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Introduction

Today, mergers and talks of mergers among the world's stock exchanges make obvious what many finance professionals have long known: capital markets are global. Greater investor wealth and education have created the demand for such markets, and technology, in particular, has made globalized markets feasible. Investors now search beyond their own borders for investment opportunities and, unlike the past, many of these investors are not large companies, financial firms, or extremely wealthy individuals. A good number are "typical" retail investors—individuals with normal jobs and average incomes—who save for retirement and their children's education, and who may be well-educated, but nonetheless are not "sophisticated investors" in the legal sense. Investors (whether retail or professional) and large firms pursue international opportunities for the same reasons: higher investment returns and the reduction in risk offered by portfolio diversification.

It is this seamless capital market, made possible by technology, that now, more than anything, presses on financial regulators around the world. The fundamental mandate of the Securities and Exchange Commission ("SEC") remains the same—protecting investors, ensuring the efficiency and transparency of U.S. markets, and facilitating capital formation in the United States. However, the manner in which the SEC can best achieve this mandate in the...
The face of this new investor demand is changing. Borders that have blurred for most market participants are proving as sharp as ever where market regulation is concerned. Also, the technology that has proven so beneficial for investors and issuers poses a serious threat to the integrity of markets. As a consequence, the traditional methods that the SEC and its foreign counterparts use to oversee cross-border market activity have lost some of their historical efficacy. Our markets are now interconnected and viewing them in isolation—as we have for so long—is no longer the best approach to protecting our investors, promoting an efficient and transparent U.S. market, or facilitating capital formation for U.S. issuers.

This Article proposes a new framework to apply to foreign financial service providers accessing the U.S. capital market, by providing investment services and products not otherwise available on the U.S. market. Rather than requiring such foreign stock exchanges and foreign broker-dealers to register with the SEC, as is currently the case, the proposed framework relies on a system of substituted compliance with SEC regulations. Instead of being subject to direct SEC supervision and U.S. federal securities regulations and rules, foreign stock exchanges and broker-dealers would apply for an exemption from SEC registration based on their compliance with substantively comparable foreign securities regulations and laws and supervision by a foreign securities regulator with oversight powers and a regulatory and enforcement philosophy substantively similar to the SEC’s. The SEC would still retain jurisdiction to pursue violations of the anti-fraud provisions of the U.S. federal securities laws. The comparability finding would need to be complemented by an unambiguous arrangement between the SEC and its foreign counterpart to share extensive enforcement- and supervisory-related information. This should greatly reduce the transaction costs investors currently pay when investing overseas, and allow the current situation of overlapping and duplicative registration and oversight requirements for certain stock exchanges and broker-dealers to end.

The overarching objective of the framework is, first and foremost, to further the SEC’s mandate of investor protection. As foreign markets develop and adopt higher regulatory standards, U.S. investors predictably are looking at them as potential investment opportunities. However, the current international environment has enforcement and oversight gaps that present risks that do not exist in a domestic context. U.S. investors also face high transaction costs when investing overseas—transaction costs that provide investors with no real benefit. By constructing a new model for international cooperation between the SEC and certain like-minded foreign securities regulators, the framework will facilitate the SEC’s ability to protect U.S. investors and lead to a collaborative effort in promoting high-quality regulatory standards in a globalized market. It will also increase competition in financial ser-

vices—both here and abroad—and lower cross-border transaction costs, to
the benefit of investors around the world.

In laying out this framework, we first discuss how technology and globalization are changing the shape of modern capital markets and how they are regulated. We also explore how recent financial scandals, both in the United States and abroad, have changed the shape of securities regulation and created new mandates, burdens, and demands for regulators that, if not implemented carefully and in a coordinated fashion, threaten to harm investors and issuers with unnecessary regulatory transaction costs. Second, we lay out the critical elements of U.S. securities regulation and the legislative “first principles” that constrain what the SEC can do, and the manner in which these first principles have led to the SEC’s historic approach to regulating cross-border securities activities. We then discuss how these first principles necessarily shape any SEC response to this new global capital market. Third, and finally, we detail a framework, based on these first principles, that would increase U.S. investor access to foreign investment opportunities and lower investor transaction costs while bolstering the integrity of the U.S. capital market and discouraging the type of “regulatory arbitrage” that can undermine investor confidence in markets everywhere.

I. Capital Markets in Flux

Capital markets around the world today are characterized by two series of events, one recent and unprecedented, and the other ancient but recurring. The first is the globalization of all types of world markets and the explosion of information technology. The second is a series of financial scandals, beginning with Enron in 2001, that has forced securities regulators to reevaluate the mechanisms used to ensure that disclosure-based market regulatory systems function effectively.

A. Technology and Globalization in the New Market

International trade is not new, and it has expanded and contracted in the past. However, advances in technology have lowered structural barriers to the global trade in services as well as goods, making a truly global capital market (in every sense of the word) a real possibility. Whereas not so long ago a major financial firm might employ a bank of telephones to conduct just a single cross-border transaction, today an entire stock exchange, regardless of

where it is located in the world, can be accessed via trading screens located in any number of broker-dealers’ offices.\(^7\) Clearance and settlement technology is now commercially available to stock markets everywhere, making it possible for even the youngest exchanges to have the type of systems necessary to make the technical aspects of their operations first-class (assuming they can afford them).

The largest financial institutions have long had operations and offices overseas, but increasingly these firms are globalized in their outlook as well as their operations. It is not surprising in today’s economic environment for companies and financial institutions to earn a greater portion of their income from outside their “home” market rather than from inside it. At the same time, even the smallest financial institution or market participant now has access to capital markets located abroad, frequently through intermediaries and foreign gatekeepers, but also directly. For many financial intermediaries, access to overseas securities, commodities, and currency markets is vital to staying in business.

Nowhere is this trend more evident than with the New York Stock Exchange (“NYSE”), the largest stock market in the world, but also one that for much of its history was almost exclusively domestic in orientation. In 1975, only thirty-three foreign companies listed their shares on the NYSE, a mere 2.12% of the 1557 companies listed on the exchange. By 1990, this figure had jumped to ninety-six companies, and 5.14% of New York’s total number of issuers.\(^8\) Today, more than 450 non-U.S. companies list on the NYSE, out of a total of 2672 issuers—16.9% of the NYSE’s total. In terms of market capitalization, these 450 foreign private issuers had a total market capitalization of $7.9 trillion at the end of 2005, or 37% of the NYSE’s total $21.2 trillion market capitalization.\(^9\)

The technological revolution that has fueled capital market globalization, of course, is not limited to just exchanges and large investment banks. Computing and communication technology have advanced so rapidly and have spread into so many different aspects of our lives that the information available to all market participants today is not just quantitatively different, but has resulted in a qualitative change as well. While the need to make decisions under conditions of insufficient information—the “fog of war” applied to the financial world—still remains, it is overlaid by the problem of vast quantities of information available to us in real time. Information-processing technology has made managing this information not just possible, but possible at unprecedented speed.


\(^8\) Coffee, supra note 3, at 1772.

Furthermore, the sources of information available to market participants have proliferated. Some of this information is formalized, such as the press releases issued by companies, news reports put out by media outlets using a formal editing and review process, or government statistics. Some of this information is mandated by regulation, such as corporate financial filings, presented through a formalized process determined by national accounting standards. Other information is informal—the high-tech equivalent of gossip—received from some media reports, “blogs,” and other sources. Rarely is any of this information complete and in many cases the information is inaccurate. Nonetheless, collectively the information forms part of an ever-changing mosaic that investors, regulators, and others use when assessing a situation under conditions of uncertainty. One common thread, however, is that today all of this information is globalized. These new sources and ways of distributing information create enormous opportunities to enhance the efficiency of our markets. Globalization also means that investors in the United States have more information about foreign investment opportunities than they had in the past.

While vastly improving market efficiency, these new sources of information have also introduced new, previously unimagined, risks. For the largest firms, even small information processing errors have proven to have potentially devastating effects. For investors, the sheer volume of information presents filtering problems. While this has generated demand for professional information “gatekeepers” and “filtering services” (i.e., securities analysts, credit rating agencies, private news services, etc.), heavy reliance on these professional services also raises new risks, ranging from conflicts of interest to moral hazard.

Technology and globalization have also created new opportunities for securities fraud. It is well recognized that the technology that allows for cross-border markets also allows for cross-border fraud. Just as Walt Wriston’s Citibank of the 1950s had to employ dozens of telephone operators just to conduct a single cross-border transaction, boiler-room operators and other fraud-


11. Few examples illustrate this risk more potently than the recent case of Mizuho Securities in Japan. On December 8, 2005, a trader at Mizuho inadvertently offered to sell 610,000 shares of J-Com (a Japanese job-recruiting company) for ¥1 ($0.008) per share, while meaning to sell one share of the company for ¥610,000 ($52,000). Because of modern information technology, this mistake was immediately noticed and cost Mizuho approximately $223 million in a matter of minutes. The confusion appears to have contributed to a 1.95% drop in the Nikkei average, perhaps fueled by concerns about the Tokyo Stock Exchange’s ability to deal with error-trades. See Japan Rebukes Exchange for Costly Trading Error, Int’l Herald Trib., Dec. 9, 2005, available at http://www.iht.com/articles/2005/12/09/business/error.php.


sters in the past were also constrained by technology, employing large banks of telephones just to cold-call a few hundred potential victims. Today all that is necessary for a successful boiler-room operation is a single individual with a computer, who can now “spam” millions of e-mail addresses in minutes. Even more problematic, modern computing and communication technology has allowed for the components of fraud to be disaggregated. Lists of previous victims of fraud (often called “suckers lists”\(^{14}\) are now marketed and sold over the Internet, along with e-mail addresses pulled from the World Wide Web using various automated computer programs. “Legal service providers” market themselves over the Internet as providing others with assistance in establishing corporations or bank accounts in offshore jurisdictions, with oblique references to the jurisdictions’ lack of enforcement and information-sharing arrangements with other countries.\(^{15}\)

The threat posed by technology-enhanced cross-border securities fraud cannot be understated. If left unchecked, widespread cross-border fraud may even force jurisdictions into a regulatory race to the bottom, to the detriment of investors and issuers everywhere. This is because, while “competition” among the world’s securities regulators theoretically might push securities regulation to an optimal level, where the costs of regulation to issuers do not outweigh the benefits of regulation to investors, fraud can undermine this calculus. The benefits a jurisdiction would enjoy by developing an optimal level of regulation, which might attract issuers by lowering the cost of capital, cannot be realized if those who commit fraud can avoid a jurisdiction’s enforcement regime by fleeing or disaggregating the fraud across borders. In such a situation, the resources a jurisdiction devotes to achieving optimal regulation are wasted, and rather than attracting issuers through a lower cost of capital, jurisdictions instead can only attract them by offering less burdensome regulatory oversight. A race to optimality becomes, instead, a race to the bottom.


When you send an international bank wire using the S.A. Corporation no one monitoring the international wires as some countries do knows who the actual owners of the corporation are that are receiving the funds. If ownership of a corporation is publicly recorded rest assured it is in numerous databases and can be accessed in seconds to determine who is actually receiving money sent to a corporation... The MLAT requires that there first needs to be a criminal prosecution case on file in the criminal courts of the requesting government (which means no fishing expeditions) [...]. These cases can take months and even years for completion. At times the country where the bank is located has been known to once alerted to the problem, conduct their own investigation first and this usually requires them to seize the relevant records and documents which can stall the process for a long time even years since their justice systems typically moves quite slow and statues of limitation can run out.
B. Financial Scandals of the Twenty-first Century

The Enron, WorldCom, and other corporate scandals that seemed to suddenly erupt in 2001 as the stock market bubble burst are examples of the threat posed by cross-border securities fraud. Unlike the facets of modern capital represented by globalization and technological change, financial scandals are not unprecedented, but their most recent manifestation has changed the regulatory landscape of securities markets. Stock market scandals are nearly as old as stock markets themselves, with the English stock market suffering its first “crash” in 1696.16 Eighteenth-century joint-stock corporations such as the Scottish Darien Company and the French Mississippi Company appear remarkably modern, both in their cross-border stock offerings and in the financial crises they spawned. The scandals tied to the 1929 Stock Market Crash led directly to passage of the first federal securities laws.17

As in 1929, the financial fraud linked to the more recent scandals uncovered deep problems in how U.S. markets were regulated. Complicating matters, it soon became apparent that these problems were not inherent to the American model of securities regulation. While the U.S. market led the trend with Enron and WorldCom, financial scandals abroad rapidly followed, involving companies such as Parmalat (Italy),18 Ahold (The Netherlands),19 Royal Dutch Shell (United Kingdom and the Netherlands),20 Vivendi (France),21 Hollinger (Canada),22 Livedoor (Japan),23 TV Azteca (Mexico),24 and others. Each new case seemed to highlight a different flaw in the mechanisms securities regulators around the world relied upon to protect the integrity of their disclosure-based market oversight regimes.25 Furthermore,

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25. In 2003, international concern about the regulatory flaws exposed by the deluge of financial scandals occurring around the world led the International Organization of Securities Commissions (“IOSCO”) to form a high-level task force of securities regulators from the world’s largest markets to investigate the nature of these flaws and propose an international action plan to address them. The task force, jointly
the international breadth and depth of these “foreign” financial scandals highlighted how profoundly interconnected global capital markets are already. Most of the overseas financial scandals and fraud cases involved issuers selling securities in more than one jurisdiction and with shares cross-listed on multiple stock exchanges. Given the sheer size and liquidity of the U.S. capital market, many overseas financial scandals directly affected U.S. investors and led to the SEC’s involvement in a cross-border, multiple jurisdiction investigation, just as Enron, WorldCom, and the other U.S. financial scandals affected foreign investors who owned shares in those companies.

Within months of Enron and WorldCom, the U.S. Congress passed the Sarbanes-Oxley Act in an effort to address the regulatory weaknesses that had come to light in the United States. In particular, the Act focused on several key areas highlighted by the U.S.-based scandals, including conflicts of interest at, and inadequate oversight over, the audit firms charged with confirming the integrity of an issuer’s financial statements; corporate boards insufficiently independent of the corporate officers they were charged with monitoring; and poor internal controls at many public companies. Most of the Act’s requirements made no distinction with regard to whether an issuer selling shares in the United States was headquartered here or abroad.

A significant number of the Sarbanes-Oxley reforms have been implemented, in one form or another, in other major markets as well. Nonetheless, the

28. See id. tit. 3.
29. See id. § 404.
30. See Roel C. Campos, Comm’r, SEC, Embracing International Business in the Post-Enron Era, Speech at the Center for European Policy Studies (June 11, 2003) (transcript available at http://www.sec.gov/news/speech/spch0601103cc.htm) (“Few distinctions have been made based on the domicile of the issuer or service provider. After all, U.S. investors are entitled to the same protections regardless of whether an issuer is foreign or domestic.”).
Sarbanes-Oxley Act has proven controversial. Whereas most earlier U.S. federal securities laws had focused on disclosure, Sarbanes-Oxley (and its foreign counterparts) have delved more deeply into corporate governance, auditor oversight, and other matters bearing directly on overseeing the quality of the disclosures issuers make.\(^{32}\) Previously, each of these areas was regulated primarily by state governments, by the exchanges, or by the industries themselves through self-regulation.

The reason for this historic shift was that so many of the prominent financial fraud cases that followed the 1990s stock market boom involved a breakdown in the oversight mechanisms designed to ensure that these disclosures were meaningful. Enron, WorldCom, and even many of the foreign financial fraud cases involved inaccurate and misleading disclosures that violated existing laws. Since existing disclosure rules had been flouted so widely, further disclosure requirements alone were not the answer. If the problem had been limited to a “few bad apples,” as some suggested it was,\(^ {33}\) then enforcement of the existing laws and punishment of the offenders should have been sufficient. Yet investors soon perceived that the violations were so widespread that they concluded the oversight mechanisms designed to ensure that the laws were followed were inadequate. Independent audits were compromised by conflicts of interest.\(^ {34}\) Internal controls were weak or nonexistent.\(^ {35}\) Corporate boards lacked any true independence from management,\(^ {36}\) and critical board committees often lacked not just independence from management, but also crucial skill sets and independent legal advice.

In addressing each of these problems, the Sarbanes-Oxley Act deviated from the disclosure approach of previous securities laws and touched directly on areas of corporate governance and auditor oversight.\(^ {37}\) In addition, broader market changes, such as the demutualization of U.S. stock exchanges, the proliferation of new investment vehicles, and increasingly global operations of many SEC-regulated market intermediaries, called into question the efficacy of the SEC’s existing regulation of these areas as well, with the SEC respond-

\(^{32}\) The strength of a disclosure-based securities regulatory approach is that it permits individual investors to evaluate their own risk-preferences and invest accordingly. Provided investors, in aggregate, are able to access sufficient information to make informed investment choices (or are at least aware of what information is not available), markets are, theoretically, able to allocate capital more efficiently than any one decision-maker. See Fama, supra note 10, at 58. However, embedded within the disclosure-based model is an acceptance of calculated risk and foolish decisions. As Louis Loss once wrote regarding the Securities Act, “Congress did not take away from the citizen ‘his inalienable right to make a fool of himself.’ It simply attempted to prevent others from making a fool of him.” Louis Loss & Joel Seligman, 1 Fundamentals of Securities Regulation 177 (3d ed. 1998) (quoting the 1935 Report of the [Canadian] Royal Commission on Price Spreads at 38).


\(^{34}\) See Seligman, supra note 17, at 721 n.17, 736.


\(^{36}\) Technical Comm., supra note 25, at 5.

ing with a number of new regulations designed to address this changing landscape.\textsuperscript{38}

The combination of these regulatory changes has created a new set of international issues with which the SEC and other securities regulators must contend. If securities regulation were limited only to disclosure requirements, cross-border regulatory conflicts would be relatively few and dealt with easily. A transnational entity could effectively tackle a disclosure discrepancy by adhering to the strictest set of requirements, since it is unusual for jurisdictions to impose limits on how much information a market participant can disclose. However, corporate governance, auditor oversight requirements, and prudential regulatory approaches, for example, vary widely among jurisdictions, reflecting differences in culture, legal systems, and market structure. For a transnational issuer or investment bank, addressing these kinds of regulatory discrepancies can be difficult and costly.

Yet, at no time has the need for oversight of the quality of disclosures and operations of market intermediaries been more important. Investors, issuers, investment banks, and even stock exchanges have gone global. Globalized financial markets make globalized systemic financial risks a real possibility. For regulators such as the SEC, it is not just the Enrons, WorldComs, and Parmalats that present dangers. Individual investor losses because of fraud are always deplorable, but as the 1997 Asian financial crisis demonstrated, the systemic risks extend beyond just individual investors to our entire economy. Furthermore, these risks are not limited to the United States; foreign fraudsters in the past have used the U.S. markets to violate the laws in their home jurisdictions, hoping that by conducting their trading in the United States, law enforcement officials in their own countries will not be able to detect the fraud.\textsuperscript{39} Needless to say, it is not in the U.S. national interest for its


markets to be used to undermine the integrity of other jurisdictions’ securities laws.

C. The Era of the Global Ownership Society

Today, more than half of all U.S. households are invested in the stock market, either directly or through mutual funds and pension schemes. While this figure is high compared to many other jurisdictions, trends in Europe and elsewhere follow this pattern, with retail investors more willing than in the past to put their savings into the capital market, rather than in safer but comparatively low-return bank savings accounts. Demographic trends and the “aging” of many developed economies push our societies into even heavier reliance on our capital markets for pension funds and retirement income because of the markets’ efficiency and historically high returns over the long-term.

The result is the rise of a new global ownership society. In one sense, these new shareholders obliterate traditional notions regarding labor and capital; they are both employees and owners of the companies for which they work. In ways that we are only just now beginning to understand, this fact changes the types and form of information investors demand for the companies in which they invest.

Simultaneously with this trend, retail investors, like institutional investors, no longer limit themselves to investment opportunities within the United States. This trend is logical. Many of the world’s fastest growing and most profitable companies are headquartered outside the United States, and many of these companies are already familiar names to American investors, who on a daily basis use the cars, computers, clothing, and services provided by these companies. Likewise, modern portfolio theory advises the wise investor to diversify his or her risk widely. Investing abroad offers the investor just this kind of diversity, even offering a degree of hedging against exchange-rate fluctuations and (to some degree) macroeconomic cyclical events that a purely domestic investment portfolio might not provide.

Nonetheless, foreign capital markets, particularly for retail investors, present risks not present when investing in the United States. One can expect

42. See, e.g., Guiso et al., supra note 41.
44. See Mark Rubinstein, Markowitz’s “Portfolio Selection”: A Fifty-Year Retrospective, 57 J. FIN. 1041, 1042 (2002).
that some of these, such as currency risks, can be understood and adapted to by retail investors relatively quickly. Yet other risks, particularly those relating to corporate disclosure requirements and enforcement regimes, might not be so readily recognized by retail investors. For the past seventy two years, investors (both American and foreign) have expected U.S. capital markets to be overseen by a regulator with strong enforcement powers and be subject to corporate disclosure requirements based on a robust, high-quality, comprehensive set of accounting standards. Even if an individual retail investor did not read or understand all these disclosures, he or she could be confident that others did, and that this knowledge and understanding was reflected in the company’s stock price.\footnote{Fama, supra note 10, at 58.} This is not always the case abroad, particularly in markets lacking adequate liquidity, where the public float of most traded companies is small, or where laws against market manipulation are poorly enforced.\footnote{Id. at 157.}

II. THE SEC’S LEGISLATIVE MANDATE

The SEC’s approach to regulating U.S. capital markets should adapt to the changing global financial environment if it is adequately to protect investors and provide issuers with the low cost of capital afforded by the most efficient and transparent markets in the world. This will require a new degree of openness for the SEC—an openness not just to foreign market participants, but also to new ideas and new ways of cooperating with the SEC’s foreign counterparts. At the same time, it will require that the SEC reaffirm the fundamental principles that underlie its legislative mandate.

In adapting to this new environment, the SEC is constrained by its legislative mandate. This mandate is provided by the federal securities laws—the powers the SEC is granted, the obligations imposed on it, and the direct orders given it by the U.S. Congress. Nonetheless, along with these constraints, Congress has also given the SEC considerable flexibility in how the federal securities laws should be applied, interpreted, and implemented. This flexibility has proven to be one of the key strengths of our regulatory system, as it gives the SEC the ability to respond quickly to changing market circumstances without the need to seek congressional authorization.

Beyond this direct legislative mandate, however, are the “first principles” contained in the SEC’s enacting legislation, which, in a sense, define its very existence and have created the lens through which the SEC sees the world. The SEC was created by the Securities Exchange Act of 1934 (“Exchange Act”).\footnote{15 U.S.C. § 78 (2000).} At the beginning of the Exchange Act is a preamble that describes, in a somewhat detailed and inelegant fashion, why the Exchange Act and, by extension, the SEC are necessary. In particular, Section 2 of the Exchange Act

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gives two reasons for the SEC's creation: national public interest and investor protection. In other words, the preamble to the Exchange Act says that the Act, and the SEC, are necessary because perfecting the mechanisms of a national market system and insuring the maintenance of fair and honest markets are vital to the national public interest of the United States.

It is easy to dismiss this preamble as either stating what we all now believe to be obvious, or else representing a necessary, albeit perhaps meaningless, motion that Congress felt it had to go through to help ensure that such a controversial piece of legislation withstood a court challenge. And clearly the latter is partly true. When the Exchange Act was passed, there remained serious doubts about whether the federal government had the authority to regulate securities markets. However, a portion of this preamble,

49. 15 U.S.C. § 78(b) states:
For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:
(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.
(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.
(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) constitute an important part of the current of interstate commerce, (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.
(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

50. See, e.g., SELIGMAN, supra note 17, at 91.
to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, . . .51

was added only in 1975, at a time when the constitutionality of the SEC and the Exchange Act were no longer in doubt. That Congress would add such language in order to have the SEC focus on promoting a national market system clearly indicates that Congress, at least in 1975, viewed this preamble as a powerful statement of the SEC’s guiding principles.

Consequently, for a number of reasons, the preamble to the Exchange Act even today is perhaps the best indication of Congress’s overarching principles for the SEC’s oversight of U.S. capital markets. Taken in this context, all of the federal securities laws, up to and including the Sarbanes-Oxley Act of 2002, are designed to achieve certain key goals. Accordingly, there is a strong implication that the SEC’s mandate to protect the integrity of U.S. securities markets is instrumental in nature. U.S. markets are to be protected in order to safeguard the American economy and promote overall economic welfare (i.e., combat unemployment, allow the government to borrow at low interest rates and collect taxes, and improve access to capital by U.S. companies).

Interestingly, investor protection itself is not explicitly cited in the Exchange Act preamble as a reason that regulation of securities markets is necessary. Nonetheless, when granting the SEC flexibility to create new rules, exempt certain market participants from rules commanded by Congress, or in granting the SEC certain, specific, discretionary enforcement or regulatory powers, the federal securities laws repeatedly mandate that the SEC consider the protection of both investors and the public interest.52

Recent debates over the Sarbanes-Oxley Act (and even over previous federal securities laws in years past) imply a longstanding tension between what the SEC sees as its raison d’être of investor protection,53 and more recent—and recurring—concerns that investor protection, particularly as reflected in the provisions of the Sarbanes-Oxley Act, can interfere with efficient capital formation.54

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52. See, e.g., id. § 78(b)(1), (b)(2)(A).
53. Perhaps summarized most eloquently by William O. Douglas in his first press statement as the SEC chairman, “We are what I might call ‘the investor’s advocate.’” Seligman, supra note 17, at 157.
Arguably, Congress itself took this view when, in passing the National Securities Markets Improvement Act ("NSMIA")\(^\text{55}\) in 1996, it formally listed additional considerations for the SEC to consider when exercising its powers. In particular, the NSMIA added:

> Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.\(^\text{56}\)

However, this NSMIA language, couched as an “additional” consideration for the SEC, in fact recognizes the intrinsic linkage between investor protection and market integrity, and efficient, competitive markets that provide low-cost capital for issuers. In one sense, the NSMIA reaffirmed the instrumental nature of U.S. federal securities laws and the mission given to the SEC. Efficient capital formation is necessary for the strength of the American economy; protecting investors and promoting efficient and competitive markets are the methods by which efficient capital formation may best be achieved.

The SEC’s own “Mission Statement” summarizes these first principles:

> The mission of the Securities and Exchange Commission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.\(^\text{57}\)

While short, the Mission Statement contains several key concepts. Investor protection is clearly laid out as the SEC’s priority. Inclusion of the “facilitating capital formation” language is not just a bow to NSMIA, but, as described above, recognizes that market integrity, fair, orderly and efficient markets, and investor protection are necessary components of a market whose chief objective is providing low-cost capital, efficiently allocated, to the engine of U.S. economic growth. In other words, the goals of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation rephrase and synthesize the objectives of securities regulation contained within the Exchange Act’s preamble.

**A. A Nationality-Neutral Capital Market**

The emphasis in each case is on securities markets as promoting the national interest. While this might be ascribed to the parochialism of the time or the insular nature of securities markets in the 1930s, it is also important to keep in mind that bond markets at that time were quite international.\(^\text{58}\)

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\(^\text{56}\) See id. § 77b(b).
\(^\text{58}\) See, e.g., SELIGMAN, supra note 17, at 27–28.
and Section 2 of the Exchange Act notes that the “prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries.” 59 At the same time, while the focus of Section 2 is on promoting the national interest (and a national market system, after 1974), no reference is made to a need to promote U.S. firms or particular exchanges in doing so. In this regard, the Exchange Act is both explicitly nationalist and avowedly ecumenical. A strong U.S. market system is required to promote the national interest, but a strong U.S. market system is not built on preferences given to U.S. intermediaries, U.S. issuers, or even U.S. exchanges or investors.

The reasons for this tie directly back to the instrumental nature of the SEC’s mandate. The U.S. economy demands an efficient capital market, one through which U.S. companies can access capital at the lowest possible cost given the risks inherent in their business, and one in which American investors can earn the highest possible return, given their risk horizon. An efficient capital market requires transparency and liquidity. Transparency is afforded by thorough disclosure requirements, top-notch accounting standards, and independent audits conducted under the highest-quality audit standards. Liquidity is offered by investors who have confidence in the market and the standards under which market participants operate, and who have faith in the legal system and the quality and thoroughness of the enforcement of securities laws and regulations.

An efficient capital market also requires a degree of egalitarianism and blindness to national origin. Ceteris paribus, the larger the pool of investors bidding on a company’s securities, the more efficiently the price of those securities will be set and the more liquid the market for them will be. 60 If our objective is to offer U.S. public companies the lowest cost of capital a market can provide, these companies should be free to accept that capital from whichever investors offer them the best price for their securities. These investors may well be foreign citizens or entities. Indeed, our country’s earliest capital investors—companies such as Cropper, Benson & Company, Baring Brothers, and even the Browns of Baltimore (whose central partnership was based in Liverpool, England)—were foreign merchants and merchant banks who financed our fledgling international and interstate trade. 61 The New York Stock Exchange itself became the world’s second largest by the late 1860s, not by attracting foreign issuers so much as by attracting foreign (mostly British) investors in the booming American “emerging” market. 62 Today, even

though the United States is no longer the fastest growing economy in the world, foreign direct investment in the United States remains high, with capital flowing into the country even from the developing world in search of the historically high returns available in the U.S. capital markets. U.S. companies need this capital if they are to remain competitive with the rest of the world.

At the same time, the U.S. capital markets do not just serve U.S. issuers desiring sources of capital. Our markets also serve American investors, who rely on them in much the same way as do their foreign counterparts. The returns American investors make by investing in public companies fund our retirement accounts, greatly lessening the demands that would otherwise be placed on our Social Security system; they fund our children’s education; they fuel the consumer demand upon which our economy has so often relied. The health of the U.S. economy requires that American investors be provided with not just the highest standards of investor protection, but also that they be offered the broadest range of high quality investment choices. In our highly competitive global market it is inevitable that not all of the best investment opportunities will be with U.S. companies. Some will be foreign. For this reason, unlike in some countries, the U.S. federal securities laws are neutral with respect to the national origin of issuers—all are welcomed with open arms, and all play by the same rulebook and on the same playing field.

Americans investing in a foreign company listed on a U.S. stock exchange have a right to expect that the company’s financial disclosures are as thorough and as accurate as those they have come to demand of U.S. companies, and that they will be protected by the same set of laws that apply to domestic issuers.

III. The Current Financial and Regulatory Environment

Under current SEC regulations, few distinctions are drawn between foreign and domestic market participants. For the most part, foreign market participants wishing to operate in the United States, solicit U.S. investors, or otherwise access the U.S. capital market must first register with the SEC in a manner similar to their domestic counterparts. Exchanges, broker-dealers, issuers, and other market participants that do not access the U.S. capital market—even those owned by U.S. firms—do not fall under the jurisdiction of the SEC or the federal securities laws.

The effect of these requirements is to prohibit foreign stock exchanges from placing trading screens with brokerage firms or institutional clients in the United States without first registering with the SEC as an exchange. Likewise, securities listed on foreign stock exchanges are not permitted to be

offered directly to investors in the United States unless these securities are first registered with the SEC. 65 Foreign broker-dealers not registered with the SEC may not solicit investors in the United States. 66 While they may execute orders by U.S. investors if requested to do so, they may not be able to follow-up those requests with additional services, and most are unwilling to even maintain an ongoing customer relationship for fear that U.S. liability will attach. 67

Of course, U.S. investors are free to purchase such securities on foreign stock exchanges, and many do. Indeed, over the past two years, U.S. retail investment abroad has surged dramatically, mostly as a result of investors seeking higher overseas returns made possible by the devaluation of the U.S. dollar. 68 However, the process can be cumbersome and comparatively expensive. Generally speaking, American retail investors interested in these foreign investment opportunities trade non-U.S. registered securities listed on a foreign stock exchange through registered U.S. brokers. But the U.S. brokers typically funnel the trade orders through their foreign affiliates—a process that tends to involve somewhat higher transaction costs (and may take more time) than if the U.S. investors had conducted the transactions directly with the foreign affiliates or foreign brokers.

Consequently, while current U.S. laws and securities regulations do not directly limit U.S. investor access to foreign investment opportunities, in practice, access is constrained by two important factors:

1. The additional transaction costs associated with placing a trade on a foreign stock exchange through a U.S.-registered broker (or in placing the trade in a one-off transaction directly with a foreign broker); and, perhaps more importantly,
2. A lack of information about foreign investment opportunities because foreign financial service providers (and issuers) are not able to directly solicit American retail investors and U.S.-registered broker-dealers are unable to offer American investors information about or research on foreign investment products unless investors directly (and specifically) request such information.

A. Reasons Underlying the Historical SEC Approach to Cross-Border Market Access

The constraints on U.S. investor access for foreign investment opportunities discussed above are a direct result of the SEC’s concerns about investor protection. With a few exceptions, the SEC has been reluctant to permit foreign

issuers and foreign financial service providers to access the U.S. capital market, without submitting to direct SEC oversight, for a number of legal, economic and organizational reasons. First and foremost, these reasons include concerns that permitting foreign access without direct SEC oversight would result in unknown risks to investors and the U.S. capital market by making it more difficult for the SEC to detect market fraud or potential prudential risks. Despite growing international cooperation in these areas, the SEC’s power to detect and prosecute financial fraud occurring overseas is naturally weaker than it is domestically.

A second reason for the SEC’s historical reluctance to permit foreign market participants to operate in the United States without fully adhering to U.S. federal securities regulations is the fear that foreign access to U.S. investors on terms substantially different from those imposed domestically would place U.S.-registered firms and issuers at a competitive disadvantage vis-à-vis their foreign-registered counterparts. Such a situation might also lead to regulatory arbitrage, with firms registering in foreign countries imposing significantly different oversight and investor protections, while still enjoying access to the U.S. capital market. Likewise, direct foreign access by firms and issuers using disclosure standards different from those in the United States also could make it difficult for U.S. investors to compare different investment options. Issuers using different accounting standards or mutual funds using different performance standards than their American counterparts might decrease the market transparency the SEC has long sought to foster. Theoretically, this could raise the cost of capital for issuers in the U.S. market.

Finally, as discussed above, the federal securities laws charge the SEC with protecting investors, maintaining fair and orderly markets in the United States, and promoting capital formation. As an organization, significant political risk exists for the SEC should a major financial scandal at an unregistered foreign entity operating in the United States result in large losses to a significant number of American retail investors.

B. Current SEC Solution to Globalizing Markets

Over the past twenty years, as global interest in the U.S. capital market has increased, the SEC has responded with a number of initiatives designed to address specific problems that have arisen. Recognizing that different jurisdictions mandate different types of disclosure and impose different corporate governance standards, the SEC introduced a set of separate prospectus requirements for foreign issuers designed to take these differences into account. The SEC worked closely with the International Organization of Securities Commissions (“IOSCO”) to develop international disclosure standards that

could form the basis of a single prospectus to be used in multiple jurisdictions, with addenda as required by local regulations. The SEC also changed its disclosure requirements to permit foreign issuers to use high-quality foreign accounting standards, provided the figures were reconciled to U.S. Generally Accepted Accounting Principles ("U.S. GAAP")—an admittedly complicated process, but one far less onerous than having the financial statements be prepared entirely using U.S. GAAP.

To lessen the transaction costs of cross-border securities transactions, the SEC has historically also been a strong advocate for the "convergence" of national regulatory standards. Under this approach, the costs associated with complying with regulation in more than one jurisdiction could be substantially reduced if securities regulators and standards-setters in different jurisdictions were to converge their requirements into a single set of high-quality standards.

By contrast, regulatory arbitrage is a real risk where jurisdictions rely on mutual recognition of foreign regulatory systems alone to facilitate cross-border transactions. Regulatory differences between jurisdictions, or different approaches to enforcement, can create risks to market integrity if regulatory safeguards in one jurisdiction can be circumvented by moving offshore. Mutual recognition, without regulatory convergence, can also make it difficult for investors to draw meaningful comparisons regarding investment choices in different countries.

Despite its undeniable theoretical advantages, complete regulatory convergence has proven difficult to achieve over any short-to-intermediate time frame. The reasons for this are many, but the magnitude of the task stands out: the entire complement of individual regulations and standards that need to be "converged" to allow for full market integration are quite numerous. Another reason, less frequently mentioned in the convergence dialogue but perhaps just as important, is that some jurisdictions simply have fundamentally different regulatory philosophies. When these differences are significant, complete convergence may not be possible and, indeed, may not even be desirable, if eliminating these philosophical differences results in less regulatory experimentation and a rigid one-size-fits-all approach to market oversight.

While the SEC's current approach to lowering cross-border transaction costs has proven successful at many levels to a degree, the approach has been

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72. Another term occasionally used to express this same concept is "regulatory harmonization." The SEC has preferred to use "regulatory convergence" or "upwards convergence" to emphasize that the exercise is designed to come to a single "best" standard on any given matter. By contrast, "harmonization" could imply a split-the-difference compromise where regulatory differences exist.

one-sided. It has made accommodations for foreign issuers listing on U.S.
exchanges—accommodations that some have criticized for creating an unfair
playing field for foreign companies and undercutting efforts overseas to
build higher quality markets—
—but U.S. investors wishing to invest overseas have been more or less left to their own devices. Foreign broker-dealers
cannot provide services to U.S. investors unless registered in the United States,
except under certain very limited circumstances. U.S. investors can purchase
foreign securities on foreign stock exchanges; however, as noted above, doing
so usually requires the assistance of several layers of costly intermediaries.
From an investor’s perspective this situation is less than ideal.

C. The SEC’s Mandate and International Strategy

The concepts embedded in the Exchange Act are surprisingly apropos
today to any consideration of how the SEC should respond to what is a rapidly
internationalizing capital market. Reviewing these first principles leads us
to several propositions that may inform an SEC international strategy.

1. U.S. Securities Regulation Should Remain Nationality-Neutral

As described above, securities regulation that purposefully discriminates
against foreign issuers, intermediaries, exchanges or investors, is not in the U.S.
national interest. While the law’s intent is clearly that the SEC’s policies
should promote the national interest, protectionist policies of all types un-
dermine this interest by creating “hothouse” industries unable to withstand
the rigors of global competition. It also inhibits efficient capital formation
by “robbing Peter to pay Paul” with regard to other important elements critical
to our national interest (i.e., benefiting U.S. issuers to the detriment of U.S.
investors, and vice versa).

2. U.S. Securities Regulation Should Remain Flexible

Financial regulation (like investment decisions) is almost always formed
under conditions of incomplete information. The history of financial legisla-
tion, from the Bubble Act of 1720 to the Sarbanes-Oxley Act of 2002, shows
that it is usually the child of crisis. Securities regulation, likewise, must often

74. See Coffee, supra note 3, at 1823.
75. John Micklethwait & Adrian Wooldridge, The Company: A Short History of a Revo-
76. For example, the English Bubble Act of 1720 was passed in the intensely speculative environment
    of the 1720 South Sea Bubble, which, along with other new joint-stock companies, had caused the Lon-
    don stock market to increase roughly one hundred times between 1695 and 1720 (though the Bubble
    Act itself seemed to have the perverse effect of increasing demand in South Sea Company shares until the
    stock market crash later in the year). See id. In Germany, concerns about “speculation” in agricultural
    commodities led to the Bourse Law of 1896, and stock market speculation in France led to laws restrict-
    ing stock exchange activity and foreign ownership of securities in 1893 and 1898. And, of course, the
    great Stock Market Crash of 1929 led to passage of the Securities Act and Glass-Steagall Acts of 1933,
be promulgated because of exigent circumstances even in the face of incomplete cost-benefit analysis or uncertainty as to the regulation’s effectiveness.

Because of this, Congress has granted the SEC considerable interpretive and exemptive authority about how many aspects of the federal securities laws should be implemented. Consequently, any international strategy that the SEC adopts in response to the globalization of the U.S. capital market should continue to allow the SEC flexibility with regard to modifying its regulations as new information becomes available and new problems arise.

3. Regulatory Competition Is Not Always Bad

Conforming the laws and regulations of different countries around a single standard has tangible benefits for the cross-border flow of capital. However, markets also benefit from regulatory competition as much as they do from other types of competition. To believe otherwise is to assume that regulators have discovered the “one true path” to securities regulation and that dissent from this path is heresy. Such a monolithic approach can lock in bad ideas and discourage regulatory innovation.

Consequently, the SEC’s international strategy should draw a distinction between the healthy aspects of regulatory competition and regulatory arbitrage. The mere ability for a market participant to escape regulation by moving to a different jurisdiction is not regulatory arbitrage. Regulatory arbitrage, rather, might best be viewed as a subset of regulatory competition—a situation that arises in a cross-border environment when market participants can use gaps caused by jurisdictional boundaries to participate in typical market activity in a jurisdiction without being subject to that jurisdiction’s regulation (or in the case of substituted compliance, a regulatory framework that is comparable). Regulatory arbitrage is possible because regulators operate in a global market characterized by enforcement or information hurdles that undermine investors’ abilities to fully and accurately assess the risks and benefits of a given regulatory regime. As a consequence, issuers and other market participants may be tempted to relocate to jurisdictions with less costly regulation, since the market mechanisms that might normally punish such behavior are suppressed. By “arbitraging” a low-cost/low-quality regulatory regime against higher-quality/higher-cost jurisdictions without fear of a market correction, the “good” competition that encourages regulators to seek cheaper and better ways to obtain high levels of investor protection and market efficiency is instead replaced with a “bad” form of competition that achieves lower regulatory costs by sacrificing investor protection and market efficiency. Put another way, healthy regulatory competition exists when different regulators share the same overarching regulatory objectives, but, in implementing comparable regimes, compete with each other to develop the most effective and least costly ways to achieve these goals.

note 16, at 35–41; Seligman, supra note 17, at 1–100, 124–44.
For this reason, while the SEC is committed to promoting regulatory competition and the pursuit of new ideas and improved regulatory oversight, any cross-border framework should be designed in such a way that this competition is promoted among regulators devoted to maintaining the highest levels of investor protection and market efficiency, and sharing the same overarching regulatory objectives and similar philosophies about enforcement and oversight.

IV. SUBSTITUTED COMPLIANCE: A NEW INTERNATIONAL FRAMEWORK

The evolution of a new global capital market underscores the wisdom of the SEC reviewing how it regulates certain cross-border securities-related services. Two particular services stand out: foreign trading screens and foreign broker-dealers providing services directly to investors in the United States. Over the past few years, several foreign stock exchanges have requested that they not be required to register with the SEC in order to operate electronic trading screens in the United States. At the same time, American investors—and particularly large U.S.-based institutional investors—are increasingly interested in buying and selling foreign securities, both to take advantage of currency exchange rate fluctuations and to better diversify their portfolios.

Arguably, the current system of overlapping, repetitious or even contradictory obligations imposed on foreign stock exchanges and broker-dealers operating in the United States increases transaction costs for U.S. investors while offering only marginal improvements in investor protection. Even if we assume that other jurisdictions do not offer regulatory oversight and investor protections as extensive as those in the United States (particularly where private rights of action are concerned), many jurisdictions provide sufficiently robust regulation and investor protections that U.S. investors seem comfortable assuming any additional risks these markets entail. Further, the regulatory oversight offered by some of these jurisdictions is sufficiently high that the SEC’s recognition of this oversight for prudential purposes, provided there are other safeguards in place, would not equate to a dereliction of the SEC’s investor protection mandate.

The following describes in a broad manner a framework and set of mechanisms that could allow the operation of foreign trading screens and foreign broker-dealers in the U.S. capital market without imposing normal SEC regis-

77. Some economists and legal scholars suggest, quite logically, that investors will be comfortable assuming any additional risk, even in a completely unregulated market, assuming that returns are sufficiently high—and that opacity about what risks exist is merely another risk that can be hedged against through higher expected returns, securitization, insurance, and other forms of balancing risk. However, these same observers note that such situations tend to impose high transaction costs on high-quality market participants, who must expend considerable resources demonstrating to investors that they present lower risks, or else pay higher costs for investor capital. Issuers listing in a market with high regulatory standards and aggressive enforcement of these standards essentially substitute a costly demonstration of their trustworthiness with investor trust in the regulator and legal system. See Coffee, supra note 3, at 1780–83.
istration requirements and allowing for significantly less than current SEC regulatory oversight. While the regulation of exchanges and broker-dealers is quite different, the framework uses substituted compliance with U.S. securities regulations in a similar manner to allow both types of entities to access to the U.S. capital market. The proposed framework comprises two parts: an outline of exemption requirements for the exchanges and broker-dealers themselves; and a set of regulatory preconditions that would apply in the jurisdiction in which these exchanges and broker-dealers are based. These latter preconditions would entail an evaluation of the entity’s home country regulatory regime and would be hardwired through a bilateral arrangement with the SEC, possibly legally supported by a treaty between the United States and the foreign government. Such a treaty would help cement an alliance of like-minded regulators committed to working together to provide for high quality investor protections and regulatory standards.

While possibly supplemented by a formal international agreement, this framework would rely primarily on the SEC’s exemptive authority. The primary reason for this is the flexibility that the SEC’s exemptive authority offers.

Although focusing on cross-border access by foreign stock exchanges and broker-dealers, should this approach prove effective and useful, it might also be expanded to include other financial intermediaries, such as, but not limited to, electronic communications networks (“ECNs”), alternative trading systems (“ATSs”) or mutual funds.

A. Foreign Screens and Foreign Financial Service Providers

Foreign screens and foreign financial service providers are two separate types of entities. Each poses separate sets of concerns. Foreign screens are extensions of foreign stock exchanges. Exchanges tend to be large entities, frequently with quasi-regulatory capabilities, facing direct oversight by the governments of the jurisdictions in which they are based. Some are national franchises with legal monopolies and distinctive “public good” characteristics, and in some jurisdictions the national securities exchange acts as the national securities market regulator as well. In other jurisdictions, securities exchanges have been completely demutualized and function entirely as for-profit companies that compete with other exchanges to attract market participant customers. Most jurisdictions have only a handful of exchanges and monitoring these exchanges is a primary function of the national securities regulator.

Broker-dealers, by contrast, can be individuals or firms and tend to be far more numerous within most jurisdictions. While they usually operate under government license or registration, they frequently are less heavily regulated in their day-to-day operations than are exchanges. Broker-dealers often offer

78. While broadly similar to mutual recognition, the term “substituted compliance” calls for reliance on comparability of regulatory requirements and oversight as the basis for mutual recognition.
investment advisory services in addition to buying and selling securities, and they frequently hold investor assets in some type of fiduciary capacity (though the laws governing this capacity vary significantly by jurisdiction). Securities regulators usually regulate and oversee these entities in a variety of ways to help ensure that these firms and their employees are honest with their customers, that they maintain certain records, that they make certain disclosures to allow the regulator to protect the integrity of the market, that the entities are financially sound, and that investor assets are not subject to undue risks.

Yet, despite the differences between exchanges and broker-dealers, many of the cross-border issues presented by these foreign entities are similar, and the potential ways the SEC may address these issues are also similar. Both issues fundamentally involve problems of protecting U.S. investors. Currently, when U.S. investors actively seek to invest in foreign companies listed on foreign stock exchanges, they know (or should know) that the protections U.S. federal securities laws afford do not exist for these transactions, and that the disclosure, accounting and auditing standards that apply to issuers listed on those exchanges may differ significantly from those required in the United States. Likewise, investors currently purchasing securities through a foreign broker-dealer on a foreign stock exchange should know that the laws regulating these firms may differ from those in the United States and that the investor protections afforded them in the United States may not be available to them abroad. In both cases, U.S. investors typically must contact these foreign entities in order to do business (the foreign entities may not directly solicit them) and, presumably, there is an implicit recognition of any additional risks that doing business outside the United States entails.

However, ceteris paribus, if the securities of foreign companies are offered on foreign screens located in the United States (without the foreign stock exchanges and the companies listed on these exchanges registering with the SEC), investors may not be aware that their investments are regulated under an entirely different legal system. Likewise, if foreign broker-dealers are able to operate in the United States and solicit U.S. investors without being subject to SEC oversight, investors might not immediately recognize that they may face different risks than if they were conducting trades through SEC-registered firms.

B. Bilateral Substituted Compliance

Rather than relying solely on a multilateral mechanism to achieve universal regulatory convergence (which historically has been the SEC’s preferred approach), the proposed framework would, in addition, rely on a bilateral regulatory mechanism to achieve much the same result more quickly and more effectively. Bilateral substituted compliance also has the benefit of not discouraging regulatory experimentation (a risk with a regulatory convergence approach), but without encouraging regulatory arbitrage. Such a substituted compliance regime would exempt foreign stock exchanges and broker-dealers
from the normal SEC registration and prudential oversight requirements, provided the entities are regulated in a particular jurisdiction that the SEC has determined offers comparable regulatory oversight. A necessary condition of such an exemption would be a bilateral arrangement between the SEC and the home jurisdiction regulator allowing for a considerable degree of prudential and enforcement information-sharing. This arrangement would also contain an undertaking by the foreign regulator describing in detail how certain regulatory preconditions required by the SEC are met, and a similar undertaking by the SEC providing for reciprocity.

This approach, as described in more detail below, may offer several advantages. First, because it is essentially bilateral in nature, negotiating a substituted compliance regime with a select jurisdiction (including the information-sharing aspects and the regulatory preconditions) would prove efficient. This approach would also allow the SEC and its foreign partner to maintain a substantial degree of de facto prudential oversight over foreign entities in its jurisdiction by negotiating the terms of foreign access. Furthermore, by incorporating a detailed five-year review and reassessment process, the proposed bilateral mutual recognition approach would avoid the “snapshot in time” hazard that typically accompanies cross-border mutual recognition and convergence arrangements.79

These advantages are in addition to the other, more generalized, benefits that could accrue to U.S. investors by increasing foreign access to select high-quality markets. These benefits include:

- Increased competition in financial services in the United States, to the benefit of both retail and institutional investors;
- Reduced transaction costs to U.S. investors interested in buying or selling foreign securities; and,
- By limiting direct access to foreign screens and broker-dealers only from select jurisdictions with high-quality regulatory oversight and highly liquid markets, U.S. retail investors would be protected by well-developed price discovery mechanisms in these foreign markets, even if the legal level of investor protection is different from that in the United States.

Substituted compliance would also permit the United States and other countries with similar regulatory philosophies to leverage their regulatory strengths. Given the size of the U.S. capital market (particularly when combined with other developed and developing markets with similar regulatory oversight), substituted compliance may encourage other jurisdictions to adopt high regulatory standards and thus minimize regulatory arbitrage as a way to attract business away from the United States and its partners. This is because poorly...

79. The “snapshot in time” risk occurs as a direct result of the need for regulatory flexibility. Under most cross-border mutual recognition regimes, typically two or more jurisdictions initially determine that their regulatory regimes are sufficiently similar to allow mutual recognition to take place without presenting problems of regulatory arbitrage. However, because regulatory regimes evolve, similar systems may not stay similar, and as regulatory requirements diverge the risk of regulatory arbitrage grows.
regulated markets would have an incentive to bring their own regulatory system up to the highest international standards in order for their own broker-dealers and stock exchanges to gain access to this new cross-border market. At the same time, a mandatory disclosure statement required by the proposed framework warns investors that trading conducted on a foreign stock exchange or through a foreign broker may entail differing legal and regulatory protections, and that the remedies for any wrongdoing would be limited to those available in the relevant foreign jurisdiction. In this connection, foreign stock exchanges and broker-dealers are required to make available to investors and the SEC a breakdown of how the legal and regulatory protections in their home jurisdictions are distinct from those in effect in the United States.

Finally, in addition to increasing investor access to investment opportunities abroad and reducing investor transaction costs, the proposed bilateral substituted compliance approach also adheres to the basic overarching policy objectives contained in the federal securities statutes. In particular, by requiring a notification to investors of the differences in conducting transactions on foreign stock exchanges or through foreign brokers, any future problems on those exchanges can be “walled off” from affecting the integrity of the U.S. capital market, even as a degree of regulatory experimentation between the partner jurisdictions is encouraged. At the same time, U.S. exchanges and broker-dealers would be able to “brand” themselves and sell the virtues of the regulatory regime under which they operate and the rights and protections afforded their customers.

The proposed SEC international framework has two parts: one that covers foreign stock exchanges wishing to locate trading screens in the United States and offer exclusively foreign-listed securities to U.S. investors; and a second for foreign broker-dealers wishing to offer exclusively foreign investment products to these investors. Under neither scenario would the foreign entity be able to offer U.S.-registered investment products unless the exchange or broker-dealer registered with the SEC in a traditional manner. While both elements of the framework envision that the foreign entities would register with the SEC, the registration requirements would be comparatively minimal and oversight of the foreign entity would remain primarily the responsibility of the entity’s home jurisdiction. Nonetheless, U.S. federal authorities (including the SEC) would retain primary responsibility for investigating and prosecuting violations of the anti-fraud provisions of the U.S. federal securities laws if a foreign entity is found engaged in market fraud in the United States (though anti-fraud enforcement actions involving exempted foreign broker-dealers or exchanges likely would be coordinated with the SEC’s foreign counterparts in order to make best use of agency resources and ensure that the remedies sought by the relevant authorities are complimentary rather than duplicative). In short, while the SEC would not enforce the foreign jurisdiction’s rules and regulations (which would govern their activity in the United States), foreign stock exchanges and broker-dealers still would be subject to
the anti-fraud prohibitions in the U.S. federal securities laws, including SEC enforcement of Rule 10b-5.80

C. Four-Step Process

This framework envisions a four-step process for both foreign trading screens and foreign broker-dealers. The first step would involve a petition from the foreign entity to the SEC seeking an exemption from registration. The second step would involve a discussion between the SEC and the foreign securities regulator that has primary responsibility for overseeing the petitioning entity ("home regulator"). This discussion would involve a bilateral assessment to determine the degree to which the two jurisdictions' trading rules, prudential requirements, examinations, review processes for corporate filings, and other requirements are comparable. The comparability assessment would also involve a discussion of enforcement capabilities and philosophies. Because few jurisdictions have fully comparable regulatory systems, this step likely would also involve a collaborative discussion of whether regulatory adjustments may be needed to bring the two different regulatory systems into harmony and help ensure that no regulatory gaps or systemic risks exist. The second step in the framework process would conclude with negotiation of an enforcement, inspections, and information-sharing technical arrangement or memorandum of understanding that would enable the two partners not only to share enforcement-related information and cooperate with each other's enforcement investigations,81 but also to share inspections reports, conduct joint inspections, and cooperate with each other at the prudential oversight level.82

The third step in the process would involve a dialogue between the SEC and the petitioning entity. At this time, the petitioning entity would provide the SEC with the information outlined below and agree to SEC jurisdiction and service of process with regard to the U.S. securities anti-fraud laws. The fourth and final step in the process would involve the SEC giving the

80. Rule 10b-5 states:
   a. To employ any device, scheme, or artifice to defraud,
   b. To make any untrue statement of a material fact or to omit to state a material fact necessary in
   order to make the statements made, in the light of the circumstances under which they were made,
   not misleading, or
   c. To engage in any act, practice, or course of business which operates or would operate as a fraud or
deceit upon any person,
   in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b–5 (2005).
81. See, e.g., International Organization of Securities Commissions, Multilateral Memorandum of Under-
   standing Concerning Consultation and Cooperation and the Exchange of Information (May 2002),
82. See, e.g., Memorandum of Understanding Between the United States Securities and Exchange
   Commission and the United Kingdom Financial Services Authority Concerning Consultation, Cooper-
   ation and the Exchange of Information Related to Market Oversight and the Supervision of Financial
   mou.pdf.
public notice of the petition and seeking public comment in support of or in opposition to the exemption. After notice and comment is made, the Commission would deliberate on the petition and, if agreed upon, approve the petition for exemption by Commission order.

**CHART A: FOUR-STEP REGISTRATION EXEMPTION PETITION PROCESS**

1. SEC to Foreign Regulator
   - Jurisdiction regulation comparability assessment

2. Firms/Exchanges to SEC
   - Collaborative discussion and adjustment
   - Enforcement and Oversight Agreement
   - Foreign financial institution/foreign exchange petition

3. SEC to Firms/Exchanges
   - Firm/Exchange agreement to jurisdiction and service of process

4. SEC
   - SEC notice and comment
   - Commission order
   - Foreign Access based on Substituted Compliance

**V. ASSESSMENT PROCESS AND KEY PRINCIPLES**

The Commission’s determination whether to exempt from registration a foreign stock exchange or foreign broker-dealer would depend on the particular representations and information provided by the petitioning entity, but would first require as a prerequisite an assessment by the Commission of the comparability of the entity’s home jurisdiction regulation and the ability of
this home jurisdiction regulation to achieve the same objectives mandated by federal securities laws. This assessment necessarily would entail discussions with the home regulator and require an arrangement between that regulator and the SEC permitting extensive prudential and enforcement information-sharing and oversight coordination.

The objective of this exercise is to ensure that the regulatory oversight of the two different systems is sufficiently similar such that the SEC is not violating its legislative mandate to ensure compliance with the U.S. federal securities laws and to protect investors, maintain competitive, orderly, fair, and efficient markets, and promote capital formation within the United States. Comparability helps make certain that an SEC exemption to a foreign financial service provider amounts to substituted compliance and does not open the U.S. capital market to regulatory arbitrage or in any way reduce U.S. market transparency. At the same time, such comparability could allow for closer coordination between the SEC and its foreign regulatory partners and helps ensure that foreign transactions in the United States do not present a threat to the integrity of a foreign securities market.

**A. Exchange Oversight**

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A comparability assessment would contain, at a minimum, an assessment of how the foreign regulatory regime regulates its stock exchanges to determine how its requirements vary from those the SEC requires of U.S. exchanges. In particular, this would involve a comparison of: the two different jurisdictions’ registration, authorization, and other forms of licensing of exchanges; how customer funds are protected from misappropriation and misapplication; the foreign regulator’s recordkeeping, reporting, and electronic audit trail requirements; exchange governance and internal compliance; the exchange trading rules and the exchange rule approval process.

**B. Broker-Dealer Oversight**

A comparability assessment for foreign broker-dealers seeking an exemption from registration in the United States would also include comparisons of the foreign jurisdiction’s registration, authorization, and other forms of licensing; minimum financial requirements for persons that accept customer
funds; protection of customer funds from misappropriation and misapplication; recordkeeping, reporting, and electronic audit trail requirements; and internal compliance requirements for broker-dealers. It would also include a comparison of the SEC’s and foreign jurisdiction’s minimum sales practice standards, and minimum disclosure requirements with regard to potential broker-dealer conflicts of interest.

C. Issuer Requirements

In addition to comparing regulatory requirements for both exchanges and broker-dealers, the proposed comparability assessment would review disclosure requirements relating to securities bought or sold on an exchange or through a broker-dealer. This would include a comparability assessment of financial and non-financial statement disclosure requirements, the robustness of the accounting standards required in the jurisdiction, the adequacy of local auditing standards, and auditor oversight controls. It would also entail a comparability analysis of other issuer requirements designed to ensure that issuer disclosures are accurate and complete. Such requirements might include a comparison of the jurisdiction’s corporate governance, internal controls, director independence, and shareholder protection laws and regulations.

D. General Legal and Enforcement Comparability

Following this framework, the regulatory comparability assessment might also include an assessment of broader areas of oversight and regulation important to the Commission. These may include such things as adoption, implementation, and adequate enforcement of the OECD Convention Against Bribery of Foreign Public Officials in International Business Transactions, an attestation from the securities regulator that no constraints exist on it providing information to the SEC in any investigation of possible Foreign Corrupt Practices Act violations, and implementation of relevant IOSCO principles.

In addition to an assessment of the home regulator’s enforcement powers and philosophy, depending on the nature of the arrangement, a legal comparability assessment might also include an analysis of the remedies available to shareholders in the foreign jurisdiction and whether these remedies are comparable to those in the United States. Such a comparison could be important if the SEC’s substituted compliance framework were to include choice of law and choice of forum provisions that restricted private rights of action against exempted foreign entities to the remedies available in their home jurisdictions.

E. Reciprocity

In considering an exemption request, the Commission would likely wish to take into account the extent to which U.S. entities regulated by the Commis-
sion are permitted to engage in similar activities in the country from which an exemption is sought. Indeed, reciprocity would likely have to be the cornerstone of any SEC international framework to help ensure that the framework is politically acceptable in the United States and that competition is not a one-way street. Reciprocity is also essential for the SEC to fulfill its legislative mandate under the NSMIA to promote the competitiveness of the U.S. capital market and those firms and institutions accessing it.

Reciprocity might also include a choice of law or choice of forum arrangement for private rights of action. Under such an arrangement, foreign investors investing through U.S. broker-dealers and exchanges located abroad would be afforded the same rights U.S. investors have in the United States. At the same time, U.S. investors investing through exempted foreign broker-dealers and exchanges would need to avail themselves of the remedies offered under the foreign regulatory regime.

F. Bilateral Regulatory Cooperation Arrangements

Enforcement and regulatory information-sharing arrangements between the SEC and the home regulator would likely be a necessary component of the Commission’s consideration of regulatory comparability. The SEC has considerable experience with bilateral and multilateral enforcement-related information-sharing mechanisms. Currently, the SEC is a signatory to more than thirty bilateral memoranda of understanding (“MOUs”) and one multilateral MOU that permit the SEC to acquire information abroad during an enforcement investigation through the assistance of its foreign counterparts—an ability absolutely vital to permitting the SEC to carry out its mandate to enforce U.S. securities laws. While these arrangements have proven highly effective at assisting the SEC with its enforcement activities, they are likely insufficient for ongoing prudential oversight purposes.

In addition to the types of information available under existing enforcement-related MOUs (i.e., the ability to seek bank and brokerage account records, corporate documents, testimony from witnesses, etc.), the Commission would likely be able to offer registration exemptions to foreign stock exchanges and foreign broker-dealers only if a more extensive bilateral supervisory arrangement is in place. This would entail the exchange of more routine information and would not require the SEC to indicate that it is seeking the information as part of a specific investigation into suspected wrongdoing. Such an arrangement would be a mechanism by which the partners to the arrangement can keep each other apprised of not just regulatory changes in each jurisdiction, but also of risk assessments, inspection reports, and informal regulatory concerns that may have an impact on oversight of the exempted exchanges.

83. Such choice of law and choice of forum arrangements have been used in other contexts where international transactions are involved. Cf. M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972); Lipcon v. Underwriters at Lloyds of London, 148 F.3d 1285 (11th Cir. 1998).
and/or broker-dealers. Such an arrangement is particularly important if a foreign jurisdiction has financial secrecy laws that might affect the SEC's ability to protect the U.S. market against securities fraud. Where such laws exist, any bilateral arrangement would have to ensure that the financial secrecy requirements do not hinder the transfer of enforcement and regulatory information between the regulatory partners. Such a supervisory MOU might include provisions such as the ability to share non-public inspection reports, take statements from employees of foreign regulated entities, share registration and disciplinary information, and access client identification and beneficial ownership information.

Whether included in the supervisory MOU or done informally, the regulatory partners likely would also want to hold periodic regulator-to-regulator staff-level meetings to discuss prudential oversight matters of mutual concern. As a practical matter, the regulatory partners would also wish to meet regularly at senior levels to help ensure that the comparable regulatory standards and approaches remain comparable through coordinated interpretations and enforcement approaches.

**G. Five-Year Comparability Review**

Because regulations change over time, the Commission may wish to make the regulatory comparability assessment subject to an in-depth de novo review once every five years. While renewal of the arrangement would otherwise be automatic, the review would act as a useful tool for both regulators to consider whether any legal, regulatory, or policy changes in either jurisdiction might have altered the conclusions of the original assessment. Nonetheless, such a review would not be limited to only once every five years; any substantial legislative or regulatory changes in either jurisdiction in the interim might, at either partner's discretion, result in a new comparability assessment. This would ensure that substituted compliance with the foreign regulatory system is still sufficient for the SEC's exemption to comply with its legislative mandate.

**H. Commission Discretion**

The Commission would likely wish to retain broad discretion to determine that the policies of any program element generally are met, notwithstanding the fact that the foreign regulatory regime does not contain an element identical to that of the Commission's regulatory program. Conversely, the Commission might wish to retain the ability to assess how particular elements of a foreign jurisdiction's regulatory regime are, in fact, applied by a foreign supervisory authority. Thus, for example, in order to find that a particular foreign regulatory regime is comparable, the regulations of that jurisdiction would have to be applicable to all U.S. customers, notwithstanding any exemptions that might otherwise be available to particular classes of customers located offshore. A petitioner, therefore, would set forth with particularity
the factual basis for a finding of comparability and the reasons why such policies and purposes are met, notwithstanding differences of degree and kind in its regulatory program.

VI. FOREIGN STOCK EXCHANGE REGISTRATION EXEMPTION

Under the following framework, and upon a favorable comparability assessment, any exchange not located in the United States and subject to SEC registration requirements could apply for an exemption from registration by filing a petition for exemption with the Commission.

A. FOREIGN STOCK EXCHANGE PETITION

Once a foreign stock exchange files a petition for exemption from registration, the Commission, at its discretion, may grant such an exemption if that exchange demonstrates to the Commission’s satisfaction that the exemption is not otherwise contrary to the public interest or the objectives of the federal securities statutes. The SEC would likely grant an exemption to a foreign stock exchange only if it determines that all of the objectives of the SEC’s registration and oversight regime are otherwise met by the foreign stock exchange and a comparable regulatory scheme in its home jurisdiction. Consequently, the exemption criteria would contain three components:

(1) The representations and information provided by the exchange itself;
(2) A comparability assessment of the regulatory scheme in the jurisdiction in which the foreign stock exchange is located; and
(3) A bilateral arrangement with the foreign stock exchange’s home regulator that would provide the SEC with access to the information it needs in order to protect the integrity of the U.S. market.

Under this proposed framework, an entity that receives confirmation of an exemption from registration would be required to engage in all transactions in the United States through an SEC-registered broker-dealer or a foreign broker-dealer who has received confirmation of a registration exemption. An exchange may conduct business in the United States, but such screens would have to be placed with exchange members and be subject to exchange rules and oversight.

Depending on the exchange’s rules, registered or exempted broker-dealers may conduct transactions on the foreign screens placed in the United States and on behalf of either retail or institutional investors, provided certain conditions are met. In addition to written consent to submit to SEC jurisdiction for violations of the anti-fraud provisions of the U.S. federal securities laws (and designation of a U.S. agent for service of process), these conditions might include providing the Commission with certain information, most likely in the petition itself and perhaps also on a quarterly and ongoing basis to ensure that the information provided in the petition is current. In the petition itself, the SEC likely would want information and affirmations regarding the
entity’s home registration status, its disciplinary history, and which government entities and self-regulatory organizations oversee the entity (both at home and abroad). The SEC would also likely wish to have information about the exchange’s trading rules, listing requirements, corporate governance practices, and a description of the exchange’s rule approval process.

B. Disclosure Statement to U.S. Investors

This framework envisages that a foreign stock exchange, as a condition of exemption from registration, would require its members and any registered or exempt brokers conducting transactions on the exchange and on behalf of investors located in the United States to provide these investors with a risk disclosure statement. The risk disclosure statement would be required to be provided in a prominent manner and would be designed to make U.S. investors aware that the orders they place are traded on a foreign securities market not subject to SEC oversight. Such a risk warning would note that the laws and regulations that govern the foreign stock exchange may be different from those in the United States, that U.S. investors may not have access to the U.S. courts should a dispute occur, and that U.S. federal securities laws may not apply to the transaction in which they are engaging.

Depending on the nature of the arrangement between the SEC and the foreign regulator, the disclosure statement would also note any choice of law and choice of forum provisions, particularly if those provisions limited U.S. investors to the legal remedies of the foreign jurisdiction.

C. Violations

Under this framework, should a foreign stock exchange fail to provide the information required or furnish inaccurate information, this would constitute a registration violation under the SEC’s regulations, and the Commission could revoke all other registration exemptions it has accorded the entity. Should a foreign stock exchange face revocation of a registration exemption (or should the exemption be found void ab initio because of fraud or other egregious violations of U.S. law), the exchange would have to be accorded fair notice and a hearing to satisfy due process concerns. Under certain conditions (for example, where no fraud is involved), the Commission may wish to give a foreign stock exchange facing revocation of its exemption sufficient time to withdraw from the U.S. market or register with the SEC as an exchange. This would allow the entity a limited “grace period” so it does not automatically face severe (and possibly unwarranted) litigation and prosecution liability.

VII. FOREIGN BROKER-DEALER REGISTRATION EXEMPTION

As with foreign stock exchanges, under this framework and upon a favorable comparability assessment, any broker-dealer not located in the United
States and subject to SEC registration requirements under the federal securities statutes could apply for an exemption from registration by filing a petition for exemption with the Commission. An entity that received confirmation of an exemption from registration as a broker-dealer could solicit or accept orders from investors in the United States for transactions conducted on foreign stock exchanges.

Once a foreign broker-dealer files a petition for exemption from registration, the Commission, at its discretion, could grant such an exemption if the broker-dealer demonstrates to the Commission's satisfaction that the exemption is not otherwise contrary to the public interest or the objectives of the federal securities statutes. The Commission might grant an exemption to a foreign broker-dealer only if it determines that all of the objectives of the SEC's registration and oversight regime are otherwise met by the comparable regulatory scheme in the broker-dealer's home jurisdiction. As with foreign trading screens, the exemption criteria would contain three components:

(1) The representations and information provided by the broker-dealer itself;
(2) A comparability assessment of the regulatory scheme in the foreign broker-dealer's home jurisdiction; and
(3) A bilateral arrangement with the foreign broker-dealer's home regulator that would provide the SEC with access to the information it needs in order to protect the integrity of the U.S. market.

**A. Foreign Broker-Dealer Petition**

As a condition of exemption from SEC registration, a foreign broker-dealer operating in the United States would have to meet certain general requirements. For example, it would have to maintain in a separate account or accounts money, securities, and property in an amount at least sufficient to cover or satisfy all of its current obligations to U.S. investors. Such money, securities, and property would not be allowed to be commingled with the money, securities, or property of the foreign broker-dealer, with any proprietary account or to be used to secure or guarantee the obligations of, or extend credit to, the broker-dealer. Further, an exempted foreign broker-dealer which invests money, securities, or property on behalf of U.S. investors would also need to keep detailed records of these transactions and provide that information to the SEC upon request.

Under this proposed framework, a foreign broker-dealer's petition for exemption would be similar to that required of foreign stock exchanges and, as noted above, be predicated on a favorable comparability assessment and written consent to submit to SEC jurisdiction for violations of the anti-fraud provisions of U.S. federal securities laws. The SEC would likely ask for information and affirmations regarding the broker-dealer itself as well as quarterly and ongoing information designed to keep the petition information current.
B. Disclosure Statement to U.S. Investors

As with foreign stock exchanges, this framework would require that a foreign broker-dealer provide its U.S. customers with a separate written disclosure statement prior to opening an account for these customers or transacting business with them. This risk disclosure statement would note that the laws and regulations that govern the broker-dealer may be different from those in the United States and that U.S. federal securities laws (including any private rights of action and available legal remedies) may not apply to the transaction in which they are engaging.

C. Violations

As with foreign trading screens, should a foreign broker-dealer fail to consent to any of these requirements or provide inaccurate information, this would constitute a registration violation under the SEC’s regulations, and the Commission could revoke all other registration exemptions it has accorded the entity.

Also as with foreign stock exchanges, should a foreign broker-dealer face revocation of its registration exemption, the SEC would accord the firm fair notice and a hearing. Should the exemption revocation not involve fraud or other egregious conduct, the Commission may also wish to grant the foreign firm a “grace period” to withdraw from the U.S. market or else register under normal procedures so as to avoid unwarranted prosecution and litigation risk under U.S. federal securities laws.

Conclusion

This Article proposes a new framework to address the burgeoning set of conflicting issues and demands in the face of globalization of financial markets. Its objective is to improve U.S. investor access to foreign investment opportunities, while guarding the integrity of the U.S. capital market and enhancing the SEC’s ability to pursue securities law violators across borders. The framework also aims to reduce the transaction costs investors pay when investing overseas by reducing unnecessary and overlapping regulation through a system of substituted compliance with the U.S. regulatory system. Finally, the proposed framework is designed to discourage “regulatory arbitrage” that can undermine investor confidence. Instead, it encourages an international regulatory environment characterized by a regulatory “race towards optimality,” where investor protection, market transparency and efficiency, and efficient capital formation are strengthened around the world.

This proposed framework could clearly represent a significant departure from the SEC’s existing regulatory policies. However, it is a logical response to a changing international financial environment. It is also entirely consistent with the congressional objectives and first principles under which the SEC was created. This approach should directly benefit U.S. investors by pro-
viding them with greater investment opportunities at lower costs, while offering them greater protections against cross-border fraud than they currently have. At the same time, capital formation in the United States would be strengthened by increasing competition among financial service providers in the U.S. market.

The framework is, nonetheless, predicated on certain key assumptions. The first, of course, is that U.S. investors, both retail and institutional, actively seek to invest in foreign securities and would benefit from lower transaction costs and additional information about the level of protection different jurisdictions offer investors. It also assumes that U.S. investors would benefit from increased competition in the market for financial services (as would investors elsewhere). Finally, it assumes that, provided robust regulatory oversight and enforcement information-sharing agreements are in place, the regulatory differences found in certain like-minded jurisdictions are not so great that U.S. investors will be unable to assess any additional risks and make investment choices accordingly. It is, of course, possible that one or more of these assumptions is incorrect. However, if they are accurate, the framework offers investors greater choice at less cost and builds an alliance of jurisdictions committed to high standards of investor protection, thus providing U.S. investors with benefits that greatly exceed the risks.

This framework will, without doubt, prove controversial. Increased competition is never popular with incumbents in any industry, and the financial industry is no different. At the same time, the concept of a comparability assessment may prove highly unpopular with those jurisdictions that the SEC determines do not have a comparable regulatory regime. Some may object that this approach, even with its promotion of substituted compliance, still imposes too much SEC and U.S. oversight over foreign financial service providers. Nonetheless, given its clear congressional mandate, the SEC likely will remain unwilling and legally unable to cede completely regulatory oversight over entities accessing the U.S. capital market if such access harms market integrity. The framework, in this sense, offers a compromise—increased access by foreign market participants to the U.S. capital market, with a dramatic reduction in duplicative and unnecessary regulatory oversight, in exchange for a system that creates a true partnership between the SEC and the home regulator. Such a partnership should improve market integration, for the benefit of investors, issuers, and market participants in both countries.