Internationalization of Primary Public Securities Markets Revisited

by

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In my article, *Internationalization of Primary Securities Markets,* 63 Duke Journal of Law and Contemporary Problems 71 (2000) (Duke Article), I argued that in fully internationalized securities markets, issuers in public primary markets should be able to issue securities to investors worldwide using one set of optimal distribution procedures, disclosure documents, and subject to one set of liability standards and enforcement remedies. Optimal standardized issuance (OSI) across borders would reduce the costs of issuance of securities that are in international demand, a benefit which would be shared by both issuers and investors. Also, OSI would result in more perfect competition in the issuance market for such securities (just as in the goods market), and result in a more efficient allocation of capital of worldwide.

This state of affairs is currently not possible, in part, because the United States conditions public issuance in its territory—and to a significant extent to U.S. investors outside its territory—on compliance with its unique set of distribution procedures, disclosure requirements, and enforcement rules. I argued in the Duke Article that international harmonization of rules was not the answer to this problem. There is no reason to assume that the world would choose an optimal level of disclosure, particularly because the United States will push for world rules that are closely equivalent to its own, and the U.S. rules are not optimal as judged by private market disclosure benchmarks. Moreover, there is substantial doubt as to whether worldwide agreement can be reached on the full range of disclosure issues, despite the efforts of the International Standards Committee and IOSCO, let alone distribution and enforcement rules.

In the Duke Article I proposed solving the problem of inefficient primary public markets by the creation of an offshore free zone. This would require that the United States, like other countries, permit its investors to participate in the offshore market for primary distributions of foreign issuers, free of restrictions. To protect investors, the proposal required minimum disclosure based on "international standards" used in international private placements. Offshore foreign issuers would have been free to engage in "directed selling" in the U.S. One major benefit of this approach is that it would allow common worldwide distribution procedures, as well as one set of disclosures, since investors would come to the issuance of shares in one place. My proposal does not address, and leaves unchanged the appropriately light worldwide regulation of international primary private markets, e.g. Rule 144A in the United States.

In this piece, I further refine the proposal and discuss how it would fit within the European Commission's new proposal for a common prospectus. I also comment further on the harmonization alternative.

I. Refinements of the Proposal

A. Allowing Generalized Onshore Marketing but Prohibiting Onshore Selling

The original proposal envisioned that foreign issuers would be free to sell their securities in the United States and other countries. I argued in the Duke Article that if directed selling efforts were prohibited, foreign issuers would not be able to attract the attention of a sufficient individual investor community to allow a deep and active primary offshore market to develop. On the other hand, I recognized that the more directed the selling, the more possibility that U.S. investors might participate, to their possible detriment, in such markets. I resolved this tension in my Duke Article by opting for no restrictions on directed selling, arguing that once the decision had been made to allow U.S. investors to participate in offshore markets, they should know what opportunities exist in such markets.

Some have criticized this approach as basically deregulating the onshore market. They point out, with some force, that if foreign issuers can freely sell issues in the United States subject to only minimum disclosure requirements, in what sense was my proposal only concerned with the offshore market? It is one thing to argue that the United States should reign in its extraterritorial reach; it is another matter as to whether it should freely permit selling in its territory of foreign issues. I think there is merit to this criticism and therefore refine my original proposal to provide the following.

First, only general marketing of the foreign issue would be permitted in the United States; actual selling, on the other hand, would be prohibited. General marketing would, in principle, consist of any distribution of information to more than one person. It would clearly encompass any generally distributed advertising through the media, including the Internet, as well as general direct mailings. All such marketing would have to prominently disclose that the issue was not subject to the full protections of U.S. securities laws. This would represent a significant change in the U.S.'s Regulation S which currently prohibits most forms of marketing, and includes restrictive rules regarding access to websites.

The basic distinction my proposal would draw is between general marketing and selling; marketing to one individual is very difficult to distinguish from selling. There would still be some difficult line drawing problems, e.g. marketing to a small group or family, where one would want to prohibit the marketing even though technically aimed at more than one person, due to the affinities between the potential buyers and the likelihood of centralized decision making. But these problems could be worked out.

No distinction would be made as to whether the marketing was aimed at just potential buyers in the United States; thus advertisements in U.S., as well as foreign or international newspapers, would be permitted. This is in contrast to present Regulation S where advertising through domestic media is generally prohibited as part of the prohibition on "directed selling." The idea behind my revised proposal is that people should be informed as to what offshore investment choices they have, should be warned that offshore investments would not be fully protected by U.S. law, and should be required to take some initiative to complete the sale and to do so offshore. These offshore sales requirements would be designed to reinforce the idea that the buyers were subjecting themselves to some foreign regime.

Under an offshore sales rule, brokers or other agents could not call (or email or fax) customers in the United States to make sales. U.S. resident customers would have to initiate the contact through which the sales contract was completed. One might even require that the sale be through a foreign broker, although competitive considerations would push one in the opposite direction. Buyers would be required to transfer funds to an offshore location and receive receipt of their securities offshore.

The idea of permitting offshore sales under conditions where U.S. buyers should know that they are subjecting themselves to a foreign legal regime goes back to the basic rationale of

Regulation S. Secondary transactions on designated offshore securities markets were permitted because "buyers in such markets may be presumed to rely on the regulatory protection of local law and not U.S. registration requirements." Final Rule, 55 Federal Register 18306 (May 2, 1990). This same presumption underlies allowing primary sales to U.S. residents on the "physical trading floor of an established foreign securities exchange located outside the United States," 17 C.F.R. 902(h)(ii)(B)(1). My proposal, like Regulation S currently, permits offshore primary sales under conditions where buyers should know that they do not enjoy the full protection of U.S. law. It just alters the factual predicate for the presumption from making a sale on the physical trading floor of an established foreign exchange to making the sale offshore with an explicit disclosure that the sale is not fully subject to U.S. law. This is an important shift, however, since the current primary market exception for sales on a physical trading floor is of little use given that primary sales are not conducted in this fashion but rather through underwriting at fixed prices.

It is true that my proposal would give onshore potential buyers more information about offshore offers, but it is increasingly difficult to insulate U.S. residents from such information. For example, the SEC has permitted reporting by U.S. media of new foreign issues while continuing to proscribe paid for advertising in domestic media, 62 Federal Register 53948 (1997). This insures that important foreign issues will come to the attention of many potential U.S. investors. Further, active investors can reach out and easily obtain information about new issues through references from brokers or other financial advisors, the Internet, or non-domestic media sources. Isolating U.S. investors from information distributed abroad is an increasingly impossible task in the modern world of communications and technology.

B. Insuring That Primary Issues are Subject to a Competent Securities Regulation Regime

Under the Duke Article proposal, any primary issue to U.S. retail investors would be subject to minimum "international style" disclosure requirements, but there would be no guarantee that an offshore offering would be generally subject to any foreign securities regulation regime, let alone a competent one. For example, if a primary retail issue was sold in London to U.K. investors and outside the U.K. to U.S. investors, U.S. investors would not be covered by the protections of the Financial Services and Markets Act of 2000 (subject to the issuer making required disclaimers), since U.K. rules only apply territorially. Without a foreign regulatory regime, U.S. investor protection would be left entirely to the SEC enforcing minimum disclosure requirements on offshore issuers after the fact, unless one required foreign issuers to submit to preliminary registration requirements. Effective enforcement of offshore issues might be quite burdensome for the SEC.

An alternative might be some form of limited recognition (which need not be mutual) of certain foreign regulatory regimes. The U.S. or other host countries could condition waiver of its securities laws for offshore offerings on a showing that the offering was subject to a competent foreign securities regulation regime. This type of approach has been used in international banking and underlies our acceptance of Canadian rules under MJDS. Under U.S. law, The Foreign Bank Supervision Act of 1991, branches of foreign banks are only permitted to operate in the U.S. upon a showing that the bank is subject to "comprehensive supervision and regulation on a consolidated basis" in its home country. Branch applications have to make a rigorous showing that this requirement is satisfied. This approach in banking is important to my modified proposal in two respects. First, it shows that the U.S. is prepared to make qualitative judgments about foreign regulatory regimes despite the possible adverse reactions of other countries, and second, it shows that the U.S. is willing to rely on foreign regulatory regimes for protection of U.S. depositors/investors under the right circumstances.

One might argue that the U.S. approach to banking regulation, when examined more closely, does not support the proposal to rely on competent foreign regimes. Since 1991, pursuant to the FDIC Improvement Act, new branches of foreign banks in the U.S., taking deposits under $100,000 (retail deposits) and thus insured by the F.D.I.C., have been prohibited. Foreign banks seeking to take such retail deposits have been forced to incorporate separate subsidiaries in the U.S. which are fully subject to U.S. regulatory requirements. Thus, branches of foreign banks may only take uninsured deposits over $100,000. One could characterize these deposits in branches of foreign banks as the equivalent of investments by sophisticated investors in private placements, thus indicating that the U.S. is not prepared to allow the "public" to be protected by foreign regulatory regimes. This would be the wrong conclusion, however. There are certainly unsophisticated U.S. residents with $100,000 deposits. Furthermore, the principal reason for the incorporation requirement was not depositor protection but the idea that the U.S. should not insure deposits where it does not fully regulate the bank.

This approach would be an alternative to the SEC imposing its own minimum international style standards. OSI requires one set of disclosure standards, which could be either qualifying home country standards or the envisioned SEC minimum standards.

Note that the minimum standards approach does not necessarily conflict with OSI where securities are subject to the rules of a home country as long as the home country would permit public distribution under the SEC minimum, international style, disclosure rules. Thus, suppose a retail issue in the U.K. to U.K., French and U.S. residents. If the U.K. accepted the SEC minimum standards, French investors buying the securities in London would only be subject to the SEC rules (given the lack of extraterritorial application of French law), and the same would be true of U.S. investors (under my proposal). This might change, as discussed more fully below, if the EU made it more difficult for French investors to cross borders. In that event, the OSI requirement of one set of disclosure standards, as well as enforcement considerations, would suggest using the qualifying home country approach in lieu of SEC minimum standards.

II. The European Commission s Common Prospectus Proposal

On May 30, 2001, the European Commission, following up on the Final Report of the Committee of Wise Men, issued a proposal for a new Directive on a common prospectus to be required when securities are offered to the public in primary markets or admitted for trading in secondary markets, COM(2001) 280 final (Common Prospectus Proposal or CPP). This proposal requires a common prospectus, whose details will be specified by the Commission upon advice of a Securities Committee, Art. 6(1), for any primary public offering, Art. 3(1). The prospectus cannot be published until approved by the home country, Art. 11(1). Article

13 of the proposal contains rules on advertising. Article 13(1) provides: "Advertisements, notices, posters shall be communicated in advance to the competent authority of the home Member State which shall check them before publication against the principles contained in this Article [that advertisements be fair, accurate and consistent with that contained in the prospectus]. The documents shall state that a prospectus will be published and indicate where investors will be able to obtain it." The EU disclosure requirements are to be in accordance with the information requirements set out by IOSCO in Part I of their International Disclosure Standards for cross-border offerings and initial listings. Enforcement of the EU rules will generally be left to the home country, Art. 19. When the host country finds irregularities in an offer, it must refer the matter to the home country. The host country is, however, entitled to act, after informing the home country, if measures taken by the home country prove inadequate or violations of laws and regulations persist.

The Duke Article observed that European countries and Japan did not generally submit offshore issues to securities regulation, observing strict territorial limits to their asserted jurisdiction. It further observed, following the U.K. Treasury Report of 1998, that perfection of the internal EU public primary market for securities distribution was not that disturbing, given that companies could distribute their securities in one member state and allow investors to come to that state to buy the securities. Thus, it envisaged that implementation of my proposal would only be an issue for the United States, given the modifications that would be required in Regulation S. This may change if the CPP were to be implemented in its present form.[1]

Under the current EU regime, so-called "eurosecurities," not subject to "a generalized campaign of advertising or canvassing," are exempt from any EU disclosure requirements. Eurosecurities are securities (1) underwritten and distributed by a syndicate at least two of the members of which have their registered offices in different states (*multiple state underwriters)*; (2) offered on a significant scale in one or more states other than that of the issuer's registered office (*distribution in state other than the issuer's)*; and (3) subscribed for or initially acquired through a credit institution or other financial institution (*sold to financial institutions)*.

As the Duke article observed, the definition of what is advertising and canvassing was left to various host state requirements. For example, Germany provides that the "canvassing" prohibition only applies to door-to-door sales, and not apparently calls to clients, while the Netherlands provides that an investor may be approached by a financial institution as long as this is not done systematically by way of a general campaign.

Thus, under the existing EU securities regulation regime, a multiple state bank syndicate, including Deutsche Bank and Barclays, could sell the securities of a German issuer

[1] I regard securities bought by French investors in the U.K. as offshore to France. I recognize, of course, that since the U.K. and France are both EU Member States, and both subject to minimum disclosure requirements (which will be strengthened by CPP), the differences between U.K. and French requirements might be constrained. In contrast, there are no current regional or international constraints on the difference between U.S. and U.K. rules. Thus, in principle, the differences between these rules could be greater than between French and U.K. rules. But securities purchases by French and U.S. investors in the U.K. are both offshore.

to various banks in London and Germany, who might purchase them for, or immediately resell them to, retail investors throughout the EU, as long as the retail investors were not procured by a generalized advertising or canvassing campaign, the latter requirement being subject to the interpretation of host states (where the investors are). Such securities would, however, be subject to national laws, in the example the laws of England and Germany. But these laws generally provide for disclosure exemptions for offers to sophisticated investors like financial institutions, and, unlike U.S. law, would not generally integrate financial institution resales to investors into the initial offering.

Under the CPP, offshore sales in the EU may be significantly more restricted than at present. It is true that sales to financial institutions would be outside the scope of the proposal since these sales would not be defined as public offerings, Art. 3(2)(a), Art. 2(1)(c). In a sense the "eurosecurities" exemption has been widened by dropping the requirements for multiple state underwriters and distribution outside the state of the issuer, in line with the new broader exemption for sophisticated investors. However, more importantly, any advertising of such issues would be reviewed for content by the home Member State and would subject issuers to the Common Prospectus requirement. Issuers would continue to be free to sell securities under their own "international style" disclosure documents in London to financial institutions who could pass them on or resell them to retail investors, but no advertising of such offerings could be made. The power to define permissible advertising would be taken away from host Member States. German retail investors could still participate in London offerings through a financial institution, but they would be much less likely to know about them. This has the effect of making the offshore public market less accessible.

If this new regime is implemented, it will make acceptance of my proposal more difficult. My proposal assumed that offshore public markets were generally available to European and not U.S. investors, and urged the U.S. to get in line with Europe. If the EU makes offshore markets less accessible through restrictive advertising rules, this argument is more difficult to sustain. If my proposal were to be accepted, the U.S. would have to modify Regulation S <u>and</u> the EU would have to modify the advertising prohibitions in the Common Prospectus Proposal.

III. A Reprise on Harmonization

Some have argued that we should focus on harmonizing the rules in onshore markets rather than in developing more accessible offshore markets. In principle this option would be preferable because a wider investor base could be reached. Any offshore regime must be concerned with permissible onshore advertising and would ban onshore sales.

The problem is that harmonization of rules onshore is even more impractical than freeing up offshore access. Recall that OSI requires standardized distribution and enforcement rules, as well as standardized disclosure requirements. There is no prospect, nor even an ongoing effort, to achieve harmonization of countries' distribution and enforcement rules. Offshore issues, since subject to the rules of only one country achieve standardized distribution. If these distribution rules are burdensome, issuers will pick other jurisdictions in which to issue (assuming these jurisdictions meet the competent securities regulation test under my alternative home country recognition approach).

Whereas enforcement may not be completely standardized, given that countries could apply their general fraud laws extraterritorially to protect local investors, as the U.S. does in the case of 10b-5, a large measure of uniformity will still be achieved. The U.S. strict liability rules that apply to registered offerings, e.g. Sections 11 or 12(a)(1) or (2) of the ›33 Act, would not apply. Moreover, Stephen Choi has shown that there is less risk of enforcement of 10b-5 abroad than there is domestically, *Assessing the Cost of Regulatory Protections: Evidence on the Decision to Sell Securities Outside the United States,* Yale Law School, Program for Studies in Law, Economics and Public Policy, Research Paper No. 253 (2001).

There are also significant problems with harmonization of disclosure rules. To begin with, as observed in the Duke Article, the IOSCO rules, which have been adopted by the United States for foreign issues, and which the Common Prospectus Proposal would adopt within the EU, do not deal with contentious issues (discussed in Part II of the IOSCO proposal) like segmented market reporting or safe harbors for forward looking statements.

In addition, there is the language problem; disclosure documents must be distributed in the local language, thus requiring significant translation costs and potential liabilities due to discrepancies in meaning between various language versions.

The CPP has tried to address this language problem within the EU. Article 7 provides that the prospectus shall "be drawn up in a language accepted by the competent authority in the home Member State." Article 16 then states: "Where an offer is made. . . in more than one Member State, the prospectus. . .shall. . .be made available in a language customary in the sphere of finance and which is generally accepted by the competent authority of the host

Member State. In such case, the competent authority of the host Member State may only require that the summary note be translated into its domestic language."

The EU proposal raises some interpretative questions. If a French company prepares a prospectus in French, must the U.K. accept it or can it require that the entire prospectus be translated into English? This would seem to turn on whether French is a language "customary in the sphere of finance" and whether French is "generally accepted" by the U.K. In practice English is the only customary language in the sphere of international finance, but will the French accept that? If French is customary, could the English still reject it on the grounds that it is not "generally accepted" in the U.K., whatever that means? There will be significant political pressure for local authorities to insist that prospectuses, and not just summaries, be available in the local language. Even if this issue is resolved within the EU, it will not soon be resolved internationally. Clearly, the United States will not accept prospectuses in any language other than English, and it is quite unlikely that Japan will accept English prospectuses. It is also questionable that France, or other continental European countries, would accept the English prospectuses of U.S. issuers, as contrasted with those of U.K. issuers which the CPP might force them to accept.

Another major obstacle to internationally harmonized disclosure requirements are the lack of internationally accepted accounting standards. While we now have international accounting standards (IAS), which are in fact quite similar to U.S. standards, and a revamped International Accounting Standards Committee, with the independence and resources to revise and interpret the standards on an ongoing basis, U.S. acceptability of IAS is still quite doubtful. The issue is one of enforcement. In the U.S., the SEC stands behind FASB insuring that FASB standards are enforced. There is no body to enforce IAS. While the SEC itself could enforce IAS, and other host countries could do the same, this could lead to conflicting interpretations of IAS since interpretation is necessarily a part of the enforcement process. The EU will have similar problems in using IAS since there is no European securities regulator to enforce such standards on a consistent basis in Europe.

In short, harmonization has no prospect of insuring standardized distribution and enforcement procedures, and with respect to disclosure there are significant problems in harmonizing language, non-financial disclosures, and accounting standards. In the end, I believe OSI is more easily obtainable offshore than onshore.