds and 6.9 percent for endowments.

[3] 17 C.F.R. §§ 230.901-904 (1990).

[4] 17 C.F.R. § 230.144A (1990).

tained in rule 12g3-2(b) under the Securities Exchange Act of 1934 ("Exchange Act"). This rule exempts a foreign issuer from filing annual and periodic Exchange Act reports if the issuer furnishes the SEC with copies of material information made public in its home country or sent to foreign security holders.[5] Issuers entitled to rely on this exemption generally cannot have securities traded on a national securities exchange or on the National Association of Securities Dealers Automatic Quotation (NASDAQ) System, but their securities can trade in the pink sheet market, including the electronic pink sheets. Reconciliation to U.S. GAAP or General Accepted Auditing Standards ("GAAS") is unnecessary. Approximately 1,500 foreign companies have American Depository Receipt programs that trade this way.

Perhaps more importantly, foreign issuers historically have been and are currently subject to different securities registration and disclosure requirements than U.S. issuers under the federal securities laws. Under these special registration provisions, rules of general application are relaxed. Currently, Form 20-F, adopted by the SEC in 1979, is the combined registration statement and reporting form authorized for use by foreign issuers under the Exchange Act and the core document of the SEC's integrated disclosure system for foreign issuers.[6]

Most commentators agree that the ideal response to the globalization of the securities markets would be the development of international standards for accounting, auditing and disclosure by issuers. Under such a model, a common prospectus would be developed that would set forth agreed-upon international standards for all world-class companies. Similarly, if there were international standards concerning capital adequacy, customer protection, principles of business conduct and insurance of customer accounts, financial institutions could freely establish worldwide, and be governed by such international regulations.

The EU is aspiring to such harmonization within Europe and to that end has already promulgated directives on accounting, disclosure and listing standards. Similarly, the Second Banking Directive[7] and the Investment Services Directive[8] and Capital Adequacy Directive[9] are designed to permit financial institutions to operate with a single passport in all EU member states. Nevertheless, Europe has a long way to go in harmonizing financial disclosure by public issuers, and even under the single passport regime, financial institutions will be subject to host country, rather than home country regulation because of investor protection concerns.

The stumbling block to international listing and offering standards is that there are no internationally recognized standard setters. National standard-setting bodies, particularly in the United Kingdom and certain other countries, are jealous of their prerogatives in setting accounting principles. Furthermore, although the SEC is willing to participate in the process of international standard setting, it has not agreed to recognize the standards of any particular body. The SEC fears that international standards will be inferior to existing U.S. disclosure and financial reporting standards, which will result in a general race to the bottom in disclosure policies and a loss of SEC jurisdiction to establish and enforce rigorous standards.

[5] 17 C.F.R. § 240.12g3-2(b) (1990).

[6] Exchange Act Rel. No. 16371 (Nov. 29, 1979), 44 Fed. Reg. 70132, 71034 (1979).

[7] Council Directive 89/646, 1989 O.J. (L. 386) 1, *amended by* Council Corrigenda of Mar. 30, 1990, 1990 OJ (L 283) 28.

[8] Council Directive 93/22, 1993.

[9] Council Directive 93/6, 1993.

There are two international bodies that are obvious candidates for establishing worldwide disclosure standards for world-class companies. One is the International Organization of Securities Companies (IOSCO) that is comprised of securities regulators from around the world. The other is the International Accounting Standards Committee (IASC) that is an arm of the International Federation of Accountants.

IOSCO has made significant contributions to international standard setting for multijurisdictional offerings and an IOSCO working party has prepared a report on international equity offerings that represents a significant advance in the direction of common disclosure documents, whether by harmonization of standards, reciprocity or otherwise.[10] However, IOSCO is a very diverse organization that represents emerging financial centers as well as mature financial centers. It can only recommend rules of conduct to its members; it cannot impose them. Furthermore, harmonization of issuer disclosure requirements for international offerings cannot be achieved without the establishment of international accounting and auditing standards.

The IASC is the most likely body for the establishment of international accounting standards. This is a private sector organization that has a far-reaching proposal on international accounting principles released for comment. It is not likely that this proposal will be adopted for some time. If the SEC could be persuaded to accept IASC GAAP as an international standard to which foreign issuers could reconcile their financial statements, and the primary EU capital market centers and Japan would impose such standards on listed companies, many existing problems involved in multijurisdictional offerings and transnational trading activities would be solved.

Similarly, the Basle–IOSCO Committee has been attempting to formulate international capital adequacy standards for securities firms. Unfortunately, these negotiations have not been successful.

The formulation of harmonized principles of business conduct may prove easier as long as these principles are expressed very generally. IOSCO has already promulgated such principles.[11] However, an examination of the detailed articulation of business conduct principles in the United States and the United Kingdom reveals crucial differences. Furthermore, as exemplified by prohibitions against insider trading, which are being adopted universally, specific conduct interdicted in one jurisdiction may be lawful elsewhere and enforcement varies widely.

Mutual recognition affords financial products and financial institutions free transit across national borders. Under a mutual recognition regime, a prospectus prepared in accordance with the requirements of an issuer's home jurisdiction is accepted without change for securities offerings in every jurisdiction participating in an underwriting. Similarly, a financial institution licensed by and in compliance with the regulations of its home country jurisdiction has a passport to establish and sell its services in foreign jurisdictions.

The United States–Canadian multijurisdictional disclosure system ("MJDS")[12] utilizes mutual recognition and the SEC has proposed mutual recognition for certain rights and exchange offers, but has not yet passed any definitive rules to that

[10] IOSCO, INTERNATIONAL EQUITY OFFERS (1989).

[11] *See* REPORT OF THE TECHNICAL COMMITTEE OF IOSCO, INTERNATIONAL CONDUCT OF BUSINESS PRINCIPLES (July 9, 1990).

[12] Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Securities Act Rel. No. 6902 (June 13, 1991), 56 Fed. Reg. 30036 (1991).

effect.[13] The EU has enunciated mutual recognition as a basis for multiple listings on two or more European stock exchanges, for the sale of units or shares in Undertakings for Collective Investment in Transferable Securities (UCITS) and for banks and securities firms. In practice, however, the use of mutual recognition in multinational European offerings has been limited, and although in the future financial institutions may enjoy a single passport throughout Europe, they will have to submit to host country investor-protection rules.

Mutual recognition depends upon harmonized regulatory standards. It is difficult for any regulator to accept the judgment of a foreign regulator that a financial product or financial institution has satisfied standards designed for investor protection or financial system safety and soundness unless there is a similarity of regulatory objectives and mechanisms. A predicate for the United States–Canadian MJDS was the similarity not only of United States and Canadian securities laws, but their enforcement. Similarly, mutual recognition in the EC was preceded by directives harmonizing listing standards, the law relating to UCITS and the regulation of banks. At the same time, marketplace demands for the MJDS and easier cross-border capital flows in the EC served to encourage harmonization efforts.

The SEC has been an active participant in efforts to achieve international accounting standards. In particular, the SEC has labored within IOSCO and the IASC to formulate standards that it considers acceptable and could recognize. Recently, the SEC proposed to accept one IASC standard, IAS No. 7, on cash flows, as authoritative for purposes of financial statements in SEC filings.[14] Unfortunately, the SEC takes a very parochial view of what is an acceptable international standard. It regards any standard that is not essentially equivalent to U.S. standard as unacceptable. Thus, even with regard to the MJDS system with Canada, the SEC requires Canadian issuers to reconcile their financial statements to U.S. GAAP.

In theory, the Europeans have proceeded much farther with harmonization of the securities laws within Europe than have North Americans. The 1985 White Paper, later implemented by the Single European Act amendments to the Treaty of Rome, included a timetable for the adoption of securities law amendments. The White Paper envisioned a European securities market system based on EC stock exchange trading.

The first step in creating a single market in financial services in the EC was the liberalization of capital movements. Then, in order to create an EC-wide capital market that would not imperil the stability of the financial system, the EC determined that a level playing field should be established for financial suppliers and users; for example, uniform rules for stock exchange membership and harmonized capital-adequacy requirements for banks and securities firms. A series of directives eliminating technical barriers to cross-border securities offerings and trading was therefore put forward.

There are four groups of financial law directives that relate to the efforts to develop a single securities market in the EU. These groups consist of directives on financial disclosure, directives covering public securities offerings and stock exchange listings, directives regulating trading markets and directives regulating financial intermediaries.

An important series of directives has been adopted setting forth minimum stan-

[13] Securities Act Rel. No. 6896 (June 5, 1991), 56 Fed. Reg. 27569 (1991); Securities Act Rel. No. 6897 (June 4, 1991).

[14] Securities Act Rel. No. 7029 (Nov. 3, 1993).

dards for the protection of shareholders of all EU companies. These directives also protect creditors, including bondholders and suppliers. For the most part, these directives cover both public and private companies and regulate financial disclosure and related matters.[15]

A second group of directives establishes standards for disclosure in public offerings and listings of securities. These minimum disclosure standards provide a foundation for imposing an obligation on securities regulators to recognize the disclosure regulatory standards of other EU member states. EU member states must recognize stock exchange listing applications of issuers from other member states without requiring additional information, if an application filed simultaneously (or contemporaneously) is approved by the issuer's home state. Similar mutual recognition is required for any public-offer prospectus that has been subject to scrutiny and approval by a competent authority. The workings of these directives demonstrate the principles of minimum standards, mutual recognition and home country control, that are basic tenets of the single market in securities.[16]

A third group of directives deals with securities trading. The Major Shareholdings Directive[17] requires disclosure to the issuer and to competent authorities of significant acquisitions or dispositions of listed securities. The Insider Dealing Directive[18] harmonizes the law on insider trading and requires all member states to adopt legislation to prohibit insider trading.

A fourth group of directives addresses the regulation of financial intermediaries. The Second Banking Directive establishes a legal framework for a single banking market in the EU to begin on January 1, 1993. It provides that a bank established and licensed in one EU member state may provide financial services throughout the EC without obtaining additional regulatory approvals in other EU states. This right to establish branches in other EU countries, and to market and sell services in any country directly, without being required to obtain a license from the host country, is often referred to as the single passport. Although banks are subject to home rather than host country control, minimum capital adequacy and other standards are set forth in the Second Banking Directive as a predicate for mutual recognition.

The Investment Services Directive and the related Capital Adequacy Directive establish a single passport for securities firms not already covered by the Second Banking Directive, with some phasein provisions for some of the Club Med countries. The UCITS Directive sets forth minimum standards for what Americans call mutual funds.[19]

Despite all of these accomplishments, harmonization of securities law in Europe is far from complete. Although a framework now exists for the flotation and listing of securities issues, and the cross-border expansion by financial institutions and the cross-border sale of some financial products, other initiatives to integrate the financial markets have floundered. Although the Investment Services Directive was finally passed, it is not an effective instrument for integrating securities trading in the twelve member states. The present form of the directive on pension funds is unlikely to tear away restrictions against cross-border equity investment. Takeover and corporate governance directives seem to be permanently stalled. Tax and other structural barriers impede cross-border expansion of financial institu-

[15] These are discussed more fully in Roberta S. Karmel, *Securities Law in the European Community: Harmony or Cacophony?*, 1 TULANE J. INT'L & COMP. L. 3 (1993).

[16] *Id.*

[17] Council Directive 88/627, 1988 O.J. (L 348) 62.

[18] Council Directive 89/592, 1989 O.J. (L 334) 30.

[19] Council Directive 88/220, 1988 O.J. (L 100) 31.