

Centralization, Competition, and Privatization in Financial Regulation

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This essay reviews recent debates over the allocation of regulatory authority in three separate fields of financial regulation: corporate governance, securities regulation, and the regulation of financial institutions. In each field, the essay argues, reform proposals can be organized into three basic groups: those that advocate centralization of regulatory authority; those that favor competition among governmental bodies; and those that recommend the privatization of regulatory standards. While this debate is most familiar in the field of corporate governance, highly analogous policy discussions are currently taking place in securities regulation and the regulation of financial institutions. This essay traces the development of arguments over the proper allocation of regulatory authority in various sectors of the financial services industry, noting differences both in the contexts in which the issue has arisen in various sectors of the industry and also in the ways regulatory authority is currently allocated in each sector. The essay concludes with several tentative thoughts about normative grounds on which debates over the proper allocation of regulatory authority might ultimately be resolved.

A principal challenge in the field of financial regulation is selecting the appropriate institutional level at which to locate the authority to establish

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legal rules. Within the United States, with its federal system of government, this topic has attracted considerable attention over the years, particularly in the area of corporate governance. But the issue has become of increasing concern elsewhere in the world as the volume of international transactions has increased and regional compacts such as the European Union have taken on new importance. My goal in this essay is to offer a brief sketch of how academic debate over the allocation of legal authority has played out in three separate areas of financial regulation: corporate governance, securities regulation, and the regulation of financial institutions. Across all of these sectors, three competing approaches to the allocation of regulatory authority have vied for primacy: centralization, competition, and privatization. While differences in historical context and industry evolution have resulted in different solutions to the allocation of regulatory authority in various financial sectors, my claims in this essay are that the underlying structure of the debate over jurisdictional allocation has been strikingly similar in all of these fields and that a comparative analysis of these debates can deepen our understanding of the proper allocation of regulatory authority.

I.

Anyone who attended law school in the United States during the past twenty-five years has had at least some exposure to debates over regulatory design in one context: internal governance rules of public corporations. For many years, U.S. corporations have been able to choose in which state to incorporate. A corporation organized under California law can do business across state boundaries without concerning itself with conflicting corporate laws in other states. Moreover, that corporation can relocate its corporate seat to another jurisdiction, even one in which the corporation has previously done little or no business at all. At the turn of the last century, New Jersey proved a popular choice for corporate charters, but within a few decades, Delaware had become preeminent. For some time, the choice of state of incorporation was regarded as simply an inherent feature of our federalist system. But in a famous law review article published in 1974, former SEC Chairman and Columbia Law School Professor William Cary introduced a normative dimension to academic discussion of the issue by arguing that competition among states for corporate charters facilitates a destructive "race to the bottom."¹ The implication of Cary's analysis is that in lieu of

¹ William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L.J. 663 (1974). While Cary's article is traditionally identified as the opening volley

competition among state corporate statutes, the federal government should impose a single, centralized solution to the problem by establishing a unified federal charter for public corporations.

Professor Cary's article sparked an academic controversy within the United States that has burnt white hot ever since. Free-marketeers such as Ralph Winter of Yale Law School² and Dan Fischel of Chicago Law School³ immediately challenged Cary's thesis, arguing that shareholders are fully capable of ensuring healthy competition in the market for legal charters. These critics postulated that market forces encourage corporations to select the jurisdiction with the best system of corporate governance and that competition for corporate charters is a more reliable engine for designing corporate charters than centralization of control in the federal government. In the ensuing years, defenders of Cary's views, armed with anecdotes from the takeover wars of the 1980s, reformulated his arguments and emphasized the potential for managers to exploit shareholder passivity by selecting less-than-optimal state chartering statutes as an alternative justification for setting minimum standards at the federal level.⁴

This "race-to-the-bottom" versus "race-to-the-top" debate has been a perennial of corporate law scholarship in the United States over the past two decades. Throughout the 1990s, legal scholars such as Roberta Romano of Yale Law School have taken a more empirical tack and argued that a mounting body of evidence confirms that state competition in corporate charters constitutes an essential "genius of American corporate law,"⁵ implicitly rebutting the claims of Cary's modern-day defenders. Others, such

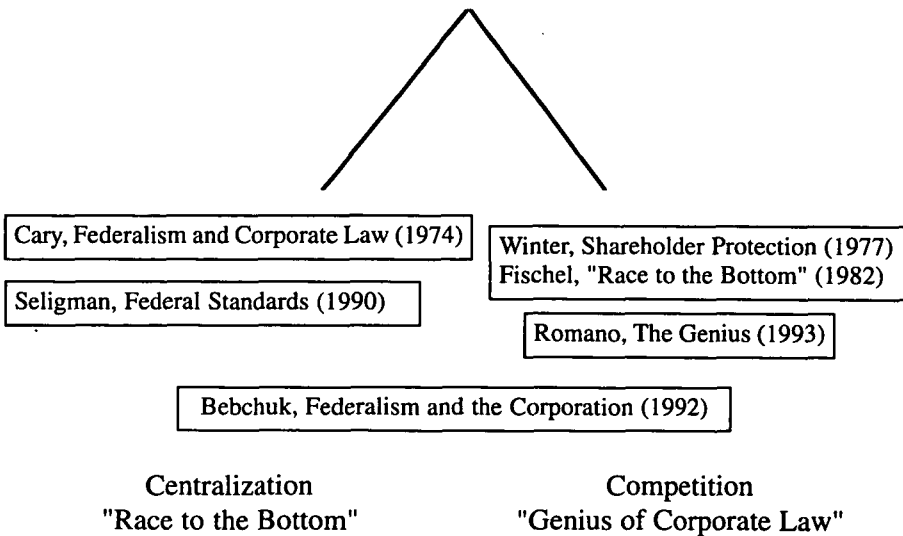
of the modern debate over regulatory competition in corporate governance, Cary himself drew on earlier writings, including judicial opinions of Justice Brandeis. See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 557-64 (1933) (Brandeis, J., dissenting) ("The race was not one of diligence but of laxity."), cited in Cary, *supra*, at 662 & n.7.

- 2 Ralph K. Winter, Jr., *Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977).
- 3 Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U. L. Rev. 913 (1982).
- 4 See, e.g., Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 Md. L. Rev. 947 (1990).
- 5 Roberta Romano, *The Genius of American Corporate Law* (1993); Roberta Romano, *Competition for Corporate Charters and the Lessons of Takeover Statutes*, 61 Fordham L. Rev. 843 (1993); see also Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225 (1985); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 Cardozo L. Rev. 709 (1987).

as my colleague Lucian Bebchuk of Harvard Law School,⁶ have remained equally adamant in their view that the available evidence is ambiguous and it is impossible to answer the question definitively without extensive additional investigation, resurrecting the possibility that Cary may have been right after all. In 1999, the *Columbia Law Review* commemorated the twenty-fifth anniversary of Professor Cary's original article with a new collection of writings on the subject.⁷

Figure One

Traditional Debate Over Corporate Governance



While attacks and defenses of Professor Cary's 1974 article constitute the principal axis of academic inquiry into corporate governance in the United States, there has also been a secondary but, I think, important extension of the

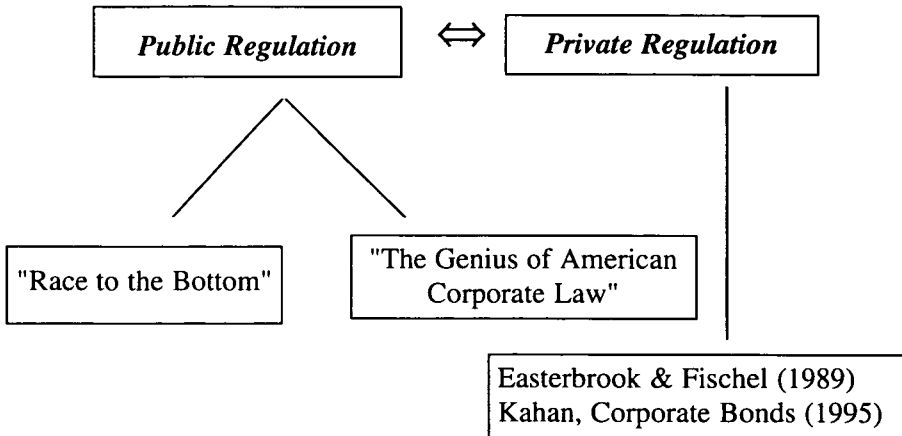
6 Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435 (1992). See also Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 Colum. L. Rev. 1908 (1998). For a recent continuation of this line of argument, see Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 Va. L. Rev. 111 (2001); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 Colum. L. Rev. 1168 (1999).

7 *Symposium: The Living Legacy of William Cary*, 99 Colum. L. Rev. 1165 (1999).

discussion in recent years. Traditionally, the corporate law debate has been cast as a dispute over whether the federal government or the various states should set the terms of corporate charters; that is, the debate was over which level of government should have primary jurisdiction in the field. Cary and his defenders argue for centralization of corporate governance rules within the federal government, whereas the other side stresses the advantages of decentralized authority and regulatory competition among state chartering authorities. Figure One above offers a schematic presentation of these traditional competing positions.

Figure Two

Centralization v. Competition v. Privatization



Beginning about ten years ago, legal academics began to explore the desirability of a third possibility: allowing private parties complete latitude to determine the terms of corporate charters—in other words, the complete privatization of the chartering process.⁸ To a considerable degree, the privatization perspective took pro-competition arguments to their logical conclusion. If competition among states were good, complete freedom of contract in the field of corporate law would be even better. A number of legal scholars are associated with this new approach to corporate law,

⁸ For a summary of this literature, see Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1549 (1989).

including Professors Easterbrook and Fischel of Chicago Law School⁹ and Professor Marcel Kahan of NYU Law School,¹⁰ as well as Harvard's Dean Robert Clark.¹¹ In effect, this new line of argument raised the possibility that corporate governance issues might best be moved entirely out of public control and placed in the hands of private parties. As a result of these developments, it is possible to find today three different theoretical perspectives in the field of corporate law: those who favor centralization in a federal charter; those who favor competition among state-chartering authorities; and those who advocate privatization of this process. Figure Two above presents these three separate strains.

II.

What is interesting about emerging debates over regulation of the financial services industry is that precisely the same three positions are now being advocated with respect to the optimal system of regulation in this field: centralization, competition, and privatization. The difference is that the context of the debate is no longer arguments over the appropriate allocation of authority in the domestic U.S. arena; rather, it is about the optimal structure of regulation in the global financial marketplace. In this Part, I will explain how these arguments have played out in two different areas of financial regulation: first, the field of securities regulation, and, second, the regulation of financial conglomerates.

A. Securities Regulation

In the United States, the law of securities regulation—that is, the law governing the terms under which corporations can issue securities to public and institutional investors—has followed a very different path than our law of corporate charters. Since the great reforms of the New Deal, federal securities laws have been mandatory and have largely superseded state laws. Thus, the traditional structure of legal regulation in this area has

9 Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989).

10 Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 Nw. U. L. Rev. 565 (1995).

11 Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 Colum. L. Rev. 1703 (1989).

been centralized standards, with very little room for competition among the states.¹²

To the extent that there was any intellectual debate over the desirability of this structure of securities regulation in the United States, it came from a relatively small group of hard-core free-marketeers, who challenged the received wisdom that the New Deal reforms had improved the operation of U.S. financial markets.¹³ Implicitly, these dissenters were arguing for the privatization of securities regulations because in their view, the pre-1930s markets (in particular, the New York Stock Exchange of the 1920s) had delivered a wholly adequate system of financial regulation. As the post-War economy and financial markets of the United States flourished, this dissenting view was, until recently, largely forgotten, as the mainstream of legal academic adopted as near-orthodoxy theoretical defenses of mandatory (implicitly federal) systems of securities regulation.¹⁴

The globalization of financial markets in the 1980s and 1990s has prompted reconsideration of established views of the optimal structure of securities regulation. While the SEC has a natural monopoly over domestic securities markets in the United States, it is simply one of many national regulatory agencies in global markets. As cross-border securities transactions became more common in the 1980s and 1990s, questions over which governmental agencies should oversee which securities transactions

12 For many years, variations in state Blue Sky laws have been a familiar feature of securities regulation in the United States. But since the onerous requirements were imposed at the federal level, variations of local regulation were generally regarded as more of an annoyance than a source of competition. In the last ten years, Congress has further diminished the role of state securities regulation by preempting an increasing number of areas in which states had traditionally exercised concurrent jurisdiction. See, e.g., Howard M. Friedman, *The Impact of NSMIA on State Regulation of Broker—Dealers and Investment Advisers*, 53 Bus. Law. 511 (1998); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1 (1998).

13 The two early challenges to mandatory securities regulation are George Stigler, *Public Regulation of the Securities Markets*, 37 J. Bus. 117 (1964); George Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 Am. Econ. Rev. 132 (1973).

14 An excellent presentation of this defense can be found in John C. Coffee, Jr., *Mandatory Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 717 (1984). See also Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1 (1983) (responding to Stigler and Benston, *supra* note 13).

became increasingly acute, particularly from the perspective of national supervisory authorities.¹⁵

The traditional approach to securities regulation, under which national authorities exercise jurisdiction over all transactions that have minimal degrees of contact with or effect upon domestic markets, produced two undesirable results. First, it created the potential for redundant and unnecessarily costly systems of overlapping regulation. In certain cases, most strikingly in the context of multinational takeovers, regulatory requirements of applicable jurisdictions could impose inconsistent duties on private parties. But even where direct conflicts did not arise, the costs and burdens of complying with two or more national regimes of securities regulation were increasingly perceived as an unnecessary barrier to capital flows. The second problem was a direct consequence of these duplicative regulatory burdens: private parties increasingly attempted to avoid redundant regulation by structuring transactions to be located where more onerous regulatory systems, particularly U.S. regulatory systems, would no longer apply. Thus, the price of maintaining our traditional system of financial regulation came increasingly to entail the loss of regulatory control over an ever-widening array of financial transactions and a denial of potential attractive investments to U.S. investors without the wherewithal to participate in offshore transactions.

In response to these dual challenges, regulatory authorities have undertaken, over the past decade, an ambitious series of experimental reforms that, in varying ways and in varying degrees, reallocate regulatory authority in the field of securities regulation. Simultaneously, academic commentators have begun to reconsider the theoretical justifications for national regulatory monopolies over securities markets. One can organize these reforms into three groups: those that attempt to centralize securities regulation; those that seek to facilitate competition in securities regulation; and those that rely on full or partial privatization of the regulation of securities markets.

Let me begin with the centralization strand, which is the approach that is analytically most reminiscent of Professor Cary's "race-to-the-bottom" argument for centralized national control over corporate law. For transnational securities offerings, centralization, if it is to occur, must take

15 See, e.g., Roberta S. Karmel, *Transnational Takeover Talk: Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66 U. Cin. L. Rev. 1133 (1998). See also James D. Cox, *Choice of Law Rules for International Securities Transactions?*, 66 U. Cin. L. Rev. 1179 (1998).

place at the supra-national level, for the sources of competition are not political subdivisions of nation-states, but the nation-states themselves. So we observe efforts towards centralization of securities regulation in the International Organization of Securities Commissioners ("IOSCO"), which is developing common disclosure standards for offering documents;¹⁶ or in the International Federation of Accountants, which is attempting to develop international standards for disclosures; or in the myriad of bilateral memoranda of understanding that link the enforcement branches of securities regulators around the world.¹⁷ Although the lack of well-developed and well-recognized systems of bodies of supra-national authority has complicated the efficacy of reforms designed to centralize securities markets, an impulse to centralize can be discerned in pockets.¹⁸

Across the European Union, we find a similar effort at centralization of securities regulation (and much else) through the promulgation of directives that, within the universe of the Member States, establish (at least in theory) a harmonized, that is, centralized, set of minimum standards. All Member States are supposed to implement local systems of securities regulation in accordance with those standards, and then (again, in theory) issuers that comply with their home country's system of securities regulation are supposed to be able to rely on those standards in pan-European offerings and listings.¹⁹ Compared to other efforts to centralize regulation in

16 This initiative is reviewed in a recent SEC release that adopted, in part, IOSCO's proposals for foreign private issuers, SEC, Final Rule: International Disclosure Standards, Release Nos. 33-7745, 34-4 1936, 17 C.F.R. pts. 210, 228-30, 239, 240, 249, 260 (Sept. 29, 1999), available at <http://www.sec.gov/rules/final/34-41936.htm>.

17 For an overview of this initiative, see SEC Concept Release: International Accounting Standards, Release Nos. 33-7801, 34-42430, 17 C.F.R. pts. 230, 240 (Feb. 16, 2000), available at <http://www.sec.gov/rules/concept/34-42430.htm>.

18 Closely akin to efforts at centralization are attempts to "allocate" jurisdiction over corporate issuers into a one-issuer-one-jurisdiction rule. See, e.g., Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 Mich. L. Rev. 2498 (1997); Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalized Market for Securities*, 97 Mich. L. Rev. 696 (1998). This approach relies on a centralized choice-of-law rule and then grants individual jurisdictions authority to determine legal standards for issuers within the allocated legal space. So long as issuers cannot manipulate the choice of law standards, perhaps a heroic assumption in a world of well-advised corporate issuers, such regimes preclude regulatory competition between jurisdictions. For an alternative perspective on harmonization, see Uri Geiger, *Harmonization of Securities Disclosure Rules in the Global Market, A Proposal*, 66 Fordham L. Rev. 1785 (1998).

19 For a fuller treatment of this aspect of EU regulation, along with an examination of the relatively modest degree of success this new system has achieved in practice,

international securities markets, the EU initiatives have the advantage of being imposed within the established framework of the EU institutions. In practice, however, these institutions have not proved particularly successful in the routine oversight of national compliance with and enforcement of directives related to financial matters, and much of the day-to-day enforcement issues have developed into informal coordination among nation authorities.²⁰

A simultaneous and, in certain respects, more successful series of reforms in the United States have worked in precisely the opposite direction, attempting to facilitate the sort of competition in securities regulation regimes that characterizes the U.S. domestic legal market for corporate charters. In an increasingly large range of transactions, foreign corporate issuers are being permitted to access U.S. capital markets without being required to comply with the full requirements of American securities laws. Rather, these issuers are permitted to comply primarily, if not exclusively, with systems of securities regulation established under foreign law. For the most part, these initiatives are limited to foreign issuers, but they represent an unmistakable trend towards the "Delawarization" of American securities laws.

An excellent case in point of this phenomenon is the SEC's decision earlier in this decade to allow large Canadian issuers to sell securities in the United States relying primarily on Canadian disclosure rules.²¹ Also illustrative would be Rule 144A and Regulation S under the Securities Act of 1933,²² both of which retract aspects of traditional U.S. securities regulation for foreign issuers that limit direct sales of securities in the United States to large institutional investors and structure their offshore offerings so as to reduce the likelihood that securities will end up in the hands of retail investors resident in the United States. Finally, for private foreign issuers that choose to access public U.S. capital markets, the SEC has promulgated a number of regulations and informal practices that, in various ways, provide for special accommodations of foreign issuers.²³ As a result of these and similarly spirited

see Howell E. Jackson & Eric R. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999, Part I*, 56 Bus. Law. 653 (2001).

20 The vehicle for this coordination is the Forum of European Securities Commissions. For a review of its activities, see <http://www.europefesco.org/v1/default.asp>.

21 See Anna T. Drummon, *Internationalization of Securities Regulation: Multijurisdictional Disclosures System for Canada and the U.S.*, 36 Vill. L. Rev. 775 (1991).

22 17 C.F.R. §§ 144A, 901 (2001).

23 The manner in which Rule 144A and Regulation S apply to foreign issuers is explored in detail in Jackson & Pan, *supra* note 19, at 665-71.

reforms, foreign issuers are increasingly accessing U.S. markets with varying degrees of exemptions from the redundant and costly U.S. securities regulation that would have governed their entry into our markets twenty years ago.²⁴

To be fair to the SEC, these incremental accommodations, made to meet the needs of foreign issuers, have not traditionally been understood as the "Delawarization" of securities regulation. Rather, they have typically been seen as pragmatic reforms designed both to reduce the costs of redundant oversight and to make additional foreign investments available to U.S. resident investors (plus perhaps also discourage the movement of transactions offshore). Still, as an analytical matter, these developments allow for an increasing degree of the sort of issuer choice associated with regulatory competition. As a result of these initiatives, some foreign issuers have a choice between full compliance with U.S. securities laws or some sort of exemption from those laws.²⁵ For those who choose the latter, their home country's system of securities regulation is the principal (if not exclusive) source of regulatory oversight. Thus, these reforms contain the two essential components of regulatory competition: a degree of issuer mobility (or choice) and variations in potential legal regimes.²⁶

The question whether we should expand regulatory competition in securities markets has become one of the hottest topics in legal academics in the corporate field over the past few years. In a pair of articles, one

24 In addition to the rules discussed in the text, which deal principally with offering documents, the Commission has also developed for foreign issuers a series of special rules governing proxy statements, insider trading, tender offers, and (most recently) Regulation FD. For another overview of the special rules for foreign private issuers, see Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 Colum. Bus. L. Rev. 1, 44-54.

25 A small case in point is the SEC requirements for quarterly reports. Foreign private issuers eligible for filings under Form 20-F do not have to file the same 10-Qs required of foreign private issuers. See Rule 13a-13(b)(2) under the 1934 Act, 17 C.F.R. § 240.13a-13(b)(2) (2001). However, in certain contexts, some foreign private issuers elect to file 10-Qs in order to assure investors of current financial information. This practice is discussed in Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999, Part II*, 56 Bus. Law. (forthcoming Nov. 2001).

26 With these two prerequisites—issuer mobility and variation in legal regimes—regulatory competition can theoretically occur. Proponents of regulatory competition believe that such competition will tend to promote better systems of regulation, whereas opponents foresee a deterioration in the quality of regulation. Implicit in these two opposing visions is a third essential feature of most models of regulatory competition, namely, governmental responsiveness. For a further exploration of these issues, see Jackson & Pan, *supra* note 19, at 658-61.

written by Roberta Romano²⁷ and the other by Professors Choi and Guzman from Berkeley Law School,²⁸ prominent American scholars have argued that corporate issuers should be permitted to pick which country's regime of securities regulation should govern their offerings, just as they can pick in which state to incorporate in the U.S. domestic context. Such an approach, its advocates claim, would instill in international securities markets the same sort of regulatory pressures that has honed the quality of American corporate law over the past century.²⁹ Like their intellectual forebears who favor competition in the market for state charters, these reformers view investors and capital markets as capable of valuing the integrity of legal regimes and thereby forcing corporations to choose whichever system of regulation that is most efficient for particular issuers.

An even more radical school of thought has challenged the question of whether governments should even play a role in the development of securities regimes. Paul Mahoney of the University of Virginia has authored a series of articles suggesting that private organizations, in particular, stock exchanges, should have the power to establish comprehensive systems of securities regulation under which issuers could opt to be governed.³⁰ This perspective,

27 Roberta Romano, *Empowering Investors, A Market Approach to Securities Regulation*, 107 Yale L.J. 2359 (1998).

28 Stephen Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. Cal. L. Rev. 903 (1998). See also Stephen Choi, *Regulating Investors not Issuers: A Market-Based Proposal*, 88 Cal. L. Rev. 279 (2000); Andrew T. Guzman, *Capital Market Regulation in Developing Countries: A Proposal*, 39 Va. J. Int'l L. 607 (1999).

29 Slight differences in perspectives separate the two principal proposals for regulatory competition in international securities markets. Professor Romano contemplates that market forces are likely to force securities regulation towards a single optimal standard, comparable to the position of Delaware law in the U.S. corporate law context. Professors Choi and Guzman speculate that the heterogeneous requirements of issuers are likely to require a variety of different legal regimes, and so they anticipate that a range of legal options would emerge if issuer choice were to become a reality in this field of law.

30 Paul G. Mahoney, *The Exchange as Regulator*, 83 Va. L. Rev. 1453 (1997). See also Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. Legal Stud. 1 (2001). For a similarly spirited proposal regarding liability rules, see Adam C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925 (1999). But see Marcel Kahan, *Some Problems with Stock Exchange-based Securities Regulation*, 83 Va. L. Rev. 1509 (1997). For another perspective on privatization in the context of securities regulation, see Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 Wash. & Lee L. Rev. 519 (1999).

essentially advocating the full privatization of securities regulation, would, in the United States, turn back the clock nearly a full century, not just before the New Deal, but further back, before the dawning of the first Blue Sky laws of the early 1900s.

Now, when I mentioned above that this has become a hot topic among legal academics, what I meant is that the enthusiasm that some legal academics have developed for additional competition in the securities markets is not universally shared. Reams of law review pages are now being dedicated to the question of under what conditions market forces might be a reasonable mechanism for selecting legal regimes for regulating securities.³¹ In addition to resurrecting lines of argument familiar from the debate on corporate governance in the United States,³² critics of this new form of regulatory competition have questioned whether capital markets are capable of pricing extraterritorial applications of foreign securities laws. Would the quality of, say, French securities regulation really be the same for investors in the United States as it is for investors in France?³³ Moreover, could capital markets be expected to price, in any meaningful sense, differences between French and Malaysian securities regulation?³⁴ Finally, other work

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- 31 See, e.g., James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 Colum. L. Rev. 1200, 1229-37 (1999) (questioning several assumptions underlying the Romano and Choi-Guzman proposals). See also Joel P. Trachtman, *Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation*, in *Regulatory Competition and Economic Integration* 289 (Daniel Esty & Damien Geradin eds., 2001).
- 32 For example, critics have noted the possibility that agency costs might allow managers to select regimes of securities regulation that are less than optimal from the perspective of investors. In addition, the possibility that mandatory disclosure may entail some public goods suggests to some critics that even if problems of managerial agency costs could be resolved, a case could still be made for centrally-imposed disclosure rules. See Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 Va. L. Rev. 1335 (1999) (exploring theoretical difficulties (both principal-agent costs and negative externalities) with a legal regime that allows issuers to choose their own disclosure rules). See also Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 Va. J. Int'l L. 563 (1998).
- 33 For an interesting discussion of these enforcement questions, see Hal S. Scott, *Internationalization of Primary Securities Markets*, 63 Law & Contemp. Probs. 71 (2000).
- 34 In addition to theoretical concerns about the extension of regulatory competition to international securities regulation, a number of practical problems arise as to how far a country like the United States might reasonably go in implementing such a proposal. Which countries' systems of securities regulation should be acceptable in

has explored the magnitude of potential benefits associated with issuer choice in securities regulation.³⁵

A number of contributors to this issue are continuing the debate over the merits of regulatory competition in international securities markets. Two of the leading proponents of issuer choice in securities regulation offer new insights on the subject. Roberta Romano gives a detailed response to a number of objections to her initial paper,³⁶ and Stephen Choi provides a useful new summary of the structure of argumentation and policy issues underlying the debate.³⁷ In an important extension of the literature, Amir Licht considers the value to smaller countries of allowing their issuers to list on local exchanges while complying with the disclosure standards of U.S. securities regulation.³⁸ Finally, Ed Rock's examination of the ways in which Israeli companies enter U.S. capital markets offers a case study of issuer choice in action within the context of U.S. capital markets under current law.³⁹

For my purposes, however, I want simply to stress the structural similarities between this academic controversy and the more familiar debate over regulatory competition in the context of corporate governance issues in the United States. As summarized in Figure Three below, one can readily identify the three basic positions of centralization, competition, and privatization in this debate. One can also, of course, recognize important variations in the debate over jurisdictional authority in this context. In the field of international securities regulation, while the centralization camp is well represented in terms of proposals, there is lacking a government body with authority and capacity comparable to the federal government in the United States. Centralization, if it is to occur, must be accomplished through either supra-national organizations or multilateral agreements or some similarly spirited device, and issues of enforcement are likely to remain problematic.⁴⁰

this regard? Should only "high quality" regimes be eligible? The U.S., yes. England, probably. Japan? France? What if only institutional investors were permitted to participate in markets where legal regimes were set through competition?

35 See Jackson & Pan, *supra* note 19; Jackson & Pan, *supra* note 24.

36 See Roberta Romano, *The Need for Competition in International Securities Regulation: A Response to Critics*, 2 *Theoretical Inquiries L.* 38 (2001).

37 See Stephen J. Choi, *Assessing Regulatory Responses to Securities Market Globalization*, 2 *Theoretical Inquiries L.* 613 (2001).

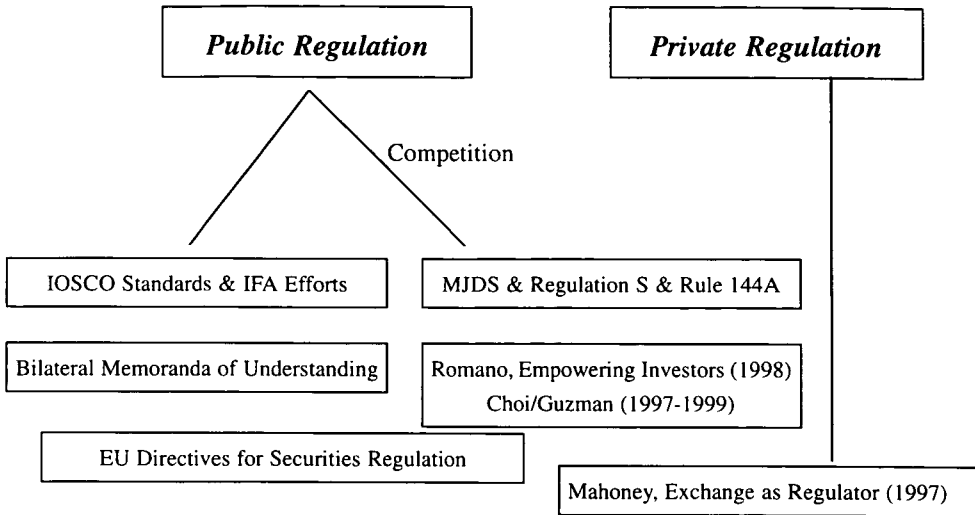
38 See Amir Licht, *David's Dilemma: A Case Study of Securities Regulation in a Small Open Market*, 2 *Theoretical Inquiries L.* 673 (2001).

39 See Edward B. Rock, *Greenhorns, Yankees and Cosmopolitans: Venture Capital, IPOs, Foreign Firms & U.S. Markets*, 2 *Theoretical Inquiries L.* 71 (2001).

40 A good illustration of the importance of centralized control can be found in the European Union. Even though existing EU institutions are adequate to formulate

Figure Three

Securities Regulation in the Global Context



Another important point to be made about the field of international securities regulation is the baseline from which reform proposals are being made. In the debate over corporate governance, the baseline, for more than a century, has been a system of regulatory competition among state chartering authorities. In the field of securities regulation, the baseline system is one of overlapping and sometimes contradictory national systems of regulation and also a system in which well-advised parties are increasingly able to structure their transactions to escape the oversight of regimes that are perceived to be hostile or unnecessarily costly. The status quo is, in other words, under substantial pressure to accommodate the desire of issuers and investors. This pressure explains, I believe, the accommodations that the SEC has been making for foreign private issuers over the past twenty years. It also suggests why legal academics are increasingly seizing upon this area as one in which fully-fledged regulatory competition may become a viable alternative.⁴¹

minimum standards for Member States, many find these structures lacking and advocate a centralized public authority for the oversight of European securities markets. *See, e.g.,* Roberta Karmel, *The Case for A European Securities Commission*, 38 Colum. J. Transnat'l L. (1999).

41 Elsewhere, Eric Pan and I explore the extent to which our current system of securities regulation in the United States already allows a good deal of regime choice for foreign issuers. Jackson & Pan, *supra* note 24.

B. Regulation of Financial Institutions

Let me turn now to a third area of financial regulation: the oversight of financial institutions such as commercial banks, insurance companies, and securities firms. Once again, the principal impetus for reform initiatives derives from globalization of markets and firms. Through a combination of corporate affiliations, contractual undertakings, and direct branching, financial conglomerates span the globe, and as a series of financial tempests culminating in the Asian crisis during 1997-1998 has shown, concerns over the solvency of individual institutions or the systemic consequences of institutional failures no longer honor national boundaries. As difficulties with BCCI and Baring's presaged in the 1990s, regulatory structures operated by national governments and designed to supervise domestic financial activities have become antiquated if not obsolete. But what neither these nor subsequent difficulties have revealed is how to project regulatory oversight into a global economy without creating the complexity of multiple, overlapping regulatory structures that have been a principal problem in capital market regulation. While no single solution has emerged, it is possible to find examples of the three basic approaches I have been discussing in this essay: centralization, competition, and privatization.

Probably the best example of centralization of regulation of financial institutions is the now venerable Basel Accord on bank capital. Now in effect for more than a decade and beginning, therefore, to show signs of age and perhaps decline, the Accord, which began as a simple agreement among central bankers from G-10 countries, constituted the first serious effort to define international standards for financial institutions. For the most part, the Basel Accord has succeeded in establishing a minimal set of capital standards, which most jurisdictions have, at least formally, imposed on principal commercial banks.⁴² Similar in spirit to the Basel Accord have been more far-reaching guidelines on the part of the Basel Committee on Banking Supervision to establish general supervisory standards for depository institutions⁴³ as well as comparable efforts by other supra-national bodies to develop international guidelines for the supervision of securities firms.⁴⁴

42 For an overview of the Basel Capital Accord and recent reform proposals, see Secretariat of the Basel Comm. on Banking Supervision, *The New Basel Capital Accord: An Explanatory Note* (Jan. 2001), at <http://www.bis.org/publ/bcbsca01.pdf> [hereinafter *The New Basel Capital Accord*].

43 See Basel Comm. on Banking Supervision, Pub. No. 30, *Core Principles for Effective Banking Supervision* (Sept. 1997), at <http://www.bis.org/publ/bcbs30a.htm>.

44 Cooperation among international securities supervisors has been less visible than at the Basel Committee on Banking Supervision, much of its work being done through

As is always the case with centralization of legal standards, the critical question in the field of financial institutions regulation is whether wide-scale compliance or even compliance within the narrower range of, say, OECD countries is a realistic aspiration. In this regard, the Asian crisis of 1997 and 1998 provides, I think, an interesting and not altogether encouraging lesson. Even with the strong, and at times coercive, encouragement of powerful international organizations such as the IMF and affiliated organizations, countries have found it difficult to align domestic regulatory structures with international standards.⁴⁵ Domestic interest groups and political considerations, which produced different (and typically less stringent) regulatory structures in the past, remain resistant to reforms, notwithstanding the existence of well-articulated international standards and commitments on the part of international elites to incorporate those standards into domestic law.⁴⁶ So, if centralization of regulatory standards is not always a viable solution for financial institutions in the international markets, might models of competition or privatization offer alternative solutions? Whatever one thinks the long-term answer to that question may be, I think it beyond dispute that experiments in both directions are currently underway in certain sectors of the industry.

An instructive illustration of the privatization solution is the international swaps market. The swaps market is an example of the kind of complex contractual networks that bind today's global economy. And, interestingly, it is one that is primarily regulated through privately developed legal rules,

bilateral agreements between supervisory agencies at the national level. In the area of overseeing financial conglomerates, however, IOSCO has worked with the Basel Commission, as well as analogous groups of insurance regulators. See Basel Comm. on Banking Supervision, Pub. No. 47, *Supervision of Financial Conglomerates* (Feb. 1999), at <http://www.bis.org/publ/bcbs47.htm>.

45 See Rudi Bonte et al., *Supervisory Lessons to Be Drawn from the Asian Crisis* (Basel Comm. on Banking Supervision Working Paper No. 2, June 1999), at http://www.bis.org/publ/bcbs_wp2.htm. The IMF staff, among others, is gradually developing expertise in evaluating country compliance with Basel Committee standards. Exactly how the evaluative process evolves and what sanctions should be imposed on non-complying countries remain to be seen. For an introduction to the problem, see *Experience with Basel Core Principle Assessments* (Apr. 12, 2000) (on file with author) (a consultative paper for the Basel Committee prepared principally by the IMF's Monetary and Exchange Affairs Department).

46 See, e.g., Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, 39 St. Louis L.J. 885 (1995). See also Patricia Jackson et al., *Capital Requirements and Bank Behaviour: The Impact of the Basel Accord* (Basel Comm. on Banking Supervision Working Paper No. 1, Apr. 1999), at http://www.bis.org/publ/bcbs_wp01.pdf.

most notably the standard agreements of the International Swaps Dealers Association ("ISDA").⁴⁷ Despite the phenomenal growth of the swaps market over the past decade and the fantastic amount of financial resources at risk through this network of arrangements, the market has functioned surprisingly well and constitutes what must be regarded as a premier example of private regulation in financial markets.

But even in the swaps market, where privatization is the dominant regulatory paradigm, a debate still simmers over whether national or supra-national (that is, centralized) regulatory control should supplement existing safeguards. The problems of Long-Term Credit Management Limited in the Fall of 1999 sparked calls for reform in this area of financial supervision.⁴⁸ And it remains uncertain, at least in my view, how the balance between privatized supervision and more traditional regulatory oversight will evolve in the coming years. Thus, while the swap market, with its peculiar characteristics and precipitous ascendancy, offers a model of privatization in international finance, where it will ultimately be located on the regulatory spectrum I am discussing remains to be seen.

Finally, a few words should be mentioned about the model of regulatory competition in the field of regulation of financial institutions. For some, it may be hard to conceive of how, for example, the United States and England might be in a position to compete in bank supervision in a way that is comparable to the way in which Delaware and New Jersey compete for corporate charters in the domestic U.S. context. But, in fact, I would argue that the current regulatory system allows for precisely such competition, and within the academic world at least, some are advocating an even higher degree of regulatory competition (as an alternative to centralization or privatization of regulatory functions).

Let me begin with the elements of regulatory competition that already exist.⁴⁹ For some time, national financial supervisors have had to take an

47 For an interesting overview of the ISDA, see Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps & Derivatives Association* (Apr. 28, 2000) (unpublished manuscript on file with author). See also the ISDA homepage at <http://www.isda.org/index.html>.

48 See U.S. GAO, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, Doc. No. GAO.GGD-00-3 (Oct. 29, 1999), at <http://www.gao.gov>.

49 Here and elsewhere in this essay, I limit my discussion to competitive contexts in which the regulated entity has at least some ability to choose a legal regime from one jurisdiction that will have application to transactions that take place in another jurisdiction. A related but distinct sort of competition can occur when transactions are moved from one jurisdiction to another in order to pick up that second jurisdiction's

interest in the offshore activities of domestic firms. For example, the Basel Concordat of the late 1970s assigns to domestic regulators supervisory responsibility over certain foreign branches of domestic banks.⁵⁰ So, for example, when a London bank opens an office in the Cayman Islands, the principal, perhaps exclusive, oversight of that branch comes from U.K. officials or delegated private agents in the Caymans. International supervisory standards refined in the aftermath of the BCCI failures of the early 1990s also call upon domestic supervisory agents to look "upstream" where domestic firms are controlled by foreign financial conglomerates to evaluate the efficacy of the entity's consolidated supervision.⁵¹ So, rather than concerning themselves exclusively with financial activities taking place within their own borders, financial regulators in England and the United States are increasingly projecting their oversight internationally and offering the rudimentary structure of global oversight.

The European Union extends this model of international oversight. Under regulatory frameworks, such as the Second Banking Directive, banks located and supervised in one EU Member State are empowered to branch across national boundaries without complying with the full supervisory structures of other Member States.⁵² An English bank can, in effect, bring English banking law with it when it opens a branch in Paris or Brussels or Berlin. Thus, not only does England "export" its regulatory structure, but that regulatory system is exclusive within certain spheres. In other words, the EU presents a model that is structurally comparable to the market for corporate charters in the United States.

laws. In the banking industry, this second sort of competition in banking services has existed for a long time. For example, in the 1960s, a market in offshore U.S. dollar deposits grew up in London in order to avoid interest rate regulation in the United States. This movement of transactions created pressure on the U.S. authority to eliminate its regulation of interest rates. See Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 Mich. J. Int'l L. 595, 599-605 (1999) (discussing the extent to which such pressure can lead to regulatory convergence).

- 50 See Basel Comm. on Banking Supervision, Principles for the Supervision of Banks' Foreign Establishments (May 1983), at <http://www.bis.org/publ/bcbasc312.pdf>.
- 51 See Daniel M. Laifer, Note, *Putting the Super Back in the Supervision of International Banking, Post-BCCI*, 60 Fordham L. Rev. S467 (1992).
- 52 Second Council Directive of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Procedures Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC (89/646/EEC), at http://europa.eu.int/eur_lex/en/lif/dat/1989/en_389L0646.html. For an overview of this aspect of supervision in the EU, see 3 The Single Market Review: Credit Institutions and Banking (1997).

While a variety of business considerations have prevented European financial institutions from exploiting this opportunity aggressively, the possibility of regulatory competition within the boundaries of the European Union exists. In theory, a bank operating under less onerous (or more efficient) supervision in one Member State might have a comparative advantage with respect to the regulatory costs imposed on banks based in other Member States. Indeed, the possibility of this inequality in regulatory oversight has prompted some European regulators to recommend that banking supervision be relocated (that is, centralized) in a pan-European agency such as the European Central Bank.⁵³

So, accepting that regulatory competition might possibly take place in the EU within the harmonized legal system that the Union affords and demands of its members, is it possible to imagine regulatory competition over financial intermediaries over a broader range of jurisdictions? The answer, at least for me, is yes. A few years ago, I was involved in precisely this sort of imaginative exercise. The exercise arose out of a United Nations Development Program project involving the Kingdom of Nepal. The project developed from a UN initiative to help Nepal develop itself as an international financial services center for European and U.S. financial institutions interested in developing a regional presence on the sub-continent and, particularly, as a way station for entry into the Indian markets.⁵⁴

The standard approach to this problem would have been to recommend that Nepal promulgate a system of financial regulations reflecting international standards of the sort that the Basel Committee has been developing and then build a regulatory infrastructure of governmental agencies and personnel to implement that system. However, in terms of expense, timing, and realistic expectations about the capabilities of a country at Nepal's level of development, our team ended up recommending a very different approach. Rather than imperfectly replicating existing regulatory standards, Nepal should, we suggested, grant licenses from financial institutions located in countries with well-established regulatory systems and then simply require licensed firms to conduct their Nepalese operations in accordance with the firms' home-country laws. While some Nepalese regulatory apparatus

53 For an overview of this debate, see Christos Hadjiemmanuil & Mads Andenas, *Banking Supervision and European Monetary Union*, 1 *J. Int'l Banking Reg.* 84 (1999).

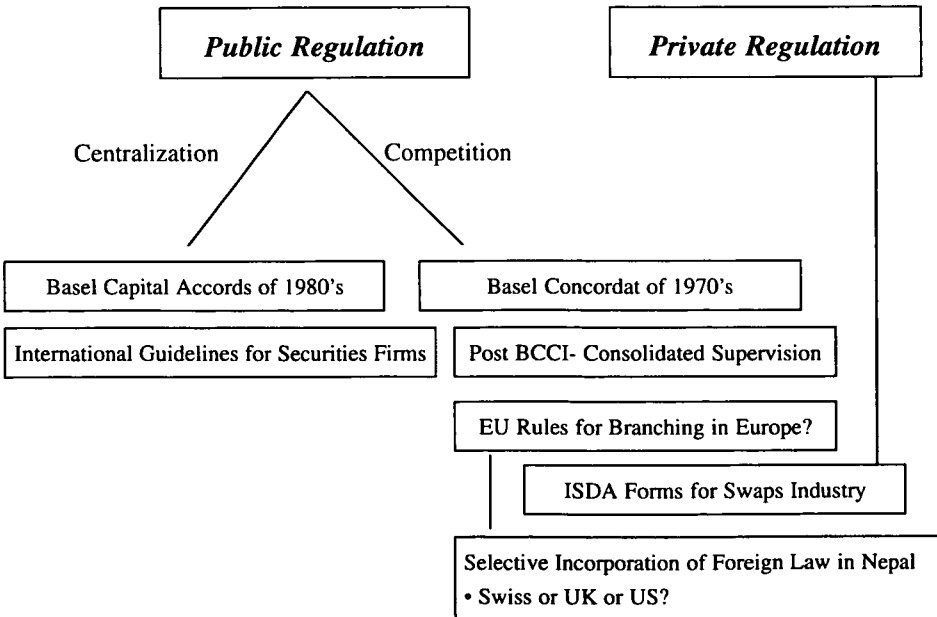
54 See Howell E. Jackson, *Selective Incorporation of Foreign Legal Systems to Promote Nepal as an International Financial Services Center*, in *Regulation and Deregulation: Policy and Practice in the Utilities and Financial Services* 367 (Christopher McCrudden ed., 1999).

would be necessary to implement this regulatory structure, it would entail a dramatically less substantial investment of resources than would the de novo creation of an indigenous Nepalese regulatory structure.

The Nepal approach is conceptually and intentionally analogous to the EU model of regulatory competition. Regulatory structures are "exported" across international borders. But, rather than predicated on prior harmonization and reciprocity, the Nepalese model depends on selecting a limited number of well-developed regulatory models and *incorporating* them into Nepalese law. Foreign financial firms who choose to operate under the Nepalese financial system will compete not only in terms of their business skills, but also in terms of the domestic regulatory structures that accompany them to Nepal. Again, within the field of jurisdictions authorized by the Nepalese, a form of regulatory competition will take place. From an academic perspective, what the Nepalese initiative represents is a fairly clear example of regulatory competition for the financial services industry, rounding out the trilogy in this final field of regulation. Figure Four below illustrates the various approaches.

Figure Four

Regulation of Financial Institutions



III.

While the goal of this essay is largely descriptive, a normative framework is implicit in my analysis and worthy of fuller treatment in another context. In selecting among the three principal approaches for allocating regulatory jurisdictions, one encounters a recurring set of problems. Privatization of regulatory functions offers the greatest degree of flexibility and space for experimentation, but may be costly and inappropriate in contexts characterized by substantial agency costs or negative externalities. Centralization of functions solves these problems, but at the expense of easy innovation. Moreover, centralization is difficult to implement in contexts that lack a coordinating public authority, a feature that is often absent in the transnational arena and may even be only marginally effective in regional compacts such as the European Union. On most of these dimensions, allocation of regulatory authority among member states represents an intermediate solution. It can create competitive pressures on regulatory officials, provided that regulated firms have mobility to select among a range of legal regimes and that other conditions of competition are present.⁵⁵ But, like privatization, allowing private firms to choose among the regulatory systems of member states raises the possibility of sub-optimal results in contexts where the mechanisms of competition are incomplete or where substantial agency costs and negative externalities may be present.

Over the past several decades, debates in the financial services industry over the proper allocation of regulatory authority have become increasingly common. To a large degree, this trend is attributable to the globalization of financial services. In earlier times, technical constraints limited the ability of issuers and intermediaries from engaging in substantial volumes of financial transactions across national boundaries. As a result, regulatory jurisdiction could be allocated on a territorial basis. But as technologies and financial markets have evolved, a greater percentage of financial transactions and intermediaries have come to span national boundaries, and regulatory authorities are being forced to choose between the imposition of overlapping,

55 Jackson & Pan, *supra* note 19, at 658-69, argue that the three essential conditions are variation in a legal regime, entity mobility, and governmental responsiveness. As noted in *supra* note 49, the capacity of transactions to move to other jurisdictions can constitute a similar sort of mobility and an analogous mechanism of competitive pressure.

potentially inconsistent supervision on a territorial basis and the creation of new mechanisms for allocating or coordinating regulatory jurisdiction.

Looking over the range of examples reviewed in this essay, one can also sense the predilections of the various parties involved in the allocation of regulatory authority. While government officials in the United States and elsewhere have sanctioned some interesting experiments in competitive structures, such as the Basel Concordat for the supervision of bank branches and certain elements of the EU regulatory structure, these officials are more naturally inclined towards centralized solutions, such as the development of international standards or fully harmonized systems of regulation. Professional sensitivity to the potential for negative externalities, particularly systemic risk in the context of financial institutions, may partially explain this reluctance to endorse market-oriented solutions to supervisory problems. In addition, as a substantial portion of a supervisor's professional life is dedicated to the prosecution of consumer fraud and other forms of market abuse, senior regulatory officials are apt to be skeptical of the ability of competitive pressures to provide comprehensive solutions to a wide range of regulatory problems.

On the other hand, financial services industry representatives and their trade groups are likely to be drawn to the advantages of privatized solutions, such as the ISDA master agreement for swap transactions⁵⁶ and similar to contractual arrangements that constitute the lifeblood of commercial enterprise.⁵⁷ Competitive pressures to refine these private regulatory solutions are likely to be perceived as substantial, and the possibility that these arrangements can be modified with ease over time has a natural appeal. At the same time, private firms often have elaborate internal procedures for controlling risks, and these procedures may seem to offer an efficient substitute for more traditional forms of mandatory governmental oversight. While there are ample reasons to doubt whether private incentives for risk-regulation are, in fact, appropriately aligned with the public interest,⁵⁸ one can

56 See sources cited at *supra* note 47.

57 An interesting recent manifestation of this preference is efforts to allow more sophisticated banks to tailor (that is, privatize) certain components of their regulatory capital requirements to reflect internal credit ratings rather than uniform public standards. See *The New Basel Capital Accord*, *supra* note 42.

58 For example, while representatives of private entities are not unmindful of issues of systemic risk and negative externalities, they may be less attuned to the possibility that the optimal level of risk-taking from a public perspective may well be lower than the optimal level from the perspective of the individual firm. As the costs of systemic risk and negative externalities are borne in large part by parties not in contractual privity with private firms, the market is not likely to force firms to internalize

appreciate how private firms and their representatives could perceive private regulatory solutions as a cost-effective alternative to more familiar systems of supervision.

Finally, there are the preferences of academic writers. While legal academics offer a range of views on this subject, the weight of current thinking (and, certainly, the preponderance of writers in this issue) seems predisposed to hybrid solutions of regulatory competition. No doubt influenced by the rich literature on regulatory competition in the provision of corporate charters in the United States, legal academics have tended to gravitate towards a division of regulatory authority that will be susceptible to at least some degree of competitive pressures. This intermediate path, combining as it does flexibility with public oversight, strikes many academics as a sensible compromise. The extension of the Delaware paradigm into other financial contexts remains, of course, a debatable proposition. Even for those who view the structure of American corporate law as, on balance, a good thing, there remain questions whether jurisdictions can export their systems of financial oversight beyond national boundaries as easily as Delaware applies its corporate code across the United States. Moreover, the ability of markets to impound accurate price information about variations in other forms of financial law remains to be demonstrated.

In sum, while each approach to the allocation of regulatory jurisdiction—centralization, competition, and privatization—has a natural constituency, no side of this trilateral debate has yet to develop an entirely unbiased or non-problematic brief for its position. Moreover, given the difference in institutional structure across the financial services industry, it seems quite possible that different allocations of regulatory authority may, in fact, be appropriate in different contexts.

these costs. In addition, moral hazard problems, collective action problems, and the incentive-suppressing effects of public regulation may deaden cost internalization on the part of some parties, like depositors, who are in contractual privity with regulated firms. Finally, industry representatives involved in policy debates are likely to be drawn from better-managed and more successful firms. They may be less cognitive of the problems of incompetent managers and the perverse incentives facing firms in financial distress than are governmental officials, who deal with bad apples on a regular basis.