

1994

Living with U.S. Regulations: Complying with the Rules and Avoiding Litigation

Roberta S. Karmel

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/faculty>



Part of the [International Law Commons](#), and the [Securities Law Commons](#)

LIVING WITH U.S. REGULATIONS: COMPLYING WITH THE RULES AND AVOIDING LITIGATION

*Roberta S. Karmel**

One aspect of the internationalization of the securities markets is the participation by foreign issuers in the U.S. public and private markets. Despite the regulatory barriers to entry into U.S. markets and the costs of overcoming those barriers, matters we have discussed all day, record numbers of foreign issuers recently have issued in the U.S. markets.

In the past three years, more than 350 foreign companies have registered with the Securities and Exchange Commission ("SEC") approximately U.S.\$95 billion of securities. In the last year and a half, approximately 140 foreign companies have entered the U.S. public market for the first time, bringing the total number of foreign companies reporting with the SEC to 559, representing forty different countries. Since the adoption of Rule 144A three years ago,¹ 184 foreign companies have raised capital in new 144A transactions. Twelve of those companies later went public in the United States.

My assignment this afternoon is to discuss the laws and regulations applicable to all of those foreign issuers after they have entered the U.S. market. However, I have a totally different problem than I expected I would have. This is that Elizabeth Rader,² Richard Kosnik,³ and the other speakers covered about ninety-five percent of what I had prepared in my written re-

* Professor, Brooklyn Law School; Partner, Kelley, Drye & Warren, New York, N.Y.; Former Commissioner of the U.S. Securities and Exchange Commission; B.A., Radcliffe College; LL.B. (*cum laude*), New York University School of Law. Professor Karmel is Co-Director of the Center for the Study of International Business Law at Brooklyn Law School. She has authored of numerous articles in legal journals, including a bi-monthly column for the *New York Law Journal*, and has published a book entitled *REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA* (Simon & Schuster, 1982).

1. 17 C.F.R. § 230.144A (1993).

2. M. Elizabeth Rader, *Accounting Issues in Cross-Border Securities Offerings*, 17 *FORDHAM INT'L L.J.* S129 (1994) (discussing key accounting and disclosure issues facing non-U.S. companies, noting flexibility of SEC in accommodating problems).

3. Richard Kosnik, *The Role of the SEC in Evaluating Foreign Issuers Coming to U.S. Markets*, 17 *FORDHAM INT'L L.J.* S97 (1994) (discussing regulatory issues facing foreign issuers).

marks. I had prepared an explanation of the various forms that foreign issuers must file with the SEC as part of their obligation under the continuous disclosure system that the SEC administers and some of the problems that non-U.S. issuers have in overcoming the regulations and complying with the regulations.⁴ I had then planned to explain the SEC's November 3, 1993 initiatives to make the task of foreign issuers a little bit easier.⁵ Since I don't want to repeat what others have said to this very patient audience that has sat here all day, my remarks will be considerably more extemporaneous and miscellaneous than I had planned upon.

First, let me give you my own insights concerning the further expansion of the market for foreign securities in the United States and what regulations ought to govern that market. Much of the discussion by this panel seems to have been a debate as to whether SEC regulations are perfect and should be maintained because they are attracting foreign issuers into the United States, or whether SEC regulations are quite faulty and should be changed so as to make it easier for foreign issuers to come into the United States.⁶

This is an important debate and I have my own views on it. Very generally, it seems to me that although mutual recognition, particularly of accounting standards, is ultimately the way in which regulators and investors will solve the many problems involved in cross-border securities offerings, there needs to be minimum international harmonization in order for mutual recognition to be practicable, workable and acceptable to investors.

4. See Rader, *supra* note 2, at S130-34 (discussing key registration requirements facing non-U.S. companies).

5. See Kosnik, *supra* note 3, at S98-110 (outlining recent SEC initiatives regarding non-U.S. issuers of securities in U.S. capital markets).

6. See Richard Breeden, *Foreign Companies and U.S. Markets in a Time of Economic Transformations*, 17 *FORDHAM INT'L L.J.* S77, S85-96 (1994) (discussing superiority of U.S. disclosure requirements and accounting practices); Pat McConnell, *Practical Company Experience in Entering U.S. Markets: Significant Issues and Hurdles from the Advisor's Perspective*, 17 *FORDHAM INT'L L.J.* S120, S122 (1994) (discussing superiority of U.S. disclosure requirements and accounting practices). *But see* William E. Decker, *The Attractions of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Accessing the U.S. Markets: From the Issuer's Perspective*, 17 *FORDHAM INT'L L.J.* S10, S23-24 (1994) (noting difficulty of reconciling non-U.S. financial statements with U.S. GAAP); James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 *FORDHAM INT'L L.J.* S58, S61-67 (1994) (noting need for more flexibility in U.S. accounting requirements)

In that regard, I think that the SEC's recent decision to recognize as authoritative International Accounting Standard ("IAS") No. 77 — that is, the IAS on cash flow — is extremely important conceptually. Jim Cochrane said earlier this was of symbolic importance.⁸ I think it is of more than symbolic importance, because this is the first time that the SEC has agreed to accept as authoritative an International Standard. Acceptance of International Standards is going to be the route both to international harmonization and mutual recognition. So I applaud the SEC for this decision and I hope that the SEC, with the cooperation of International Organization of Security Commissions ("IOSCO"), will in the near future — not in the year 2025, but much sooner than that — be able to accept a great many more International Accounting Standards as authoritative.⁹

Nevertheless, looking only at the technicalities of the accounting issues that have been discussed today is perhaps not as relevant to the future of the international securities markets in the United States as you may think.

As far as I know, there are only four ways for business enterprises to get funding to finance their activities: equity, government funding, debt, and self-funding. Much of what has been fueling the internationalization of the markets over the past few years, and in particular the increase in foreign issuer listings and offerings in the United States, is that sources of funding other than equity have simply dried up for one reason or another.

It seems government funding is not in the cards anywhere in the world in the near future. The financial collapse of former Communist and Socialist countries and the huge budget deficits all over the Western world make it very difficult, if not impossible, for economic enterprises to continue to be financed through government grants almost everywhere. This has led to privatizations in developed Western countries and in emerging countries. These privatizations have been the driving force behind much of the internationalization of the securities markets,

7. See Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, Securities Act Release No. 7029, Exchange Act Release No. 33,139, 58 Fed. Reg. 60,307-01 (Nov. 15, 1993).

8. Cochrane, *supra* note 6, at S65 (noting importance of SEC's adoption of IAS No. 7).

9. See McConnell, *supra* note 6, at S127-28 (discussing work of IASC and IOSCO).

and in particular behind the decisions of various foreign issuers to enter the U.S. markets.

Bank financing in the form of loans also is problematic for the future. Bank capital relative to the need for capital has been declining for a wide variety of reasons. In the United States, we are very used to having relatively weak banks. This is part of our history, part of our culture. It probably goes back to Andrew Jackson's attack on the Bank of the United States. It is one of the reasons that we have developed such strong equity markets as an alternative source of financing to bank financing. In other countries, particularly in Western Europe, places like Germany and France, bank financing in the past has been extremely important. But bank assets are very stretched at this time, and in addition, interest rates in Europe are high compared to the cost of capital in the U.S. capital markets.

Self-funding has also been a popular source of financing, particularly in Continental countries. Germany is a prime example. Such self-funding also is somewhat problematic for the future, due in part to demographics. Self-funding by way of large reserves has been related to financing of pensions in countries where corporations have large so-called "hidden" reserves. One of the previous speakers said the reason that German, Swiss, and other foreign companies have large reserves is not to fool investors.¹⁰ I certainly agree with that. These reserves have been developed for valid business reasons. One of the reasons they have been developed is in order to cover the pension fund obligations of the issuers that have engaged in this kind of accounting.

However, because of the demographics in Europe, European countries probably are all going to have to go to some sort of alternative system for financing pensions. That may prove to be more like the kind of pension and savings systems we have in the United States, which in turn means that you will have the growth and development of institutional investors in those countries.

As I said before, equity financing is becoming the primary way in which companies are going to have to raise capital everywhere. In many situations, the capital markets are considerably ahead of the regulators. I think that the solutions to the

10. See Decker, *supra* note 6, at S18-19 (discussing "hidden reserves" of many non-U.S. companies).

problems of the capital markets that we have been discussing today will come from investor demands, not necessarily from initiatives taken by regulators. Nevertheless, regulation is important.

I will now try to cover some of the matters that were not covered by other speakers that relate to regulations of the SEC applicable to foreign issuers in the United States. As a very general matter, the regulators in the United States, when dealing with foreign issuers, have tried to differentiate between governance matters and disclosure matters. In terms of disclosure, the regulators have tried to impose upon foreign issuers to the extent possible the same obligations that U.S. issuers have. Although there are special disclosure requirements for foreign issuers, these requirements are very similar to the requirements imposed upon U.S. issuers.

With regard to corporate governance matters, however, the SEC and the stock exchanges believe in allowing foreign issuers to follow home country regulation. Let me give you a few examples. Foreign issuers who have come into the U.S. registration and reporting system are exempt from the proxy solicitation and information statement provisions of Section 14 of the Securities Exchange Act of 1934 (the "Exchange Act")¹¹ — that is, the SEC proxy rules — and they are also exempt from the short-swing trading profits provisions of Section 16 of the Exchange Act.¹² Similarly, foreign issuers are not required by the New York Stock Exchange to comply with the same corporate governance provisions that are imposed upon U.S. issuers. Home country regulation is the regime.

Nevertheless, trying to draw a line in the regulatory sands between disclosure and corporate governance obligations is very difficult. As all of you in the audience are undoubtedly aware, the SEC has long used disclosure as leverage for getting certain types of corporate governance reforms imposed upon U.S. issuers.

Foreign issuers are subject to the Foreign Corrupt Practices Act¹³ and their registered equity securities are subject to the tender offer provisions of the Exchange Act.¹⁴

11. 15 U.S.C. § 78n (1988 & Supp. IV 1992).

12. 15 U.S.C. § 78p (1988).

13. 15 U.S.C. §§ 78dd-1 to 2 (1988).

14. 15 U.S.C. § 78n(d) & (e) (1988 & Supp. IV 1992).

In terms of the anti-fraud provisions of the Exchange Act, in my experience many foreign issuers find dealing with U.S. security analysts much more troublesome than staying out of the courts and avoiding litigation under Section 10(b)¹⁵ and Rule 10b-5 of the Exchange Act.¹⁶ I see our security analyst on the panel nodding in agreement.

This is one of the reasons why I say that the capital markets are going to solve the problems that have been discussed today much more efficiently and more quickly than I think the regulators will solve those problems. Once a foreign issuer enters the U.S. markets, that foreign issuer has to deal with the U.S. investment community and security analysts if the issuer wants a good market for its securities. There really is no point to a listing or offering in the United States by a foreign issuer if the issuer is not going to be committed to having a good market for its securities in the United States.

I had one representative of a foreign issuers say to me, "What is really troublesome about your system are those security analysts. My CEO, who is always addressed very cautiously and politely in our country, gets called on the telephone by analysts who, first of all, call him 'Joe,' and then start asking all sorts of difficult and insulting questions."

I said, "Yes. It's a great deal like dealing with the press, isn't it?"

This person thought and said, "Yes, that's just what it's like. Securities analysts are just like reporters."

I tried to explain that this was part of the way in which the U.S. securities markets work. The framework of securities laws and regulations try to assure that public companies make the minimum required disclosure, but the continuous disclosure system and the operation of the kind of efficient markets that we have in the United States really depend upon a constant flow of material information by issuers into the market.¹⁷ The analysts, to a much greater extent than the regulators, are the facilitators that flow of information.

So to a large extent, what a foreign issuer has to do when it

15. 15 U.S.C. § 78j(b) (1988).

16. 17 C.F.R. § 241.10b-5 (1993).

17. See Rader, *supra* note 2, at S129 (discussing flexibility and effectiveness of U.S. disclosure system).

enters the U.S. markets is to change its mindset. This sometimes is much more difficult than it might appear. The problem is not that the foreign issuer has followed a disclosure regime that has some kind of a sinister objective of hiding things from investors. Rather, that foreign issuer has come from a regime in a country that has had a system of corporate finance quite different than the equity-based system that the United States has long enjoyed.

That issuer may have been used to dealing with banks and having the kind of mindset with regard to accounting and disclosure matters that a lender imposes on a company. A lender has very different objectives than an equity investor has. An equity investor is interested in dividends and increases in the price of the stock even if that means the company must take risks. A lender is interested in the kind of conservatism and stability that will enable the lender to be paid interest and then to be repaid the principal that has been loaned.

Whether the switch that is going on all over the world from different types of corporate finance systems to systems that depend on equity capital is good or bad is hardly for me to say. But I think we have to recognize that the discussion that we have had at this Conference all day should be placed in a larger context. That context is the changes in corporate finance that are going on in the capital markets and the way in which issuers, investors, bank lenders, workers, pensioners, and governments, including government regulators, are adjusting to those changes.