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# Investor Choice in Global Securities Markets

Law Working Paper N° 371/2017
October 2017

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## Abstract

This paper, which forms part of the first phase of the New Special Study of the Securities Markets Project, explores how globalization has affected the operation of securities markets and the challenges this poses for their regulation. In Part I, we discuss how three secular trends – liberalization, institutionalization, and technologization – have contributed to unprecedented levels of cross-border activity in securities markets in recent decades and offer a framework for understanding cross-border issues in securities regulation policymaking. Against this background, we review the state of international regulatory cooperation and offer some conjectures as to its likely future trajectory. In Part II, we analyze regulatory aspects of cross-border equity investment in four areas: capital raising (primary markets), trading (secondary markets), intermediaries, and supervision and enforcement. In so doing, we highlight, by way of contrast, some areas where other countries have taken a notably different regulatory approach from the US. We conclude by identifying issues where further research may usefully inform the future design of US securities regulation.


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Keywords: Brexit, Capital markets, Cross-border transactions, Cross-listing, Enforcement, Extraterritoriality, Globalization, International regulatory coordination, International securities regulation; Institutionalization, Intermediaries, Liberalization, Mifid 2, Primary markets, Securities regulation, Supervision, Technologization, Trading venues

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Final Draft

July 2017

Abstract

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## 1. Introduction

This paper explores how globalization has affected the operation of securities markets and the challenges this poses for their regulation. We review the current state of the law and practice of international securities transactions and services, with a view to identifying issues where further research may usefully inform the future design of US securities regulation. In so doing, we offer a framework for understanding cross-border issues in securities regulation policymaking and consider some of the most salient phenomena debated by legal scholars and financial economists, and addressed by policymakers, in recent decades. We also zoom in, by way of contrast, on some issues on which other countries have taken a notably different regulatory approach from the US. Our focus, in keeping with the general orientation of the New Special Study ('NSS'), is on equity markets.

We begin in Section 2 by outlining macro-level issues. Securities markets have experienced unprecedented levels of cross-border activity over the past 30 years. Three secular trends have contributed to this phenomenon of 'globalization'. First, liberalization: the removal of national foreign exchange controls and barriers to trade and investment. Second, the growth of collective investment, encouraged by favorable tax treatment of retirement saving. This has fostered a shift away from retail, and toward institutional, participation in securities markets. Professional asset managers have the skills and the scale to invest beyond national borders. They are also in a better position to access less liquid asset classes, such as non-publicly traded securities. The third trend has been technological: advances in information and communications technology (ICT) have enabled the digitization of business processes, increased connectivity that seamlessly links market participants regardless of their location, and allowed for the automation of processes and services. This has facilitated new order-driven markets and precipitated a gradual decline in the role of exchanges as pools of liquidity.

Together, these factors have broken the link between listing on a particular exchange and having access to the capital base originating in the country where that exchange is located. At the same time, they have increased the attractiveness of using alternative (private) forums for capital-raising. We suggest that a framework to understand international competition and coordination issues in securities law can usefully be introduced by the slogan of 'investor choice'. Thanks to the removal of barriers to free movement of capital, the intermediation of professional managers who have the skills and the scale to invest internationally, and the digital interconnection of markets across the globe, investors can reach all markets and issuers, regardless of where the issuers raise capital and have their securities traded, or which securities laws apply on the issuers' side.

The two subsequent Sections discuss the regulatory dynamics of international securities transactions. Section 3 considers (unilateral) rules governing market access and Section 4 looks at (bilateral and multilateral) regulatory coordination. Formerly, the well-understood dilemma in international capital-raising was that regulatory competition might pressure states to compromise domestic investor protection goals. To avoid this, international coordination was used to encourage states to align their regulatory requirements and cooperate in enforcement. Initiatives for regulatory coordination were

spearheaded at the global level by the US SEC (through international institutions such as IOSCO) and, on a regional level, by the EU.

However, the trends toward collectivization and connectivity have changed this picture. If domestic retail investors' funds are channeled into investment funds, international issues need no longer affect the position of these investors. Cross-border investment and capital-raising can become a dynamic between issuers and sophisticated investors—primarily the collective investment funds themselves. Sophisticated investors don't need extensive protection, and so the former trade-off with regulatory competition is lessened. Funds are consequently channeled instead through private or 'wholesale' markets, relying on exemptions from ordinary securities laws for transactions with sophisticated investors. Growing global competition for listing and liquidity services is paradoxically paired with a waning significance, in policy terms, of regulatory competition. As a result, regulatory coordination seems likely to engender less enthusiasm in the future.

The remaining substantive Sections mirror topics covered by the other papers in the New Special Study. As regards primary markets, we consider in Section 5 the state of the international 'market for IPOs', including case studies of the UK's Alternative Investment Market ('AIM') and US private placements, the London Stock Exchange's experiments with different listing segments catering to foreign issuers of differing quality, and Asian primary markets.

In Section 6, we turn to global issues in the regulation of trading venues. We provide an overview of the trading venue options available in the US and in Europe, explore three areas where EU regulation differs significantly from the US (dark pools, the new concentration rule for EU broker-dealers, and high frequency trading) and reflect upon how these differences impact international markets. This segues into a discussion, in Section 7, of global regulatory issues in relation to intermediaries. Here we focus on a comparative overview of the US and EU regulation of cross-border investment services relating to equity markets, the US regulation of foreign broker-dealers, the implications of Brexit, and EU-style fiduciary duties for broker-dealers. A key policy question is whether and to what extent restrictions on the freedom of institutional investors to execute their trades wherever it is suitable to them and through their preferred broker-dealer wherever it is based and regulated are justified. Section 8 then considers issues of enforcement. Section 9 concludes with a discussion of implications and an agenda for future research.

## Part I

## The Global Dimension of Securities Markets

### 2. Macro-level issues

Global securities markets have experienced unprecedented levels of cross-border activity over the past 30 years. Three secular trends have contributed to this phenomenon of (financial) globalization: (1) *Liberalization*: in most economies, capital controls and national barriers to trade have been removed or considerably reduced; (2) *Institutionalization*:

encouraged by favorable tax treatment of retirement savings, collective investment has become the dominant mode of investment in publicly traded securities; and (3) *Technologization*: advances in information and communications technology (ICT) have enabled its deployment to digitize business processes, to improve connectivity by seamlessly linking market participants, wherever located, and to automate processes and services, with corresponding reductions in transaction costs. We consider each of these in turn.

### 2.1. Liberalization

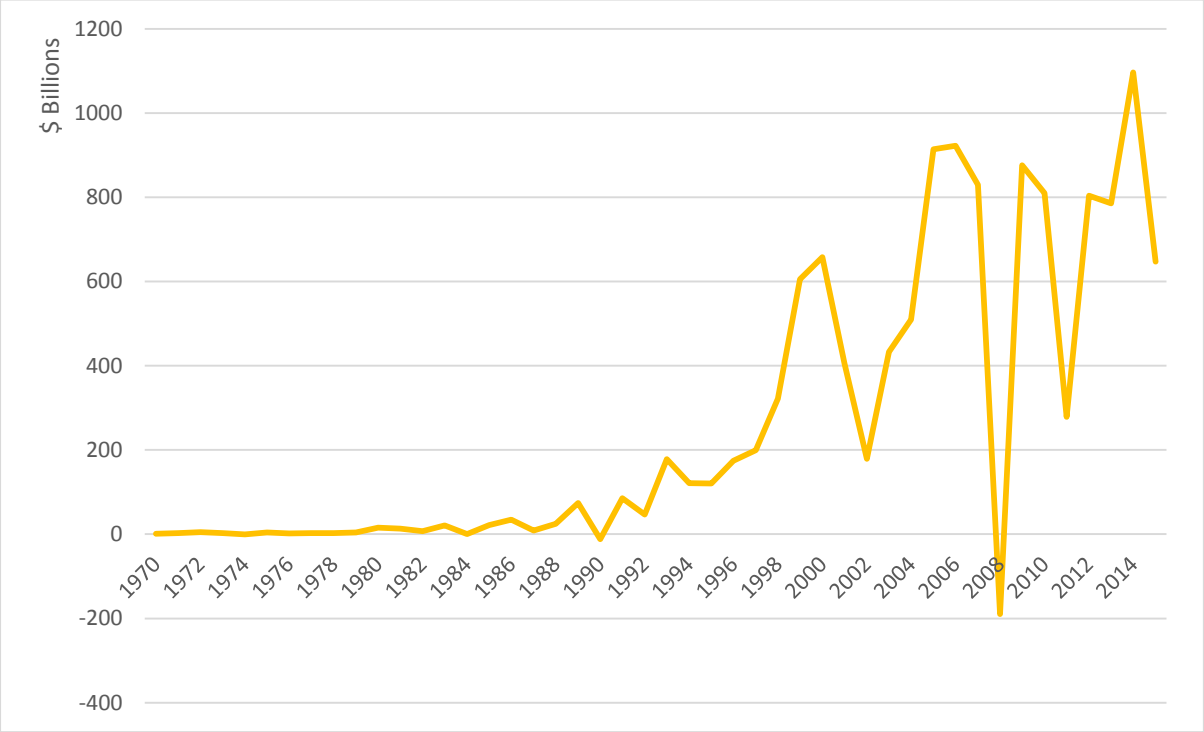
The progressive dismantling of national barriers to capital flows since the demise of the Bretton Woods system in the early 1970s has facilitated global capital flows.[1] Figure 1 reports World Bank data on aggregate global net inflows of portfolio equity (that is, investments in liquid securities) for the period 1970-2015. Inflows for each country represent capital that is invested from abroad.[2] The global aggregate of such investment gives a rough-and-ready indication of the degree of 'globalization' in relation to equity investment. As can be seen, the period from 1985-2015 was one of enormous growth in this indicator.[3]

[1] For a discussion of capital account liberalization, see, eg, MAURICE OBSTFELD & ALAN M. TAYLOR, GLOBAL CAPITAL MARKETS: INTEGRATION, CRISIS, AND GROWTH (2004) 164-168. While many barriers to cross-border investment have been dismantled, important emerging markets still deploy various tools to control capital flows and limit cross-border investment. For example, China and India both maintain capital account restrictions and limits foreign investments in certain industries.

[2] The World Bank sources this data from the IMF, which defines 'portfolio investment' as 'cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets' (*see* IMF, *Balance of Payments and International Investment Position Manual*, BPM6, para 6.54).

[3] As can also be seen in the figure, this measure experienced tremendous volatility during the global financial crisis. This experience led the IMF to explicitly acknowledge that '[t]here is no presumption that full liberalization [of countries' capital accounts] is an appropriate goal for all countries at all times'. IMF, THE LIBERALIZATION AND MANAGEMENT OF CAPITAL FLOWS: AN INSTITUTIONAL VIEW (November 14, 2012).

**Figure 1:** Global net inflows of portfolio equity, 1970-2015, $bn.




**Notes:** Data are from World Bank, *World Development Indicators*. Portfolio equity includes net cross-border inflows from equity securities other than those recorded as direct investment and including shares, stocks, depository receipts (American or global), and direct purchases of shares in local stock markets by foreign investors. Data are in current US dollars.

A first channel for international activity in securities markets is for *firms* to raise capital in foreign countries. An obvious motivation for doing this is to access additional liquidity from foreign investors—the so-called 'liquidity' rationale. A second goal may be for firms to opt into the disclosure and liability regimes of the 'host' country in which capital is raised. Where the host country's regulation is of higher quality, or more intensely enforced, than that in the issuer's home country, this can be understood as 'bonding': the firm committing itself to higher standards in order to signal that the managers have positive information about its likely performance and do not intend to expropriate investors.[4] While the bonding rationale is widely discussed in the literature, it is relevant only for a subset of cross-border capital-raising. It requires the firm to opt into a legal or enforcement regime that is clearly superior to that in the issuer's home jurisdiction. As we shall see, however, much international capital-raising is done by private placements, utilizing exemptions from regular securities laws.[5]

[4] *See, e.g.,* Craig Doidge, G. Andrew Karolyi & René M. Stulz, *Why are Foreign Firms Listed in the US Worth More?*, 71 J. FIN. ECON. 205 (2004); Craig Doidge, G. Andrew Karolyi, Karl V. Lins, Darius P. Miller & René M. Stulz, *Private Benefits of Control, Ownership, and the Cross-Listing Decision*, 64 J. FIN. 425 (2009).

[5] *See, e.g.,* Howell E. Jackson and Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 BUS. LAW. 653 (2001); Howell E. Jackson and Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe—Part II*, 3 VA. L. & BUS. REV. 207 (2008).

A second channel for international securities market activity is for *investors* to send their capital abroad, investing in firms that have issued securities under the legal and regulatory structures operative in foreign countries. Third, some sort of *international intermediation* can be offered by financial institutions. Many types of intermediation facilitate the bringing together of issuers in one country and investors in another, including international investment funds (investment funds that raise capital from domestic investors with a view to investing in foreign securities) and depositary receipts (foreign securities are purchased by an institution that then makes a market to domestic investors in claims backed by these securities). These intermediation techniques have historically often been deployed by countries to achieve some *de facto* liberalization of equity markets before official *de jure* deregulation allowed foreign investors to invest in domestic stock markets and domestic investors to invest abroad.[6] As will be further discussed in Sections 3 and 4 below, developments in securities regulation have also facilitated globalization by reducing regulatory barriers. In addition to facilitating cross-border investment for their domestic clients, intermediaries have increasingly engaged in international competition over the provision of intermediary services. In this area, US global players in the broker-dealer services markets have reached a dominant position in all major financial centers.[7]

### 2.2. Institutionalization

The second secular trend has been the continued rise of collective investment. Figure 2 illustrates this from the standpoint of the US. The lines, respectively, show the ratio of the assets under management by insurance companies and mutual funds to national GDP over the period 1980-2014. Insurance company assets have more than doubled, as a proportion of GDP, during this period. However, this increase is dwarfed by the rise in mutual fund assets, from around five per cent of GDP in 1980 to 90 per cent by 2014. Pension fund assets are only available in the World Bank time series from 1990, and so are not shown alongside, but add a further 70-80 per cent of GDP.[8] Thus, assets held by these three core institutional investor types together amount to nearly twice the size of US GDP. A similar long-term growth in institutional investment is also apparent in European financial systems, where the proportion of financial intermediation that takes place other than through banks has also been steadily rising, albeit starting from a smaller base.[9]

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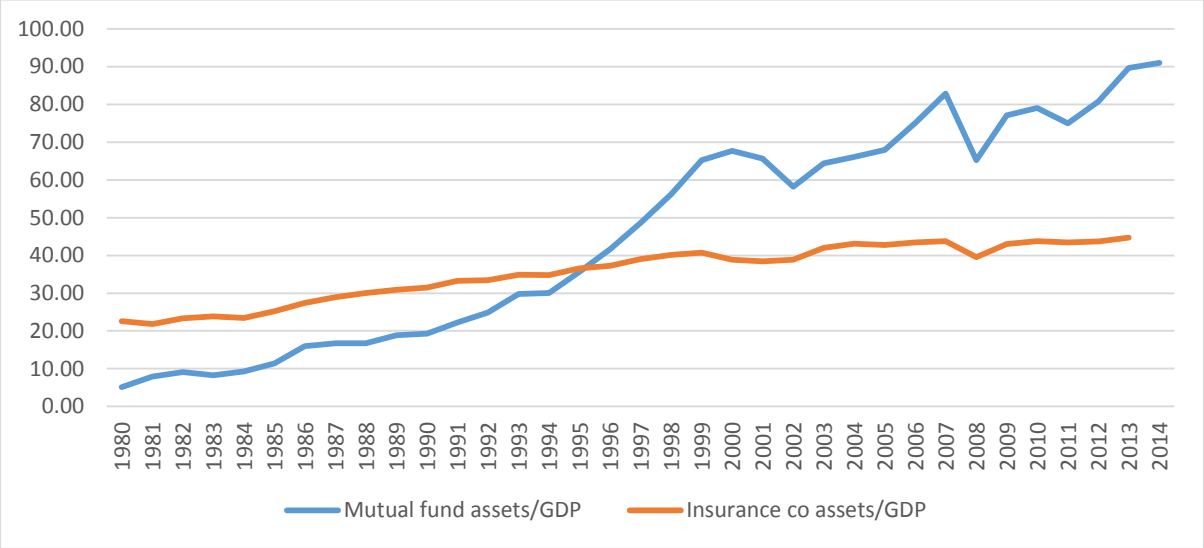
[6] *See, e.g.,* C. Lundblad, *Measurement and Impact of Equity Market Liberalization*, in THORSTEIN BECK, STIJN CLAESSENS & SERGIO K. SCHMUKLER (EDS.), THE EVIDENCE AND IMPACT OF FINANCIAL GLOBALIZATION (2013) 35 (presenting data by country of their 'official liberalization date', the date of the first ADR issuance from a firm in that country, and the date of introduction of the first closed-end mutual fund focused on issuers from that country).

[7] *See* Charles Goodhart and Dirk Schoenmaker, The United States Dominates Global Investment Banking: Does It Matter for Europe?, Bruegel Policy Contribution 2016/06 (2016).

[8] Institutional investors are gaining importance globally. For example, pension funds in the OECD have grown their assets from 51.8% of GDP in 2001 to 61.9% of GDP, or $30.2 trillion, in 2014. *See* OECD, ANNUAL SURVEY OF LARGE PENSION FUNDS AND PUBLIC PENSION RESERVE FUNDS (2016) 10.

[9] JAKOB DE HAAN, SANDER OOSTERLOO & DIRK SCHOENMAKER, FINANCIAL MARKETS AND INSTITUTIONS: A EUROPEAN PERSPECTIVE, 3rd ed (2015), 283-98.

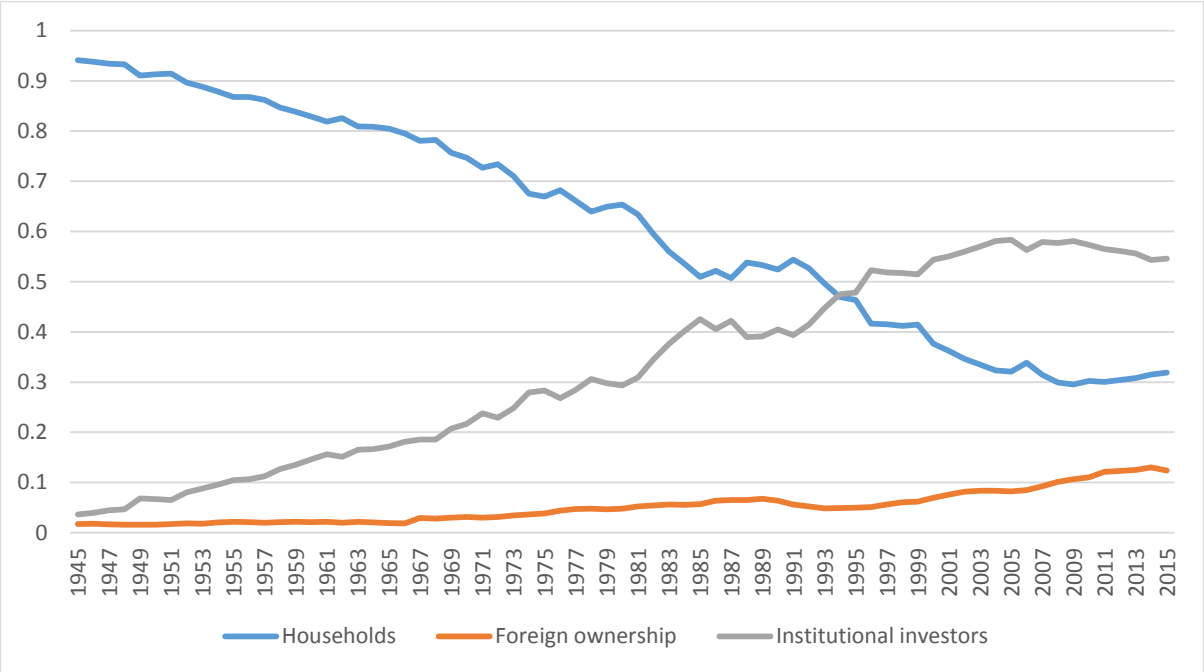
**Figure 2:** Growth of assets held by institutional investors in the US, 1980-2014.




**Notes:** Data are from the World Bank's Global Financial Development database.

This growth in the scale of institutional investors is matched by a growth in their significance as holders of equities in US corporations. Figure 3 shows the proportion of the total value of US corporations' equity stock held by different types of investor over the period 1945-2015. As can be seen, households held almost all US equities at the beginning of this period, a proportion which declined to a low of 29.5 per cent in 2009. Conversely, the proportion held by institutional investors (comprising all types of investment company, pension fund, and insurance company) grew from almost nothing in 1945 to a peak of 58 per cent in 2009. Foreign ownership of US equities has long been low, rising only since the financial crisis to a high of 13 per cent in 2014.

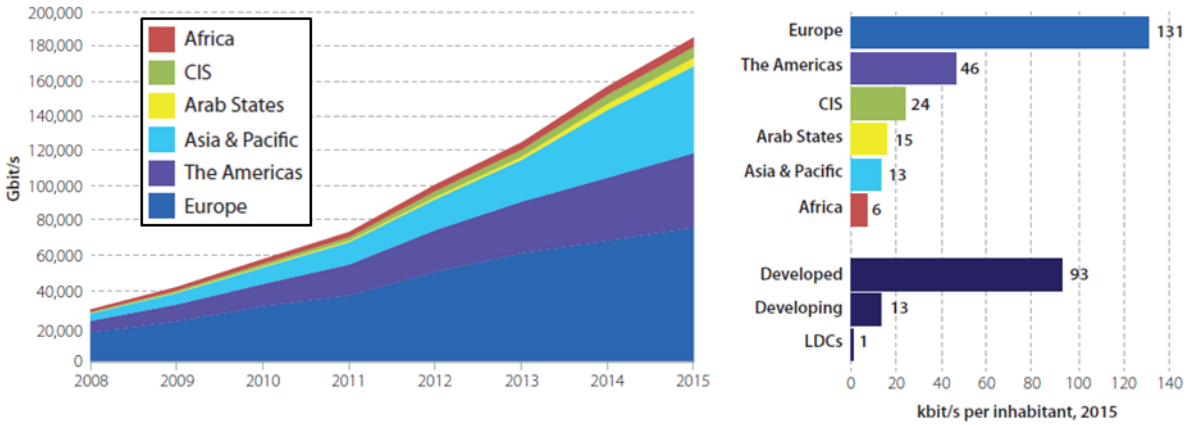
**Figure 3:** Distribution of ownership of US corporate equities, 1945-2015.



**Notes:** Data are taken from Federal Reserve, Financial Accounts of the United States, Table 223 (Corporate Equities), 1945-2015. Data are scaled to sum to the total value of US equities outstanding.

## 2.3. Technologization

**Figure 4:** Global Internet Bandwidth and its Distribution, 2008-2015.




**Notes**: Charts are taken from ITU Facts and Figures 2016. 'CIS' refers to Commonwealth of Independent States. 'LDCs' refer to the world's Least Developed Countries, as defined by the United Nations.

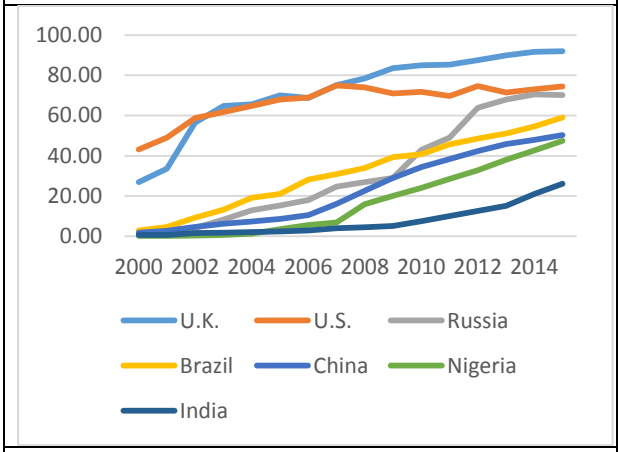
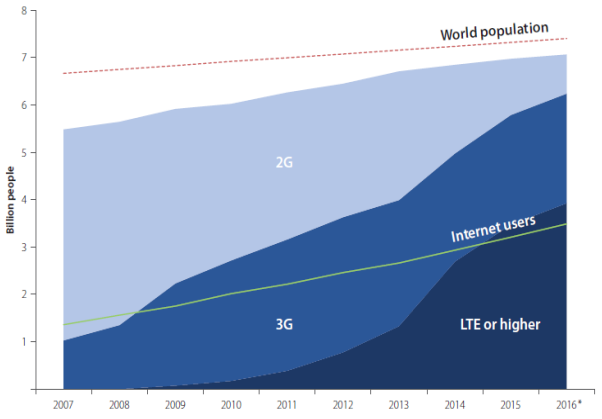
Advances in ICT, including developments in digitization, connectivity and automation, have fundamentally reshaped international capital markets. ICT has allowed information and capital to flow seamlessly across borders, fostering international integration.[10] As an example of the evolution in the infrastructure supporting international interconnectedness, Figure 4 shows the growth of global internet bandwidth in recent years. Total global bandwidth reached 185,000 Gigabits per second at the end of 2015, a six-fold increase on 2008, although it is distributed unevenly around the world.

Countries outside of the Americas and Europe are nevertheless catching up. Figure 5 compares internet penetration of selected countries. While Nigeria, the most populous country in Africa, had almost no internet penetration at the turn of the century, this had mushroomed to 47 per cent by 2015, equivalent to the US level in 2001. Mobile broadband is growing particularly rapidly throughout the world,[11] such that 95 per cent of the global population now live in an area covered by a mobile network, as shown in Figure 6.[12]

[10] For early analyses of the impact of technology on securities regulation, *see* Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985) and John C. Coffee, *Brave New World? The Impact(s) of the Internet on Modern Securities Regulation*, 52, BUS. LAWYER 1195 (1997).

[11] ITU, ICT FACTS AND FIGURES: THE WORLD IN 2015 (mobile broadband penetration grew twelve-fold between 2007 and 2015 and covered 47% of the world's population in 2015.

[12] Of course, connection speeds differ: in the U.S., the average broadband connection is at 16.3 Megabits per second ('Mbps'), with 39 per cent of connections above 15 Mbps. This compares to average connection speeds in China of 5.7 Mbps (with 1 per cent above 15Mbps), Brazil of 5.5 Mbps (with 3 per cent above 15Mbps) and world leader South Korea at 26.3 Mbps (with 61 per cent above 15Mbps): AKAMAI, STATE OF THE INTERNET REPORT (Q3 2016).

| **Figure 5**. Percentage of individuals using the Internet in selected countries. | **Figure 6**. Mobile network coverage (estimated), by technology. |
|---|---|
|  |  |
| **Source**: ITU. | **Source**: ITU Facts and Figures 2016. |

As the level and speed of connectivity increases, geographical proximity decreases in importance. This allows for decentralization of existing market functions and higher levels of market participation, as new countries and investors get cheap access to international markets. Technological advances allow issuers to have their securities trading on venues abroad and investors to gain access to an increasingly international set of investment opportunities.

Automation, in turn, has dramatically changed the day-to-day operation of capital markets. Machines have replaced human beings in fundamental market functions such as market making and inter-market price arbitrage (via high frequency trading) and trading on newly available information (via algo-trading). This process is now extending its reach to investment services such as financial advice (via robo-advisors). The cost of processing data and information have plummeted, making it easier for analysts and professional investors to use big data to identify price discrepancies that human beings would have been unable to gauge.

In short, technology has increased the markets' liquidity and informational efficiency and made new trading venues competitive.[13] More specifically, it has lowered the costs of international trading by (amongst other things) allowing for instant transmission of data, automating processes to reduce the need for human involvement, improving execution quality, reducing the need for physical facilities, and increasing transparency to facilitate competition. These factors have contributed to the commoditization of trading services and allowed new entrants into markets.[14] Consequently the costs of trading international equities have declined over time, to the point where trading in some emerging markets is

[13] *See, e.g.,* Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1464-65 (2008).

[14] *Id.*, at 1459-66 and STEPHANIE HAMMER, ARCHITECTS OF ELECTRONIC TRADING: TECHNOLOGY LEADERS WHO ARE SHAPING TODAY'S FINANCIAL MARKETS (2013) 69-73.

reportedly cheaper than in certain established markets.[15] Nevertheless, institutional trading costs for large-cap US stocks remain among the lowest in the world.[16]

At the same time, increased connectivity reinforces the trend towards collective investment and has stimulated the creation of new models for pooled investments.[17] The combination of connectivity and collective investment has made listing on a stock exchange just one of many alternative channels through which issuers can raise capital. Significant amounts of equity capital are now raised privately,[18] and shares sold in such offerings can be traded on electronic ATSs.[19]

### 2.4.Limits to securities markets globalization

Securities markets globalization can be thought of as the process of integration of such markets across countries. While the secular trends outlined above have arguably contributed to increased integration of markets across the world, there is no single measure that allows for a definitive assessment of the extent of securities markets globalization.[20] There are, however, various metrics that can be used to assess different aspects of the phenomenon, such as cross-border asset price correlation, international portfolio diversification (or its inverse: investment 'home bias'), cross-border capital flows, as well as indices that aim to measure a country's level of openness to cross-border investment.[21] Some of these metrics have been discussed above; here, we will next briefly review the home bias phenomenon to illustrate the limits to globalization.

Across the world, investors persistently direct a larger amount of their funds to investments in their home country than is warranted by its share of the global investment portfolio. Such home bias is not easily explained by standard finance theory, which would

[15] INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: MOVING FROM LIQUIDITY- TO GROWTH-DRIVEN MARKETS (April 2014) 73 (the average cost of a one-way global equity trade declined by approximately half between 2000 and 2013).

[16] James J. Angel, Lawrence E. Harris & Chester S. Spatt, *Equity Trading in the 21st Century: An Update*, 5 Q. J. FIN. 1, 19 (2015) (also providing a comparison of institutional trading costs for different markets across the world).

[17] *See, e.g.*, IOSCO, RESEARCH REPORT ON FINANCIAL TECHNOLOGIES (Feb. 2017) 68 (describing how technological advances have facilitated the creation of cross-border investment platforms in Asia).

[18] *See, e.g.*, Chris Brummer, *Disruptive Technology and Securities Regulation*, 84 FORDHAM L. REV. 977 (2015) 1020-24.

[19] *See, e.g.*, Elizabeth Pollman, *Information Issues on Wall Street 2.0*, U. PA. L. REV. 179 (2012).

[20] Merritt Fox characterises 'full globalization' of securities markets as involving two distinct dimensions: a price dimension (the extent to which the 'law of one price' holds true between countries) and a stock ownership dimension (the extent to which investors hold globally diversified portfolios). Fox concluded in 1997 that markets were not 'fully global', particularly as regards stock ownership, but predicted a move toward full globalization if national regulators did not obstruct market participants. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997). For an updated discussion, *see* Merritt Fox, *The Rise of Foreign Ownership and Corporate Governance*, in JEFFREY GORDON & WOLF-GEORG RINGE (EDS), THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (forthcoming).

[21] HAL S. SCOTT & ANNA GELPERN, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 22-25 (2016).

suggest that investors should form global portfolios to invest in the most profitable projects worldwide and benefit from international diversification.[22] Measurements of home bias in recent decades suggest that although globalization has increased—reflected in a reduction in home bias over time—enough home bias remains to suggest we are still far from full globalization.[23] For example, a recent study found that US investors allocated 77 per cent of their equity investments to domestic stocks, even though the US only represents 33 per cent of global market capitalization.[24]

Various factors help explain why home bias persists, pointing up the current limits of securities markets globalization.[25] First, while technologization has increased the interconnectedness of countries and markets, information markets are not yet fully global, meaning local investors may find it easier to procure accurate information, understand the language of issuers' disclosures, or assess the reputation and credibility of directors and officers who write such disclosures.[26] Secondly, less-than-full liberalization may prevent foreign investors from entering certain equity markets, make entry more expensive through tax laws, or deny full exit from a domestic regime by way of prudential regulation.[27] Relatedly, national laws requiring securities to be cleared, settled, or held with local organizations may also make the administration of a global portfolio expensive, although institutionalization responds to and mitigates this concern. Fourth, investors may want to avoid the exchange rate exposure that foreign equity investment brings, or prefer local securities for their superior ability to hedge against local risk factors. Fifth, cultural factors, for example the acceptance of egalitarianism, may influence the extent to which investors confidently invest overseas.[28] Familiarity is a sixth factor: individuals invest more

[22] *See, e.g.*, Fox, Securities Disclosure, *supra* note 20, at 2508-12.

[23] Nicolas Coeurdacier & Hélène Rey, *Home Bias in Open Economy Financial Macroeconomics*, 51 J. ECON. LIT. 63 (2013). Whether full globalization is desirable is a separate question that we do not attempt to answer.

[24] *Id.*

[25] The factors discussed in this paragraph are analyzed in more detailed in, e.g., Fox, Securities Disclosure, *supra* note 20; Coeurdacier & Rey, *supra* note 23; and Piet Sercu & Rosanne Vanpée, *The Home Bias Puzzle in Equity Portfolios*, in H. KENT BAKER & LEIGH A. RIDDICK (ED.), INTERNATIONAL FINANCE: A SURVEY (2012).

[26] This may have real effects. *See, e.g.*, Bok Baik, Jun-Koo Jang & Jin-Mo Kim, *Local Institutional Investors, Information Asymmetries, and Equity Returns*, 97 J. FIN. ECON. 81 (2010) (finding, based only on intra-US data, that local institutional investors have a significant information advantage over non-local investors and execute more profitable trades).

[27] *See* Zsolt Darvas & Dirk Schoenmaker, *Institutional Investors and Home Bias in Europe's Capital Markets Union*, Bruegel Working Paper 2/2017 (finding that home bias is positively related to prudential restrictions on pension funds' foreign investment as measured by the OECD, and that larger pension funds display less home bias). For recent data on the state of foreign ownership restrictions, *see* UNCTAD, WORLD INVESTMENT REPORT 2016, Chapter IV (presenting data that 78 per cent of countries globally have at least one industry where foreign equity ownership is limited below 50 per cent, while the figure is 100 per cent in Europe and 64 per cent in Africa). *See also* OECD, Is investment protectionism on the rise? Evidence from the OECD FDI Regulatory Restrictiveness Index (March 2017), available at http://www.oecd.org/investment/fdiindex.htm.

[28] Jordan I. Siegel, Amir N. Licht & Shalom H. Schwartz, *Egalitarianism and International Investment*, 102 J. FIN. ECON. 621 (2011); Jordan I. Siegel, Amir N. Licht & Shalom H. Schwartz, *Egalitarianism, Cultural Distance, and Foreign Direct Investment: A New Approach*, 24 ORG. SCIENCE 1174 (2013).

internationally as they get older (and presumably gain experience) and those who live in areas with a higher proportion of residents born abroad have less home bias.[29] Corporate law and governance rules may present another factor of significance: in countries where corporate insiders or the government can appropriate value from outside investors, large local shareholders may be the optimal way to control agency costs.[30] Finally, it is not necessarily the case that investors suffering from home bias are suffering at all. An empirical study found that investors with more concentrated holdings earned higher risk-adjusted returns—a finding that supports the proposition that investors have an information advantage in their local markets and thus rationally prefer to invest there.[31]

It may be helpful to keep these various frictions in mind, as we later note other phenomena that might not be expected under full globalization. For example, depositary receipts and cross-listings on foreign stock exchanges, which are frequently observed, would not add value in a world of full globalization, but they presumably provide relatively efficient solutions to reduce frictions in international securities markets today.

## 3. Market access and unilateralist approaches to cross-border securities regulation

Cross-border capital-raising, investment, and investment services pose questions of regulatory interface. We can characterize the core question for regulatory policy as a jurisdiction's approach to *market access*. In this Section, we focus on unilateral approaches to cross-border securities regulation, that is, how an individual jurisdiction may set its own rules in isolation from others, while in Section 4 we turn to bilateral and multilateral approaches, based on international cooperation.

Countries are free in principle to make their rules about international securities market access as liberal or restrictive as they wish. Public-interest minded policymakers tend to prioritize concerns related to investor protection and capital formation. As regards investors, policymakers may wish to avoid exposing domestic investors to international investment risks from which local regulation would protect them vis-a-vis domestic securities. On the other hand, policymakers may also care that domestic investors have available to them as large a pool of potential investment opportunities as possible. Turning to capital formation concerns, there may be a desire to stimulate inward investment from foreign investors, if domestic savings are insufficient to meet domestic firms' demands for finance.

However, policymakers may also cater to special interests: they may seek to channel domestic investment to domestic firms, to which cause national securities law rules may be conscripted to serve. While capital constraints of this latter type were largely abandoned in

[29] Geert Bekaert, Kenton Hoyem, Wei-Yin Hu & Enrichetta Ravina, *Who Is Internationally Diversified? Evidence from the 401(k) Plans of 296 Firms*, 124 J. FIN. ECON. 86 (2017).

[30] Rene M. Stulz, *The Limits of Financial Globalization*, 60 J. FIN. 1595 (2006).

[31] Nicole Choi, Mark Fedenia, Hilla Skiba & Tatyana Sokolyk, *Portfolio Concentration and Performance of Institutional Investors Worldwide*, 123 J. FIN. ECON. 189 (2017).

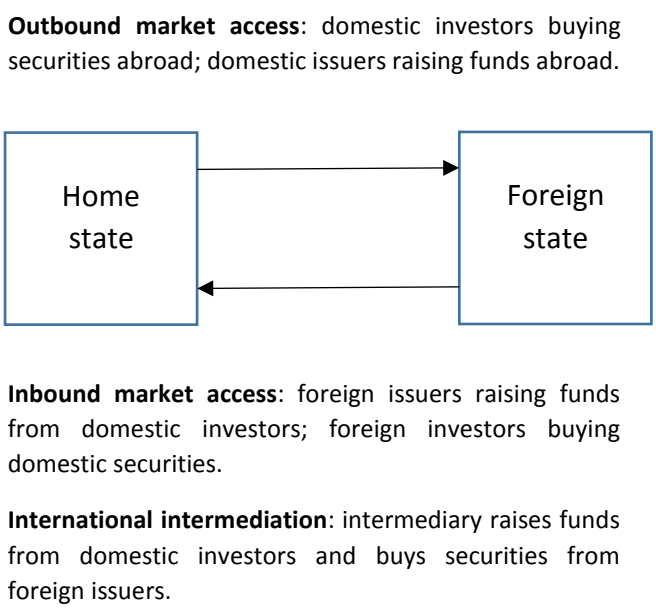
the last quarter of the twentieth century, they may yet enjoy renewed interest given the recent resurgence of economic nationalism. Similarly, policymakers may take the financial services industry's interests to heart. Although it is in society's interests to have a competitive financial sector, if attracting foreign business for the domestic securities industry becomes a goal in itself, then the main concern becomes the maximization of the finance industry's profits—and the associated tax revenues. That may well be at odds with the goal of protecting domestic investors, and even with the goal of facilitating capital formation for domestic issuers.[32] It therefore tends to be pursued most aggressively in 'finance hubs': jurisdictions for which the scale of the finance industry is large relative to the economy at large. Such financial centers compete internationally in markets for listings on stock exchanges and for liquidity services—whether on stock exchanges or other trading venues.

The trend towards institutionalization of investment enables a new sort of balance to be struck between the interests of the real economy and those of the financial sector. Investment institutionalization means investor protection can be focused on the point at which investors' funds enter collective vehicles. Investments *by* such funds are then made as sophisticated investors, who do not need the protections provided for retail investors. This implies that the quality of the legal regime under which issuers operate becomes less important, as institutions are better able to do their own due diligence and insist on appropriate protections.[33] Moreover, increasingly large pools of liquidity can be tapped through exemptions available only to sophisticated investors, giving rise to a whole range of 'private capital markets'. Facilitating the operation of such private markets provides a parallel channel through which larger countries can pursue business for their domestic securities industry, without harming domestic retail investors. Such private markets carry few regulatory compliance obligations, making them a low-cost option for foreign issuers. At the same time, if more foreign firms tap a country's private markets, there is less need for sophisticated investors from that country to make investments abroad, as opposed to through domestic private markets.

[32] A striking recent example is the UK FCA's proposal for a new subcategory of premium listings for 'sovereign controlled companies', which would involve disapplying rules requiring a shareholder vote for related party transactions as between such a company and its sovereign controlling shareholder: *see* FCA, Proposal to create a new premium listing category for sovereign controlled companies, Consultation Paper CP17/21 (2017). This seems quite transparently directed towards encouraging Saudi Aramco to list in London: *see e.g.,* Caroline Binham, Dan McCrum and Hannah Murphy, *London Reforms Set to Open Door for Saudi Aramco Listing*, FIN. TIMES, July 13, 2017.

[33] *See* Craig Doidge, G. Andrew Karolyi and René M Stulz, *The US Left Behind? Financial Globalization and the Rise of IPOs Outside the US,* 110 J. FIN. ECON. 546, 548 (2013).

**Figure 7:** Inbound and outbound capital market access




In the following Sections, we discuss regulatory choices on market access by distinguishing between *inbound* and *outbound* market access, as illustrated in Figure 7. Inbound market access is concerned with the extent to which foreign firms are permitted to raise capital from, or to provide investment services to, domestic investors. Outbound market access is concerned with the extent to which, on the one hand, domestic investors are permitted to invest in securities that are only traded abroad and, on the other, domestic issuers are permitted to raise capital abroad without triggering the application of their own domestic rules. While this twofold distinction is necessarily an over-simplification—the role of intermediaries blurs the line between the two categories—we offer it here as an organizing heuristic for expositional purposes.

### 3.1. Inbound capital-raising and local compliance

A simple position to take for inbound market access is that foreign issuers and intermediaries wishing to offer securities and investment services to domestic investors must comply with the entire body of domestic securities regulation. This *local compliance* model, better-known as 'national treatment',[34] ensures that domestic investors receive seamless protection, independent of the origin of the securities and the investment services

[34] Hal S. Scott, *International finance: Rule choices for global financial markets*, in ANDREW T. GUZMAN & ALAN O. SYKES (EDS), RESEARCH HANDBOOK IN INTERNATIONAL ECONOMIC LAW 361 (2007), 370-386. IOSCO (Sep 2015) - Task Force on Cross-Border Regulation - Final Report 6, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD507.pdf.

they are offered. With due qualifications, most countries—including the US—have traditionally taken this approach.[35]

Local compliance is costly for foreign firms: if they are also raising capital in their own jurisdiction or are subject to their own state broker-dealer rules, they must comply with two sets of regulatory requirements.[36] This cost may cause foreign firms to forego capital-raising and business opportunities in jurisdictions enforcing local compliance, reducing the range of investment opportunities for those jurisdictions' domestic investors. Where the domestic economy is large, this approach may be readily justifiable. It is reasonable to assume that the amount of domestic capital for investment, and the number of domestic investment opportunities, are both increasing functions of the overall size of the economy.[37] In this case, the marginal gain to domestic investors from permitting capital to be raised by foreign firms is only a modest increase in diversification. At the same time, a large pool of domestic capital for investment will make the potential gains to foreign firms from inbound market access relatively large. Consequently, they will be willing to incur compliance costs to do so.

In any event, where the domestic regime has high-quality rules and/or enforcement, then compliance can allow foreign firms from jurisdictions with weaker securities regimes to 'bond' themselves to high standards of behavior vis-à-vis their investors.[38] Consequently, for well-designed and enforced securities regimes, local compliance may be expected to *attract* high-quality foreign issuers for which the additional regulatory costs are more than offset by the reduction in cost of capital obtained by credibly signaling their quality to investors. This is also consistent with protecting domestic investors.

Local compliance regimes are subject to various exemptions, to which we now turn.

*Exemptions specifically for foreign firms.* Where regulators provide exemptions specifically to foreign firms, this seems hard to explain in investor-facing terms. Were the goal the broadening of investment opportunities, there would be no reason to treat foreign issuers—the monitoring of which by domestic investors is intuitively more difficult—more leniently than domestic ones. Nevertheless, many jurisdictions offer such exemptions. For example, in the US, companies qualifying as 'foreign private issuers' (FPIs) that have securities registered with the SEC are granted several exemptions from domestic securities regulation, including the proxy rules, the requirement to file quarterly reports, and

[35] *See, e.g.*, Chris Brummer, *Territoriality As a Regulatory Technique: Notes from the Financial Crisis*, 79 U. CIN. L. REV. 499, 502-3 (2010).

[36] Of course, foreign entrepreneurs may decide simply to found and grow their firms in the market where the largest pool of capital is available. For discussion of this in relation to innovative start-up firms, *see* Edward B. Rock, *Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and US Markets,* 2 THEO. ENQ. L. 711 (2001).

[37] For countries that have relatively large financial services sectors (that is, finance hubs), the trade-off is rather different. Finance hubs are likely to be more concerned to attract foreign firms as a way of generating business for their financial sectors, and less concerned about the welfare of their domestic investors.

[38] *See also infra*, Section 5.2.

Regulation Fair Disclosure.[39] In the UK, the practice until 2010 was to have a special market segment for foreign firms known as 'secondary listing', to which corporate governance and related party transaction provisions did not apply.[40]

*Exemptions for transactions with sophisticated investors.* Another important set of exemptions relate to transactions with investors sophisticated enough to fend for themselves. Such investors (that is, institutional investors and high net-worth individuals), enjoy economies of scale in purchasing investment advice and can make investments in a much more informed way. Similarly, sophisticated investors' large asset portfolios mean that access to foreign investments is significantly more valuable to them than to retail investors. Such exemptions permit a jurisdiction to attract foreign issuers consistently with investor protection at home. The rise of institutional investors makes these exemptions of growing significance in practice.

*Exemptions for particular jurisdictions*. Another way to condition waivers of local compliance obligations is by reference to the quality of foreign regulation applying to issuers or intermediaries. This approach is known as 'substituted compliance' in the US,[41] and 'equivalence' in the EU.[42] This involves domestic authorities performing an assessment of the quality of foreign regulatory environments, and granting exemptions where they are comparable to the local regime. The idea is that local investors can then be confident that the foreign regime provides equivalent, or substituted, protection. If the regimes really are equivalent, then purchasing securities or services in the foreign jurisdiction should expose local investors to no higher risks of fraud or misbehavior than if they dealt with domestic issuers and intermediaries. This approach has been applied quite widely by the EU since the financial crisis, including, for example, in relation to prospectuses for securities offers.[43] However, examples can also be found in US securities laws[44] and elsewhere.[45]

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[39] Rule 3a12-3 under the Exchange Act (proxy rules), Rule 101(b), 17 CFR 243.101 (Regulation FD).

[40] *See infra*, Section 5.3.

[41] *See eg*, Ethiopis Tafara and Robert J. Peterson, *A Blueprint for Cross-Border Access to US Investors: A New International Framework,* 48 HARV. INTL'L L.J. 31 (2007); Howell E. Jackson, *A System of Selective Substitute Compliance*, 48 HARV. INTL'L L.J. 105 (2007); Howell E. Jackson, *Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm*, 1 J. FIN. REGULATION 169 (2015).

[42] John Armour, *Brexit and Financial Services*, 33 OXFORD REV. ECON. POL'Y S54 (2017); Eilís Ferran, *The UK as a Third Country Actor in EU Financial Services Regulation*, 3 J. FIN. REG. 40 (2017).

[43] Prospectus Directive 2003/71/EC, Art. 20; Proposed Prospectus Regulation COM(2015) 583 final, Art. 27.

[44] These include the concept of a 'designated offshore securities market', a status accorded to a foreign market by the SEC based on various substantive regulatory and oversight requirements: SEC Regulation S, 17 CFR § 230.902(b).

[45] For Instance, Israeli regulations allow Israeli and foreign companies listed on NASDAQ, NYSE, and the London Stock Exchange to dual list and conduct offerings in Israel without subjecting to Israeli securities law. *See* ISA, Dual Listing (http://www.isa.gov.il/sites/ISAEng/Supervised%20Departments/Public%20Companies/Dual_Listing/Pages/default.aspx).

### 3.2. Outbound capital-raising

Issuers may tap domestic capital markets, foreign ones, or both. They may engage in domestic and/or in foreign offerings and, relatedly, may list on a domestic and/or a foreign trading venue. In doing so, they usually choose the applicable securities law as well. This introduces an element of regulatory arbitrage,[46] which the macro trends we have highlighted in Section 2 only make more salient: liquidity pools are more mobile, and ICT makes foreign listing cheaper. Nevertheless, policymakers may subject domestic firms that choose to list abroad to local compliance—even firms that do not enter the domestic primary market—whenever a given number of domestic investors come to hold those firms' securities.[47] This may act as a curb to outbound capital raising when, as was the case in the U.S. until recently, it is impossible for a firm to stay below the relevant thresholds without sacrificing key governance arrangements, such as broad-based equity compensation policies.[48]

### 3.3. Cross-border investment

Ever since capital controls were abandoned in the late twentieth century, there has been little restriction on outbound market access for capital, that is, on the ability of domestic investors to invest abroad: most jurisdictions, including the US and the EU, take the view that if investors wish to pursue opportunities abroad, then it is disproportionate to try to prevent them from doing so.[49] The traditional justification for this was that retail domestic investors were unlikely to purchase foreign securities: the search costs and generally the transaction costs were simply too high to make this a common phenomenon worthy of policymakers' attention.

The rise of institutional investment and of connectivity has profoundly changed the dynamics of offshore investing. Thanks to the size and scope of their investment business, sophisticated institutions can make offshore investments at a relatively low cost and—thanks to ICT—at a low informational disadvantage to foreign investors and traders.[50] Correspondingly, in primary markets, US institutions can invest in foreign-issued securities with no US listing by participating in private placements of securities admitted to trading on

[46] Brummer, *Stock Exchanges*, *supra* note 13, at 1449.

[47] Registration with the SEC is triggered, under section 12(g)(1) of the Securities Exchange Act, when a firm has more than $10 million in assets and its shares are held of record by either 2,000 persons or 500 persons who are not accredited investors. Note that subjecting domestic issuers to securities regulation even when they only tap foreign markets may be justified, if its rationale is to ensure efficiency through better allocation of capital and reduced intra-firm agency costs. *See* Merritt B. Fox, *Securities Disclosures in a Globalized Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498, 2582 (1997).

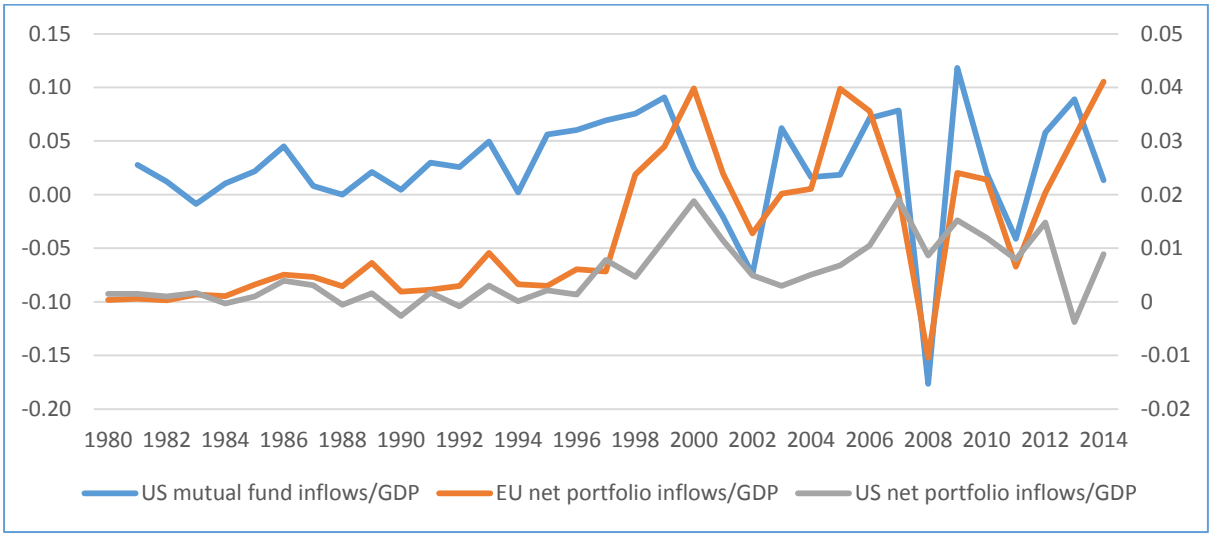
[48] In May 2016, the SEC amended its Rule 12g5-1 to exclude from the calculation of the number of holders of record (which mandates Exchange Act registration when exceeding specified thresholds) employees that hold securities received under an employee compensation plan. 17 CFR § 240.12g5-1.

[49] This is provided that securities of foreign firms and related services are not marketed to domestic investors within domestic territory, which would otherwise prompt local compliance.

[50] Brummer, *Stock Exchanges*, *supra* note 13, at 1461.

foreign trading venues: liquidity will be ensured on the foreign venues that issuers have chosen. This means that the traditional picture described in relation to inbound access for public markets—whereby a large economy such as the US can rely on the size of its domestic pool of liquidity to make it worthwhile for foreign firms to list on its exchanges and therefore to comply with local regulation—has been undermined. Foreign firms can tap US capital markets without engaging in a US public offering and without listing on a US exchange. And even in the absence of a private placement in the US, foreign firms' securities will be accessible to US institutional investors via secondary trading on any main stock exchange or trading venue.

**Figure 8**: US mutual fund inflows and net equity portfolio inflows in the US and EU, 1980-2014




**Notes**: Data are from the World Bank's Global Development Indicators (GDP and net portfolio inflows) and Global Financial Development (mutual fund holdings).

Figure 8 illustrates some interesting apparent implications of this trend. It shows (blue line) the net annual inflows of assets under management by US mutual funds, scaled for US GDP. The orange and grey lines, respectively, show annual inflows of portfolio equity in the EU and US, also scaled for GDP. What is interesting is the correlation, since the turn of the century, between the inflows to the US mutual fund sector and to EU portfolio equity.[51] This is consistent with US mutual funds having become an increasingly important source of equity investment for the EU.

### 3.4. Extraterritorial financial regulation and systemic risk

Especially since the financial crisis, the US and the EU have made certain aspects of financial regulation applicable on an extraterritorial basis. This means that the rules apply to the activity in question wherever located in the world, and not just in US or EU territories, respectively. Extraterritoriality, which goes against principles of international comity, has

[51] The correlation coefficient for US mutual fund inflows and EU portfolio equity inflows for 1981-2014 is 0.42, rising to 0.66 for 2000-2014.

been justified in these instances by the need to maintain *financial stability*. These rules apply to aspects of the activity of firms that could have a systemic impact in the US or the EU. Extraterritoriality is deployed in particular for rules governing to OTC derivatives, except where the relevant authorities satisfy themselves of the equivalence of another jurisdiction's regime.[52] However, given the focus of the New Special Study on equity markets, we do not here consider the implications of extraterritoriality in OTC derivatives markets.[53]

Core securities laws aimed at 'investor protection' and focused on equity and other securities markets have a much less direct connection with systemic risk. One consequence of this is that securities regulators did not focus as much on systemic risk before the global financial crisis as did prudential regulators. As legislators and regulators drew lessons from the crisis, however, the need to reduce systemic risk has become an important rationale for new initiatives also in securities regulation. IOSCO, for example, revised its 'Objectives and Principles of Securities Regulation' to increase the focus on systemic risk reduction.[54] Building on joint work by the FSB, IMF, and BIS,[55] IOSCO documented sources of systemic risk in securities markets, highlighted factors that securities regulators should monitor, and reviewed regulatory tools that may be useful in combating systematic risk.[56] In the US, systemic risk was a key rationale for the introduction under the Dodd-Frank Act of 2010 of new frameworks for financial market utilities (systems for transfer, clearing, and settlement), disclosure requirements on investment advisers to private funds, the orderly

[52] *See* § 722(d), Dodd Frank Act (Commodity Exchange Act provisions relating to swaps have extraterritorial reach); Articles 4, 9, 10 and 11, Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, O.J.E.U. L201/1 (2012) (known as the European Markets Infrastructure Regulation or 'EMIR') (similarly applying OTC derivatives rules to transactions involving non-EU counterparties).

[53] For discussion of such matters, *see*, e.g., Alexey Artamonov, *Cross-Border Application of OTC Derivatives Rules: Revisiting the Substituted Compliance Approach*, 1 J. FIN. REG. 206 (2015).

[54] *See* IOSCO, Press Release: Global securities regulators adopt new principles and increase focus on systemic risk (June 10, 2010), available at https://www.iosco.org/news/pdf/IOSCONEWS188.pdf. IOSCO also created a research department tasked with establishing a methodology for securities regulators to monitor and mitigate systemic risk, and now publishes annual reports assessing risks in the securities markets. *See* Werner Bijkerk, *Systemic Risk Research at IOSCO* (26 Oct. 2011), available at https://www.iosco.org/research/pdf/Introduction_to_Research_at_IOSCO.pdf.

[55] Financial Stability Board, International Monetary Fund & Bank for International Settlements, Report to G20 Finance Ministers and Governors: Guidance to assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations (October 2009), available at http://www.bis.org/publ/othp07.pdf.

[56] IOSCO, *Mitigating Systemic Risk: A Role for Securities Regulators* (Discussion Paper OR01/11, Feb. 2011), availalable at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf. IOSCO subsequently mapped the various practices employed by securities regulators to identify and assess systemic risk; *see* IOSCO, RISK IDENTIFICATION AND ASSESSMENT METHODOLOGIES FOR SECURITIES REGULATIONS (JUNE 2014).

liquidation of systemically important broker-dealers, and the Volcker rule that prohibits banks from engaging in proprietary trading.[57]

The need to mitigate systemic risk is arguably a strong rationale for extraterritorial regulation, but it has not historically been a prominent justification in the US. Until 2010, most US courts applied a conduct and an effects test to determine whether the US prohibition of securities fraud applied to transactions carried out beyond US territory.[58] While that interpretation was quashed by the Supreme Court in *Morrison*,[59] a provision was added to the Dodd-Frank Act, late in the legislative process, that attempted to revive the antifraud rule's extraterritorial reach. Section 929P(b) of the Dodd-Frank Act purports to extend US courts' jurisdiction to actions brought by the SEC or the Department of Justice for extraterritorial violations that have a connection with the US according to a conduct or an effects test, in line with the case law prior to *Morrison*, but its extraterritorial reach is subject to uncertainty and debate.[60] Further, the transactional approach in *Morrison* may be inadequate or insufficient from the perspective of preventing systemic risk – an issue to which we will return in Section 9, where we propose a research agenda.

## 4. Regulatory coordination in securities regulation

Regulatory coordination in securities regulation can take a variety of forms, ranging from relatively modest cooperation in enforcement among securities regulators to full-scale convergence in substantive rules. The grant of exemptions from local compliance conditional on foreign regimes demonstrating equivalent levels of regulation and oversight can be used as a means of encouraging such coordination, especially in the hands of larger players.

A number of steps have been made towards cross-jurisdictional cooperation in securities regulation over the past 40 years, often at the initiative of the U.S. S.E.C.

[57] For an overview of the SEC's work on systemic risk reduction and its role under the Dodd-Frank Act, *see* Mary Jo White, Testimony on 'Mitigating Systemic Risk in the Financial Markets through Wall Street Reforms' before the United States Senate Committee on Banking, Housing, and Urban Affairs (July 30, 2013), available at https://www.sec.gov/news/testimony/2013-ts073013mjw#_ftn6.

[58] *See Morrison et al. v National Australia Bank Ltd. et al*., 561 U.S. 247, 255-61 (2010), for references to prior case law.

[59] *Id.*

[60] This uncertainty relates to the new provision's potential failure to address the actual issue in the *Morrison* holding. In *Morrison*, the Supreme Court declined to apply the 1934 Act extraterritorially because of a lack of Congressional intent for extraterritorial application – a merits issue, while § 929P, read literally, grants subject-matter jurisdiction, which *Morrison* had explicitly recognized (*ibid* at 253-4). Consequently, it has been suggested that § 929P might be '"stillborn" in that it conferred jurisdiction that could not be used for anything substantive—in cases without a U.S. securities transaction—until a further statute were enacted.': Richard W. Painter, *The Dodd-Frank Extraterritorial Jurisdiction Provision: Was it Effective, Needed or Sufficient?*, 1 HARV. BUS. L. REV. 195, 208 (2011). *See also* Edward Greene & Arpan Patel, *Consequences of* Morrison v NAB*, securities litigation and beyond*, 11 CAPITAL MARKETS L.J. 145 (2016). *But see* SEC v. Traffic Monsoon, LLC, No. 2:16-cv-00832-JNP, 2017 WL 1166333 (D. Utah Mar. 28, 2017) (interpreting § 929P to provide congressional intent for extraterritorial application).

Nevertheless, such cooperation has delivered fewer meaningful achievements in the field of securities regulation than in other segments of financial regulation. The simple explanation is that the inter-jurisdictional externalities that may derive from securities regulation, at least as far as equity markets are concerned, are far less dramatic than those stemming from failures in prudential regulation. States' incentives to compromise and to adapt to other regulatory frameworks in multilateral negotiations are correspondingly weaker.

Historically, what prompted international cooperation in securities regulation was the need for assistance from foreign regulators in enforcement: the detection and investigation of securities fraud—more specifically, insider trading—on U.S. markets.[61] The realization that there would be no way to find out who lay behind trades originating from anonymous Swiss bank accounts unless Swiss authorities agreed to cooperate led the U.S. S.E.C. to push for such agreements. That, in turn, required at least a minimum degree of convergence in substantive rules: without it, and specifically, without the global adoption of insider trading prohibitions, cooperation in enforcement would have been much harder to achieve.

In fact, the criminalization of insider trading is perhaps the most visible attainment in the quest for regulatory convergence that started in the 1980s.[62] Of course, the nitty-gritty details of securities laws still diverge widely, as reflected by the general vagueness of multilateral codes of conduct and best practices such as IOSCO's,[63] not to mention the gap in enforcement intensity between the U.S. and virtually all other jurisdictions.[64] Even so, most jurisdictions now have laws on their books that reflect the core pillars of U.S. securities regulation: a ban on insider trading and securities fraud, mandatory disclosures in the case of public offerings and, on an ongoing basis, for corporations with publicly traded securities, and rules on broker-dealers and mutual funds.[65]

A number of factors have contributed to this convergence. First, many jurisdictions—in Europe and elsewhere—saw this as a route to boost their equity markets and attract investment from abroad. In other words, regulatory emulation was at play.[66] Second, the World Bank and the IMF prompted East Asian countries to overhaul their financial

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[61] *See, e.g.,* James D. Cox, *Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old S.E.C.*, 95 VA. L. REV. 941, 984 (2009).

[62] *See, e.g.,* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002).

[63] Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 INDIANA L.J. 1405, 1451 (2013).

[64] Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207 (2009); John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PENN. L. REV. 229 (2007).

[65] *See generally*, Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144 (2005); Rafael La Porta, Florencio Lopes-de-Silanes and Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006).

[66] *See e.g.* Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, U. PA. J. INT'L ECON. L. 1, 22 (2006) (discussing Europe).

regulations and corporate laws following the 1997 crisis,[67] and more generally insisted on the adoption of core common principles in their regular consultations with member states.[68] Finally, the U.S. S.E.C. used international fora, such as IOSCO, to press for convergence.[69]

In fact, one important impetus for such convergence has been the work of international financial institutions and standard setters. An additional driver of convergence has been reciprocal arrangements over market access. The most ambitious experiment to date is the multilateral 'passporting' facilitated within the EU, but reciprocal arrangements also exist outside the EU. In the subsections that follow, we consider international institutions and reciprocal arrangements, including within the EU, and then reflect on the prospects for further international coordination.

### 4.1. International institutions and convergence

The international institutions active in financial regulation may be characterized as 'agenda setters', 'standard setters', and financial institutions.[70] International agenda setters are intergovernmental organizations that facilitate high-level policy coordination amongst their members. International standard setters are inter-agency organizations that share information and coordinate standards between domestic regulators. International financial institutions, established under international treaties to provide direct investment in public finance projects, in some cases also encourage compliance with international financial standards:

*(a) Agenda-setting institutions*

*The FSB.* In the period since the financial crisis, the most influential agenda-setter for financial regulation at the international level has been the G20 group, a forum for finance ministers and central bankers of the world's 20 largest economies, and its offshoot, the Financial Stability Board (FSB). The FSB (formerly the Financial Stability Forum) was established in 2009 and charged with responsibility for coordinating the design and implementation of the G20's post-crisis policy agenda for ensuring financial stability.[71] The

[67] *See, e.g.,* Verdier, *supra* note 63, at 1419.

[68] *See infra*, Section 4.3.

[69] *See, e.g.*, Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 329-30 (2010). In going beyond what might have been sufficient to ensure cooperation in the enforcement of its own securities laws, the S.E.C. appears to have been motivated by a number of rationales. First, it sought to protect the interests of U.S. domestic investors making investments abroad: *id.* at 334. A second reason is that regulatory convergence lowers domestic firms' costs of providing intermediary services or raising capital abroad—reducing risks of conflicting duties and lowering the costs of setting up shop abroad. Third, international approximation to the U.S. securities law paradigm enhanced the prestige of the S.E.C. and its officers (Brummer, *supra*, at 335). And fourth, in an environment where the U.S. financial sector competes internationally to attract issuers, having foreign securities laws approximate to those of the US reduces the possibilities for other jurisdictions to pursue a 'race to the bottom' to attract (lower-quality) issuers.

[70] Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257 (2011).

[71] The FSB's mandate includes: (1) assessing vulnerabilities affecting the global financial system and reviewing the regulatory, supervisory, and other actions needed to address them; (2) promoting coordination and information exchange among authorities responsible for financial stability; (3) monitoring and advising on

FSB has no formal enforcement powers,[72] but FSB member states must submit themselves to periodic peer reviews.[73] As financial stability is not generally a core concern for securities regulation, the FSB has made relatively few statements relevant to the current enquiry.[74]

*The US-EU Joint Financial Regulatory Forum.* The US and EU have also since 2002 maintained a bilateral regulatory dialogue on financial regulation. Initially known as the Financial Markets Regulatory Dialogue, this has recently been re-branded as the 'US-EU Joint Financial Regulatory Forum' as part of an effort to 'enhance the dialogue'.[75] The Forum is intended to meet twice per year, with a view to identifying and solving potential issues at an early stage.[76] A particular goal is to expedite the completion of equivalence or substituted compliance assessments.[77]

*(b) Standard-setting for securities*

The most influential international standard-setting body for securities is the International Organization of Securities Commissions (IOSCO). Also important, however, are the International Accounting Standards Board (IASB) and the Committee on Payment and Settlement Systems (CPSS).

*IOSCO.* Established in 1983, IOSCO is the premier global venue for cross-country interaction among securities regulators. Its objectives are (i) to promote *cooperation* among its members in the development and implementation of regulation, supervision and enforcement; (ii) to enhance *investor protection* and promote investor confidence in the

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market developments and their implications for regulatory policy; (4) coordinating the policy development work of international standard setters, and (5) promoting member states implementation of agreed upon commitments, standards, and policy recommendations through monitoring, peer review, and disclosure. The FSB is also responsible for coordinating cross-border contingency planning in connection with the failure of systemically important financial institutions.

[72] Simultaneously, however, the eligibility of members must be reviewed periodically by the plenary board in light of the FSB's objectives; FSB Charter, Art. 5. Theoretically, this could lead to the discharge of members which consistently fail to implement FSB policy initiatives.

[73] FSB, *Framework for Strengthening Adherence to International Standards*, www.financialstabilityboard.org/publications/r_100109a.pdf; FSB, *Handbook for Peer Reviews,* www.financialstabilityboard.org/publications/r_120201.pdf.

[74] These include statements on OTC derivatives and beneficial ownership transparency.

[75] *See* US Treasury press release: https://www.treasury.gov/press-center/press-releases/Pages/jl0528.aspx.

[76] *See* EU press release, 'Upgrading EU financial regulatory cooperation with the United States' at http://ec.europa.eu/newsroom/fisma/itemlongdetail.cfm?item_id=33100. Participants include representatives of, on the EU side, the Commission, the European Supervisory Authorities ('ESAs') and the Single Resolution Board and Single Supervisory Mechanism; and on the US side, the Treasury, the CFTC, the SEC, the PCAOB, the Federal Reserve.

[77] US Treasury Press release, *supra* note 75.

integrity of securities markets; and (iii) to *exchange information* about members' experiences. IOSCO has 214 members, of which 126 are ordinary members.[78]

In order to join IOSCO, a securities regulator must sign the Multilateral Memorandum of Understanding concerning consultation and cooperation and the exchange of information (MMoU).[79] This is a framework for mutual assistance and exchange of information.[80] The SEC, the CFTC and the UK's FCA are among the current 109 MMoU signatories.[81] The volume of information requests among international regulators under the MMoU has grown from 56 requests in 2003 to 3,203 requests in 2015.[82]

IOSCO conducts policy work through eight subject-matter committees.[83] It also sets up task forces and working groups; some of these cooperate with other international standard setters such as the CPMI or the BCBS.[84] IOSCO issues standards and recommendations which are not legally binding on its members but still influential. IOSCO has established *Objectives and Principles of Securities Regulation*, which have been endorsed by the G20 and the FSB. They form the basis for the evaluation of the securities sector for the Financial Sector Assessment Programs (FSAPs) of the IMF and the World Bank.

IOSCO's work stream has traditionally been heavily influenced by the US,[85] with the SEC having initiated early IOSCO work towards cross-border cooperation between securities regulators.[86] Moreover, a number of IOSCO's standards owe their format to US norms.[87]

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[78] *See* 'Ordinary Members of IOSCO' at https://www.iosco.org/about/?subsection=membership&memid=1. Associate members include the European Commission, ESMA, and the IMF: *See* 'Associate Members of IOSCO' at https://www.iosco.org/about/?subsection=membership&memid=2.

[79] *See* 'Becoming a Member', at https://www.iosco.org/about/?subsection=becoming_a_member. For the MmoU, *see* IOSCO, Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2012), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD386.pdf.

[80] *Id*, Clause 7.

[81] IOSCO, 'Signatories to Appendix A and Appendix B List', at https://www.iosco.org/about/?subSection=mmou&subSection1=signatories. Not all IOSCO members have yet signed the MMoU, and IOSCO are working on getting the remainder signed up. IOSCO maintains a public list of the members that have not signed up, which currently includes 19 countries such as Algeria, Bolivia, Chile and the Philippines, and is available at https://www.iosco.org/about/?subSection=mmou&subSection1=2013_list.

[82] *See* https://www.iosco.org/about/?subsection=mmou.

[83] These cover, respectively: (1) issuer accounting, audit, and disclosure; (2) regulation of secondary markets; (3) regulation of market intermediaries; (4) enforcement and information exchange; (5) investment management; (6) credit rating agencies; (7) commodities futures markets, and (8) retail investors.

[84] Stavros Gadinis, *Three Pathways to Global Standards: Private, Regulator, and Ministry Networks*, 109 AMER. J. INT'L. L. 1 (2015), 25-28.

[85] *See* eg CALLY JORDAN, INTERNATIONAL CAPITAL MARKETS (2014), 32-36.

[86] Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in International Securities Regulation*, 34 BROOK. J. INT'L L. 883, 913 et seq. (2009).

[87] For example, its International Disclosure Standards, which were rolled into the EU Prospectus Directive, were based on US standards: JORDAN, *supra* note 85, 36.

However, when the US was evaluated by the IMF in 2015, and the report recommended a detailed plan of actions as regards IOSCO's *Objectives and Principles*,[88] the US authorities responded that they 'disagreed with certain of the conclusions, recommendations, ratings, and interpretations of the IOSCO principles.'[89] While IOSCO has established a 'Strategic Direction to 2020', which includes reinforcing IOSCO's position as the key global reference point for markets regulation,[90] some commentators suggest it has become subservient to the work of the FSB.[91]

*IASB.* Established in 2001, the IASB is the independent standard setting body of the International Financial Reporting Standards (IFRS) Foundation.[92] Uniquely amongst international financial standard setters, IASB members are not representatives of the governments or regulatory authorities of the states which adopt its standards.[93] Rather, the IASB is composed of 16 independent experts specifically drawn from around the world,[94] and funded by private contributions.[95] Monitoring of compliance with IFRS is the responsibility of its Interpretations Committee.[96] The primary monitoring objective is to identify divergences in national accounting practices with a view to determining whether it is necessary to issue an official Interpretation of IFRS in relation to the point in question.

To ensure accountability, the IASB members are selected by the IFRS Foundation Trustees, whose own appointments are subject to approval from a Monitoring Board of representatives of the European Commission, IOSCO, Japan's Financial Services Agency, the

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[88] INTERNATIONAL MONETARY FUND, DETAILED ASSESSMENT OF IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION – UNITED STATES (April 2015) 31-33.

[89] *Id*., at 34.

[90] *See generally,* Janet Austin, *The Power and Influence of IOSCO in Formulating and Enforcing Securities Regulations*, 15 ASPER REV. INT'L BUS. & TRADE L. 1 (2015).

[91] Roberta Karmel, *IOSCO's Response to the Global Financial Crisis*, 37 J. CORP. L. 849, 901 (2012) (IOSCO has become 'to some extent subservient to the G-20' and is not among the most important international financial regulators).

[92] The objectives of the IFRS Foundation are to: (1) develop a single set of high quality, understandable, enforceable, and globally accepted international financial reporting standards (IFRS); (2) promote the use and rigorous application of those standards; (3) to take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs), and (4) promote and facilitate the adoption of IFRS through the convergence of national accounting standards and IFRS: IFRS Constitution, s. 2.

[93] Karmel & Kelly, *supra* note 86, 901-3; Tim Buthe and Walter Mattli, *The New Global Rulers: The Privatization of Regulation in the Global Economy* (Princeton University Press, Princeton, 2011); Gadinis, *supra* note 84, 21-25.

[94] They are drawn from the following regions: Asia Oceania (4 members), Europe (4 members), North America (4 members), Africa (1 member), and South America (1 member): IFRS Constitution, s. 26. The remaining two members can be appointed from any area, subject to maintaining an overall geographical balance.

[95] The big four accounting firms are the largest donors ($2.5m each in 2015). *See* http://www.ifrs.org/About-us/Documents/2015-financial-supporters.pdf.

[96] The Interpretations Committee is composed of 14 members appointed by the Trustees for renewable 3-year terms: IFRS Constitution, s. 39.

US SEC, and the BCBS.[97] Despite its formal independence, the relationship between the IASB and politics is contested. On the one hand, the EU has sought to exert greater influence over its standard-setting since the financial crisis;[98] on the other hand, concerns have been raised that the process is open to influence by the agendas of business and accounting firms.[99]

The question whether IFRS and US GAAP would merge into one global accounting standard appears to have decreased in salience as they converged. The two accounting standards are broadly similar in philosophy, and reconciliation is no longer needed for US listings. This appears to have reduced frictions enough so that the issue no longer is a significant bottleneck for international transactions.

*CPSS.* The CPSS, which operates under the aegis of the Bank for International Settlements (BIS), is an international standard-setting body for payment, clearing, and securities settlement systems. It undertakes studies and spearheads policy initiatives at the request of the BIS, or at its own discretion. It also serves as a forum for central banks to monitor and analyze developments in domestic payment, clearing, and settlement systems as well as in cross-border and multicurrency settlement systems. Its most significant recent policy initiative has been the joint CPSS-IOSCO *Principles for Financial Market Infrastructure*. The CPSS has no formal enforcement powers. However, the *Principles* will form the basis of future IMF/World Bank FSAP assessments.[100]

*(c) Financial institutions: the IMF and World Bank*

International financial institutions include global organizations such as the International Monetary Fund (IMF) and World Bank, along with various regional development banks.[101] While the IMF does not play a direct role in the design of international financial standards, it does play a frontline role in conducting surveillance of member states' compliance with these standards, both individually and jointly with the World Bank under the auspices of the Financial Sector Assistance Program (FSAP).

The World Bank and the IMF prompted East Asian countries to overhaul their financial regulations and corporate laws following the 1997 crisis,[102] and have more generally insisted on the adoption of core common principles in their regular consultations with member states. The World Bank has also, since then, sponsored an influential

[97] IFRS Constitution, s. 21.

[98] Elias Bengtsson, *Repoliticalization of Accounting Standard Setting*, 22 CRIT. PERSP. ON ACCOUNTING 567 (2011).

[99] KARTHIK RAMANNA, POLITICAL STANDARDS: CORPORATE INTEREST, IDEOLOGY, AND LEADERSHIP IN THE SHAPING OF ACCOUNTING RULES FOR THE MARKET ECONOMY (2015).

[100] *See* CPSS, 'CPSS: Standard Setting Activities', available at www.bis.org/cpss/cpssinfo02.htm.

[101] These include the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB) and the more recently-established New Development Bank (NDB, formerly the BRICS Bank) and Asian Infrastructure Investment Bank (AIIB).

[102] *See e.g.,* Thomas Carothers, *The Rule of Law Revival*, 77 FOREIGN AFF. 95 (1998); Peter Boone, Alasdair Breach and Eric Friedman, *Corporate Governance in the Asian Financial Crisis,* 58 J. FIN. ECON. 141 (2000).

comparative ranking of the quality of the legal environment—the *Doing Business* survey—the results of which have (controversially) been associated with outcomes in securities markets.[103]

### 4.2. The European Union: Harmonization and passporting

The European Union is perhaps the most ambitious voluntarily-adopted international legal order in global history. Its legislative process is deliberately designed to give precedence to a strong technocratic civil service, in the form of the European Commission. This is intended to foster the pursuit of common aims and de-emphasize the potential for domestic politics.

The EU is also an outlier when it comes to the use of reciprocal market access within its borders, having in place a broad-scope scheme of mutual recognition for issuers and intermediaries: with due qualifications, they need only comply with regulation in their home country to offer their securities or services to investors throughout the EU. The driver for the project has been as much market forces as politics: financial services exporter countries such as the UK, Ireland and Luxembourg leveraged a strong political push toward the creation of a single market to obtain mutual recognition in many areas of financial regulation.[104] This freedom to approach investors throughout the EU is known as 'passporting' the firm's compliance with their local regulations.[105] In the EU, a precondition for agreement on passporting was the requirement for jurisdictions to align their regulations, a process known as 'harmonization'. But passporting still requires mutual trust in the quality of local supervision and enforcement. Mutual trust also has to extend to local regulation, insofar as harmonization is incomplete—as it still is in many areas—or where negative synergies exist with other components of a given legal system.

Harmonization in the EU was traditionally achieved through the means of a type of legislation known as a 'Directive', which specifies to states the general goals to be achieved but leaves the precise format to be implemented in national law in accordance with the local regime. This permits some degree of cross-sectional variation, which is problematic in areas where mutual trust is crucial. Moreover, legislators lack the time and expertise to produce rules of sufficient detail, and to update them with sufficient speed, to provide a workable regime. Consequently the EU financial markets regime has seen the evolution of a specialist delegated legislation mechanism, whereby 'implementing' measures produced by specialist committees buttress general securities legislation.[106] Since the financial crisis, the alignment has been tightened even further by the establishment of the European Securities

[103] *See* La Porta et al, *supra* note 65. For critical responses, *see* KENNETH W. DAM, THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT (2007); John Armour, Simon Deakin, Priya Lele and Mathias Siems, *How Do Legal Rules Evolve? Evidence from a Crosscountry Comparison of Shareholder, Creditor, and Worker Protection*, 57 AM. J. COMP. L. 579 (2009), 582-92; Holger Spamann, *The 'Antidirector Rights Index' Revisited*, 23 REV. FIN. STUD. 467 (2010).

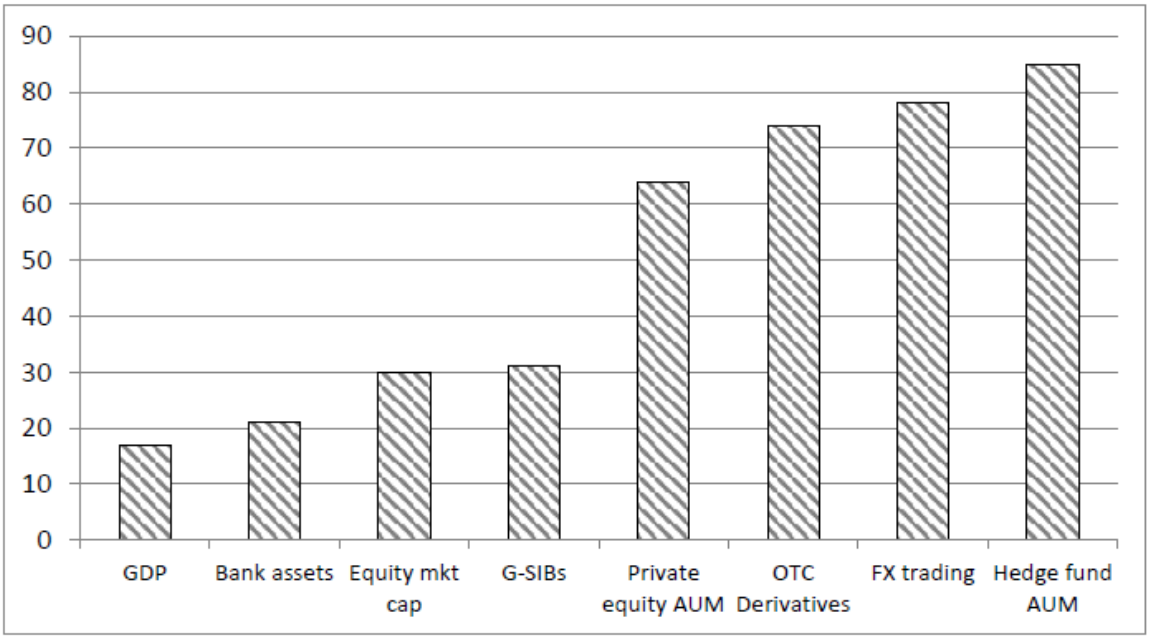
[104] *See* John Armour & Wolf-Georg Ringe, *European Company Law 1999-2000: Renaissance and Crisis*, 48 COMMON MKT. L. REV. 125, 154-7 (2011).

[105] *See generally* NIAMH MOLONEY, EU SECURITIES AND FINANCIAL MARKETS REGULATION (3d ed. 2014).

[106] *See* EILÍS FERRAN, BUILDING AN EU SECURITIES MARKET (2004); MOLONEY, *supra* note 105.

Market Authority (ESMA), to which jurisdiction to make the most detailed implementing measures – the so-called 'single rule book'—has been transferred from national securities regulators.[107] However, with few exceptions,[108] enforcement is still generally a matter of national competence. Given the differences in resources allocated to national securities authorities,[109] this likely leaves considerable variation in the extent to which the rules affect firms' behavior.[110]

**Figure 9:** Percentage of EU-wide activity taking place in the UK, by sector (2015).




**Notes**: GDP and equity market data are from World Bank. Bank asset data are from ECB and PRA. G-SIB data are from FSB. Data on private equity assets under management, OTC derivatives transactions, FX trading and hedge fund assets under management from TheCityUK. Source: John Armour, *Brexit and Financial Services*, 33 OXFORD REV. ECON. POL'Y S54, S55 (2017).

The persistent role of national regulators in the enforcement of securities laws can be more easily understood in the light of the very UK-centric nature of EU capital markets. Figure 9 shows the proportion of various types of EU economic and financial activity based in the UK. As can be seen, the UK's GDP accounts for 17 per cent of the EU's aggregate GDP. This is closely tracked by the fraction of EU bank assets held by UK banks (21 per cent). However, the UK's share of total EU activity grows as we move to the right of Figure 9, encompassing 30 per cent of equity market capitalization, and very high proportions of

[107] *See* High-Level Group on Financial Supervision in the EU, *Report of the High-Level Group on Financial Supervision in the EU* (the 'de Larosière Report') (2009).

[108] ESMA has direct supervisory powers in respect of CRAs and Trade Repositories: *see generally* MOLONEY, *supra* note 106, 973-1009.

[109] *See infra,* Section 8.

[110] *See* Luca Enriques & Matteo Gatti, *Is There a Uniform European Securities Law After the Financial Services Action Plan?*, 14 STANFORD JOURNAL OF LAW, BUSINESS & FINANCE 43 (2008).

wholesale market activities such as OTC derivatives and hedge fund assets under management. The UK's outsize representation in financial markets meant that, in effect, the rest of Europe could rely on the City of London for the supply of financial services (especially wholesale ones) to the entire area. Given London's success as the regional financial hub and the political clout that the British government derived from it, the centralization of securities law enforcement within an EU-level supervisory authority on the lines of the US SEC has until very recently been a political non-starter. With the UK imminently departing from the EU, this division of labor is likely to be revisited very rapidly, and a centralized supervisory framework may well be the outcome.[111]

### 4.3.Reciprocal market access more generally

Reciprocal market access can in principle be used as a lever towards convergence more generally.[112] Where a foreign regulatory regime is of similar quality to the domestic one, such agreement will be relatively easy to achieve: potential losses to domestic investors, and costs to domestic firms, are relatively modest. This is consistent with the pattern observed in the EU, discussed in Section 4.2.

However, performing an assessment of the functional equivalence of securities laws is extremely complex, requiring the local authority to evaluate not only the applicable foreign rules, but also the quality of the relevant supervisory agencies and the intensity of enforcement. Each of these features is hard to observe. Consequently, such assessments are a potential minefield: they are both politically sensitive and prone to errors. For these reasons, the US has generally fought shy of such assessments.

*The US: Substituted compliance*. In the US, reciprocal access arrangements are known as 'substituted compliance'. Although the idea showed great promise in the pre-crisis era, the SEC only managed to implement a couple of instances before post-crisis political realities put paid to further moves.[113] Although the US reached a mutual recognition agreement with Australia in 2008, which provides a framework for stock exchanges and broker-dealers to operate in both countries,[114] it has not resulted in the granting of any actual exemptive relief.[115] This means that the only current mutual recognition arrangement

[111] *See* André Sapir, Dirk Schoenmaker & Nicolas Véron, Making the Best of Brexit for the EU-27 Financial System, Peterson Institute for International Economics Policy Brief 17-8 (2017).

[112] *See, e.g.,* European Commission, *EU Equivalence Decisions in Financial Services Policy: An Assessment*, SWD(2017) 102 final, 4 ('A possible equivalence finding by the EU is one of the major incentives for third-country regulators to enhance supervisory co-operation and to seek closer regulatory convergence with the EU.')

[113] Tafara & Peterson, *supra* note 41, at 53, 56.

[114] SEC Press Release, 'SEC, Australian Authorities sign Mutual Recognition Agreement' (Aug. 25, 2008). A schedule for the completion of a process agreement with Canada aimed at a similar mutual recognition agreement was also announced (*see* SEC Press Release, 'Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement' (May 29, 2008)), but was never followed by the actual agreement.

[115] Howell E. Jackson, *Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm*, 1 J. FIN. REGULATION 169, 180 (2015).

of practical importance is the SEC's Multijurisdictional Disclosure System (MJDS) with Canada, which allows Canadian issuers that meet certain eligibility criteria to conduct securities offerings in the US based on their compliance with Canadian law and without SEC review.[116]

*The EU: Third country equivalence*. Central to the EU's emerging approach to market access arrangements with third countries are 'equivalence' determinations. These are legislatively-sanctioned assessments of third country regulations and regulators, delivered by the European Commission, acting on guidance from ESMA. While many of the equivalence frameworks in place are—at least facially—unilateral in their operation, there is an increasing trend toward making their application depend expressly on reciprocity. This includes most significantly the MiFIR/MiFID II regime, whereby the potential for a determination regarding regulatory equivalence is conditioned expressly on the need for reciprocity of treatment.[117] This shifts the determination of 'equivalence' away from what is facially an enquiry as to the relative quality of the foreign regulatory regime in favor of the sort of horse-trading negotiations that might encompass a bilateral reciprocal access arrangement.

### 4.4.Prospects for future international cooperation

We conclude this Section with some conjectures as to the likely future trajectory of international regulatory coordination. While there are obvious political contingencies,[118] our focus here is on the implications of the secular trends in global equity markets we have highlighted.

First, technological advances push down the cost of direct investment abroad by U.S. retail investors. While this might be expected to stimulate demand for better local rules aimed at investor protection in foreign jurisdictions, the massive parallel shift away from individuals' direct investment in securities to their delegation to specialized institutions makes the need for convergence in investor protection regulation—such as conduct of business rules for broker-dealers—less salient.

Second, the international dominance of U.S. investment banks reduces incentives for U.S. regulators to encourage regulatory coordination as a means of facilitating export of investment services. U.S. firms have already conquered the main global markets and are

[116] The agreement is mutual and could also be used by US companies to raise capital in Canada, but its main use has been for Canadian capital raisings in the US. *See, e.g.,* CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM (2015) 55.

[117] Markets in Financial Instruments Regulation (EU) No 600/2014, Art. 47(1).

[118] Not only the resurgence of US isolationist tendencies, but also the displacement of democratic governments by semi-dictatorial regimes in various countries. Such regimes raise the risk that governmental power, including those related to securities regulation, may be used against citizens and organizations who happen to fall out with the ruling majority. This may erode the trust that underlies cooperation among securities regulators: they may rightly be reluctant to share information with another country's supervisor, if they can fear that information thereby exchanged may be used to quash political opponents.

now powerful incumbents wherever they are present. Regulatory idiosyncrasies in those markets raise new entrants' costs and therefore actually favor the U.S. incumbents.

Third, stronger competition in the markets for listings and liquidity services may increase the demand for special, more lenient rules for foreign private issuers, but is unlikely also to lead to any push for international coordination, because the U.S. markets no longer enjoy a dominant position globally, making it more difficult for U.S. regulators to impose their solutions on other jurisdictions.[119]

Fourth, institutionalization and the global reach of the major asset manager companies—with the ability to invest and purchase broker-dealer services in every relevant market—make agreements aimed at lifting domestic compliance burdens for foreign issuers and broker-dealers—such as the MJDS or the mutual recognition agreement between the US and Australia—obsolete.

Nevertheless, the institutionalization of savings and the increased tendency of U.S. institutional investors to invest abroad may still generate pressure for the U.S. government to seek improvements in foreign securities and corporate governance regulations. Giant U.S. institutional investors may feel that the political risks of lobbying local policymakers directly for enhanced investor protection are too high. They may prefer to lobby the U.S. government, via the S.E.C., to seek better investor protection rules in the usual fora, such as IOSCO.

To conclude, the combination of (1) technological progress, (2) global dominance of U.S. players in the investment banking sector, (3) a more decentralized market for listings and liquidity services, and (4) institutionalization seems to imply a reduced impetus for international coordination in securities regulation. The first three factors greatly reduce the incentives for the U.S. to take a leadership role in regulatory coordination, and the fourth reduces demand for substitute compliance or equivalence regimes for broker-dealers. That said, a U.S. Government push towards better issuer-facing securities laws around the world may still be prompted by pressures from institutional investors holding ever more internationally-diversified equity portfolios.

[119] Brummer, *Post-American*, *supra* note 69; Stavros Gadinis, *The Politics of Competition in International Financial Regulation*, 49 HARV. INT'L L.J. 447 (2008).

## Part II

## Regulation of cross-border securities transactions

In Part II, we consider aspects of securities market regulation that are of particular relevance to cross-border equity investment. The discussion has a comparative orientation, contrasting regulatory strategies in major non-US jurisdictions—especially the EU—with those in the US, which are more fully described in the other chapters of the *New Special Study.* Such a comparative approach is valuable for at least two reasons. First, for descriptive analysis, it enables a better understanding of actual market practices in cross-border transactions, which are a function of triangulation between various relevant regulatory regimes. Second, from a normative perspective, it may provide insights as to the relative functionality of different regulatory choices.

Part II begins in Section 5 with cross-border capital raising (primary markets). Next, in Section 6, we turn to cross-border trading (secondary markets), while Section 7 focuses on the regulation of cross-border investment intermediation. Finally, Section 8 discusses supervision and enforcement.

### 5. Primary markets and cross-listings

As regards *primary markets*, we consider first inbound market access to the US and the EU (and in particular the UK)—that is, domestic rules governing how foreign issuers may raise capital from local investors. After establishing these 'rules of the game' and potential frictions with cross-border capital raising, we discuss the state of the international 'market for IPOs', including case studies of competition between the UK's Alternative Investment Market ('AIM') and US private placements, the London Stock Exchange's experiments with different listing segments catering to foreign firms of differing quality, and Asian primary markets.

### 5.1. Capital raising and market access

#### *(a) Foreign firms raising capital in the US*

Foreign issuers seeking to raise funds from US investors may (a) pursue a US public offer, necessitating full local compliance with US securities laws, (b) make a US private offering, relying on one or more exemptions from US securities laws, or (c) raise capital from US investors offshore.[120] In addition, Canadian issuers may rely on their domestic offering materials based on the substituted compliance approach of the MJDS.[121]

[120] Offshore transactions could be categorised as 'outbound' access, but we discuss Regulation S offerings by foreign issuers under this heading, since they can approach US investors for an offshore transaction.

[121] *See* text accompanying note 116.

Capital-raising in the form of a public offering would involve registration with the SEC and periodic reporting requirements.[122] However, there are several relevant exemptions that may be used to avoid making a public offering in the US.[123] The most important of these are (i) Regulation D; (ii) Rule 144A; and (iii) Regulation S. At the beginning of the twenty-first century, foreign firms raised approximately two-thirds of their US equity through private offerings, a figure which has since risen steadily to 95 per cent in 2015.[124]

*Regulation D* provides the most important set of exemptions through which private offers to sophisticated investors are made in the US.[125] Over the period 2009-2014, an average of $660 billion per annum in fresh equity was issued using Regulation D offers, nearly three times as much as was raised each year using public (registered) equity offers.[126] Of this, approximately twenty per cent was raised by foreign issuers.[127] Regulation D offers tend to be very small in comparison to offers via public markets, with the mean capital-raising being only $28 million.[128]

*Rule 144A* is a sophisticated investor exemption for private placements that allows both domestic and foreign issuers to avoid various restrictions that apply to other types of exempt offerings. Rule 144A is technically a resale rule, under which purchasers must be 'qualified institutional buyers' (QIBs),[129] but private offerings are made to an 'initial purchaser' who may resell the securities to other QIBs. To fall within Rule 144A, the securities offered must not be fungible with securities listed on a US exchange.[130] Once issued, Rule 144A securities can be traded among QIBs, but are otherwise 'restricted',

[122] Securities Act, § 5, Exchange Act § 15(d) requires ongoing reporting following a registered offering under the Securities Act.

[123] Notably, the exemptions introduced in Regulation A+ in 2015 are not available to non-Canadian FPIs (since the SEC preferred to first evaluate the impact of the regulation on a smaller set of issuers). *See* SEC, Final rule: Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed Regulation 21806 (Apr. 20, 2015).

[124] Committee on Capital Markets Regulation, Press Release: Continuing Competitive Weakness in U.S. Public Capital Markets (Oct. 28, 2016) (presenting data for initial offerings of foreign equity in the U.S.). We note that while FINRA now collects and disseminates data on Rule 144A debt transactions, there is no official source for data regarding the Rule 144A equity market.

[125] Securities Act of 1933, §§ 3(b) and 4(a)(2); SEC Regulation D, Rules 504-506.

[126] Scott Bauguess, Rachite Gullapalli & Vladimir Ivanov, *Capital Raising in the US: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014*, SEC Division of Economic and Risk Analysis Working Paper (2015), 7-11.

[127] *Id.*, at 18-19.

[128] *Id.*, at 9.

[129] QIBs are typically institutions with a securities investment portfolio above $100 million. *See* Rule 144A(a)(1).

[130] The securities must, further, not be 'quoted on a U.S. automated inter-dealer quotation system', but there are currently no systems designated as such. Greene et al., supra note [ref], at 5-21. This appears to mean that securities issued under Rule 144A may be fungible with securities traded off-exchange.

meaning they cannot be resold for at least six months.[131] Unlike Regulation D offerings, however, almost all (over 99%) Rule 144A transactions involve debt securities.[132]

*Regulation S* provides a safe harbor from registration for offshore offerings, where the *sale* occurs outside the US, without any prior directed selling efforts in the US.[133] Regulation S also contains a safe harbor for resales, which for foreign issuers is available for offshore transactions without directed selling efforts in the US.[134] However, securities issued under Regulation S may be resold to US QIBs under Rule 144A.[135] The annual amount of capital (both debt and equity) raised by using Regulation S over the period 2009-2014 was approximately $140 billion,[136] slightly less than the total of $200 billion per year raised by foreign issuers using Regulation D over the same period.[137]

*(b) Non-EU firms raising capital in the EU*

Foreign firms wishing to raise capital through a public offer in the EU face a similar regulatory starting point to that in the US. They must in principle comply with the local rules applicable to primary offers, set out in the Prospectus Directive,[138] and—once listed—with continuing disclosure obligations set out in the Transparency Directive.[139] However, the enforcement of securities law obligations is—for the present time at least—a matter for Member States' national competent authorities (NCAs), as opposed to an EU-level agency. Supervision and enforcement jurisdiction is allocated to the country in which the third country firm first offers securities to the public, or is admitted to trading on a regulated market.[140] In other words, third country issuers can choose which individual securities law and enforcement apparatus will apply to them. Variation in the quality of enforcement, as

[131] Six months if the issuer is SEC reporting, otherwise one year. Rules 144(a)(3), 144(d).

[132] Bauguess et al., *supra* note 126, at 11.

[133] Regulation S stipulates different requirements for the availability of the safe harbor depending on the type of security offered. If the FPI does not have 'substantial US market interest' (SUSMI) in the particular class of equity security offered, the offering is 'Category 1' and only the requirements of an offshore transaction and no directed selling efforts apply. However, if there is 'substantial US market interest' (SUSMI) in the particular class of equity offered, further requirements will apply. SUSMI requires, however, that the US is either the largest trading market for the securities, or constitutes at least 20% of trading while less than 55% of trading took place in, on or through another country's markets. 17 CFR § 230.902(j)(1).

[134] Rule 904.

[135] *See* Baugess et al., *supra* note 126, at 6.

[136] *Id.*, at 7.

[137] This figure includes both debt and equity issuances: *ibid.*

[138] Directive 2003/71/EC, as amended.

[139] Directive 2004/109/EC, as amended.

[140] Prospectus Directive, Art. 2(m)(iii).

well as in key aspects of related substantive law (for example, the liability regime for misrepresentations), there is significant scope for regulatory arbitrage.[141]

There is a general exemption from the EU prospectus obligations for issues offered solely to sophisticated investors, analogous to Regulation D in the US. A typical EU capital-raising transaction then consists of a listing in the issuer's home jurisdiction coupled with capital-raising on wholesale markets across the EU, as well in the US.[142]

There are, however, significant aspects without analogies in the US rules. One is that, unlike the US, no effective resale restrictions apply to those who purchase securities in an EU private placement.[143] A second is that the EU regime has an exception to local compliance where a third country issuer has complied with rules in the (non-EU) country of the issuer's registered office, which are equivalent to those applicable under the EU regime. 'Equivalence' denotes not only substantive equivalence of disclosure obligations with those set out in the Prospectus Directive itself, but also in accordance with the IOSCO disclosure standards.[144] The Prospectus Directive contains perhaps the earliest example of a third country equivalence framework in EU financial markets law. In contrast to later legislative instruments, the determination of equivalence is a matter for the NCAs in the Member State in which the issuer wishes to first make the offer. This is then deemed to be the issuer's home state for the purposes of application of the Directive. Delegating the matter to NCAs in this way of course creates an incentive to take a relaxed approach to equivalence determinations: the revenues from the issue and associated trading will be local to the country of listing, but the investors who might buy the securities are dispersed throughout the EU. To ensure greater uniformity, ESMA has taken to issuing guidance on equivalence.[145] However, the framework is set to be centralized in the hands of the European Commission under the forthcoming Prospectus Regulation.[146]

For US issuers—that is firms that have already issued securities in the US—there may also be outbound obligations with which to comply when raising capital abroad. Such firms

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[141] EU domestic issuers can make a similar choice, provided they incorporate in their desired jurisdiction. *See* Luca Enriques & Tobias Tröger, *Issuer Choice in Europe*, 67 CAMBRIDGE LAW JOURNAL 521 (2008). Despite attempts to curb regulatory arbitrage, this will continue to be the case under the Prospectus Regulation, which will shortly replace the Prospectus Directive. *See* Article 2(1)(m)(i), Prospectus Regulation Proposal, as approved by the Council and the Parliament.

[142] Jackson & Pan, *Regulatory Competition (Part I)*, *supra* note 5.

[143] *See* Prospectus Directive, Art. 3(2), second para. *See also* Luca Enriques, A Proportionate Approach to Disclosure Regulation for Securities Offerings Within the EU (2017) (unpublished manuscript, on file with the authors).

[144] Prospectus Directive, Art. 20.

[145] To date, such an assessment has been offered in favour of two countries: Israel and Turkey. *See* ESMA Opinion, Framework for the assessment of third country prospectuses under Article 20 of the Prospectus Directive (20 March 2013).

[146] Proposed Regulation on the prospectus to be published when securities are offered to the public or admitted to trading, COM (2015) 583 final, Articles 26-28.

can make use of Regulation S to conduct an offshore offering that is exempt from the Securities Act. This would be a 'Category 3' offering, meaning that more restrictions apply than for an FPI. In particular, a 'distribution compliance period' of six months (one year if the issuer is a non-reporting company) will apply, during which (among other things) Regulation S securities may not be sold to US persons.[147]

### 5.2. International primary markets

The traditional explanation for cross-border listings was to see them as a way for issuers to overcome investment barriers, to reach investors who were otherwise practically prevented from supplying capital.[148] This explanation is often labelled the 'market segmentation' hypothesis. However, it looks increasingly implausible given the liberalization of cross-border investment barriers and consequent interconnection of markets. The collectivization of investment means that much liquidity is available through private placements. Consequently, it is no longer necessary for firms to establish listings in multiple countries to deliver liquidity. Issuers can rather select their preferred jurisdiction for listing—whether for bonding reasons, to ensure access to analyst coverage, or to exploit or build brand recognition among retail investors—and tap into liquidity elsewhere using private placements.[149]

An alternative explanation for cross-listings is known as the 'bonding' hypothesis.[150] This characterizes cross-listing as a commitment device that allows firms from jurisdictions with weak substantive securities laws, and/or enforcement to signal their quality by subjecting themselves to a regulatory regime with strong substantive rules and/or high-intensity enforcement—such as the US. Rendering themselves open to enforcement action either by the SEC or private plaintiffs in securities class actions is something that is credibly more costly for a low-quality than for a high-quality issuer, hence making cross-listing a

[147] Other requirements include that the securities of a US issuer must contain a legend to the effect that transfer is prohibited except in accordance with Regulation S; *see* 17 CFR § 230.903(b)(iii)(B)(3). This, and other technical aspects of the rule such as a requirement to send a notice of Regulation S requirements to the purchaser, has caused problems for US issuers that wished to offer and list securities abroad, since modern trading systems do not provide for share certificates with legends or notices to be sent. *See* EDWARD GREENE ET AL, U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS §6.27 et seq. (2014). While the London Stock Exchange and Euroclear have provided a technical solution, its legal status is uncertain: *see* Travers Smith, One Year On: Electronic Settlement of Category 3, Regulation S Securities (Jan. 2017), available at http://www.traverssmith.com/assets/pdf/legal-briefings/One_Year_On_Electronic_Settlement_of_Category_3_Regulation_S_Securities.pdf.

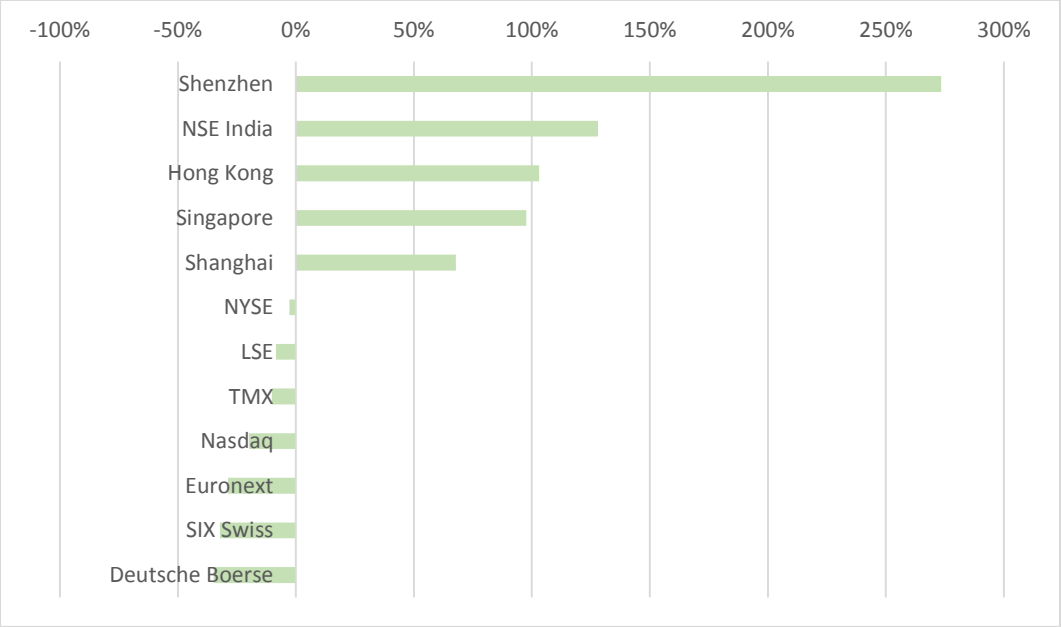
[148] *See, e.g.,* G. Andrew Karolyi, *Why Do Companies List Shares Abroad? A Survey of the Evidence and Its Managerial Implications*, 7 FINANCIAL MARKETS, INSTITUTIONS AND INSTRUMENTS 1, 19 (1998) (dividing investment barriers into 'direct costs', which includes foreign exchange controls, withholding taxes, and limits on foreign ownership, and 'indirect costs', which arise from higher monitoring costs of firms in low-disclosure regimes).

[149] As can be seen in Figure 12 below, issuers appear to overwhelmingly prefer to list in their home country.

[150] René M. Stulz. *Globalization, Corporate Finance, and the Cost of Capital*, 12 J. APPLIED CORP. FIN. 8 (1999), John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641 (1999); G. Andrew Karolyi, *Corporate Governance, Agency Problems and International Cross-listings: A Defense of the Bonding Hypothesis*, 13 EMERGING MARKETS REV. 516 (2012).

plausible signal of quality. The differential may be expected to persist over time, generating significant costs for issuers who mistreat investors and consequently serving as a bond of good behavior. Low levels of SEC enforcement against foreign firms in the early 2000s led some to question how much work was done by bonding to legal rules (as opposed, perhaps, to a contemporaneous reputational bond).[151] More recent evidence suggests, however, that the SEC has subsequently increased its enforcement activity in relation to foreign firms.[152]

**Figure 11**: Change in number of listed companies for selected exchanges (2003-2017)




**Notes**: data are from World Federation of Exchanges.

When measured by total market capitalization, the largest stock markets in the world are still in the US. However, if we focus instead on changes in the number of listed firms, captured in Figure 11, US exchanges show less dynamism.[153] For example, Nasdaq has 717 (or 20 per cent) fewer firms listed today than in 2003. By contrast, the Hong Kong Stock Exchange has more than doubled its number of listed firms over the same period. Consistently with the picture in Figure 11, many of the world's largest IPOs no longer take place in the US markets. Of the ten largest IPOs in 2016, six were in Asia and four in Europe.[154] Figure 12 ranks by offer size the 15 largest IPOs worldwide in the last five years. In 14 of these 15 offerings, issuers listed on an exchange in their home country, which indicates that investor mobility is high.

[151] Jordan Siegel, *Can foreign firms bond themselves effectively by renting U.S. securities laws?*, 75 J. FIN. ECON. 319 (2005).

[152] Roger Silvers, *The Valuation Impact of SEC Enforcement Actions on Nontarget Foreign Firms*, 54 J. ACCT. RES. 187 (2016).

[153] *See* Craig Doidge, G. Andrew Karolyi & René M. Stulz, *The US Listing Gap*, 123 J. FIN. ECON. 464 (2017).

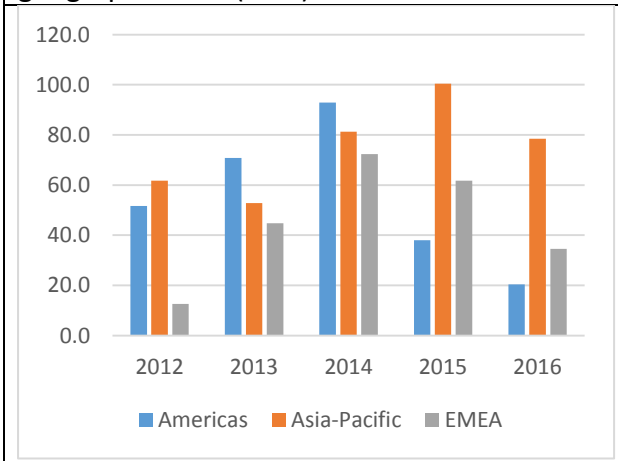
[154] Dealogic, Investment Banking Scorecard, available at http://graphics.wsj.com/investment-banking-scorecard/.

**Figure 12:** 15 Largest IPOs worldwide since 2012

| Rank | Issuer | Listing Venue | Offer Size ($ m) | Market Cap at Offer | Industry | Issuer Domicile |
|---|---|---|---|---|---|---|
| 1 | Alibaba Group Holding Ltd | NYSE | $25,032 | $167.6 bn | Internet | China |
| 2 | Facebook Inc | NASDAQ | $16,007 | $24.1 bn | Internet | US |
| 3 | Japan Post Holdings Co Ltd | Tokyo | $8,855 | $80.5 bn | Insurance | Japan |
| 4 | Japan Airlines Co Ltd | Tokyo | $8,437 | $8.7bn | Airlines | Japan |
| 5 | Postal Savings Bank of China Co Ltd | Hong Kong | $7,624 | $12.2bn | Banks | China |
| 6 | National Commercial Bank | Saudi Arabia | $6,000 | N/A | Banks | Saudi Arabia |
| 7 | BB Seguridade Participacoes | BM&F Bovespa | $5,669 | N/A | Insurance | Brazil |
| 8 | Innogy SE | Xetra | $5,179 | $22.3bn | Energy | Germany |
| 9 | Medibank Pvt | ASE | $4,986 | $4.99bn | Insurance | Australia |
| 10 | Japan Post Bank Co Ltd | Tokyo | $4,959 | $54.1bn | Banks | Japan |
| 11 | Guotai Junan Securities Co Ltd | Shanghai | $4,852 | $24.3bn | Diversified Financial | China |
| 12 | Aena SA | Soc.Bol SIBE | $4,798 | $9.8bn | Engineering | Spain |
| 13 | ABN Amro Group NV | Euronext Amsterdam | $4,213 | $18.3bn | Banks | Netherlands |
| 14 | Kyushu Railway | Tokyo | $4,068 | $4.1bn | Transportation | Japan |
| 15 | Dalian Wanda Commercial Properties Co Ltd | Hong Kong | $4,039 | $27.7bn | Real Estate | China |

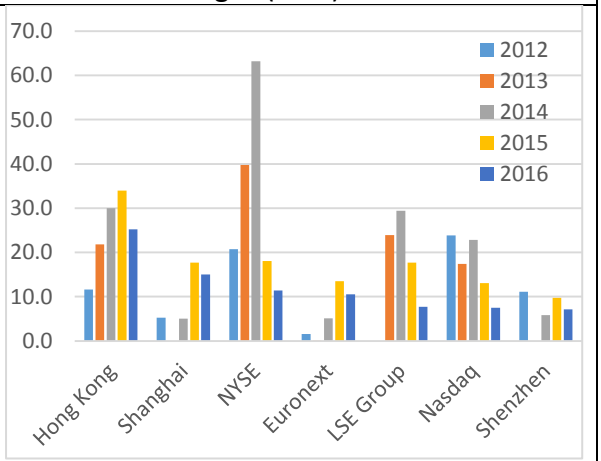
**Source:** Bloomberg (IPOs completed between 1 January 2012 and 30 June 2017).

**Figure 13:** IPO funds raised 2012-2016, by geographic area ($ bn)




**Source:** Data from World Federation of Exchanges

**Figure 14:** IPO funds raised 2012-2016, selected exchanges ($ bn)

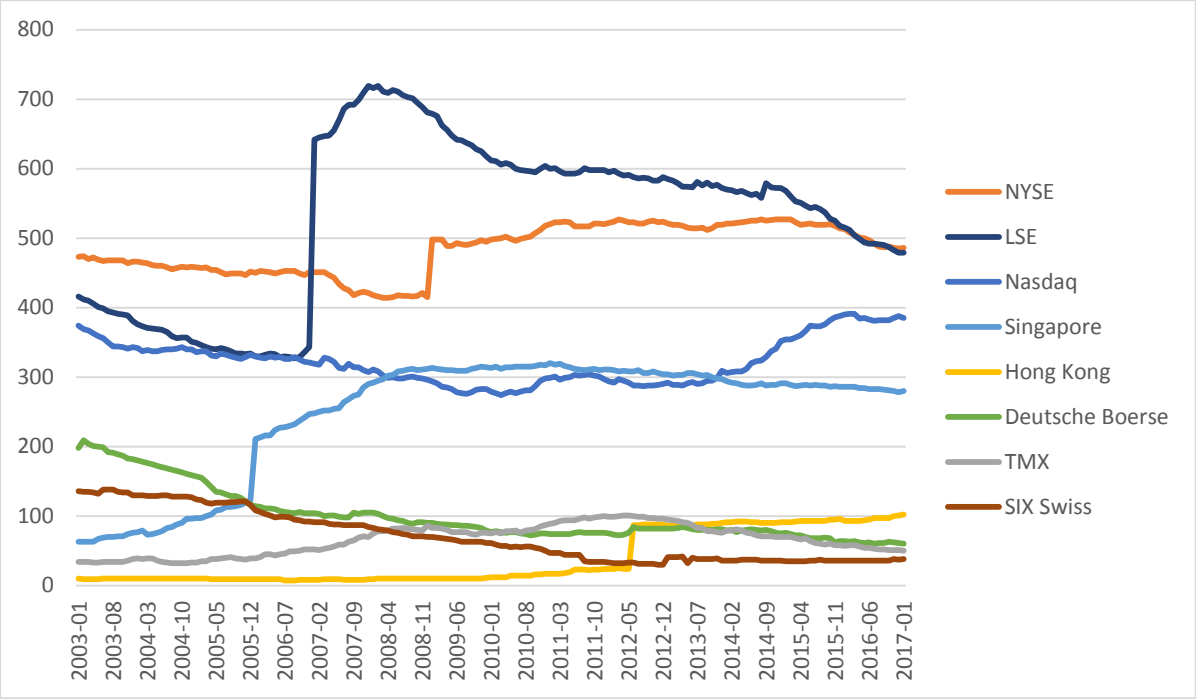



**Source:** Data from World Federation of Exchanges

The trend to raising capital through local IPOs is also reflected in Figures 13 and 14 above, showing the regions and exchanges that raised the most IPO funds. While the NYSE was the exchange on which most IPO funds were raised in 2013 and 2014, and the Americas the number one region, Asia-Pacific IPOs received the most IPO funds in 2015 and 2016, with

Hong Kong the world's largest exchange in terms of money channeled to IPOs in the two most recent years.

**Figure 15**: Number of foreign companies listed on selected exchanges (2003-2017)




**Notes**: data are from World Federation of Exchanges.

Figure 15 shows World Federation of Exchanges data on the development of the number of foreign companies listed on NYSE and Nasdaq, as well as for selected other major exchanges. Although the numbers of cross-listings on the major US exchanges have been relatively stable in recent years, the US cross-listings market peaked at around the turn of the millennium.[155] However, the time series data used for this figure suffer from a lack of consistency, with sudden jumps owing to recategorization of which companies count as 'foreign' by various exchanges at various points in time. [156]

To verify the downward trend in US cross-listings, we also hand-collected data from the SEC on foreign issuers, which are reported in Table 1. There were approximately 1,310 foreign issuers registered with the SEC at the end of 2000, which had declined steadily to only 926 foreign issuers by the end of 2015. However, there has been significant turnover in the composition of foreign issuers each year, also presented in Table 1 to add a sense of the dynamics. In the last 15 years, we estimate that 1,350 foreign issuers have become SEC registrants (mean 90 per year) while 1,734 (mean 116 per year) have left the US regime. Of

[155] Doidge et al, *supra* note 4, at 258.

[156] The increase for the London Stock Exchange in January 2007 appears to relate to a recategorization, where issuers that in effect were UK 'topcos' of overseas companies were designated as foreign issuers. The increase for NYSE in January 2009 appears to relate to the addition of ARCA and AMEX to the data.

the 1,310 foreign issuers registered with the SEC at the end of 2000, only 300 remained at the end of 2015.

**Table 1:** Number of foreign-incorporated issuers registered and reporting with the SEC, 2000-2015

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| Start of year | 1,310 | 1,344 | 1,323 | 1,235 | 1,245 | 1,237 | 1,146 |
| New entrants | 198 | 106 | 93 | 112 | 116 | 76 | 102 |
| Leavers | 164 | 127 | 181 | 102 | 124 | 167 | 187 |
| **End of year** | **1,344** | **1,323** | **1,235** | **1,245** | **1,237** | **1,146** | **1,061** |

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| Start of year | 1,061 | 1,028 | 968 | 974 | 965 | 947 | 940 | 906 |
| New entrants | 57 | 57 | 102 | 72 | 58 | 56 | 69 | 76 |
| Leavers | 90 | 117 | 96 | 81 | 76 | 63 | 103 | 56 |
| **End of year** | **1,028** | **968** | **974** | **965** | **947** | **940** | **906** | **926** |

**Notes:** Data for foreign-incorporated issuers from 2000 to 2015 made available by the SEC at https://www.sec.gov/divisions/corpfin/internatl/companies.shtml. The SEC presents this issuer data by year. We collated it and reviewed it for changes of issuers' registered names during the period, to avoid counting a name change as a combined exit from the US by one issuer and an entry by another. Our totals may differ slightly from those of the SEC as we sought to remove duplicate records and made other minor adjustments.

A variety of (potentially complementary) explanations exist for the decline in US cross-listings. Some focus on US-specific factors, such as the perceived increased cost of US regulation, in particular the Sarbanes-Oxley Act of 2002.[157] Another perspective is that the US had a competitive advantage in capital markets after World War II since its economic infrastructure was undamaged, and it did not face real competition until the 1980s.[158] A third possibility is the considerably higher IPO fees typically charged in the US than elsewhere.[159] However, for present purposes the most interesting explanations are those that relate to the macro trends described in Section 2. On this view, it is less important to bring listings to the US to access capital from US investors: they can be reached through a private placement or invest offshore in a foreign issue.[160]

The attraction of cross-listing as a bonding mechanism may also have been damped. Bonding depends on differences in the practical intensity of securities laws. Efforts at

[157] COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT (NOV. 2006).

[158] Donald C. Langevoort, *U.S. Securities Regulation and Global Competition*, 3 VA. L. & BUS. REV. 191, 193-96 (2008).

[159] Mark Abrahamson, Tim Jenkinson & Howard Jones, *Why Don't US Issuers Demand European Fees for IPOs?*, 66 J. FIN. 2055 (2011) (documenting US IPO fees typically at 7% whereas European IPO fees typically at 4%, and falling).

[160] Howell E. Jackson, *A System*, *supra* note 41.

international regulatory coordination, discussed in Section 4, have reduced these differences, at least amongst developed countries.[161] Moreover, the growth in institutional investment may mean that the protections offered to investors by regulation may be less important, as they are better able to assess protection at the firm-level than retail investors.[162] Consistently with this view, a recent study reports that the Supreme Court's 2010 decision in *Morrison*, which geographically limited the reach of private enforcement of US securities law, triggered indifferent or even positive market reactions for affected firms.[163] This suggests that the majority of such firms had received no valuation benefit from legal bonding.

Nevertheless, it seems likely that bonding continues to play a role. Convergence in securities law has reduced, but not eliminated, differences in substantive securities laws, and there remain substantial differences in enforcement styles and intensity.[164] Empirical support for a continued role for bonding comes from a study of foreign issuers that elected to terminate their US registration and associated reporting obligations following the introduction of SEC Rule 12h-6 in 2007, which made termination easier.[165] The firms that consequently de-registered generally had lower funding requirements than the foreign issuers that remained. This is consistent with bonding, as the benefits of a more credible commitment to investor protection should be more pronounced for firms with an ongoing need to raise capital.[166] Another study found that the value of a US cross-listing was significantly reduced following the introduction of Rule 12h-6; a finding that is consistent with both the legal and the reputational versions of the bonding hypothesis.[167] It thus

[161] *See* Andreas Wöller, *How the Globalization of Capital Markets Has Affected the Listing Behavior of Foreign Issuers - The Case of Daimler's Listing on the NYSE (Part II)*, 38 DAJV Newsl. 54 (2013) (studying Daimler's 1993 listing on – and 2010 delisting from - the NYSE and arguing that bonding effects have been dissipated by refinements in German securities laws).

[162] Doidge et al, *supra* note 153.

[163] Amir N. Licht, Christopher Poliquin, Jordan I. Siegel and Xi Li, *What Makes the Bonding Stick? A Natural Experiment Involving the US Supreme Court and Cross-Listed Firms*, forthcoming J. FIN. ECON. (2018). The *Morrison* decision is discussed *infra,* Sections 5.5 and 8.

[164] Coffee, *supra* note 64. *See also* Howell E. Jackson, *The Impact of Enforcement: A Reflection*, 156 U. PA. L. REV. PENNUMBRA 400 (2008), http://www.pennumbra.corn/responses/02-2008/Jackson.pdf. *See also infra*, Section 8.

[165] Rule 12h-6 made de-registration easier for foreign issuers whose securities were comparatively thinly traded in US markets: *see* SEC, Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 Fed. Reg. 16,934 (April 5, 2007).

[166] Craig Doidge, G. Andrew Karolyi & René M. Stulz, *Why do Foreign Firms Leave U.S. Equity Markets?*, 65 J. FIN. 1507 (2010).

[167] Chinmoy Ghosh & Fan He, *The Diminishing Benefits of U.S. Cross-Listing: Economic Consequences of SEC Rule 12h-6*, 52 J. FIN. & QUANTITATIVE ANALYSIS 1143 (2017). Using the voting premium in dual-class firms as a proxy for agency costs, the authors found (with a difference-in-difference approach) that the voting premium had declined significantly in US cross-listed firms relative to their not cross-listed peers, and that the overall 'cross-listing premium' had declined from 29% to 8% following the introduction of Rule 12h-6. This decline was most significant for firms from countries with weak disclosure rules and weak investor protection, indicating a

appears that, as US disclosure regulation became less of a 'lobster trap' (easy to enter, hard to leave) after the introduction of Rule 12h-6, foreign issuers were no longer able to make credible commitments to the US disclosure regime for an indefinite period of time and their valuation suffered.[168]

### 5.3. Case study: Primary markets in the UK

While the literature on bonding reported measurable valuation and cost of capital benefits associated with foreign firms listing in the US,[169] there were no equivalent results in relation to listing in the UK.[170] However, the UK listing regime in place at the time of these studies relegated most foreign issuers to a junior segment of the market. Until 2005, foreign firms were required to list in a 'Secondary' segment, which imposed only the EU minimum rules. It seems likely such a listing would have proved most appealing to liquidity-seeking firms, rather than those wishing to bond, as it was significantly more lenient to issuers than the 'Primary' segment, which was reserved for domestic issuers. However, foreign companies could obtain a Primary listing if they were willing to incorporate a new 'topco' in the UK, which it appears from Figure 15 was done quite frequently.[171]

Following a three-year review, the UK amended its listing regime in 2010 to divide issuers—both domestic and foreign—into 'Premium' and a 'Standard' listings.[172] A Standard listing, like the former Secondary listing, entails only compliance with the minimum requirements of EU rules, whereas a Premium listing—like the former Primary listing—contains various super-equivalent provisions. A Premium listing requires issuers to establish a three-year financial track record, to apply rules on shareholder approval for significant transactions and pre-emption rights for seasoned equity offerings, and to comply with the UK Corporate Governance Code (or explain non-compliance).[173] The rationale was to seek to establish a separating equilibrium for cross-listing firms: bonding for high-quality firms,

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reduction in the value of legal bonding mechanisms. Interestingly, the authors also found that reputational bonding mechanisms (proxied by analyst coverage and institutional ownership) were associated with a higher cross-listing premium, and that issuers with higher levels of analyst coverage (but not institutional ownership) suffered less of a decline in cross-listing premium following the introduction of Rule 12h-6.

[168] *See generally* Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002).

[169] Luzi Hail and Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations Around US Cross-Listings*, 93 J. FIN. ECON. 428 (2009); see also sources cited *supra* note 4.

[170] Craig Doidge, G. Andrew Karolyi & René M. Stulz, *Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices Over Time*, 91 J. FIN. ECON. 253 (2009).

[171] *See supra*, note **Error! Bookmark not defined.**.

[172] Until 2010, the UK listing regime was divided into 'primary' and 'secondary' listings. Primary listings were for IPOs, and were consequently largely UK companies. The secondary listing segment, in contrast, was only open to overseas companies. However, the term 'secondary' became a misnomer after 2005, from when foreign firms were permitted to have this listing type in London without a primary listing in their home jurisdictions: *see* FSA, A Review of the Structure of the Listing Regime, DP08/1, 12 (2008).

[173] Only companies with a Premium listing are eligible for inclusion in the LSE's main FTSE indices, however; *see* FTSE RUSSELL, GROUND RULES FOR THE FTSE UK INDEX SERIES, V12.8 (May 2016).

using the more onerous Premium listing; and the pursuit of liquidity at lower cost, using the Standard listing, for lower-quality firms. The 2010 changes permit cross-listing firms to distinguish themselves more clearly. However, we are aware of no studies specifically investigating the performance of foreign firms that have opted into the Premium regime. This is an interesting avenue for future research.

Of course, the extent to which such bonding can occur depends on how effective the rules and their associated enforcement are in dealing with corporate governance problems. Cheffins argues that the UK corporate governance model, aimed primarily at tackling managerial agency costs, rather than abuse by dominant shareholders, is ineffective when it comes to policing the blockholder-controlled firms that have tended to cross-list in the UK, often obtaining Premium listing status.[174] For example, the cornerstone of the UK's Corporate Governance Code – the 'comply or explain' model – is undermined when there is a dominant shareholder who declines to take action.[175] For that reason, the FCA recently amended its Listing Rules to insert provisions that tackle companies with a dominant shareholder. They do so mainly by strengthening directors' independence and, subject to one director alleging abuse of power by the dominant shareholder, by widening the scope of related party transaction provisions.[176]

However, the changes described in this paper have meant that cross-listing is in decline in the UK as well. In February 2017, the UK Financial Conduct Authority (FCA) announced another review of the regulation of primary markets.[177] The FCA is concerned that cross-listings are in long-term decline and that stakeholders have informed it that this is due to the increasing ease with which institutional investors can transact in overseas stock markets using Global Depositary Receipts (GDRs).[178] The FCA has floated the question whether an 'international segment' could better serve issuers and investors by providing a more prestigious form of listing than the current Standard listing, while still being less stringent than the Premium listing.[179]

As we have seen, however, there are routes to tap liquidity that have even lower costs than cross-listing on a 'Standard' segment. These consist of private placements to institutional investors that are undertaken without any associated listing. In the US, this has traditionally occurred using private placements to institutional buyers. This mechanism also underpins London's much-touted Alternative Investment Market (AIM), launched in 1995. AIM is actually only a secondary market, with the primary market component operating as a

[174] Brian Cheffins, *The Undermining of UK Corporate Governance(?)*, 33 OXFORD J. LEG. STUD. 503 (2013).

[175] *Id.*, at 509-513. *See also* Eilís Ferran, *Corporate Mobility and Company Law*, 79 MODERN L. REV. 813 (2016).

[176] *See* Roger Barker & Iris H-Y Chiu, *Protecting Minority Shareholders in Blockholder-Controlled Companies – Critically Evaluating the UK's Enhanced Listing Regime*, 10 CAP. MARKETS L.J. 98 (2015).

[177] FINANCIAL CONDUCT AUTHORITY, DISCUSSION PAPER: REVIEW OF THE EFFECTIVENESS OF PRIMARY MARKETS: THE UK PRIMARY MARKETS LANDSCAPE (Feb. 2017).

[178] FCA DP 17/02, at 22.

[179] FCA DP 17/02, at 21-23. The FCA is at the same time apparently content to relax certain Premium listing rules in favour of sovereign-controlled issuers: *see supra*, note 32.

private placement. However, unlike US private placements, thanks to the absence of meaningful resale restrictions, retail as well as sophisticated investors can participate in AIM's secondary market. It was deliberately structured in this way to take advantage of then-EU rules that exempted a 'multilateral trading facility' (MTF) from compliance with issuer securities law rules. Empirical studies suggest that firms that list on AIM are typically smaller and younger than those listing on the Main Market, and that they join AIM to take advantage of its lower costs.[180] AIM-listing firms are not, however distinguishable from Main Market firms in terms of market valuation or risk of failure.[181]

In its first decade, AIM was highly successful in attracting issuers, so much so that in 2006, its 'IPOs' raised more funds than those on NASDAQ.[182] In so doing, it drew the ire of US regulators, with an SEC commissioner labelling it a 'casino' where 30 per cent of new listings were 'gone in a year'[183] and the then-head of the NYSE saying AIM 'did not have any standards at all'.[184] Subsequent empirical research reports that AIM-listed firms have underperformed those listed on traditional regulated exchanges. Firms with a higher proportion of retail investors were particularly badly affected,[185] suggesting investor protection concerns are a real issue. Another study found that firms switching from AIM to the London Main Market saw positive announcement returns, whereas those moving in the opposite direction had negative announcement returns.[186]

After peaking in 2007 with 1,694 issuers (347 of which were international),[187] AIM's size has steadily declined, today having only 973 issuers (171 of which are international). Many firms on AIM are small and, as such, unlikely to list on a regulated exchange; only 36 per cent have a market capitalization above £50m ($62m). Part of AIM's decline is

[180] John A. Doukas & Hafiz Hoque, *Why firms favour the AIM when they can list on main market?*, 60 J. INT'L MONEY & FIN. 378 (2016).

[181] Ulf Nielsson, *Do less regulated markets attract lower quality firms? Evidence from the London AIM Market*, 22 J. FIN. INTERMEDIATION 335 (2013).

[182] Joseph Gerakos, Mark Lang & Mark Maffett, *Post-listing performance and private sector regulation: The experience of London's Alternative Investment Market*, 56 J. ACC. & ECON. 189 (2013).

[183] Jeremy Grant, Norma Cohen & David Blackwell, SEC official sparks row over Aim 'casino', Fin. Times (Mar 8, 2007) (also noting that Commissioner Campos explained that his comments were taken out of context).

[184] John Gapper, *Thain lambasts AIM standards*, FIN. TIMES (Jan. 26, 2007). *See also*, in this volume, Donald C. Langevoort, Primary Markets and the Securities Laws: Capital-raising and Secondary Trading (discussing 'large scale private financing with a high level of resale liquidity but none of the burdens of regulatory "publicness"' as either 'nirvana or … a terrifying void, depending on one's perspective'; a description that seems to suit the AIM market well).

[185] Gerakos et al, *supra* note 182.

[186] Tim Jenkinson & Tarun Ramadorai, *Does One Size Fit All? The Consequences of Switching Markets with Different Regulatory Standards*, 19 EUR. FIN. MGMT. 852 (2013). However, these authors also found positive cumulative abnormal returns of 25 per cent in the year after a switch to the AIM market, implying that these firms had used the flexibility to opt into a regime more suitable to their needs, in the ultimate interest of shareholders.

[187] London Stock Exchange, AIM Factsheet (Jan 2017).

attributable to changes in EU laws that partially assimilated MTFs to regular exchanges,[188] making AIM access costlier. The London Stock Exchange has recently begun a review of the AIM Rules.[189]

### 5.4.Primary markets in Asia

In addition to being the region channeling the most IPO funds to issuers in 2015 and 2016,[190] exchanges in Asia also have significant amounts of trading and new listings, as shown in Figures 16 and 17 below.[191] More than half of all listed companies in the world are listed in Asia, but they represent only a third of the world's market capitalization.[192] Singapore is a financial hub whose main exchange has the fourth highest number of cross-listed firms in the world, serving many of the developing countries of Asia.[193] In contrast, the Stock Exchange of Hong Kong (SEHK) is focused on China. Since December 2016, SEHK operates two links to Chinese mainland markets - the 'Shanghai-Hong Kong Stock Connect' which was introduced in 2014 and the more recent 'Shenzhen-Hong Kong Stock Connect' in December 2016. These links allow international investors to trade stocks listed in Shanghai or Shenzhen in mainland China, with clearing through the local Hong Kong system.

[188] As a recent example, the EU Market Abuse Regulation that came into effect in July 2016 extended the framework to cover instruments trading on MTFs, including AIM.

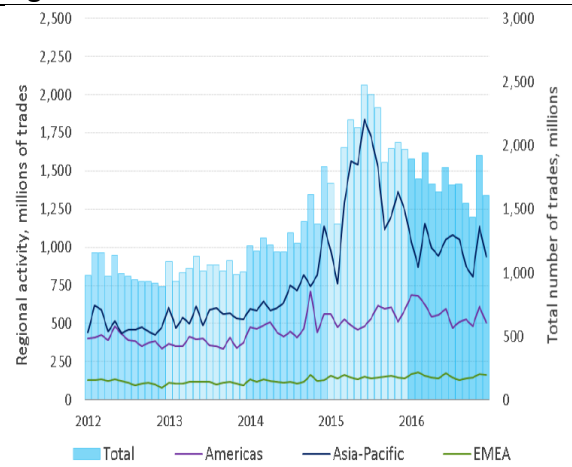
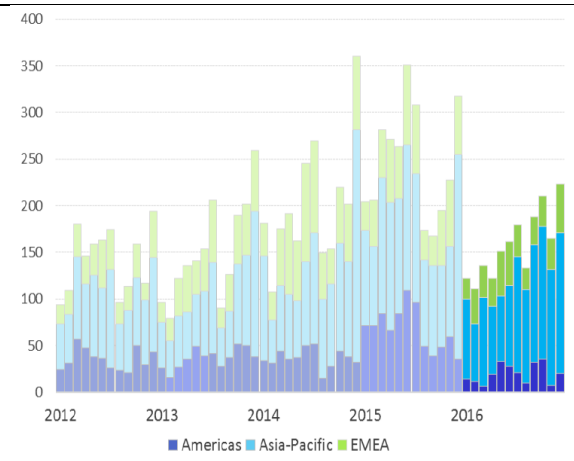
[189] *See, e.g.,* London Stock Exchange Group, Discussion Paper: AIM Rules Review (2017).

[190] *See supra*, Section 5.2.

[191] Note that the statistics from WFE are based on data from its member exchanges. For the US, only data from Nasdaq and NYSE are included.

[192] According to data from the World Federation of Exchanges as of the end of January 2017, Asia had 26,959 listings out of a global total of 51,651.

[193] David C. Donald, *Bridging Finance without Fragmentation: A Comparative Look at Market Connectivity in the US, Europe and Asia*, 16 EUR. BUS. ORG. L. REV. 173 (2015).

| **Figure 16**: Number of trades (millions), by region | **Figure 17:** Number of new listings, by region |
|---|---|
|  |  |
| **Source:** World Federation of Exchanges | **Source:** World Federation of Exchanges |

In 2014, HKEX (the SEHK's parent company) launched a public consultation regarding safeguards to permit dual-class share listings.[194] The exchange concluded from the responses that it had support for a proposal which would include various safeguards for firms listing with a non-one-share-one-vote structure. Contemplated safeguards included only allowing such structures for very high expected market cap firms and tougher rules for independent non-executive directors.[195] However, the Hong Kong Securities and Futures Commission did not support the proposal,[196] and since its approval was required to amend the listing standards of the exchange, the HKEx was forced to abandon the project. As a result of the one-share-one-vote requirement, several significant technology firms, such as Alibaba, Baidu, JD.com and Weibo have instead opted to list in the US.

Asian stock markets have been found to be more subject to 'idiosyncratic' influences in pricing, and more detached from fundamentals, than other stock markets in the G-7.[197] IMF researchers have recommended improvements to securities regulation to reduce the observed 'noise' in stock pricing.[198] The Hong Kong market has recently exhibited several unusual events, including inexplicable rallies and crashes.[199] The Hong Kong market is also idiosyncratic in that much of the equity placed in IPOs in the last year was sold to

[194] HKEX, Concept Paper: Weighted Voting Rights (August 2014).

[195] HKEX, Consultation Conclusions to Concept Paper on Weighted Voting Rights (June 2015).

[196] SFC statement on the SEHK's draft proposal on weighted voting rights (2015-06-25).

[197] Fabian Lipinsky & Li Lian Ong, Asia's Stock Markets: Are There Crouching Tigers and Hidden Dragons? (IMF working paper, Feb. 2014).

[198] *Id*.

[199] Jennifer Hughes, *Hong Kong struggles with proposed IPO shake-up*, FIN. TIMES, Sept. 20, 2016.

cornerstone investors who enter into lock-up agreements and do not trade (reducing the free float), and in that the government controls the board of the exchange.

### 5.5.The impact of *Morrison*

For a foreign issuer choosing how to enter the US capital markets, the Supreme Court's decision in *Morrison v. NAB* and decisions of lower courts have chiseled out some relatively clear boundaries for when and how § 10(b) liability will apply.

*Morrison* established a 'transactional test' for § 10(b) such that it applies to 'transactions in securities listed on domestic exchanges, and domestic transactions in other securities'.[200] The first prong ('domestic exchanges') has been interpreted narrowly to exclude transactions in securities not listed on a US exchange.[201] Further, a cross-listing on a US exchange will not be sufficient to fulfil this test if the plaintiff transacted in such securities on a non-US exchange.[202] This has been explicitly confirmed in a case where plaintiffs purchased foreign shares of an issuer with American Depositary Receipts (ADRs) listed on a US exchange.[203]

Issuer-sponsored ADR programs come in three types. Level III ADRs permit capital raising and are listed on a stock exchange. Level I and Level II ADRs do not permit capital raising; the difference between them is that Level II ADRs are listed on a stock exchange while Level I ADRs may only be quoted OTC.[204] Since Level III and Level II ADRs are listed on a US exchange, they would be covered by the first prong of *Morrison* and § 10(b) claims would not suffer automatic preclusion due to extraterritoriality. Level I ADRs, which trade OTC and therefore are not 'listed' as required under the first prong, would instead need to be covered by the second ('domestic transactions') prong. The Second Circuit has elucidated that it will find a 'domestic transaction' when 'irrevocable liability is incurred or title passes'

[200] 561 U.S. 247, 267 (2010).

[201] Absolute Activist Value Master Fund Ltd v Ficeto, 677 F3d 60, 66 (2d Cir 2012), United States v Georgiou, 777 F3d 125, 134 (3d Cir 2015) (the Third Circuit Court simply noted that the OTC Bullein Board and the Pink Sheets were not among the eighteen national securities exchanges registered with the SEC).

[202] City of Pontiac Policemen's & Firemen's Ret Sys v UBS AG, 752 F3d 173 (2d Cir 2014). The court clarified that both prongs of *Morrison* should be read to take aim at domestic transactions, and that the first prong's 'domestic listing' phrase should be considered a proxy for a domestic transaction; *id.* at 180. The court also held that the placing of a buy order in the US for the purchase of a foreign security on a foreign exchange was not sufficient to allege that irrevocable liability was transferred under *Absolute Activist*; *id*.

[203] In re Royal Bank of Scotland Grp PLC Sec Litig, 765 F Supp 2d 327, 336 (SDNY 2011) ('The idea that a foreign company is subject to U.S. [s]ecurities laws everywhere it conducts foreign transactions merely because it has 'listed' some securities in the United States is simply contrary to the spirit of Morrison.')

[204] For Level I, only a Form F-6 needs to be filed with the SEC to establish the ADR facility (17 CFR 239.36). This is a short form that is focused only on the ADR arrangements; no information about the company's business is necessary. For Level II, the company must also annually register and file Form 20-F and ongoing disclosures.

in the US.[205] This formulation inevitably leads to deeper inquiries into the specific facts than the transaction test's first prong.

In addition, in *Parkcentral v Porsche*, the Second Circuit held that 'a domestic transaction is necessary but not necessarily sufficient' to bring a § 10(b) claim where the transaction is 'predominantly foreign' in character.[206] In *US v Georgiou*, the Third Circuit found that this second prong applied to transactions in the US OTC markets, since the transactions took place through US-based market-makers.[207] In a recent Californian case relating to Volkswagen's Level I ADRs trading in the OTCQX market, the parties agreed that the first prong was unavailable and the defendants did not dispute that the transaction was domestic under the second prong.[208] Instead, the defendants argued that the transaction was predominantly foreign under *Parkcentral*, on the basis that Volkswagen's Level I ADR program did not allow it to raise capital in the US and only required compliance with German disclosure laws. The court rejected this argument, concluding that Volkswagen, by sponsoring the ADR program, had taken 'affirmative steps' to allow US investors to buy its securities. Unsponsored ADRs, discussed further in Section 7, have been found not to create a domestic transaction under the second prong due to a lack of issuer involvement.[209]

From the perspective of a foreign issuer considering whether to enter the US capital markets, *Morrison*'s first prong appears settled: listing on a US exchange means entering the purview of the private right of action under § 10(b). As regards the second prong, *Volkswagen* is the only case available on Level I ADRs to date, which may mean that the case law is less settled.[210] To summarize, the post-*Morrison* regulatory environment appears to allow issuers to estimate their US liability exposure with reference to the proportion of their securities that they decide to actually make available in the US.

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[205] Absolute Activist Value Master Fund Ltd v Ficeto, 677 F3d 60 (2d Cir 2012). The court noted that, in order to allege that irrevocable liability was incurred or that title was transferred within the US, the plaintiff would need to allege that some of the following took place in the US: the 'formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money'; *id*. at 70. In United States v. Vilar, 729 F.3d 62, 77 n. 11 (2d Cir. 2013), the Second Circuit has also held that 'territoriality under *Morrison* concerns where, physically, the purchaser or seller committed him or herself, not where, as a matter of law, a contract is said to have been executed'.

[206] Parkcentral Global Hub Ltd v Porsche Auto Holdings SE, 763 F3d 198 (2014) (finding that the German company Porsche could not be held liable for securities fraud in the US for statements it had made in relation to its intentions to take over Volkswagen when international hedge funds suffered losses on a securities-based swap agreement entered into in the US which referenced Volkswagen's share price when Porsche was unaware of, and not a party to, such swap agreement).

[207] United States v Georgiou, 777 F3d 125, at 134 (3d Cir 2015).

[208] Order Re: Motions to Dismiss the Consolidated Securities Class Action Complaint, In re: Volkswagen 'Clean Diesel' Marketing, Sales Practices, and Products Liability Litigation, MDL No. 2672 CRB. (C.D. Cal. Jan. 4, 2017).

[209] Stoyas v. Toshiba Corp., 191 F. Supp. 3d 1080 (C.D. Cal. 2016).

[210] Dudek has recently argued that Level I ADR programs should not, without more, give rise to a § 10(b) claim, since the SEC itself has long considered issuers behind such programs not to actively access the US capital markets. *See* Paul Dudek, *Applying Morrison to American Depositary Receipts*, 31:2 Insights 9 (February 2017).

## 6. Secondary market trading

In this Section, we consider global issues in the regulation of trading venues. We first examine the 'menu' of trading venues on offer in the US and the EU; next we briefly discuss the new EU rules on dark pools and concentration of trading on multilateral trading venues; finally, we offer a substantive comparison of the regulation of high frequency trading and insider trading and reflect upon the significance, if any, of these differences for the operation of international markets.

### 6.1. Investor choice: the US venue menu

From a regulatory perspective, there are two main types of US stock markets: national securities exchanges (such as NYSE and NASDAQ)[211] and Alternative Trading Systems (ATSs), such as Electronic Communication Networks (ECNs) and dark pools. In addition, broker-dealers can quote stocks on non-ATS systems as OTC market-makers or block positioners.[212] The 21 national securities exchanges are the only venues where equity securities can be *listed*,[213] although exchanges' revenue from listing services have generally decreased in importance in recent years.[214]

ATSs technically fall within the statutory definition of an 'exchange', but do not have to register as such if they instead comply with Regulation ATS.[215] Among the more significant differences between exchanges and ATSs are that exchanges must undertake self-regulatory obligations over their members and that ATSs do not have to publicly disclose details about their services or fees. In addition, ATSs have greater control over which traders to allow access to.[216]

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[211] An *exchange* is defined as 'any organization… which constitutes, maintains or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood'. Section 3(a)(1) of the Exchange Act. A *national securities exchange* is an exchange registered with the SEC, Section 6(a) of the Exchange Act.

[212] For a description of the features of the different types of venues, *see* SEC, Concept Release on Equity Market Structure; Proposed Rule, 75 Fed. Regulation 3594 (Jan 21, 2010).

[213] The SEC provides a list of regulated exchanges on https://www.sec.gov/divisions/marketreg/mrexchanges.shtml (last accessed March 2, 2017).

[214] OECD, BUSINESS AND FINANCE OUTLOOK 2016 122-23 (comparing the revenue structure of 18 listed stock exchanges in 2004 and 2014 and finding that listing fees on average decreased as a percentage of revenue from 14% in 2004 to 8% in 2014).

[215] 17 CFR § 242.300-303. Regulation ATS requires ATSs to register as broker-dealers, *see* 17 CFR § 242.301(b)(1).

[216] In 2015, the SEC proposed to amend Regulation ATS to increase ATS transparency. SEC, Regulation of NMS Stock Alternative Trading Systems; Proposed Rule, 80 Fed .Regulation 80998 (Dec. 28, 2015). If an ATS has more than 5% of the average daily volume of an exchange-listed stock, however, it becomes subject to a rule to not unreasonably limit access. *See* Regulation ATS Rule 17 CFR § 242.301(b)(5). In contrast, exchanges are required to allow any qualified broker-dealer to become a member; Section 6(a)(2) of the Exchange Act.

However, significant amounts of trading occur beyond both exchanges and ATSs; in fact more off-exchange trading of listed stocks occurs off, than on, ATSs. [217] Such trading includes inter-dealer quotation systems where dealers may post quotes for securities.[218] One of these over-the-counter markets is the Pink Open Market ('POM'), where the equity of foreign firms not listed on a US exchange is quoted by brokers. OTC Markets Inc., which operates POM and other OTC markets, compares itself to the UK AIM market.[219] OTC Markets Inc. has established various market segments and criteria, of which POM is the segment subject to the least requirements.[220] As of February 2017, POM had 8,245 securities quoted, of which 670 were from the UK. It was recently announced that a leading provider of automated trading systems would incorporate OTC Markets Inc. data into its order book,[221] a move which could facilitate cross-border arbitrage in foreign securities quoted in POM and listed abroad.[222] Retail investors are able to buy unlisted equities quoted on the OTC Markets through their regular brokers, and are the predominant owners of such equities.[223]

### 6.2. Investor choice: the EU venue menu

Under EU rules, two types of multilateral trading venues are available for equity trading: regulated markets (RMs) and multilateral trading facilities (MTFs). These are neutral venues that may not execute client orders against proprietary capital and must provide traders access on a non-discriminatory basis.[224] In addition, investment firms that deal on their own account to execute client orders outside an RM or MTF on an 'organized, frequent, systematic and substantial' basis are subject to a regulatory framework for 'systematic internalizers' (SIs).[225]

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[217] LAURA TUTTLE, OTC TRADING: DESCRIPTION OF NON-ATS OTC TRADING IN NATIONAL MARKET SYSTEM STOCKS (March 2014).

[218] 17 CFR § 240.15c2-11(e)(2) ('any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers').

[219] *Infra,* Section 5.3. *See* OTC Markets, Presentation to SEC Advisory Committee on Small and Emerging Companies (presentation by Dan Zinn, General Counsel, arguing that OTC Markets had 60 issuers that 'graduated' to a national exchange in 2015, compared to just 4 for the AIM Market), available at https://www.sec.gov/info/smallbus/acsec-071916-otc-zinn-reg-a.pdf.

[220] The POM in turn has three tiers, where the least onerous tier is called 'No Information' and includes firms that do not provide disclosure to investors. *See* further https://www.otcmarkets.com/marketplaces/otc-pink.

[221] OTC Markets, Press Release: OTC Markets Group Data Now Available Via Redline Trading Solutions (March 30, 2016).

[222] ADRs established on the basis of 12g3-2(b) require a listing in the home country.

[223] Andrew Ang, Assaf A. Shtauber & Paul C. Tetlock, *Asset Pricing in the Dark: The Cross-Section of OTC Stocks*, 26 REV. FIN. STUD. 2985 (2013).

[224] MiFID II, Art. 53(1) (RMs), Art. 18(3) (MTFs), Recital (7) (principles). MiFID II, which together with the companion regulation MIFIR will replace what is now known as MiFID I, will come into force on January 1st 2018. We refer to MiFID II and MIFIR in the footnotes. Unless we indicate otherwise, the forthcoming rules described in the text do not innovate on the MiFID I regime.

[225] MiFID II, Art. 4(1)(20), Art. 14.

The regime in force until the end of 2017 puts a premium on competition among trading venues and other liquidity services providers, by banning any concentration rule across the EU. It does so in the absence of a consolidated tape and with weak enforcement of the best execution rule. Reacting to widespread concerns about the unfairness of this open-architecture framework for retail investors, the forthcoming MiFID II regime makes a U-turn and, with due exceptions, mandates equity trading on organized trading venues with the purpose of reducing market fragmentation and facilitating efficient price discovery. The new regime also promotes the private supply of a consolidated tape of executed trades by channeling post-trade transparency reporting via specified routes which should facilitate private party solutions to data consolidation. [226] Nevertheless, it is interesting to note that in contrast to the US, a consolidated tape of trading quotes—and hence a 'European Market System'—is not yet part of the EU equity markets environment and is unlikely to operate before the next decade.[227]

### 6.3. Old and new topics in the regulation of cross-border trading

In comparing US and EU trading regulation, we have identified four areas of diverging approaches that may affect cross-border coordination or competition or anyhow deserve further reflections and analysis in a New Special Study. We discuss dark pools, the EU's new trading obligation, high-frequency trading (HFT), and insider trading prohibitions.

*(a) Dark pools*

With MiFID II, the EU will introduce limits on trading in dark pools, with the goal of protecting price formation on organized trading venues.[228] All trading venues will generally be required to provide pre-trade transparency on a continuous basis,[229] but competent authorities will be permitted to waive this requirement for (a) reference price trades (where dark orders are matched at a price set at another venue); (b) negotiated transactions (e.g., where orders are matched within the volume-weighted spread of quotes of market makers of the trading venue operating the system); (c) large-scale orders; and (d) orders held in an order management facility (such as 'iceberg orders' where only a portion of the full order is initially displayed and gradually revealing new portions as it executes). Waivers under (a) and (b) will be capped at a maximum of 4 per cent of an equity security's total trading volume, and no more than 8 per cent of all trading in any equity security may take place under such waivers.[230] This is known as the 'double volume cap' (DVC). If trading exceeds these limits in a 12-month period, dark trading will be suspended on the venue in question or across the EU, depending on the cap exceeded.

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[226] MiFIR, Arts. 20-22.

[227] *See, e.g.,* Hogan Lovells, MiFID II Data Reporting Services (2017) (*available at* http://hoganlovells.com/~/media/hogan-lovells/pdf/mifid/subtopic-pdf/lwdlib01-4925126-v1-mifid_ii_data_publication_v2.pdf).

[228] MiFIR, Art. 5 gives this rationale.

[229] MiFIR, Art. 3.

[230] MiFIR, Arts 4-5.

As this type of cap is a new technique to regulate trading in dark liquidity pools, the change of EU regimes may serve as a natural experiment to see whether the new market structure framework results in improved price formation.[231] The double volume cap also raises the question whether EU trading in dark pools could move to third countries if the EU suspends dark trading in a security. It appears that EU market participants have prepared new order types and functionality to maintain opportunities for dark trading, so this may not be an immediate risk.[232]

*(b) The new trading concentration rule*

While the double volume cap rule is aimed at trading venues, MiFIR also introduces a requirement, known as the share trading obligation (STO), that where shares are available for trading on organized EU trading venues, or a third-country venue that has been assessed as equivalent, EU investment firms must actually trade them on such organized venues.[233]

The STO could have significant effects on cross-border trading because of its bias toward EU trading venues. Where US and other 'third country' stocks are also traded on EU trading venues, the STO would require EU investment firms to trade them on the EU venues, regardless of how its pricing and market depth compares to non-EU venues (save those designated as 'equivalent'). For example, in the last 12 months there has been a relatively small amount of trading of Apple stock on EU venues.[234] Under the STO, unless and until NASDAQ is assessed as equivalent to a EU trading venue, EU trading would have to be directed to EU venues.

The STO is currently a source of significant uncertainty for EU investment firms, since it is unclear both to what extent there will be equivalence decisions in place when it comes into effect in January 2018 and how it relates to best execution obligations that would designate a non-EU venue. In particular, unless the UK following Brexit is immediately deemed equivalent, EU investment firms would be required to avoid trading on the London Stock Exchange when the relevant equity security is available on alternative EU trading venues.

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[231] *See also* SEC Commissioner Luis A. Aguilar, Public Statement: Shedding Light on Dark Pools (Nov. 18, 2015) (suggesting that the SEC should monitor the effects of EU initiatives), available at https://www.sec.gov/news/statement/shedding-light-on-dark-pools.html. For a discussion of how studies of the EU framework could be designed, *see* Merritt B. Fox, *MiFID II and Equity Trading: A US View*, in DANNY BUSCH & GUIDO FERRARINI (EDS), REGULATION OF THE EU FINANCIAL MARKETS: MIFID II AND MIFIR 487, at 519.

[232] *See* Peter Gomber & Ilya Gvozdevskiy, *Dark Trading under MiFID II*, in DANNY BUSCH & GUIDO FERRARINI (EDS), REGULATION OF THE EU FINANCIAL MARKETS: MIFID II AND MIFIR 363, at 386-88.

[233] Art. 23 provides two limited exceptions to this obligation: (1) non-systematic, ad-hoc, irregular, and infrequent trades, and (2) trades between eligible counterparties that do not contribute to price discovery.

[234] For example, data from the Fidessa Fragulator indicates that a relatively small portion of the volume in Apple stock (typically less than 0.20%) trades over the Deutsche Börse. *See* http://fragmentation.fidessa.com/fragulator/.

The EU rule could also impact US equity market structure. If the EU were to take a selective approach and grant equivalence only to certain US exchanges,[235] trading of US stocks by EU investment firms could only take place on such venues, meaning that EU regulation would drive inbound US liquidity to the venues deemed equivalent.

*(c) Algorithmic and high-frequency trading*

Exchanges and trading venues compete for volume, both intra- and inter-jurisdictionally. Attracting high-frequency traders (HFTs) can add significantly to such volume. In fact, they are estimated to account for between 24 and 43 per cent of the value traded within the EU.[236]

In the aftermath of the financial crisis, European policymakers addressed the regulatory challenges posed by HFT by applying the 'precautionary principle': they viewed HFTs as capable of exacerbating market volatility and malfunctioning, which could create systemic risk.[237] Hence, they targeted HFTs with *ex ante* regulatory strategies in order to prevent or reduce harm rather than having to respond to issues in real time (which is difficult, given that 'real time' for HFTs is milliseconds or less):[238] more precisely, they deployed, first, *entry regulation*, which includes the requirement to be licensed by the regulator. Second, they resorted to *conduct regulation*, such as restrictions on cancellations of orders or market maker obligations to post quotes. Finally, in a subset of countries, including France and Italy, a structural restriction in the form of a financial transaction tax (FTT) aimed at curbing undesirably excessive activity was introduced.

The first European country to tackle HFTs was Germany, in 2013.[239] Its legislation served as a model for the subsequent EU-wide regime, which will enter into force in 2018. HFTs on German markets are required to obtain authorization and are supervised by the German regulator, regardless of where they are physically located. In addition, HFTs must flag orders generated by algorithms to allow market surveillance of individual algorithms, while trading venues are required to determine a minimum tick size, establish an order-to-trade ratio for each traded instrument, charge separate fees for excessive usage of their systems, and have circuit breakers in place. The German Act is only applicable to German

[235] The equivalence assessment will proceed under Art. 23(1) MiFIR, which directs to Art. 4(1) of the Prospectus Directive 2003/71 via Art. 25(4)(a) MiFID II. The process entails an assessment by the Commission of whether the third country trading venue is equivalent with an EU regulated market (i.e., not an MTF), which suggests that it is more likely that a US exchange will be deemed equivalent than an ATS.

[236] ESMA, ECONOMIC REPORT 1/2014: HIGH-FREQUENCY TRADING ACTIVITY IN EU EQUITY MARKETS, 4 (the two figures reflect two different approaches to identify HFT activity).

[237] MiFIR, Recital 32.

[238] O. Linton, M. O'Hara & J. P. Zigrand, *The Regulatory Challenge of High-Frequency Markets*, in DAVID EASLEY, MARCOS LÓPEZ DE PRADO & MAUREEN O'HARA, HIGH-FREQUENCY TRADING: NEW REALITIES FOR TRADERS, MARKETS AND REGULATORS (eds, 2013) 207 at 208-9.

[239] An English translation of the German law is available at the German regulator's website: https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Gesetz/hft_en.html.

markets, a fact used in a study of its effects which reported that it had reduced the amount of intraday messages, but had only a small impact on trade execution in the form of a negligible widening of the bid-ask spread.[240]

Similarly, the new MiFID II regime will introduce specific EU rules for algorithmic trading (AT)[241] and HFT,[242] where the latter is a subset of the former. The new regime will harmonize EU rules, bringing to an end a period of varied regulatory approaches to HFT across EU member states, ranging from permissive (UK) to uncertain (France),[243] to prescriptive (as in Germany).

The new European rules will treat HFT as a regulated investment activity,[244] and require HFTs to be authorized as investment firms and comply with rules on minimum initial capital, comprehensive obligations with respect to organizational and risk-management matters, 'fit and proper' requirements for management and qualifying shareholders, and numerous reporting and disclosure requirements. Firms engaging in AT will have to notify this to competent authorities both in their home state (which acts as the primary regulator) and in the state of the relevant trading venue. AT firms will be subject to specific requirements on systems and risk controls and are required to test algorithms before deployment. Further, they will be subject to specific reporting requirements allowing authorities to request, regularly or episodically, detailed descriptions of their trading strategies including parameters, limits and risk controls.[245] HFTs are, in addition, required to

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[240] Martin Haferkorn & Kai Zimmermann, *The German High-Frequency Trading Act: Implications for Market Quality* (Working Paper, Oct. 24, 2014), available at http://dx.doi.org/10.2139/ssrn.2514334 (noting that many HFTs in Germany already had prior regulatory authorization in another capacity).

[241] The EU defines 'algorithmic trading' as 'trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention'. MiFID II, Art. 4(1)(39).

[242] The EU defines HFT as 'an algorithmic trading technique characterised by: (a) infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access; (b) system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders; and (c) high message intraday rates which constitute orders, quotes or cancellations.' MiFID II, Art. 4(1)(40). The EU considers high message intraday rates to be two messages per second for any single financial instrument or four messages per second for all financial instruments. Art. 19 of the Commission Delegated Regulation (EU) of 25.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, [C(2016) 2398].

[243] A December 2015 decision by the French financial regulator has been described as a '*de facto* ban on HFT in France' in Pierre-Henri Conac, *Algorithmic Trading and High-Frequency Trading (HFT)*, in DANNY BUSCH & GUIDO FERRARINI (EDS), REGULATION OF THE EU FINANCIAL MARKETS: MIFID II AND MIFIR (2017). However, a recent study by the French regulator did not appear to treat HFT as banned, noting that 'high-frequency traders … are … best able to offer effective inventory management in an increasingly fast-moving and fragmented market'. *See* AUTORITÉ DES MARCHÉS FINANCIERS, STUDY OF THE BEHAVIOUR OF HIGH-FREQUENCY TRADERS ON EURONEXT PARIS (Jan. 2017).

[244] MiFID II, Recital (18), Art. 2(1)(d).

[245] MiFID II, Art. 17(1), 17(2).

keep records of all orders placed and make such records available to authorities on request.[246] Further, AT firms pursuing market-making strategies[247] must enter into written agreements with the relevant trading venues, containing express obligations to provide liquidity on a 'regular and predictable basis', save under exceptional circumstances.[248]

In addition to entry rules, again following the German model, MiFID II requires regulated exchanges to have circuit breakers in place,[249] to have a minimum tick size,[250] to be able to identify orders generated by algorithmic trading,[251] and to limit the ratio of unexecuted orders to transactions that may be entered into the system by a member or participant.[252] MiFID II also explicitly preserves Member States' ability to permit 'a regulated market to impose a higher fee for placing an order that is subsequently cancelled than an order which is executed and to impose a higher fee on participants placing a high ratio of cancelled orders to executed orders and on those operating a high-frequency algorithmic trading technique in order to reflect the additional burden on system capacity.'[253]Regulation that raises the cost of running HFT businesses will create barriers to entry, but is neutral to the extent that it merely codifies pre-existing practices (such as requiring the testing of algorithms). While entry barriers can trigger industry consolidation, reduce competition, and increase margins (and market share) for significant players, entry regulation has no impact *per se* on the 'disruption' HFTs may bring to securities markets, or any negative impact they may have on other market participants. However, structural barriers that instead curb HFT by reducing the available revenue (such as a FTT), and conduct regulation (such as tick size rules, restrictions on cancellations of orders, or obligations on market makers) will directly affect the size of the HFT market.

After the EU rules enter into force, we may expect less liquidity (and perhaps less volatility in abnormal times) in European markets. This means that the EU may be an interesting source of data when considering alternative models of regulation.[254] Similarly,

[246] MiFID II, Art. 17.

[247] An investment firm pursues a market-making strategy when 'as a member or participant of one or more trading venues, its strategy, when dealing on own account, involves posting firm, simultaneous two-way quotes of comparable size and at competitive prices relating to one or more financial instruments on a single trading venue or across different trading venues, with the result of providing liquidity on a regular and frequent basis to the overall market.' MiFID II, Art. 17(4).

[248] MiFID II, Art. 17(3).

[249] MiFID II, Art. 48(5).

[250] MiFID II, Art. 49.

[251] MiFID II, Art. 48(10). This may be by means of flagging from members or from participants.

[252] MiFID II, Art. 48(6).

[253] MiFID II, Art. 48(9), third para.

[254] *See also* Fox, *supra* note 232, at 523 (noting that it may be instructive to study the market reaction in France to a ruling that HFT order cancellation constituted market abuse).

while we would not expect any interjurisdictional spill-overs to the US to follow from the EU's forthcoming stringent rules, cross-listed stocks may provide useful data for research.[255]

*(d) Insider trading regulation and enforcement*

At the time of the first Special Study, the prohibition of insider trading (or at least its enforcement) was a novel US idiosyncrasy.[256] Following the SEC's efforts,[257] it has become global. Perhaps because SEC was behind global adoption,[258] however, the philosophy adopted across the rest of the globe is the SEC's 'market egalitarianism' model, rather than the Supreme Court's more restrictive theory. The EU has a broad prohibition on trading on inside information, regardless of how the information was acquired. So too do Australia, Brazil, Hong Kong, and Singapore.[259] The Japanese approach is limited to enumerated categories of insiders and shareholders, but still prohibits tippees from knowingly trading on material information,[260] which is not always the result under the US framework.[261]

The global picture is thus one in which the US stands alone in its unique approach to insider trading, whereas many other countries have theoretically simpler and functionally similar frameworks employing the SEC's 'disclose or abstain' model (simplifying just to 'abstain' for individuals with inside information considering whether to trade in anonymous securities markets). Since most other countries have a ban on insider trading that extends beyond the scope of the US prohibition, the lack of a globally accepted and readily-

[255] For example, it may be interesting to see (as a measurement of market interconnectedness via cross-border arbitrage) whether liquidity decreases in stocks cross-listed on US markets when HFT activity becomes costlier in EU markets.

[256] The SEC had, in effect, launched the 'disclose or abstain' policy two years earlier. *See In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

[257] *See, e.g.,* Luca Enriques, Gerard Hertig, Reinier Kraakman & Edward Rock, *Corporate Law and Securities Markets*, in JOHN ARMOUR, LUCA ENRIQUES ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, at 257-58 (3rd ed. 2017).

[258] An investigation of how insider trading law enactment and enforcement spread found that having an MoU with the US SEC made a country four times more likely to adopt insider trading laws, whereas membership of IOSCO significantly increased the likelihood of enforcement. David Bach & Abraham L. Newman, *Transgovernmental Networks and Domestic Policy Convergence: Evidence from Insider Trading Regulation*, 64 INT'L ORG. 505 (2010).

[259] *See* DOUGLAS W. ARNER ET AL., FINANCIAL MARKETS IN HONG KONG (2nd ed., 2016) 538 et seq. (Hong Kong), Luca Enriques et al., *Related-Party Transactions*, in ARMOUR, ENRIQUES ET AL., *supra* note 257, at 159-161 (Brazil); Alexander F. Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore*, 54 AM. J. COMP. L. 123 (2006) (Australia and Singapore).

[260] Luca Enriques et al., *Related-Party Transactions*, *supra* note 259, at 159-161.

[261] Martin Bengtzen, *Private Investor Meetings in Public Firms: The Case for Increasing Transparency*, 22 FORDHAM J. CORP. & FIN. L. 33 (2017).

comprehensible framework for insider trading in today's integrated capital markets is likely only to cause practical problems for Americans.[262]

In the EU, rules on insider trading are closely connected with those governing *ad hoc* corporate disclosure. The same materiality threshold simultaneously activates a requirement for a firm to disclose the information and the blanket ban on trading.[263] In contrast, the US has no general requirement to disclose information as soon as it becomes material.[264] Of course, certain categories of information must be disclosed on Form 8-K (such as entering into a material agreement), but even here there is a difference, in that US companies have four business days to make such information public.[265] To see this, imagine that a US and an EU firm enter into a mutually material agreement on a Thursday morning in New York. The EU firm would need to issue a press release immediately, whereas the US firm need only to file its 8-K by the following Wednesday. It is unclear why US firms need so much longer to prepare announcements than do their EU counterparts. This account of the law on the books implies that disclosure dynamics are radically different on the different sides of the Atlantic. It may be fruitful to investigate whether this is the case in practice, and whether there is scope to reduce the lead-times in the US disclosure framework.[266]

The US is undoubtedly the most zealous of jurisdictions when it comes to insider trading enforcement.[267] One study has found that, as a functional matter, enforcement is particularly important, such that firms' cost of capital decreases not with a country's adoption of insider trading laws, but on its first prosecution of violators.[268] This may raise

[262] Indeed, it has. *See* UK Financial Services Authority, In the Matter of David Einhorn (Jan. 12, 2012), where a US hedge fund manager refused to sign a confidentiality agreement with a UK public firm but received inside information regardless, traded on it (allegedly in good faith), and was found to have breached UK rules on market abuse.

[263] Arts. 14 and 17 Market Abuse Regulation 596/2014, 2014 O.J. (L 173) 1.

[264] While US stock exchanges typically require prompt issuer disclosure of material information as part of their listing rules, they do not appear to enforce these rules. For example, NYSE Rule 202.05 requires 'quick' disclosure, but has never been used to sanction an issuer. *See, e.g.,* Gill North, *National Company Disclosure Regulatory Frameworks: Superficially Similar but Substantively Different*, 3 J. MARSHALL GLOBAL MARKETS L.J. 187, 194 (noting that all NYSE disciplinary actions related to the conduct of intermediaries).

[265] 17 C.F.R. § 249.308.

[266] Reducing disclosure lead times may also be of interest in light of a recent study that found that US insiders trade profitably in the time period between the occurrence of an event and its subsequent public disclosure; Alma Cohen, Robert J. Jackson, Jr. & Joshua R. Mitts, *The 8-K Trading Gap*, Columbia Law School Working Paper No. 524 (Sep. 7, 2015), available at ssrn.com/abstract_id=2657877. We note that Donald Langevoort's contribution to this volume also highlights these issues: *see* Langevoort, *supra* note 184.

[267] *See* Luca Enriques et al., *supra* note 260, at 160. *See also* Lev Bromberg, George Gilligan & Ian Ramsay, *The Extent and Intensity of Insider Trading Enforcement – an International Comparison*, 2016 J. CORP. L. STUD. 1 (2016) (comparing public enforcement of insider trading in Australia, Canada, Hong Kong, Singapore, the UK and the US; concluding that the US imposes the greatest dollar value, but not always the most severe, sanctions).

[268] Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002).

the question whether the US would find it difficult to designate another country as equivalent for the purposes of mutual recognition.

## 7. Intermediaries

This Section considers global regulatory issues in relation to *intermediaries* and focuses on (i) a comparative overview of US and EU regulation of cross-border broker-dealer services relating to equity markets; (ii) the US regulation of foreign broker-dealers; (iii) an analysis of the implications of Brexit; and (iv) an account of fiduciary duties owed to clients by EU 'investment firms' (encompassing broker-dealers, investment advisers and portfolio managers) and banks engaging in investment services.[269]

### 7.1. The regulation of US/EU cross-border broker-dealer services

A key policy question for regulators is whether, and to what, extent domestic investors need access to international intermediaries, or whether access to domestic intermediaries which can themselves invest internationally will suffice. In this subsection, we review the respective approaches of the US and the EU to regulation of cross-border broker-dealer services in the equity markets. We focus on the US federal securities regulation and the EU MiFID II/MiFIR regime which will come into effect from January 2018.[270] This new EU regime brings significant changes, among them a new framework pertaining to non-EU investment firms (so-called third country firms) seeking to do business in the EU.

*(a) Investment services provision by non-EU firms within the EU*

*Retail clients.* MiFID II gives each EU member state the right to regulate third country firms by devolving to them the decision of whether third country firms intending to provide investment services to clients in their territory shall be required to establish a branch.[271] If a branch is required (and authorization to open it is granted),[272] then the firm can provide investment services to all types of clients—retail and sophisticated—within that country's territory. If a branch is not established, the third country firm will operate outside of MiFID II and must comply with national rules, which must be no less stringent than MiFID II.

*Sophisticated clients.* For transactions with sophisticated clients, MiFIR provides for a harmonized third country regime under which an eligible third country investment firm can

[269] 'Investment services' include broker-dealer, underwriting and placement of securities, including securities issued by the investment services provider itself, and investment advice and portfolio management services. *See* MiFID II, Annex 1, Section A.

[270] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 ('MiFID II') and the Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 ('MIFIR').

[271] Arts. 39-43, MiFID II.

[272] Subject to the conditions set out in Article 39(2) MiFID II, which inter alia requires that a cooperation agreement is entered into between the competent authority of the EU state and the one in the third country (Article 39(2)(b)).

obtain a passport to operate across the EU.[273] For a third country firm to be eligible, various conditions must be satisfied in relation both to the firm and as to the country in which its head office is located (its 'home country'). First, the Commission must have assessed the firm's home country's regulatory regime and concluded that it is *equivalent* to the EU regime.[274] Such an equivalence determination itself has three components: (i) *substantive equivalence*: that the home country rules have equivalent effect to the prudential and conduct of business rules of MiFiD II and MiFIR; (ii) *Compliance*: that the legal and supervisory arrangements in the home country ensure that firms authorized there actually comply with these requirements; and (iii) *Reciprocity*: that the third country's legal framework provides for reciprocal recognition of EU firms.[275] Second, there must be a *cooperation* agreement in place between ESMA and the third country's regulatory authorities encompassing information exchange regarding relevant firms.[276] Third, the firm must either have registered a branch under MiFID II in an EU Member State, or must register with ESMA.[277]

*(b) Broker-dealers' cross-border direct access to stock-exchanges*

We now consider the respective EU and US regulation of a foreign broker-dealer (for the EU, a 'third country' investment firm) seeking to become a member of an exchange in the region in order to execute orders electronically there.

Our first scenario is where a US broker-dealer seeks to become a member of an EU exchange in order to execute orders from its US clients. This situation is, as noted above, not regulated by MiFID II but left to each EU member state. In the UK, for example, a US broker-dealer that seeks to execute orders for a US client on the London Stock Exchange does not require any regulatory authorization,[278] but will (of course) need to fulfil the membership requirements of the exchange. However, the SEC restricts direct cross-border trading from the US on an EU exchange by prohibiting foreign exchanges from placing trading terminals in the US without registering as a US exchange that becomes subject to its regulation and supervision.[279]

The US regulates the reverse first scenario, where an EU broker seeks to execute EU orders on a US exchange, in a less permissive fashion than the EU. Brokers may not solicit

[273] MiFIR, Arts. 46-49 (and transitional rules in Art. 54).

[274] MiFIR, Art. 46(2)(a).

[275] *Id.*, Art. 47(1).

[276] *Id.*, Arts 47(2); MiFID II, Art. 39(2)(b).

[277] MiFIR, Arts. 46, 47(3).

[278] While buying or selling securities is a regulated activity, there are exemptions for an 'Overseas Person' that apply in this case.

[279] *See* Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, *Foreign Trading Screens in the United States*, 1 CAPITAL MARKETS L. J. 54 (2006).

transactions in any security unless they are registered with the SEC.[280] While Rule 15a-6(a)(1) offers a general exemption for foreign broker-dealers that effect transactions with or for persons they have not solicited, for practical purposes the SEC's broad definition of solicitation restricts that possibility to cases where foreign broker-dealers' quotations are distributed by third parties through systems that do not allow for execution.[281] In addition, Section 6(c)(1) of the Exchange Act stipulates that an exchange may not grant membership to anyone who is not a registered broker or dealer. The effect of these provisions is that an EU broker cannot access a US exchange without registration as (or cooperation with) a US broker-dealer.

Our second scenario is where a US broker-dealer is approached by EU investors to engage in securities trading on a US stock exchange. In this case, MiFID II stipulates that such *reverse* solicitation (solicitation by EU clients of third country firms) shall not require authorization.[282] It appears that MiFID II may have arrived at this approach by taking the perspective of the client requesting the service, since that is how Article 42 is drafted, but the outcome is that EU member states are proscribed from regulating foreign firms in this respect. The reverse second scenario is where an EU broker-dealer is approached by US investors to engage in securities trading on an EU stock exchange. As we have seen, EU broker-dealers may execute such trades provided they do not engage in any solicitation in the US, as broadly defined by the SEC.[283]

Our third scenario is where a US broker seeks to approach EU investors to engage in securities trading on a US stock exchange. MiFID II directs the regulation of this issue to each member state.[284] The UK regime, for example, provides that a US broker may solicit business from sophisticated investors without authorization.[285] The reverse third scenario is where an EU broker seeks to approach US investors to engage in securities trading on an EU stock exchange. Again, the US SEC's regulation on solicitation prohibits such activity.

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[280] Section 15(a)(1) of the Exchange Act. Section 3(a)(4)(A) of the Exchange Act defines a broker as 'any person engaged in the business of effecting transactions in securities for the account of others'. Section 3(a)(17) of the Exchange Act defines interstate commerce to include communication between any foreign country and any US state.

[281] Securities and Exchange Commission, Final Rule: Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 34-27017, 54 Fed. Reg. 30013, 30018 (July 18, 1989).

[282] Art. 42, MiFID II.

[283] The SEC views 'solicitation' as 'any affirmative effort by a broker or dealer intended to induce transactional business for the broker-dealer or its affiliates,' including 'the dissemination in the United States of a broker-dealer's quotes for a security' (54 Fed. Reg. 30017-18). But *see also supra* text preceding note 281.

[284] Art. 39, MiFID II.

[285] This is the case as long as the US broker-dealer can establish on reasonable grounds that the recipient is sufficiently knowledgeable to understand the risks of the activity, has informed the investor about the lack of protection under the UK Financial Services and Markets Act, and the investor has agreed to such terms. *See* Art. 33 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005.

*(c) Investors' cross-border direct access to stock exchanges*

Can investors trade directly on exchanges abroad, without the intermediation of a broker? Neither the EU nor the UK have any regulatory requirements that serve to prevent its investors from trading on exchanges abroad. US exchange membership requires registration as a broker-dealer, however, a requirement which also applies to EU investors.

The US also takes a stricter approach in relation to US investors' ability to access foreign exchanges directly. Foreign exchanges may not provide for the dissemination of quotes in the US without registering with the SEC as an exchange. The practical effect of this is that US investors cannot get direct access to foreign exchanges.

*(d) Broker-dealers' facilitation of cross-border investment*

There are various ways in which a country's domestic broker-dealer may facilitate cross-border trading by its clients. One is by making an OTC market for a foreign security.[286] The other is to set up an unsponsored American Depositary Receipts (UADR) program. Following amendments to SEC Rule 12g3-2(b) in 2008, foreign private issuers are automatically exempted from registration so long as they have their shares listed on a non-US exchange, publish all their material mandatory disclosures under local law on their website, and are not otherwise required to report under the Exchange Act. This exemption is therefore available to ADRs that are not listed in the US, including UADRs. Following the SEC rule change there has indeed been a significant increase in UADR programs, from 169 programs before the change to 1,579 programs as of February, 2015.[287] UADRs appear to fulfil an important role for smaller US asset managers, allowing them to compete with larger investors who can access foreign equities overseas, and also for other investor types, such as those that are restricted to buying US securities.[288] Yet, it should be noted that the laws of some countries, notably Brazil, Russia and Malaysia, reportedly prohibit the establishment of UADR programs.[289]

A study of firms that had their securities become subject to UADR programs following the SEC's rule change found that firms with such 'involuntary cross-listing' experienced a decrease in firm value, attributed to increased perceived litigation risk.[290]

### 7.2. The US exemption for foreign broker-dealers

While Section 15 of the Exchange Act requires brokers or dealers providing services to US investors to be registered with the SEC, a general exemption from such registration has

[286] *See supra*, text to notes 218-223.

[287] DEUTSCHE BANK, UNSPONSORED ADRS, MARKET REVIEW (May 2015).

[288] Steve Johnson, *Unprecedented demand for unsponsored ADRs*, Financial Times (June 1, 2014).

[289] DEUTSCHE BANK, UNSPONSORED ADRS, MARKET REVIEW (May 2015) 4.

[290] Peter Iliev, Darius P. Miller & Lukas Roth, *Uninvited U.S. Investors? Economic Consequences of Involuntary Cross-Listings*, 52 J. ACC. RES. 473 (2014).

been available since 1989 for foreign intermediaries that have only limited interactions with US investors (Rule 15a-6). Interactions that are generally permitted without registration include effecting unsolicited transactions, transacting with registered broker-dealers and certain other persons, and providing research reports.

Foreign broker-dealers may solicit securities transactions from certain US institutional investors provided that they enter into a chaperone agreement with a US broker-dealer.[291] The chaperone must then effect all transactions with such investors and take on certain responsibilities, including issuing confirmations to the institutional investors and maintaining a consent to service of process from the foreign broker-dealer.[292] If the foreign broker-dealer would like to visit institutional investors in the US, a representative of the chaperoning broker-dealer must be present and take responsibility for its communications. The chaperone must also participate in any phone calls the foreign broker-dealer makes to US institutional investors, unless such investors have more than $100 million of assets under management.[293] In 2008, against the backdrop of 'ever increasing market globalization' and advances in technology, the SEC proposed to expand the 15a-6 exemptions for foreign intermediaries to allow targeting of 'qualified investors' with more than $25 million in investments,[294] reduce the role of chaperones in order to 'allow qualified investors the more direct contact they seek with those expert in foreign markets and foreign securities',[295] and somewhat soften the SEC's interpretation of what constitutes solicitation so that quotes for securities could be disseminated in systems that did not allow for execution. These proposals were never enacted.

A separate but fundamental question relating to Rule 15a-6 is how to reconcile its aim to regulate overseas conduct relating to overseas transactions with *Morrison v. NAB*. In *SEC v. Benger*,[296] the court held that, following *Morrison*'s pronouncements on the scope of the Exchange Act, it could not find any Congressional intent to require registration under the Act of 'brokers involved in foreign transactions on foreign exchanges'.[297] The SEC has

[291] 17 CFR 240.15a-6(a)(3).

[292] The chaperoning US broker-dealer may delegate to the foreign broker-dealer the actual execution of the foreign securities trades and processing of records. *See* EDWARD GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS 14, at 45-46 (2014).

[293] Chaperoning is not required for phone calls that take place outside of US business hours and do not involve transactions in US securities. *See* GREENE ET AL., *supra* note 292, 14-43.

[294] *See* Section 3(a)(54) of the Exchange Act for the full definition of 'qualified investor'.

[295] Proposal: SEC Proposed Rule, Exemption of Certain Foreign Brokers or Dealers, Release No 34-58047, 73 FR 39182, 39188 (July 8, 2008).

[296] SEC v. Benger, 934 F. Supp. 2d 1008 (N.D. Ill. 2013).

[297] '[I]n light of *Morrison*, a broker's failure to register under Section 15(a) of the Act is not actionable in those cases where the ultimate and intended purchase and sale was foreign and thus, itself, outside the scope of the Act.'

not commented on the issue, but there is clearly significant uncertainty about the continued applicability of the rule.[298]

### 7.3.U.S. investor access to off-shore liquidity and investment services

In a framework where retail investors have indirect access to capital markets via institutional investors, it is less important to allow retail investors direct access to the services of foreign broker-dealers and/or to foreign trading venues (via domestic or foreign brokers). The relevant question is rather whether the regulatory restrictions for institutional investors (including investment advisers, who are treated like institutional investors under the relevant exemption rules) are justified or whether they impose unduly high costs to protect the business of domestic broker-dealers.

Table 2 summarizes the inbound and outbound interactions between investors, intermediaries and issuers according to rules in force on the two sides of the Atlantic. The SEC does not allow trading screens of foreign exchanges to be placed in the U.S. unless such exchanges choose to opt into its regulations.[299] Hence, U.S. investors cannot transact on European exchanges via such trading screens, but can execute transactions via other methods. For example, they can engage foreign broker-dealers either from their own overseas offices or through execution-only interactions from their US offices which avoid triggering SEC registration requirements as long as the foreign broker-dealer does not actively solicit such business.[300] This latter method would also apply to individual investors. The SEC's current approach may thus mainly have the effect of making trading of foreign securities costlier, particularly for retail investors.

[298] LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, VI SECURITIES REGULATION 691-694 n. 297 (5TH ED. 2014). *See also* Edward Greene & Arpan Patel, *Consequences of* Morrison v NAB*, securities litigation and beyond*, 11 |CAP. MARKETS L.J. 145, at 167-68 (2016) (describing difficulties in applying Morrison's transactional approach to intermediary registration provisions).

[299] *See* Jackson et al., *Foreign trading screens*, *supra* note 279.

[300] *Id*., at 69-75.

**Table 2.** Overview of US-EU Regulation of Cross-Border Investment Activity.

| | EU Clients | EU Brokers | EU Exchanges | EU Issuers |
|---|---|---|---|---|
| US Clients | | If exemption applies, or reverse solicitation, and only for foreign securities | Direct access via membership for some institutional investors under EU rules (but US prohibits trading screens) | US Prospectus exemptions (including for qualified buyers) |
| US Brokers | MiFID rules apply for securities transactions to be carried out on US markets, unless reverse solicitation | | Direct access via membership, on behalf of US clients (but US prohibits trading screens) | Yes, after US resale restrictions cease to apply; UADRs can be traded in the US upon US brokers' initiative. |
| US Exchanges | Not an issue under EU rules; through US brokers under US rules | Not unless authorized as US brokers | | No specific EU regulation of issuer that only lists outside EU |
| US Issuers | Prospectus exemptions (including for qualified buyers) | No resale restrictions under EU rules | SEC registration required unless limited holders of record. | |

### 7.4. Implications of Brexit

Brexit now looks likely to involve the UK leaving the European single market, in which case it will become a third country. This raises the question of the extent to which the new MiFIR third country passport regime for sophisticated client business could be used to provide UK investment firms with continued EU market access.[301]

The UK government has announced that its likely strategy on exit from the EU will be a wholesale enactment of all previously-binding EU law into domestic UK law. It follows that, at the point of exit, the UK will have in place a body of financial regulation that necessarily will be substantively equivalent to EU law. The UK's FCA and PRA have larger enforcement budgets than many other EU Member States' financial regulators, which should suffice to meet the Commission's enquiries regarding compliance. And it will naturally be in the UK government's interests to agree, where necessary, to reciprocity for EU financial services firms wishing to do business in the UK.

There is a widely held fear that the process of determining equivalence may become politicized in the context of a messy Brexit negotiation. Yet this likely under-appreciates the merits of leaving decisions to technocrats, which is precisely what the democratically-opaque structure of the Commission, and a fortiori, the delegation of the initial assessment

[301] The following text draws on Armour, *supra* note 42, at S61-S64.

to the European Supervisory Authorities, is intended to achieve.[302] The Commission have already made equivalence decisions in favor of many of the G20 countries and other international financial centers in respect of other provisions of EU financial regulation.[303]

A more plausible concern is whether the Commission will have completed the necessary equivalence determinations by the time the UK's two-year 'exit period' is completed. Neither a third country, nor its firms, have any right to compel the Commission to start the process of making an equivalence determination, even if the third country would manifestly meet the criteria. The very earliest equivalence decisions under EMIR, for Australia, Hong Kong and Singapore, took two years from when the legislation came into force.

A further concern relates to the future beyond the short term. Equivalence must be reviewed periodically, and an initial decision in favor of the UK may be withdrawn by the Commission at will. While the regimes will be equivalent on exit, they may rapidly diverge. The EU has produced new legislation governing the financial sector at an astonishing rate since the financial crisis, and this shows little sign of abating. On ceasing to be hardwired into the system, the UK will rapidly fall behind unless it adopts a mechanism for automatic implementation of new EU financial regulation initiatives into domestic law, likely along with some kind of enforcement machinery.

This would on the face of it relegate the UK to a 'rule-taker'. However, outside the single market, the UK would have another option if it was dissatisfied with actual or proposed EU rules in a particular area. It could cease to maintain equivalence with the EU in that particular area, while continuing to do so in other areas. This would harm EU-UK trade, but potentially put the UK in a competitive position vis-à-vis the EU in relation to other third countries. Maintaining the possibility of a la carte non-equivalence of this sort would give the UK a credible 'threat' in any informal discussions regarding proposed new EU rules. Some commentators have floated the idea of a 'parallel regime' within the UK, one EU-compliant and one not.[304]

### 7.5. EU-Style Broker-Dealer Fiduciary Duties

One of the most debated issues in recent years by U.S. securities law scholars and policymakers is whether broker-dealers and others providing similar services to clients should be subject to a fiduciary duty towards their clients. In referring the reader to the relevant chapter of this book for a discussion, we focus here on the European rules that, since the 1990s, have imposed obligations akin to fiduciary duties on European investment firms and banks (here, together, investment firms) engaged in investment services.

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[302] Niamh Moloney, *Financial Services, the EU, and Brexit: An Uncertain Future for the City?*, 17 GERM. L.J. 75 (2016).

[303] Armour, *supra* note 42, atS62.

[304] *See* Ferran, *supra* note 42.

More precisely, EU investment firms must 'act honestly, fairly and professionally in accordance with the best interests of [their] clients'[305] (hereinafter: the fiduciary duty). Not only does breach of such duties typically entail private enforcement by investment firms' clients, but it also triggers administrative sanctions.[306]

The fiduciary duty co-exists with more specific duties that apply to investment firms depending on the individual services they provide and which can be held to be a specification thereof: for instance, they are subject to a suitability rule if they provide advisory or portfolio management services,[307] while for other services, with due exceptions, they must apply an appropriateness test before assisting clients in the purchase of a given financial instrument.[308] When these or any of the other MiFID II specific conduct of business rules apply, but circumstances are such that compliance with those rules is insufficient to ensure that the investor's interest is duly protected, the client can invoke the fiduciary duty to obtain redress.[309]

Whenever MiFID II permits waiver of specific obligations, the fiduciary duty may still apply, in whole or in part. For instance, the duty to assess the appropriateness of investment services and financial instruments is waived for the execution of trading orders concerning non-complex financial instruments,[310] to the extent that such activities are performed at the initiative of the clients.[311] However, even for such 'execution-only' services, MiFID II does not exempt investment firms from the fiduciary duty, which may hence support clients' claims, for instance, in situations where the investment firm somehow promoted the purchase of the financial instrument without providing advice to the client.[312]

The fiduciary duty applies, with narrowly defined exceptions, whatever the client's characteristics—that is, regardless of whether the client is 'professional' or not.[313] Of the two exemptions from the duty, the more salient one is partial in both content and scope:[314]

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[305] Art. 24(1) MiFID II.

[306] *See*, respectively, Art. 69(2) MiFID II; Art. 70(3)(a)(x) MiFID II.

[307] Art. 25(2) MiFID II.

[308] Art. 25(3) MiFID II.

[309] *See* Luca Enriques & Matteo Gargantini, *The Overarching Duty to Act in the Best Interest of the Client in MiFID II*, in REGULATION OF EU FINANCIAL MARKETS: MIFID II AND MIFIR 85, at 88 (Danny Busch & Guido Ferrarini eds, 2017).

[310] As defined by Article 25(4)(a), MiFID II.

[311] Art. 25(4) MiFID II.

[312] *See* Enriques & Gargantini, *supra* note 309, at 95.

[313] 'Professional clients' are defined by MiFID's Annex II to include, in addition to financial institutions, large non-financial firms, governments, and wealthy individuals who are particularly active on securities markets and have requested to be treated as such.

[314] A full exemption is only provided for the non-discretionary crossing of buying and selling interests within trading venues (Arts. 19(4) & 53(4), MiFID II).

investment firms are exempted from the duty to act in clients' best interests, but not from the duty to act honestly, fairly and professionally, when they engage in execution of orders (whether by matching the client with another trader or entering the contract as dealers) with 'eligible counterparties,'—that is, clients that are themselves financial institutions, such as other banks and investment firms, and asset managers and insurance companies.[315]

While the operation of the fiduciary duty is unproblematic in relation to the provision of investment advice and portfolio management services, reconciling its implications with transactional relationships such as dealing on one's own account and the placement of the investment firms' own securities—which is also qualified as an investment service[316]—is rather more difficult.

Where firms are operating as counterparties to their clients, the duty to put their clients' 'best interests' first can scarcely be reconciled with the duties trading desk employees owe to their principals. So much so that doubts have been raised, including by some national competent authorities under the previous regime, over whether conduct of business rules, including the fiduciary duty, apply at all when investment firms merely act as dealers. Nevertheless, first the Commission and then ESMA have clearly adhered to view that they do.[317]

The irreconcilable tension between the transactional nature of the service and the content of the fiduciary duty means that the duty sometimes serves as an indirect prohibition on certain activities. Two case studies serve to illustrate these difficulties.

First, ESMA has opined that when an investment firm acts as counterparty to retail clients in contracts for differences (CFD)—where a client's losses are obviously the investment firm's gains—the incentives to profit at investors' expense implies a *per se* breach of the fiduciary duty. ESMA's conclusion is that the offer of CFDs and other speculative products to retail clients should therefore be avoided altogether.[318]

Second, in combination with rules setting out obligations to consider clients' interests in the process of developing new investment products, the fiduciary duty affects their commercial policies as well: according to ESMA, when it would be impossible not to breach the duty to act in the client's best interest for any possible target clientele of a given new product, a ban on the selling of that product may ensue.[319]

To conclude, the EU has long since imposed a fiduciary duty on investment firms, and this duty is now an important pillar of broker-dealer client-facing regulations within the EU. We

[315] Art. 30(2), MiFID II.

[316] Art. 4(1)(5), MiFID II.

[317] *See* Enriques & Gargantini, *supra* note 309, at 112.

[318] *See* ESMA, 'Questions and Answers relating to the provision of CFDs and other speculative products to retail investors under MiFID', 18 and 20 (ESMA/2016/590) (2016).

[319] ESMA, 'MiFID practices for firms selling complex products', 3 (ESMA/2014/146) (2014).

have hinted here at some of the implications of a broad duty of this kind and, specifically, how it can shape the boundaries of permissible services, marketing practices, and financial products. This is an area where comparative research, both legal and empirical, may shed some light on the merits of policy proposals currently debated in the U.S.

## 8. Supervision and enforcement in global securities regulation

Our final substantive Section considers issues of enforcement and the implications of the Morrison decision. We ask whether the 'new structure' we have identified for global securities regulation means that the model of the US as 'global enforcer' of securities regulation is now outmoded.

### 8.1. The US: An Outlier?

The influential role played by the US in global securities regulation is perhaps most keenly felt in enforcement. Foreign issuers' securities law transgressions may often be acted upon sooner, and with more meaningful consequences, by the US SEC than by these firms' domestic regulators.

The literature on comparative financial supervision and enforcement places the US as both a global leader and a global outlier. For example, both the number of enforcement actions by the public regulator and the dollar amount of assessed sanctions has been found to be significantly higher in the US than in the UK and Germany.[320] For a full picture, private sanctions should also be considered, but there is little doubt that the US leads the way also in this respect.[321] It has been suggested that these disparities in enforcement activity could make it difficult for other countries to be considered equivalent to the US under a substituted compliance approach.[322]

However, institutional differences between countries may make direct comparisons difficult. The UK system of financial regulation, for example, relies significantly on informal, difficult-to-quantify enforcement mechanisms that may make an apples-to-apples cross-country comparison of enforcement intensity less straightforward than it appears.[323] Further, as globalization increases, so too does the difficulty of conducting meaningful international comparisons. For example, some national regulators invest more in policy

[320] Howell E. Jackson, *Variation in the Intensity of Financial Regulation*: *Preliminary Evidence and Potential Implications*, 24 YALE J. REGULATION 253, 281-85 (2007) (scaling data by stock market capitalization). Looking specifically at the costs of operating the securities regulator (scaled by the size of the stock market in respective countries), the US does not stand out, however. *See id*., at 269 (estimating the securities budget per $bn of market cap at $98,000 for the US, compared to $138,000 in the UK and $280,000 in Australia).

[321] *See, e.g*., Coffee, *Law and the Market*, *supra* note 64, at 267.

[322] *Id*., at 307-8.

[323] *See*, e.g., John Armour, *Enforcement Strategies in UK Corporate Governance*, in J. ARMOUR & J. PAYNE (EDS, 2009), RATIONALITY IN COMPANY LAW – ESSAYS IN HONOUR OF DD PRENTICE (2009) 71 (describing the several institutions that form part of the UK supervision and enforcement framework and detailing how informal enforcement, both by public enforcement agencies and private investors, plays a more important role than formal enforcement).

analysis and/or international harmonization efforts, the results of which may be available to others to draw upon at low cost, and increasing amounts of cross-border transactions mean that national regulators cooperate more with their foreign counterparts.[324] Another confounding factor is that a country whose larger issuers are cross-listed in the US may save on regulatory costs by deferring to the enforcement efforts of the US SEC.[325] The SEC's enforcement intensity towards foreign firms has increased significantly during the last fifteen years.[326] Non-targeted foreign firms see their value increase on the announcement of such enforcement actions. In particular, firms with weaker domestic regimes gain relatively more in value. This implies these firms' domestic regulators are effectively delegating enforcement to the SEC.[327]

In conclusion, if or when the SEC resumes its consideration of substituted compliance as a regulatory strategy, research regarding the details of comparative financial regulation, supervision and enforcement in key jurisdictions would be highly useful, if not necessary, for its assessment of their regulatory quality.[328]

### 8.2. The impact of *Morrison*

The US Supreme Court's 2010 decision in *Morrison v. NAB*[329] was an earthquake that significantly changed the global securities litigation landscape, and although the tremors may not yet have finished entirely, we will briefly survey the emerging topography.

In the pre-*Morrison* era, behavior that had been conducted,[330] or had effects,[331] in the US was accepted as founding jurisdiction for US courts under § 10(b) of the Exchange Act. These 'conduct' and 'effects' tests were originally developed in the Second Circuit, but were widely embraced. In *Morrison*, the Supreme Court rejected them both in favor of a new 'transactional test', under which § 10(b) applies only to purchases and sales of securities taking place in the United States. This, the court explained, covers 'transactions in securities listed on domestic exchanges, and domestic transactions in other securities'.[332]

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[324] Howell E. Jackson, *The Impact*, *supra* note 164, at 408-9.

[325] *Id*.

[326] Silvers, *supra* note 152.

[327] *Id*.

[328] *Cf.* Jackson, *Variation*, *supra* note 320, at 289 (suggesting that the US could benefit from an international comparison of its system for financial regulation and enforcement in order to benchmark its costs and benefits).

[329] 561 U.S. 247 (2010).

[330] Leasco Data Processing Equipment v Maxwell, 468 F.2d 1326 (2d Cir. 1972) (fraudulent representations made in the US by the British media proprietor Robert Maxwell, the relevant securities were foreign and traded only in foreign markets – court found U.S. subject matter jurisdiction).

[331] Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (sufficient domestic 'effects' even though the conduct occurred outside the U.S.).

[332] 561 U.S. 247, at 267 (2010).

The Dodd-Frank Act required the SEC to study the international scope of the private right of action under § 10(b).[333] As part of this study, it analyzed the impact of *Morrison* on the share prices of cross-listed firms and found no statistically significant costs or benefits to shareholders of foreign companies with listings on both a non-U.S. and a U.S. exchange stemming from the *Morrison* decision. An analysis of whether *Morrison* prompted institutional investors to reallocate their investments in cross-listed firms to US-traded securities in order to preserve their rights to participate in 10b-5 actions did not find any evidence to support that claim.[334]

Commentators predicted that *Morrison* would result in increasing globalization of securities litigation and that European litigation would increase to make up for the unavailability of US actions,[335] but it was less obvious that the US plaintiffs' bar would lead the way. However, as recently detailed by Coffee, American law firms have created innovative structures to allow for global securities settlements building on a Dutch statute, announcing a European record $1.3 billion settlement in 2016.[336]

## 9. Research agenda

### 9.1. Introduction

In this chapter, we have explored the effects of globalization on the operation of securities markets and the challenges this poses for their regulation. We have argued that three macro-level trends—capital market liberalization, institutionalization of investment, and technologization of market activity—have severed the link between listing on a particular exchange and having access to the capital base originating in the country where that exchange is located. They have simultaneously increased the attractiveness of alternative (private) forums for capital-raising. Thanks to the removal of barriers to free movement of capital, the intermediation of professional managers who have the skills and the scale to invest internationally, and the digital interconnection of markets across the globe, investors can reach all markets and issuers, regardless of where the issuers raise capital and have their securities traded, or which securities laws apply on the issuers' side. We capture this idea in the label 'investor choice', reflected in the chapter's title.

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[333] Section 929Y of the Dodd-Frank Act. We note that § 929P(b)(2) of the Dodd-Frank Act (purporting to grant extraterritorial jurisdiction to the SEC and the Department of Justice to US conduct or effects that violate the § 10(b) antifraud provision) has been described as unlikely to offset any impact of Morrison since it only confers subject-matter jurisdiction. *See, e.g.,* Richard W. Painter, *The Dodd-Frank Extraterritorial Jurisdiction Provision: Was it Effective, Needed or Sufficient?*, 1 HARV. BUS. L. REV. 195 (2011).

[334] Robert P. Bartlett III, *Do Institutional Investors Value the Rule 10b-5 Private Right of Action? Evidence from Investors' Trading Behavior following Morrison v. National Australia Bank Ltd.*, 44 J. LEGAL STUD. 183 (2015).

[335] *See, e.g.,* Vincent Smith, *'Bridging the Gap': Contrasting Effects of US Supreme Court Territorial Restraint on European Collective Claims*, in DUNCAN FAIRGRIEVE & EVA LEIN (EDS.), EXTRATERRITORIALITY AND COLLECTIVE REDRESS 389 (2012) (predicting that London, Amsterdam, and Germany would become the main fora for collective actions in Europe).

[336] John C. Coffee, Jr., The Globalization of Entrepreneurial Litigation: Law, Culture, and Incentives (Working Paper, Jan. 7, 2017), available at ssrn.com/abstract=2857258 (describing various steps taken to create a 'synthetic' opt-out class action).

Many of the issues we have reviewed in this paper raise important questions for further research. As the research agenda for the New Special Study of the Securities Markets is drawn up, international aspects are bound to feature in many areas. In the remainder of this concluding Section, we identify, under the same section headings used earlier in this paper, the questions that we believe are particularly worthy of scholarly attention.

## 9.2.Macro-level issues

The secular trends driving globalization that we identified and discussed in Section 2 raise fundamental questions for further research. First, the trend towards collectivization of investments and the concomitant institutionalization of the stock market mean that retail investors are decreasingly directly active in the trading of individual stocks. This raises two important questions.

1 To what extent are current securities regulation provisions dealing with market access based on the view that retail investor protection is needed, and are these measures still appropriate, necessary, and beneficial? [337]

2 As the institutionalization of the securities market means that investment capital is increasingly held through institutions that qualify for participation in exempt securities offerings (which provide more flexibility than the public markets to tailor investor protection to requirements), what role is envisaged for public securities markets in the future?

Increasing institutionalization means that investment intermediaries increasingly become the market entry point for retail investors and are likely to continue to grow in size and influence, which merits an analysis of the suitability of their regulation:

3 Following from question 1 above, should the focus of retail investor protection be shifted towards intermediaries? If so, is the current regulation adequate?

4 Is the regulation of intermediaries satisfactory for purposes of reducing systemic risk and ensuring financial stability or may, for example, micro-prudential regulation be warranted?[338]

The ongoing technologization of society and markets is another important development where we believe the NSS would benefit from addressing important questions such as the following:

5 The regulatory perimeter will come into the spotlight as technological innovations attempt to substitute for various functions currently performed by more established

[337] Needless to say, this is the kind of question that a New Special Study will have to ask in relation to many areas of securities regulation.

[338] *See* FINANCIAL STABILITY BOARD, POLICY RECOMMENDATIONS TO ADDRESS STRUCTURAL VULNERABILITIES FROM ASSET MANAGEMENT ACTIVITIES (Jan 12, 2017), available at http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

players in the securities markets. How do new FinTech equivalents work, and how do they work in different countries? Do new products warrant a review of the perimeter of securities regulation (such as the definition of a security)? [339]

6 With global capital raising becoming technically possible, does nationally-bounded regulation actually become a major impediment?

7 Online offerings are segmented across geographic lines. Can technology (eg, the algorithms in peer-to-peer lending) substitute for creditor protection rules, making geographic segmentation of these markets obsolete?

8 In light of increasing global interconnectedness, is it desirable for the US stock market to become further globalized, both as regards issuers and investors?[340] What might be the costs and benefits of this for the US, and for other nations? With nationalistic positions being adopted in political discourse, this appears a particularly salient normative issue.

### 9.3. Market access and extraterritoriality

9 What drives cross-border investment structuring for US institutional investors? In which cases and why do US institutional investors choose to operate from foreign countries? When do they invest via ADRs and when do they invest directly in foreign stock? Is regulation driving structuring and, if so, is it desirable?[341] This is an area where interviews with market participants, including institutional investors and issuers, could provide an up-to-date account of market practices to inform regulation.[342]

10 To what extent should financial stability be a concern for global securities markets and international securities regulation?

11 What tools and powers should the SEC have available to deal with cross-border issues (in their prudential implications)? For example, does the transaction-focused approach in *Morrison*, as further developed by the lower courts, provide the SEC with the tools necessary to mitigate systemic risks to the US financial system wherever they arise in the world?

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[339] The issues here are certainly not exclusively international, but there may be benefits in studying the experiences in countries that have been early adopters of promising new technology. As just one example, proxy voting via distributed ledger technology has been successfully trialled in Estonia; *see* Nasdaq MarketInsite, *Is Blockchain the Answer to E-Voting? Nasdaq Believes So* (Jan. 23, 2017), available at http://business.nasdaq.com/marketinsite/2017/Is-Blockchain-the-Answer-to-E-voting-Nasdaq-Believes-So.html.

[340] For an interesting recent contribution to this literature, *see, e.g.*, Jan Bena et al., *Are foreign investors locusts? The long-term effects of foreign institutional ownership*, J. FIN. ECON. (forthcoming) (finding that greater foreign ownership supports long-term investments).

[341] To give an example of the sort of adaption to regulation that we have in mind here, it was suggested during discussions at the NSS conference that the Reg. S safe harbor for offshore offerings led US investors to set up offices abroad.

[342] For an earlier and highly successful application of this methodology, *see* Jackson & Pan, *supra* note 5.

## 9.4.Regulatory coordination

12 Where does regulation still make a difference to outcomes, given that much of the domestic investor protection edifice is optional in institutional markets? Does it affect innovation?

13 Against the backdrop of the various EU initiatives described in Section 6.3, how will regulatory heterogeneity affect outcomes?

## 9.5.Primary markets and cross-listings

The secular trends discussed in Section 2 have also played a part in the declining amounts of US IPOs and cross-listings. The following research questions are particularly relevant:

14 How do countries' industrial and financial structures relate – to each other and to growth over time? This may be a useful starting point in establishing what may be the theoretically optimal footprint for securities markets (as opposed to other types of capital-raising) and whether the maximization of IPOs (by dollars or volume) is a valuable regulatory goal.

15 What are the overall welfare implications of reduced cross-listings?[343] Foreign firms' decisions not to list in the US could be rooted in globalization, in that US institutional investors may now be able to invest more efficiently in foreign issuers through these issuers' home markets (which are often more liquid and therefore preferable), rendering a US listing unnecessary. If that is the case, US trading venues and broker-dealers may see less US business,[344] but if the investment opportunity is still available to US investors, albeit in a foreign country, there may not be much cause for alarm.[345]

If more cross-listings are considered desirable (following an inquiry such as that outlined in question 15), further research along the following lines could elucidate how best to design policy.

16 What is the main motivation for those foreign firms choosing to conduct IPOs or to cross-list in the US today? Are they choosing a US listing because of the attractiveness of the US regime or the unattractiveness of the home country

[343] Another issue that might usefully be explored is the desirable role of the listing function in future equity markets. *See*, e.g., Onnig H. Dombalagian, *Exchanges, Listless?: The Disintermediation of the Listing Function*, 50 WAKE FOREST L. REV. 579 (2015).

[344] We say 'US business' since US broker-dealers have strong market positions across the world (*see supra* Section 4.4). They may thus be involved in foreign issuers' home country listings, the subsequent trading of their stocks, and provide a variety of investment banking services to them abroad.

[345] We note that the new Chairman of the SEC (previously a transactional securities lawyer) as part of his Senate confirmation hearing highlighted that US capital markets 'faced growing competition from abroad' and that 'US-listed IPOs by non-US companies have slowed dramatically'; a situation which had reduced the 'investment opportunities [available to] Main Street investors' but provides 'meaningful room for improvement'. *See* Opening Statement of Jay Clayton, Nominee for Chairman, Securities and Exchange Commission, Senate Committee on Banking, Housing and Urban Affairs (March 23, 2017).

regime,[346] and what does the answer to that question imply for the future of cross-listings as a phenomenon? Is legal bonding or reputational bonding more important for issuers seeking a US listing? Are there regulatory levers available to attract more foreign issuers? Are there significant foreign stock markets that US institutional investors are unable to access? If so, what are the reasons and are they likely to persist in the medium to long term?

17 Has *Morrison* changed the risk-benefit tradeoff for foreign issuers by providing greater certainty as regards litigation risk? Does it affect US listings at the margin?

18 Can factors such as the availability of passive investment funds (such as ETFs that invest in certain indices) or the persistence of home bias explain the choice of listing venue?

19 Increased cross-border investment flows imply that issuers may not need to list abroad to get access to capital. What is the nature of these investment flows? How do they vary by country? How do they relate to domestic corporate finance?

### 9.6. Secondary market trading

Section 6.3 noted various few areas where the new EU approach in MiFID II may provide useful insights regarding market structure.

### 9.7.Intermediaries

20 Consideration could be given to whether foreign models of regulation might offer lessons for the US—in particular, the EU's unified approach to regulating investment firms rather than broker-dealers and investment advisors in separate regimes.

### 9.8.Supervision and enforcement

21 What types of enforcement actions (ex ante or ex post; private or public; formal or informal) really make a difference? A comparative inquiry could provide further insights.

22 Securities law practitioners interviewed two years before *Morrison* were very clear that US class actions acted as a significant deterrent to foreign firms entering the US capital markets.[347] In light of competition between international listing venues, and considering that the SEC may exempt classes of persons and transactions from the Exchange Act,[348] it may be informative to conduct new practitioner interviews to see to what extent *Morrison* has alleviated concerns regarding the perimeter of liability.

[346] Although most commentators tend to see the US as a regime that combines strong regulation and enforcement, foreign issuers' domestic regimes could, at least in theory, be stronger or weaker than the US regime, meaning that issuers may choose the US either to avoiding a weak home country regime or to avoid a strong home country regime.

[347] Howell E. Jackson, *Summary of Research Findings on Extra-Territorial Application of Federal Securities Law*, in GLOBAL CAPITAL MARKETS & THE U.S. SECURITIES LAWS 2009 (PLI Corp. Law & Practice) (presenting information received from interviews with twenty-two leading practitioners and academics, seventeen of whom were practicing lawyers).

[348] Section 36 of the Exchange Act. 15 U.S.C. § 78mm.

23 What are the longer term effects of *Morrison*? Has it led to changes in market practices?

24 How does international data protection law, such as the EU General Data Protection Regulation,[349] affect cross-border securities supervision and enforcement?

[349] Regulation (EU) 2016/679.

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