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Optimal Regulatory Areas for Securities Disclosure

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OPTIMAL REGULATORY AREAS FOR SECURITIES DISCLOSURE

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INTRODUCTION

The corporate governance scandals of 2003 have brought renewed focus on mandatory disclosure. One of the most fundamental questions relating to this kind of regulation is the choice of regulatory area. The United States initially faced this question in the 1930s when, after intense debate, it decided to move from an exclusively state-based system to one primarily relying on federal regulation. It is a hot issue today as well. The countries of Europe, for example, are currently deciding the extent to which the European Community, rather than its member states, should determine securities disclosure in Europe.[1] Canada is deciding whether to follow the path taken by Australia in the 1980s and to enlarge the role of the federal government in a system that has traditionally left disclosure regulation primarily to the provinces.[2] Also, advocates of issuer choice are urging the United States to reconsider its 1930s decision and to give issuers the option to choose among a reinvigorated set of state regulatory regimes.[3] The issuer-choice school of thought is influencing the debates in

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1. *See, e.g.*, COMMITTEE OF WISE MEN, FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (Feb. 15, 2001) (the "Lamfalussy Report"); NIAMH MOLONEY, EC SECURITIES REGULATION 29-32 (2002).

2. *See, e.g.*, *Memorandum of Understanding Regarding the Regulation of Securities in Canada*, 17 ONTARIO SECURITIES COMMISSION BULLETIN 4401 (1994); Minister Throne, Speech at the Canadian House of Commons, House of Common Debates (Feb. 27, 1996); Jeffrey G. MacIntosh, *A National Securities Exchange for Canada?*, *in* REFORMING THE CANADIAN FINANCIAL SECTOR: CANADA IN GLOBAL PERSPECTIVE 185 (Thomas Courchene & Edwin Neave eds., 1997). An excellent review of both past reform proposals and the current state of the debate can be found in A. Douglas Harris, *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?* (University of Toronto Capital Markets Institute, White Paper) (Oct. 2002), *at* http://www.cfie.ca/en/pdf/WhitePaper_Oct8-02.pdf [hereinafter Harris]. Canada has periodically faced this question over the last several decades. ROYAL COMMISSION ON BANKING AND FINANCE, PORTER COMMISSION REPORT 561 (1964) (the "Porter Report"); *CANSEC: Legal and Administrative Concepts*, ONTARIO SECURITIES COMMISSION BULLETIN 61 (Nov. 1967), *cited in* Harris, *supra*, at 12 n.18.

3. Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998) [hereinafter Choi & Guzman]; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) [hereinafter *Empowering Investors*]; Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES IN L. 387 (2001) [hereinafter *Need for Competition*].

Europe and Canada as well.[4] Finally, other advocates are pushing for a move in the opposite direction, arguing that standards for issuer disclosure should be set at a global level.[5]

This Article constructs an economic-efficiency based theory of optimal regulatory areas for securities disclosure. While larger political and constitutional considerations unrelated to efficiency will inevitably also play a role in the resolution of the debates recounted above, efficiency considerations are important because they go to the capacity of capital markets to promote the generation of real wealth. The theory developed here can help identify the efficiency-related tradeoffs involved in choosing one level of government versus another and the information that is needed to choose intelligently.

The optimal structure of disclosure regulation over the world's issuers is determined by the answers to two questions: (1) With respect to any point on earth, what level of government, out of all the levels that have control over the point, should be the one regulating disclosure? (2) Among all the units of government identified by the answer to the first question as the ones that should be engaging in disclosure regulation, which one or ones should regulate any given issuer?

Because all governmental units existing in the world today have a territorial base, answering the first question—the level of government to regulate securities disclosure—involves dividing the globe territorially, either more or less finely. What distinguishes one governmental unit from

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4. *See, e.g.*, Harris, *supra* note 2, at 84-86.

5. *See, e.g.*, Uri Geiger, *The Case for the Harmonization of Securities Disclosure Rules in the Global Market*, 1997 COLUM. BUS. L. REV. 241 (1997); Marc I. Steinberg & Lee E. Michaels, *Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity*, 20 MICH. J. INT'L. L. 207, 261-65 (1999) [hereinafter Steinberg & Michaels] (the world's countries, by self selection, would be divided into three groups—developed market, semi-developed market, and emerging market—and each group would work out uniform disclosure rules for its countries' issuers that would permit the sale and trade of their securities anywhere within the group). The International Organization of Securities Commissions ("IOSCO"), a worldwide organization of countries that provides a forum for meetings of the securities regulators of member states, initially undertook a straddle in which it urged countries either to adopt uniform rules (international uniformity) or reciprocity (essentially the issuer nationality approach). INTERNATIONAL EQUITY OFFERS, REPORT OF THE TECHNICAL COMMITTEE OF IOSCO 75 (Sept. 1989) [hereinafter TECHNICAL COMMITTEE REPORT]. IOSCO, in cooperation with the International Accounting Standards Committee (the "IASC"), is now seeking to develop a recommended set of international accounting standards and has developed a set of non-financial disclosure standards that could be used in a single uniform disclosure document for cross-border offerings. Thus, IOSCO has tilted toward international uniformity as the preferred result. *See* TECHNICAL COMMITTEE REPORT, *supra*. *See also* Michel V. Hurley, *International and Debt and Equity Markets: U.S. Participation in the Globalization Trend*, 8 EMORY INT'L. L. REV. 701, 733 (1994); Steinberg & Michaels, *supra*, at 241, 243-46; Roberta S. Karmel, *The IOSCO Venice Conference*, NEW YORK L.J., Oct. 19, 1989, at 3.

another is the territory associated with it. Thus, the answer to the second question—which governmental unit or units at the chosen level regulates any given issuer—is going to depend on the issuer's ties to the chosen unit's territory. Potentially relevant territorial ties include: where the issuer is located ("issuer location"), where its securities are being offered or traded ("transaction location"), and where the purchasers or traders of the issuer's shares reside ("investor location"). Alternatively, as the issuer choice proposals suggest, the determination of which governmental unit regulates an issuer could be made to depend solely on the issuer's own consent.

In prior writing, I have taken the answer to the first question—the level of government—as given. I have instead primarily focused on the second question—what kind of a tie an issuer needs to have to a territory to justify regulation of the issuer's disclosure by the government associated with the territory.[6] For example, I have assumed that for the United States, the proper level of government to be regulating securities disclosure is the one governing the territory of the nation as a whole. Given this assumption, I concluded that issuer location—the place where an issuer has its economic center of gravity as a firm—should be the territorial tie that triggers application of the U.S. regime to an issuer.[7] Thus, the U.S. government should regulate the disclosure of all issuers located in the United States, and no others, except those who consent to U.S. regulation. The place or places where an issuer's securities are being offered or traded, and the place or places where the purchasers or traders in the issuers' shares reside, should, in my view, be irrelevant.

In contrast, the primary focus of this Article is the proper level of government needed to regulate securities disclosure in a world with a high degree of international capital mobility. Part I briefly reviews the role of issuer disclosure in promoting economic efficiency and demonstrates that each issuer has a socially optimal level of disclosure. Part II identifies a regulatory structure for disclosure by the world's issuers as having two

6. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997) [hereinafter *Disclosure in a Globalizing Market*]; Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696 (1998) [hereinafter *Political Economy*]; Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) [hereinafter *Retaining Mandatory Disclosure*]; Merritt B. Fox, *The Securities Globalization Disclosure Debate*, 78 WASH. U. L.Q. 567 (2000) [hereinafter *Disclosure Debate*]; Merritt B. Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES IN L. 563 (2001) [hereinafter *Issuer Choice Debate*].

7. *Political Economy*, *supra* note 6, at 730-57.

components: a division of the world into a set of areas and a rule of territorial tie that assigns issuers to these different areas for regulation by their respective governmental units. I suggest that the optimal world regulatory structure is the one that pairs issuers and governmental units in such a way that for each issuer, the persons who would ultimately benefit from the issuer being well regulated have residences that are, to the greatest extent possible, concentrated within the area of the regulating governmental unit.

Part III considers an ideal world conforming to assumptions that permit its division into geographic areas where there is very little economic integration across territorial lines *except* portfolio investment capital flows. I show that this division of the world, combined with an issuer location rule of territorial tie, results in an optimal regulatory structure. Use of an investor location or transaction location rule of territorial tie is shown to result in regulatory structures less conducive to efficiency, as is also the case with issuer choice.

Part IV considers the implications of the real-world breakdown in the assumptions relating to each area that are used to construct Part III's ideal world. Part III's ideal world is built upon two sets of assumptions. One set is that most trade occurs within the area, that labor and entrepreneurs have low mobility across territorial lines, and that all issuers operating within the area have their economic centers of gravity there. The second set is that the governmental unit associated with the area is responsive to the needs of its residents and capable of effective application and enforcement of its rules and that all issuers within the area have the same optimal level of disclosure. Taking the political subdivisions present in the real world, the first set of assumptions could only be met perfectly if the world is a single large regulatory area. The second set of assumptions could only be met, even approximately, if much smaller regulatory areas were employed. The discussion helps identify where the optimal point of tradeoff is between the advantages of larger sized areas and the advantages of smaller sized areas under various circumstances prevailing in different parts of the world. The breakdown in assumptions is shown not to resurrect the case for using investor location or transaction location as the rule for territorial tie or the case for adopting issuer choice.

Part V concludes the Article by sketching how the overall analysis can be applied to current debates. It suggests that the United States should maintain its nationally based system of regulation and that Canada should move from a provincially based system to a nationally based one. It finds that, for the European Community, the choice between Community-level disclosure regulation and national regulation is a close one. Considerable problems are found with proposals for regulation by some kind of global disclosure authority.

I. ISSUER DISCLOSURE AND ECONOMIC EFFICIENCY

The purpose of this Article is to construct an economic-efficiency-based theory of optimal regulatory areas for issuer disclosure. The necessary starting point is an efficiency analysis of issuer disclosure in general. This analysis arises from the observation that disclosure has both social benefits and social costs.[8]

A. Social Benefits and Social Costs of Disclosure

1. Benefits

An act of disclosure by an issuer produces social benefits by improving how proposed new investment projects in the real economy are selected for implementation and how existing projects are operated.

a. Benefits from Effects on Issuer's Own Behavior

Consider first the social benefits derived from an act of disclosure's effects on the issuer's *own* behavior. The disclosure produces these benefits directly when the issuer contemplates implementing a new project by means of a new offering of stock. Because of the disclosure-induced increase in the accuracy of the price at which the shares will be sold, the firm's cost of capital is brought more in line with the social cost of investing society's scarce savings in the contemplated project, which increases the chances that the issuer will implement socially worthwhile projects and avoid socially unworthwhile projects.[9] The disclosure produces benefits through a second route as well, unrelated to whether the issuer is offering new shares, by increasing the effectiveness of several of the devices that limit the extent to which managers of a public corporation place their own interests above those of their shareholders. Additional disclosure assists in the effective exercise of the shareholder franchise and

8. I have analyzed this question in more detail elsewhere. *See Disclosure in a Globalizing Market*, *supra* note 6, at 2544-50. *See also* Marcel Kahan, *Securities Laws and the Social Cost of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

9. *See Retaining Mandatory Disclosure*, *supra* note 6, at 1358-63.

in shareholder enforcement of management's fiduciary duties.[10] It also increases the threat of hostile takeover when managers engage in non-share-value-maximizing behavior. It does so both by making a takeover less risky for potential acquirers and by reducing the chance that a value-enhancing acquisition will be deterred because the target has an inaccurately high share price. Finally, by reducing the risk associated with holding an issuer's stock in a less than fully diversified portfolio, additional disclosure increases the use of share-price-based management compensation, which also helps align the interests of managers and shareholders.[11]

b. Benefits from Effects on Behavior of Others

Consider second how an issuer's disclosure produces additional social benefits derived from its effects on the behavior of *other* issuers. Information about one issuer helps investors understand better the prospects and operations of other issuers as well, particularly the issuer's competitors, major suppliers, and customers. As a result, capital allocation and managerial agency cost reduction are improved for these other issuers as well through the same mechanisms described just above.

c. Social Benefits Exceed Private Benefits

A plausible story can be told concerning how the benefits arising from the effects of the disclosure on the issuer's own activities are captured by the issuer through a higher sale price when, at the time of the primary market sale of its shares, it makes a commitment to provide such information on an ongoing basis.[12] The issuer will not, however, be able to capture the benefits arising from the effects of the disclosure on the behavior of other issuers because the prospect of such benefits will not make the disclosing issuer's shares any more attractive in the market. Thus, the private benefits from an act of disclosure will be less than the social benefits.

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10. *See* Merritt B. Fox, *Required Disclosure and Corporate Governance*, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 701-718 (Klaus I. Hopt et al. eds., 1998).
11. *See Disclosure in a Globalizing Market*, *supra* note 6, at 2548-50.
12. *See Retaining Mandatory Disclosure*, *supra* note 6, at 1365.

2. *Costs*

An act of disclosure entails costs as well. An individual issuer's disclosure involves two different kinds of costs, "operational" costs and "interfirm" costs. Operational costs are the out-of-pocket expenses and the diversions of management and staff time that issuers incur to provide the information. Interfirm costs arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors (by allowing them to compete more effectively) and to its major suppliers and major customers (by allowing them to bargain more effectively). The operational costs are the social costs of the issuer's act of disclosure: they are costs both to the individual firm and to society as a whole. The interfirm costs are costs only to the individual firm. They are not social costs because the interfirm disadvantages to the issuer from the disclosure are counterbalanced by the advantages the disclosure confers on the other firms. Thus, at all levels of disclosure, an issuer's private marginal costs will exceed its social marginal cost by an amount equal to these interfirm costs.[13]

B. An Issuer's Socially Optimal Level of Disclosure

As a result of these benefits and costs, an issuer's level of disclosure affects the real returns generated by both it and other issuers. An issuer's socially optimal level of disclosure is the level at which the marginal social benefits just equal the marginal social costs.

Issuers will not disclose at their optimal levels if we rely on market forces alone. Under such a regime, an issuer's private benefits from disclosure will be less than its social benefits, and its private costs from disclosure will be greater than its social costs. Thus, each issuer will choose to disclose at a level below its social optimum.[14] This market failure constitutes the key efficiency-based rationale for regulating issuer disclosure.[15]

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13. I have considered this point in more detail elsewhere. *See* Fox, *Disclosure in a Globalizing Market*, *supra* note 6, at 2537-39. *See also* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1490-91 (1992); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 721-23 (1984); Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 672-73 (1984).

14. The analysis shows this conclusion to be true even if the issuer's managers completely identify with existing shareholders and seek to maximize share value.

15. It is, of course, possible that because of governmental failure, the cure would be worse than

II. THE APPROACH TO DETERMINING OPTIMAL REGULATORY AREAS

A regulatory structure for disclosure by the world's issuers can be identified in terms of two components: a division of the world into a set of areas and a rule of territorial tie for assigning issuers to these different areas for regulation by their respective governmental units. Global economic welfare is maximized when each of the world's issuers discloses at its socially optimal level. The goal therefore is a global regulatory structure in which each such issuer would be prompted to disclose as close as is cost effectively possible to its socially optimal level. Assume for now that governmental units are responsive to the needs of their residents. The regulatory structure that is likely to come closest to the goal is therefore one that pairs issuers and governmental units in such a way that for each issuer, the persons who would ultimately benefit from the issuer being well regulated—*i.e.*, the persons who would be the ultimate beneficiaries of the greater real economic returns resulting from the issuer disclosing at its optimal level—have residences that are to the greatest extent possible concentrated within the regulating governmental unit's area.

Each of the world's governmental units has associated with it a certain portion of the world's territory. Thus, any particular global regulatory structure implies a particular set of regulatory areas. The optimal set of regulatory areas is the one that corresponds to the best global regulatory structure.

III. OPTIMAL REGULATORY AREAS—THE IDEAL CASE

A. The Starting Point

It is easiest to see what each member of the optimal set of regulatory areas would look like by first considering an ideal case not found in the real world. This ideal case involves a division of the world into geographic areas where there is very little economic integration across territorial lines *except* in portfolio investment capital flows. More specifically, five assumptions apply to each regulatory area in this ideal case:

1. Trade in goods and services with persons outside the area is a small percentage of the area's gross domestic product ("GDP").

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the disease, *i.e.*, that governmental regulation would result in issuers disclosing at levels further from what is optimal than would reliance on market forces alone. This possibility does not eliminate the need to determine the optimal regulatory areas for securities disclosure. With respect to each of the world's issuers, we still need to determine what governmental unit should make the determination that governmental failure would exceed market failure.

2. Labor and entrepreneurs residing within the area have little mobility across the lines separating this area from the rest of the world.

3. The governmental unit associated with the area is responsive to the needs of the residents of the area and is capable of effective application and enforcement of its rules.

4. Each issuer that has any real economic activities in the area is "located" in the area, which means that its economic center of gravity as a firm is located within the area. There are thus no multinational enterprises operating within the area. Indicators of an issuer's economic center of gravity would include where the issuer's headquarters are located, where it has its greatest concentration of physical capital and employees, and where its entrepreneurs resided at the time of the firm's founding.[16] Each issuer operating in the area would therefore be combining factors of production located primarily within the area to create goods and services that are primarily consumed within the area.

5. Each issuer located within the area would be sufficiently similar in its corporate governance structure that it would have the same socially optimal level of disclosure.

It is possible, however, for the shares of each of these issuers to be offered to investors residing outside the area or to be traded among investors residing outside the area or traded on exchanges located outside the area. Thus, portfolio capital flows are global, but real economic activity is local to the area.

Part IV considers what the real world breakdown of these five assumptions would imply.

B. The Governmental Unit as Exclusive Regulator of Issuers Located in the Area

In this ideal case, a regulatory incidence analysis strongly suggests that the level of government that corresponds to the unit associated with each of these areas should be the exclusive regulator of the disclosure of all issuers located in the area. We will see below that with this pairing of issuers and governmental units, the ultimate beneficiaries of good regulation by any given regulating governmental unit will be primarily persons residing within its area. Thus, given the assumption that each governmental unit is responsive to the needs of the residents of its

16. The issuer's jurisdiction of incorporation would not be a primary indicator.

territory, this subdivision of the world, combined with an issuer location rule of territorial tie, involves the optimal regulatory structure.

The first step in seeing why this pairing of issuers and governmental units appropriately concentrates the benefits of good regulation, recall that, through its effects on capital allocation and the agency costs of management, an issuer's level of disclosure can enhance the real returns generated by both it and its competitors, major suppliers, and major customers.[17] An issuer discloses at its optimal level when its disclosure's enhancement of these returns equals, at the margin, the disclosure's marginal social cost. Because of the assumption of little trade outside the area, we know that all the competitors, major suppliers, and major customers of each issuer in the area will also be located in the area. Thus, if the governmental unit regulates in a way that prompts all the issuers located in the area to disclose at their socially optimal levels, the aggregate disclosure-induced net enhancement to the real returns generated by the area's capital-utilizing enterprises would be maximized. There would be no enhancement of the real returns generated by issuers located in any other area, and the disclosure levels of the issuers in all the other areas would have no effect on this area's issuer returns.

This observation, however, does not complete the inquiry because a regulatory incidence analysis requires a determination of who are the ultimate beneficiaries from these enhanced returns. Analysis shows that it is not the investors in the area's issuers, who may or may not be residents of the area. Rather it is labor and entrepreneurs associated with the area's issuers, who do reside in the area.

1. *Investors Are Not The Ultimate Beneficiaries*

In an efficient market, an issuer's share price takes into account the effect on the issuer's future expected cash flow from the particular disclosure rules imposed on the issuer and on its competitors, major customers, and major suppliers. At the same time, if capital is relatively mobile internationally, competitive forces push capital toward receiving a single global expected rate of return (adjusted for risk). As a result, investors in all the world's issuers tend to get the same risk-adjusted expected return even though issuer disclosure practices may vary widely from one regulatory area to another. Thus, investors in issuers located in

17. *See supra* Part I.A.

any given regulatory area will not receive any better returns whether issuers located in the area disclose at their optimal level or not.[18]

2. Entrepreneurs and Labor Residing in the Area Are the Ultimate Beneficiaries

The higher returns that result from an area's issuers disclosing at their optimal level are real and must, of course, go to someone. Where they go is largely to the suppliers of the issuers' less mobile factors of production. These are the area's entrepreneurs, who will get higher prices when they sell shares in the firms they founded, and labor, who are likely to enjoy higher wages in an economy where capital is allocated and used efficiently. Thus, the persons in the world who primarily benefit from higher real returns when the areas issuers disclose at their optimal level are the area's entrepreneurial talent and labor, who are residents of the area, not the investors in these issuers, who may live elsewhere.[19]

C. The Inappropriateness of Investor Location as a Territorial Tie

In the ideal case, it is easy to see why investor location would be an inappropriate alternative to issuer location as a rule of territorial tie. Governmental units outside any given regulatory area should not attempt

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18. *But see infra* notes 19 and 25.

19. If the area's issuers represent only a small portion of all equities available to investors in the world, investors would share in none of these gains. The area would be analogous to a single small firm in a perfectly competitive industry. Such a firm's level of production has no effect on price. Following this analogy, what the area produces are investment opportunities—dollars of future expected cash flow—just like the firm produces products. A disclosure improvement's positive effects on managerial motivation and choice of real investment projects will increase the number of dollars of future expected cash flow that the country has to sell. This benefits the entrepreneurs, who are selling the cash flow, and labor, who gain from the overall increase in the area's economic efficiency. *See Disclosure in a Globalizing Market*, *supra* note 6, at 2561-69. Because the area is like a small firm, however, the increase in the amount supplied is not great enough to lower the price at which a dollar of future expected cash flow is sold. Thus there is no benefit to investors, the "buyers" of these dollars of expected future cash flow.

If the area's issuers represent a substantial portion of all equities available to investors in the world, as is the case with the United States, investors will share in some of these gains. A disclosure improvement's increase in the number of dollars of future expected cash flow that the area has to offer would be great enough to lower the price at which a dollar of future expected cash flow is sold, at least slightly. Thus, all investors would gain from the improvement. This is equally true of investors from outside the area as for ones within the area and equally true for investors in issuers located within the area as for investors in issuers located outside the area. Furthermore, it is equally true of disclosure improvements of issuers located within the area whose shares are primarily sold to, or traded among, only foreign investors as it is of issuers located within the area primarily with investors residing in the area. For more detailed discussions of these points, see *id.* at 2552-80; *Political Economy*, *supra* note 6, at 732-39.

to regulate the disclosure of issuers located within this area even if the securities are sold to, or traded among, residents of the territories governed by these other units. This is because the disclosure level of issuers located within the area does not affect the welfare of residents of the territories governed by these other governmental units. For the same reasons, the government associated with the area should not attempt to regulate the disclosure level of issuers located outside the area even when the shares of these issuers are sold to, or traded among, residents of this area.

This rejection of investor location as a rule of territorial tie would appear to ignore another claimed benefit of mandatory disclosure—investor protection—which will be concentrated where an issuer's investors are concentrated. Investor protection, however, is not a sound justification for mandatory disclosure: disclosure is not necessary to protect investors against either unfair prices or risk. Consider first unfair prices. Under the efficient capital market hypothesis, securities prices are unbiased whether there is a great deal of information available about an issuer or very little. In other words, share prices will on average equal the actual value of the shares involved whether issuers are required to produce a lot of disclosure or only a little. Thus, greater disclosure is not necessary to protect investors from buying their shares at prices that are, on average, unfair, *i.e.*, greater than their actual values. Now consider risk. With less information available about an issuer, share price, while still unbiased, is less accurate, *i.e.*, it is more likely to be significantly off one way or the other from the share's actual value. For an investor with a less than fully diversified portfolio, less share price accuracy can make the portfolio more risky. High quality disclosure would, to some extent, protect such an investor by reducing this risk. The investor, however, can protect herself much more effectively, and at less social cost, by simply diversifying more.[20]

D. The Inappropriateness of Transaction Location as a Territorial Tie

The location of transactions in an issuer's shares is also an inappropriate rule of territorial tie. The analysis above shows that transaction location is irrelevant to where the benefits and costs of the issuer's disclosure practices are felt. Thus, governmental units outside any

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20. In portfolio theory terms, issuer disclosure reduces firm-specific ("unsystematic") risk. Firm-specific risk can be completely eliminated by sufficient diversification. *See* Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984).

given regulatory area should not attempt to regulate the disclosure of issuers located within the area even if the issuers' securities are traded on exchanges located in territories governed by these other outside governmental units. Likewise, the area's government should not attempt to regulate the disclosure level of issuers located outside the area even when the shares of these issuers are traded on an exchange located within the area.

E. *The Inappropriateness of Issuer Choice*

Finally, the analysis above shows that issuer choice, which eliminates any territorial tie at all, is inappropriate as well.[21] Under issuer choice, as proposed by both Professor Romano and by Professors Choi and Guzman, each issuer in the world could choose whichever regulatory area's disclosure regime it wished.[22] Romano argues that issuer choice would lead to jurisdictions competing to offer issuers regulations that maximize share value.[23] Choi and Guzman argue that it would lead to a diversity of available regimes and permit each issuer to select the one best suited to its particular needs.[24] Neither argument, however, adequately takes account of the fact that issuer choice would result in each issuer selecting a regime requiring it to disclose at less than its socially optimal level. This is because each issuer will make its choice based on its calculations of the private benefits and costs that would arise from complying with each area's required level of disclosure. As we have seen, an issuer's private costs of disclosure exceed the social costs of disclosure, while its private benefits are less than the social benefits. Under the standard assumption that marginal costs rise and marginal benefits decline, the level of disclosure at which the marginal private benefits equal the marginal private costs is, therefore, lower than the socially optimal level, which is the level at which marginal social costs equal marginal social benefits.

Given this market failure, using an issuer location territorial tie will lead to greater global economic efficiency than issuer choice unless the regulations adopted by the selected governmental units cause issuers to deviate even more (just in the opposite direction) from their optimal

21. I have previously written extensively on the question of issuer choice. *See Retaining Mandatory Disclosure*, *supra* note 6; *Issuer Choice Debate*, *supra* note 6. I will accordingly keep my remarks here brief. Professor Romano's reactions to these writings can be found in *Need for Competition*, *supra* note 3.

22. *Empowering Investors*, *supra* note 3, at 2361-62; Choi & Guzman, *supra* note 3, at 907.

23. *Empowering Investors*, *supra* note 3, at 2362.

24. Choi & Guzman, *supra* note 3, at 916-17.

disclosure levels than would issuer choice. Such suboptimal regulation is unlikely given our assumptions. The analysis above shows that the persons who benefit from the good regulation of the disclosure of issuers located in an area are concentrated in that area. And the governmental unit undertaking this regulation is assumed to be responsive to the needs of its residents.

F. Conclusion

In sum, if the world were divided into areas resembling the ideal case above and each issuer's disclosure was regulated exclusively by the governmental unit associated with the area in which the issuer was located, an optimal global regulatory structure would exist. The beneficiaries of any given issuer disclosing at its optimal level would be concentrated within the area in which the issuer is located. The governmental unit associated with this area, which we have assumed to be responsive, would have full incentives to set the level of disclosure at this level.

The disclosure level of issuers located outside a given area will have no effect on the welfare of the area's residents, even when shares of these outside issuers are purchased or traded by residents of the area or traded on exchanges located in the area. Thus, the fact that the governmental unit associated with the area will not regulate the level of disclosure of these outside issuers is of no matter to the residents of the area. Such a policy of forbearance also avoids conflicts with other governmental units. This is because any effort by the area's government to regulate the disclosure of outside issuers will affect the welfare of residents of the territories in which the outside issuers are located without these residents being able to participate as citizens in the process by which the regulations are set.

These conclusions hold over a wide range of assumptions concerning how global equity investing really is. We have assumed so far that equity investing is totally globalized and that investor location plays no role in who invests in which issuers. The conclusions hold at least as strongly, however, if global equity investing has not proceeded to the point where there is one global risk adjusted expected rate of return on capital. If investors exhibit some, or even a great deal of home bias, the concentration of benefits of good regulation at home is simply reinforced.[25]

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25. To the extent that globalization has not yet proceeded far enough to result fully in a single global-risk-adjusted expected rate of return on capital, the remaining market segmentation simply

IV. AN OPTIMAL REGULATORY AREA: REAL WORLD CONSIDERATIONS

Real world considerations make it impossible to find a set of regulatory areas that fit the ideal assumed in Part III. This can be seen by considering an extreme example. Imagine first that there is only one regulatory area: the whole world. In this "division" of the world, some of the assumptions employed in Part III—most trade being within the area, low mobility of labor and entrepreneurs to outside the area, and all issuers operating within the area having their economic centers of gravity there—can be met perfectly. The remaining assumptions—the governmental unit associated with the regulatory area being responsive to the needs of the residents of the area and capable of effective application and enforcement of its rules, and all issuers having the same optimal level of disclosure—would, however, be wildly off the mark. Now imagine that we subdivide the world into smaller regulatory areas. As we make the regulatory areas smaller, the failure of this second set of assumptions is likely to become less severe. Problems begin to arise, however, with the first set of assumptions: there will be too much cross-border trade, too much factor mobility across area lines, and too many issuers with no clear economic center of gravity. Thus, whatever the chosen set of regulatory areas, at least some of Part III's five assumptions will not be met.

This Part examines the implications of this breakdown in assumptions. This examination has two functions. First, it helps identify where the optimal point of tradeoff is between the advantages of larger sized areas

reinforces the point that the gains from an area's issuers disclosing at their optimal levels will be concentrated at home. An area whose issuers disclose at the optimal level of disclosure will have capital-utilizing enterprises that produce higher returns net of costs of disclosure. If the single-rate assumption is correct, the gains from getting the disclosure level right will primarily be enjoyed by the less mobile claimants on these returns, domestic entrepreneurs, and labor, not by the suppliers of capital, who, wherever in the world they live, will at best enjoy a slight increase in the overall global expected return on capital. *See supra* note 19. If the assumption is incorrect, the reason would be that each area's investors still have a degree of bias against issuers from other areas. In that event, U.S. investors, for example, might share disproportionately in the gains from moving the U.S. issuer disclosure level toward its optimal level. The bias of foreign investors against U.S. issuers would mean that the increase in the number of expected dollars of future cash flow resulting from the change in required disclosure would be offered to a somewhat restricted market and push the price for them down more for U.S. investors than for other investors. *Id*. To the extent that a U.S. issuer has U.S. shareholders, the fact that U.S. investors will share disproportionately in the gains from optimal disclosure simply creates an additional U.S. interest in the level of the issuer's disclosure. As for U.S. issuers whose shares are sold to and traded among only foreign investors, entrepreneurs and labor in the United States would, just as if there were a single global expected rate of return on capital, enjoy most of the gains from optimal disclosure. *See* Fox, *Disclosure in a Globalizing Market*, *supra* note 6, at 2561-69. Thus, in this example, the United States interest in the disclosure behavior of this second set of issuers would be as strong as it is shown to be under the assumption in the text.

and the advantages of smaller sized areas under various circumstances prevailing in different parts of the world. Second, it reveals that the breakdown of the assumptions, while making the world a messy place with no ideal solution to its division into regulatory areas, does not resurrect the case for using investor location or transaction location as the territorial tie to determine which government regulates which issuer, nor does it resurrect the case for issuer choice.

A. Assumptions that Fail as the Regulatory Areas Grow Smaller

1. Trans-Border Trade

The smaller a regulatory area, the greater the likelihood that there will be a substantial amount of trans-border trade. This creates problems even if labor and entrepreneurs are still relatively immobile. With substantial trans-border trade, many of the issuers located in a given area will count among their competitors, and major suppliers and customers, issuers located outside the area.

The existence of these out-of-area competitors, major suppliers, and major customers biases the area's government downward when it compares requiring a higher level of disclosure to a lower one. The government knows that if it chooses the higher level, each of the area's issuers will both suffer costs and enjoy benefits. The issuer will suffer the costs associated with *all* of its competitors, major suppliers, and major customers finding out the additional required information. This is so whether the competitors, suppliers, or customers are located inside or outside the area. The issuer will benefit, however, from finding out the additional required information only from its competitors, major suppliers, and major customers that are located inside the area, and hence subject to the higher disclosure requirement. The area's issuers' competitors, major suppliers, and major customers located outside the area are the ones who enjoy the rest of the benefits from the higher level of disclosure. Thus, there is a trans-border externality associated with the national government's decision setting the level of disclosure for its issuers. The government will choose the level that will maximize the welfare of its residents. The government will not account for the portion of the benefits from additional disclosure that would be enjoyed by its issuers' foreign competitors, major suppliers, and major customers, just for the costs to its issuers of these outsiders learning the information.

Utilizing a larger regulatory area corresponding to a higher level of government reduces or eliminates this bias by internalizing some or all of these information externalities,[26] but doing so will entail the disadvantages of larger regulatory areas discussed below. This dilemma cannot be resolved by utilizing a smaller area but choosing investor nationality or transaction location as a territorial tie instead of issuer location. While choosing such ties would subject some issuers outside the area to regulation by the area's government, the set of outside issuers that would be regulated would bear no systematic relation to the ones whose disclosure levels affect the welfare of persons within the area. This is because regulation would be the result of an outside issuer having investors residing within the area or trades in its shares occurring on the area's exchanges. It would not be because of the outside issuer's status as a competitor, major supplier, or major customer of issuers located within the area.

The dilemma would also not be resolved by combining a smaller regulatory area with issuer choice. Because of the downward bias caused by trans-border information externalities, regulation based on issuer location only partially, not fully, corrects for the market failure caused by the overall information externalities that justify regulation in the first place.[27] With issuer choice, this market failure would not be corrected at all.[28]

2. Factor Mobility

The smaller the regulatory area, the greater the likelihood that there will be significant mobility in labor and entrepreneurial talent across the area's borders. The greater this mobility, the more the returns to labor and entrepreneurs residing within the regulatory area will be affected by the demand for them outside the regulatory area. In essence, the greater the mobility the more that the effective market for these factors can be seen as covering a territory larger than the regulatory area.

Because the returns to labor and entrepreneurs residing within the regulatory area are affected by demand outside the regulatory area, the

26. I discuss these points in more detail elsewhere. *See*, *Political Economy*, *supra* note 6, at 747-49, 762-64.

27. *See supra* Part I.B.

28. *See supra* Part III.E. Ed Kitch and Stephen Choi have each expressed the concern that the issuer location approach is undermined by these trans-border externalities. Edmund W. Kitch, *Proposals for Reform of Securities Regulation: An Overview*, 41 VA. J. INT'L L. 629, 651 (2001); Stephen J. Choi, *Assessing Regulatory Responses to Securities Market Globalization*, 2 THEORETICAL INQUIRIES IN L. 613, 646 (2001). They are in a sense correct, but they do not follow through to see its ultimate implications. The defect in my approach is that the system would only partially correct for a market failure that their issuer choice approach would not correct at all.

benefits from regulation that prompts issuers located within the area to disclose at their optimal level are deconcentrated. Entrepreneurs and labor residing outside the area enjoy some of the benefit because of increased demand due to the more efficient utilization of capital by issuers within the area. At the same time, where issuers located outside the area are not subject to regulation that prompts them to disclose at their optimal levels, the returns to entrepreneurs and labor residing inside the area are lower than they otherwise would be.

This deconcentration of the benefits reduces the political incentive for the government associated with the regulatory area to undertake good regulation. This effect, however, is different, and less pernicious, than the downward bias caused by cross-border trade. The government still does best by its residents by setting the required level of disclosure equal to the socially optimal level of the issuers located within its area. The gain for doing so, however, is less, and so other matters are more likely to take political priority. Thus, there is less likelihood that the government will make the full effort needed to get the disclosure level right.

This problem created by the breakdown of the labor and entrepreneurial talent assumptions would not be solved by utilizing investor nationality or transaction location instead of issuer location as the territorial tie. This is because the set of outside issuers that would be subject to the area's disclosure regulation under these approaches would bear no systematic relation to the ones whose disclosure levels would affect demand for entrepreneurial talent and labor residing within the area. Nor would the problem be solved by issuer choice. Again, issuer choice fails to address in the first place the market failure that prompts the need for regulation to correct what would otherwise be a suboptimal level of disclosure. The failure of the low mobility assumption simply means that the global regulatory structure will not be as fully effective at correcting this market failure as would otherwise be the case.

3. Issuers with No Clear Economic Center of Gravity

The smaller the regulatory areas, the more issuers in the world will have no clear economic center of gravity. This breaks down the assumption that every issuer has a clear economic center of gravity in one regulatory area or another. The consequences of this breakdown are very similar to those of the breakdown of the assumption of no significant labor and entrepreneurial talent mobility.

The benefits from an issuer with no clear economic center of gravity disclosing at its optimal level are experienced in significant part by persons residing in more than one area. If the issuer is regulated by a government associated with one of these areas, the benefits will be deconcentrated. This deconcentration reduces the political incentive for the government to undertake good regulation. In addition, even if the government does strive to regulate in a way that prompts its purely domestic issuers (*i.e.*, issuers that clearly are located within the area) to disclose at their optimal level, the regulation is less likely to be right for the issuer with no clear center of gravity, which may well have a corporate governance arrangement that is different from most of the purely domestic issuers. A different corporate governance arrangement can imply a different (higher or lower) optimal level of disclosure.[29]

If the disclosure of the issuer with no clear economic center of gravity is regulated by governments associated with more than one of these areas, compliance by the issuer with multiple sets of regulation can be costly in terms of real resources. Moreover, while regulation by multiple governments decreases the chance that the issuer will end up disclosing at a level below its optimal level, it increases the chance it will be required to disclose above its optimal level.

Again, neither the investor location nor the transaction location approaches have features that would address these problems. Issuer choice would have the advantage of assuring that no issuer would be regulated by a jurisdiction that requires disclosure above its optimal level because no issuer would choose such a jurisdiction. However, because issuer choice does not correct the market failure that leads to the need for mandatory disclosure in the first place, it is likely to result in most issuers being regulated by jurisdictions that require disclosure below their optimal levels.

B. Assumptions That Fail as the Regulatory Areas Grow Larger

1. Responsive Government with Effective Enforcement

The larger the regulatory area, the less likely it is that the governmental unit regulating it will be responsive to the needs of the residents of the area. This proposition reflects the ideas behind the concept of "subsidiarity," specifically, that regulation should be undertaken by the lowest level of government capable of handling the task properly. Citizen access to governments serving large numbers of geographically dispersed

29. *See infra* Part IV.B.2.

people is bound to be more difficult, everything else being equal. Also, while up to a point there may be economies of scale in terms of the resources necessary to develop a certain level of expertise on the part of government officials, beyond that point it is harder for government officials to be knowledgeable about the more diverse set of conditions likely to prevail in a regulatory area containing more people and a larger amount of territory.

These problems become most extreme when regulation is undertaken by some kind of multinational entity. Current political realities mean that national governments and trans-national bureaucracies each need to play a large role in the governance of such entities if they are to have any meaningful influence. These intricacies lead to concerns about the "democratic deficit" that critics claim is displayed by multinational bodies such as the European Community and the World Trade Organization. Such multinational entities are also likely to have particularly great problems effectively enforcing their rules. Even when they have their own enforcement authorities and institutions to apply their rules to specific cases, they are likely to require use of the legal systems of their member states to impose any effective sanctions on persons they find to have violated these rules.

2. Issuers Having the Same Optimal Level of Disclosure

The larger the regulatory areas, the more likely it is that the assumption that all issuers have the same socially optimal level of disclosure will break down significantly. There are important differences among issuers worldwide in terms of the level of disclosure that will maximize returns, net of the costs of this disclosure, that the issuers' capital utilizing productive activities generate. These differences in the issuers' socially optimal disclosure levels are significantly related to where the issuers are located. This is because differences in optimal disclosure levels arise out of differences in corporate governance arrangements, which vary in different parts of the world. Disclosure is of more value, for example, in a market-centered economy than in a bank-centered economy, and therefore, despite the higher costs of greater disclosure, issuers in a market-centered economy will tend to have a higher socially optimal level of disclosure.[30] A single mandated disclosure level covering the issuers located in a larger

30. *See Political Economy*, *supra* note 6, at 758-60; Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227, 237-53 (1998).

regulatory area will, therefore, be further away on average from each individual issuer's socially optimal disclosure level.

Neither the investor location nor transaction location approaches have features that would address these problems. Each of these approaches would lead, for some issuers within a larger regulatory area, to their disclosure being regulated by a government outside the area. There would be no systematic relation, however, between the issuers subject under these approaches to an outside government's regulatory regime and the issuers within the area that had socially optimal disclosure levels particularly far from that of the average issuer in the area. Again, relative to a larger regulatory area with issuer location as the territorial tie, issuer choice would have the benefit of assuring that no issuer would be regulated by a jurisdiction requiring disclosure above the issuer's optimal level. However, issuer choice is likely to result in most issuers being regulated by jurisdictions requiring disclosure below their optimal levels.

V. CONCLUSION: APPLICATIONS

The choice of regulatory area for securities disclosure is, as noted in the introduction, a hot issue today around the world. The United States, which decided in the 1930s to move from an exclusively state-based system to one primarily relying on federal regulation, is being urged by the proponents of issuer choice to reconsider and give issuers the option to choose among a reinvigorated set of state regulatory regimes.[31] Canada is currently debating whether to enlarge the role of the federal government in a system that has traditionally left disclosure regulation primarily to the provinces, a switch undertaken by Australia in the 1980s.[32] The countries of Europe are also deciding the extent to which the European Community, rather than its member states, should determine securities disclosure in Europe.[33] Of the participants in the Canadian and European debates who urge that provincial or state-level regulation be maintained, some simply seek to maintain the status quo. Others are proposing at the same time changes that would convert the regulatory structures for Canada and Europe into *de facto* issuer-choice systems.[34] There are also calls for making the whole world a single regulatory area where uniform standards

31. *See supra* note 3 and accompanying text.
32. *See supra* note 2 and accompanying text.
33. *See supra* note 1 and accompanying text.
34. *See, e.g.*, Harris, *supra* note 2, at 84-86.

are set for issuers around the world either by a multinational entity or through harmonization of state-level requirements.[35]

The theory of optimal regulatory areas set out here establishes a framework for analyzing all of these debates. While more definitive answers would require in-depth research concerning the specific features of each of the situations, application of certain commonly known facts is at least suggestive of the proper outcomes.

A. The United States and Canada

1. The United States

Putting issuer choice aside for a moment, there seems to be no case for returning the United States to a state-based regulatory structure. A large percentage of trade in goods and services in each state is with persons outside the state. There is sufficient mobility of labor and entrepreneurial talent between states that the market for them has a substantial national component. There is no strong evidence that state regulators would be significantly more responsive to the needs of their residents in the area of disclosure regulation than would be federal authorities. In the typical state, much of the economic activity is undertaken by issuers that cannot be characterized as having their economic center of gravity in the state. Whatever variation exists in the corporate governance structures of issuers across the country, little of it is geographically related. Thus, there is no reason to believe that issuers from one state would on average have a different optimal level of disclosure than issuers from another state.

A reinvigoration of state disclosure regulation would be called for if the United States were to adopt issuer choice. As we have seen, however, the economic efficiency case for mandatory disclosure is based on the market failure that arises from each issuer's private benefits from disclosure being less than the social benefits and its private costs being higher than the social costs. These divergences result in unregulated issuers disclosing at a level below their social optimum. Issuer choice does not correct this failure. Thus, issuer choice cannot be justified on economic efficiency grounds unless the regulations adopted by the federal government have caused issuers to deviate even more (just in the opposite direction) from their optimal disclosure levels than issuer choice would. I

35. *See supra* note 5 and accompanying text.

have argued elsewhere that the proponents of issuer choice have not made a persuasive argument that this is the case.[36]

2. Canada

The economic efficiency case for Canada to be a single regulatory area is strong, though not as strong as for the United States. Quebec and the western provinces may be more economically separate and distinct in their corporate governance arrangements from the rest of the country than is the case with any of the regions of the United States. Still, the overall situation in Canada seems close to that of the United States. There is a great deal of trade between provinces and much mobility of labor and entrepreneurial talent across provincial lines. Many corporations have significant operations across the country or at least in multiple provinces. The federal government appears reasonably responsive and effective in its enforcement capabilities. Beyond the distinctive features of some issuers in Quebec and the western provinces, any corporate governance differences among the country's issuers do not appear to be highly correlated with geography.

A driving force behind reform is the inconvenience of the current regulatory structure whereby the provinces are the regulatory areas, and investor location and transaction location are used in part as rules of territorial tie. This can force issuers to comply with multiple disclosure regimes in order to participate in the national capital market. One solution to this problem is to move to a single large national regulatory area, as suggested here. Other solutions are to maintain the provinces as the regulatory areas but either to adopt issuer location as the sole rule of territorial tie or to adopt issuer choice.

Each of these alternative solutions would be as good as national regulation for eliminating the costly need to comply with multiple regimes. The theory of optimal regulatory areas developed here, however, suggests that national regulation is superior to provincial regulation with issuer location as the sole territorial tie. The other alternative, issuer choice, cannot correct the market failures that lead unregulated issuers to disclose at a level below what is socially optimal. As previously noted, issuer choice thus cannot be justified on economic efficiency grounds unless the regulations that can be expected to be adopted by the Canadian

36. *Retaining Mandatory Disclosure*, *supra* note 6, at 1416-19.

federal government would cause issuers to deviate even more from their optimal disclosure levels than would issuer choice.

These potential problems with issuer choice are important to note. One possible route that reform could take would be to retain the provinces as the regulatory areas and to use issuer location to be the rule of territorial tie, but to equate an issuer's location with the issuer's place of incorporation rather than with its economic center of gravity. This sort of arrangement would establish a *de facto* regime of issuer choice. An issuer could choose for its place of incorporation or reincorporation the province that has the disclosure rules it most prefers and then go on to do business anywhere in Canada.

3. A Single Combined Regulatory Area

This discussion of the United States and Canada can be concluded with a provocative thought. A consideration of the five factors that need to be traded off in the construction of optimal disclosure areas suggests that perhaps the United States and Canada should be combined into a single regulatory area. The two economies are highly integrated with free trade and significant mobility of labor and entrepreneurial talent between the two. Their corporate governance systems are relatively similar. Establishing a responsive and effective regulatory entity might be difficult, but the closest substitute, harmonization of disclosure requirements, might be quite possible. Indeed, significant steps have already been taken in this regard. In 1991, the U.S. Securities and Exchange Commission (the "SEC") adopted rules and forms implementing the Canadian multi-jurisdictional disclosure system, under which substantial Canadian issuers could offer securities in the United States based primarily on their Canadian disclosure filings.[37] The negotiations between the SEC and the various Canadian provincial securities commissioners leading up implementation of the system resulted in the major provinces adding requirements that resembled what was already required in the United States, suggesting a certain kind of harmonization.[38]

37. Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 33-6902, 49 SEC Docket 260 (June 21, 1991). The issuers are required, however, to provide a reconciliation between the published accounts and U.S. generally accepted accounting principles. They are subject to the U.S. liability system.

38. *See* EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKET § 8.01 n.1 (3d ed. 1996).

B. Europe

The countries of Europe are also currently deciding the extent to which the European Community, rather than its member states, should determine securities disclosure in Europe.[39] It is a close question whether there should be a single regulatory area encompassing the whole Community or multiple regulatory areas corresponding with the member states. While a much more detailed exploration is required to come to any definitive conclusions, several features of the situation stand out.

While the ambition of the Community is to have a highly integrated economy with large amounts of cross border trade and high mobility of labor and entrepreneurial talent, the reality may lag behind. Overall, the level of economic integration appears not to be as great as in the United States or Canada, particularly with respect to the portion of the Community's territory constituting the new members. On the other hand, there appears to be far more integration among the member states than among the regulatory areas in the ideal case discussed in Part III or even, as a general matter, between member states and countries outside the Community.

Compared to Canada or the United States, the European Community displays considerable more diversity in corporate governance arrangements. Thus, the U.K.'s market-centered corporate governance looks quite different than Germany's bank-centered one. Italy, with its domination by family companies and relatively low protections for minority shareholders, looks quite different from either of the other two.

The Community-level governmental institutions, with the continuing large role played by member states and the central bureaucracy, may be substantially less responsive to the needs of its residents than most of member states' governments, whose top officials are chosen pursuant to direct democratic elections.

In sum, there are no simple answers to the question of the optimal regulatory area or areas for Europe. The underlying level of economic integration provides substantial arguments for a single regulatory area. The level of trade is sufficiently high to cause the kind of information externalities that would result in a significant downward bias in the level of disclosure that a member state is likely to require of its issuers. There is also enough labor and entrepreneurial talent mobility to reduce the incentives of member state governments to try to get the regulations right.

39. *See supra* note 1 and accompanying text.

On the other hand, the institutional factors argue the other way. The very large differences among countries in corporate governance arrangements suggest that their issuers have considerably different optimal levels of disclosure. And the bureaucracy in Brussels that would be operating a Community-wide regime appears to be the subject of considerable resentment for its lack of responsiveness.

C. A Single Global Regulatory Area

The theory of optimal regulatory areas developed here strongly argues against a single global regulatory area, at least for all but the truly multinational issuers such as Daimler-Chrysler and BP-Amoco. Despite all the talk of globalization, we fall short today of having a truly integrated global economy.[40] This suggests that while cross-border mobility of trade, labor and entrepreneurial talent, and the existence of issuers with no clear economic center of gravity cause substantial problems when we use countries or regional economic communities as the regulatory areas rather than the globe as a whole, these problems are not so large as to completely vitiate the logic set out in the ideal case in Part III.

As noted above, problems relating institutional factors raise serious questions concerning the desirability of a single European regulatory area. Such problems are far more grave when we contemplate the whole globe being a single regulatory area. Setting up from scratch a responsive, effective multinational body to administer such a system would be a daunting task. Moreover, unlike with a nationally based system, dealings between the entrepreneurs or managers of the issuers and the officials regulating them would often not be between persons who share a common culture, language, and understanding of business practices. Finally, there are wide differences in corporate governance arrangements around the world that involve additional dimensions even beyond what we have seen in the comparison of the U.K., Germany, and Italy.

In sum, the degree of world economic integration is not so complete as to vitiate the logic of national regulation and compel movement to a single regime. And the institutional factors argue strongly against such a move.

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40. Most of the world's issuers, even ones labeled "multinational," for example, still have a distinct nationality of this sort in some country (particularly if the E.C. is for these purposes treated as a single country). In 1990, profits from foreign operations of U.S. corporations amounted to only about one-sixth of all corporate profits. *See* NIPA Table 6.16C, 72 SURV. CURRENT BUS. No. 12 at 14 (1992). In 1989, overseas assets of even U.S. corporations designated as "multinational" were only about one-fifth of their total assets. *See* Jeffrey H. Lowe & Raymond J. Mataloni, Jr., *U.S. Direct Investment Abroad: 1989 Benchmark Survey Results*, 71 SURV. CURRENT BUS. 29 tbl.2 (Oct. 1991).