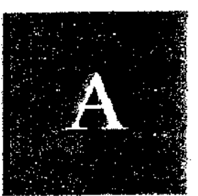
LISTING OF FOREIGN SECURITIES ON U.S. EXCHANGES

*by Franklin R. Edwards, Columbia University**



controversy has arisen between U.S. exchanges and the Securities and Exchange Commission over the listing and trading of foreign securities on U.S. exchanges. A foreign company's securities cannot be listed on a U.S. exchange unless that company registers with the SEC in accordance with the Securities Exchange Act of 1934. Among other things, registration requires that a company disclose certain information about itself in a format that conforms to Generally Accepted Accounting Principles in the United States (U.S. GAAP). Although many foreign companies meet all of the listing requirements of U.S. exchanges, most have chosen not to register with the SEC, making their securities ineligible for trading on U.S. exchanges.

Foreign issuers contend that the reporting required by SEC registration is costly for them, unnecessary to protect stockholders, and in some cases may even mislead their stockholders. They argue that the information they already provide to stockholders, which is in accordance with their own country's disclosure requirements and accounting principles, is sufficient for stockholders. In particular, the requirement that foreign firms reconcile their financial statements to U.S. GAAP often provides no new information to stockholders but simply imposes on them the additional cost of having to compile and restate information in a different format. Further, although in some cases reconciliation would require firms to disclose additional information, foreign firms generally consider such information to be of little value and perhaps even detrimental to stockholders' interests by disclosing important information to competitors.

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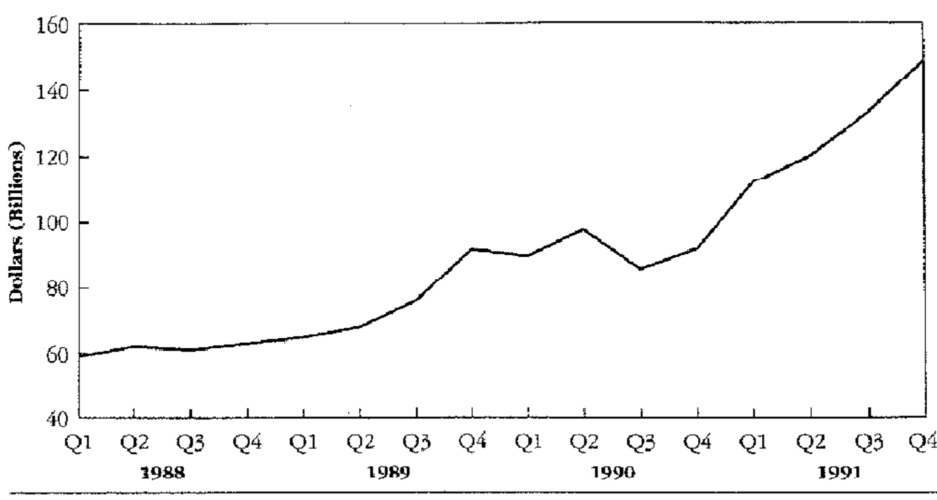
FIGURE 1
HOLDINGS OF FOREIGN EQUITIES BY U.S. RESIDENTS



Source: Federal Reserve Board Flow of Funds.

THE GROWTH OF FOREIGN SECURITIES TRADING AND WORLDWIDE COMPETITION

Why has this controversy arisen now? The SEC requirement that firms be registered to qualify for listing on U.S. exchanges is, after all, not new. It has applied to foreign issuers for decades, and in 1983 the requirement was extended to the listing and trading of foreign shares on NASDAQ as well. The issue has taken on new importance in the last few years because of the rapid growth of trading in foreign shares, and because of the development and growth of foreign securities exchanges, which are now providing intense competition for U.S. exchanges. Further, as capital markets in foreign countries continue to grow, the trading of foreign companies' shares promises to become a huge market. Thus, the SEC's registration requirement, and more particularly its requirement of reconciliation to U.S. GAAP, stands as an insurmountable competitive barrier for U.S. exchanges in their quest to capture a significant share of the growing foreign equities market.

While it is difficult to measure the growth of trading in foreign equities worldwide, we do know that U.S. investors have become much more active in this market. Ownership of foreign equities by U.S. investors has more than doubled over the last four years. By the end of 1991, U.S. investors held $148.8 billion in foreign equities, up from only $58.8 billion in early 1988. (See Figure 1.) Most of these shares are held by institutional investors—roughly 80% by ERISA pension funds and 13% by global and international mutual funds or closed-end country funds.[1]

There has also been a significant increase in the trading of foreign securities by U.S. investors in foreign equity markets. This trading has expanded at a cumulative annual growth rate of 32.8% during the 1980s; U.S. purchases and sales of securities abroad grew from $17.9 billion in 1980 to $230.3 billion in 1989.[2] (See Table 1.) Japanese and British markets were the big winners in attracting U.S. investors. Although foreign purchases and sales in U.S. equity markets have also grown during the 1980s, they have grown at a slower pace (at a compound annual growth rate of 21.0%).[3]

U.S. exchanges fear that, by not being able to list the securities of large and actively-traded foreign firms, they will lose out in the competitive struggle with foreign exchanges. Since the application of the SEC's registration requirement to NASDAQ in 1983, there has been no growth in the number of foreign listings on U.S. exchanges and NASDAQ, despite the rapid expansion that has taken place in the trading of foreign securities. (There are currently a total of

1. Estimates of Salomon Brothers.
2. Joseph A. Grundfest, "Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences," *Journal of Financial Services Research*, Vol. 4, No. 4, December, 1990, pp. 99-100.
3. *Ibid.*, pp. 352-353.

TABLE 1
AGGREGATE U.S. PURCHASES AND SALES OF FOREIGN SECURITIES BY GEOGRAPHIC REGION, 1980-1989

	1980	1983	1986	1989	1980-1989 CAGR*	1989 Mkt Share
Canada	6.7	5.0	9.8	10.9	5.5%	4.7%
Total Europe	6.9	13.6	55.3	128.9	38.5%	56.0%
▪ United Kingdom	2.8	6.5	32.6	80.1	45.3%	34.8%
▪ Switzerland	1.6	1.8	3.2	8.5	20.8%	3.7%
▪ Other Europe	2.5	5.4	19.5	40.3	36.0%	17.5%
Total Asia	3.3	9.4	30.1	75.8	41.8%	32.9%
▪ Japan	2.7	8.0	25.6	65.8	42.4%	28.6%
▪ Other Asia	0.6	1.4	4.5	10.1	38.0%	4.3%
Latin America	0.7	1.6	3.6	9.3	33.3%	4.0%
All Other	0.3	0.8	2.7	5.4	36.4%	2.3%
Total	17.9	30.3	101.5	230.3	32.8%	100.0%

Source: Office of the Secretary, U.S. Department of Treasury. *Treasury Bulletin*, table CM-V-5, Spring issues.
*CARG is the cumulative annual growth rate.

399 foreign listings on the NYSE, AMEX, and NASDAQ.[4]) Further, improved technology and the expansion of trading on foreign securities exchanges threaten to make foreign exchanges even more effective competitors in the future. If U.S. exchanges continue to be unable to compete with foreign exchanges, in the next few years foreign exchanges could gain an irrevocable advantage in the trading of foreign shares that U.S. exchanges may never be able to overcome. London, in particular, is racing ahead in an effort to capture this market; nearly 2,000 foreign issues are already traded in London, many on an unlisted basis.

In an effort to alter the competitive imbalance, the New York Stock Exchange has proposed that 200 "world-class issuers"—those with stock market capitalizations in excess of $1 billion, with substantial foreign share ownership, and which are listed on at least one major world exchange in addition to a home-country exchange—be permitted to have their shares listed and traded on U.S. exchanges without having to reconcile their financial statements to U.S. GAAP. Instead, these companies would be allowed to file their own, independently audited, home-country financial statements, together with a written explanation of the material differences between home-country accounting practices and U.S. GAAP.

THE SEC'S OPPOSITION TO FOREIGN LISTINGS

The SEC has rejected this proposal. The longstanding SEC position has been that foreign issuers should be subject to the same rules and requirements that apply to U.S. (or domestic) issuers—in other words, to "national" or "host-country" treatment. The NYSE's proposal opens the door to at least the partial application of a "home-country" policy, since at least some foreign firms would need to disclose only in accordance with their home countries' requirements. As a consequence, the present situation is in stalemate: U.S. exchanges are unable to compete for a large and growing segment of foreign securities trading, and the SEC is standing firm on its contention that it is unnecessary to alter its present disclosure requirements vis-a-vis foreign issuers.

The SEC bases its unwillingness to alter its requirements on two primary policy considerations: (1) investor protection and (2) the need to avoid a disclosure system that would discriminate against U.S. issuers.[5] We can surmise, from various statements issued by representatives of the SEC, that the SEC fears that any change in the disclosure requirements applicable to foreign issuers may undermine

4. See footnote no. 7 for a more complete breakdown of this number.
5. See, for example, the statement by former SEC Commissioner Philip R. Lochner, Jr., "The Effect of the S.E.C.'s Foreign Company Reporting Requirements on the U.S. Equity Markets," Remarks before the 11th Annual Ray Garret Jr. Corporate and Securities Law Institute Conference, Chicago, Illin., 12 (May, 1991). See, also, Securities Act Release No. 33-6437 (Nov. 19, 1982), "Adoption of Foreign Issuer Integrated Disclosure System," 26 S.E.C. Docket (CCH) 964; and Securities Act Release 6360, 24 SEC Dock. 3, 6 (1981).

In the next few years foreign exchanges could gain an irrevocable advantage in the trading of foreign shares that U.S. exchanges may never be able to overcome. London, in particular, is racing ahead in an effort to capture this market; nearly 2,000 foreign issues are already traded in London, many on an unlisted basis.

the protection of U.S. investors for two reasons. First, if foreign firms do not make public the same information currently provided by U.S. issuers to stockholders, U.S. investors will not be able to establish the values of foreign companies with the same accuracy. As a consequence, there will be mispricing of foreign shares—or less price efficiency. Some investors may pay too much, others too little. This argument, obviously, is based on the implicit assumption that the information disclosed by foreign firms under home-country standards is inferior to the information disclosed by U.S. firms. Second, the SEC fears that, in the absence of equivalent disclosure, U.S. markets will become less "fair." U.S. investors in foreign companies will be subject to more "insider trading" since there will be more scope for insiders in these companies to possess superior knowledge about the company.[6]

The SEC's second policy concern is that to adopt different disclosure requirements for foreign issuers would establish a two-tier disclosure system: one for foreign firms, and a more onerous one for U.S. firms. This would arguably put U.S. firms at a competitive disadvantage, since it would impose greater disclosure costs on them. Further, the eventual result of unequal disclosure standards might be the complete unravelling of the current SEC disclosure standards, since U.S. firms may then also seek to avoid the more onerous U.S. regulations. (The implicit assumption that would seem to underlie this scenario is that investors do not place a value on the additional information disclosed by U.S. firms equal to the cost of producing it. Otherwise, the additional disclosure requirements imposed on U.S. firms would not be a competitive disadvantage.)

SEC PROTECTION OF U.S. INVESTORS: WHO AND HOW?

SEC mandatory disclosure requirements arguably protect investors principally by requiring firms to disclose information that investors need to value a firm, or its stock. In addition, the Securities and Exchange Act (herafter "the SEA") establishes penalties for improper or fraudulent disclosure, and has the subsidiary benefit of imposing uniformity on the way that firms report information. Uniformity of accounting and reporting should reduce the transactions costs experienced by investors in collecting and deciphering information.

The public interest rationale for mandatory disclosure, therefore, contains the obvious assumption that unregulated firms in a free-market setting will fail to report sufficient information for shareholders to be able to value their shares accurately. Or, alternatively, that unregulated firms will disclose misleading or fraudulent information with the intent of deceiving shareholders. Further, if these practices were widespread, equity markets would be less fair and investors might abandon them, resulting in less liquid and less price-efficient markets.

These assumptions are not accepted by everyone. Critics of SEC disclosure requirements argue that, even in the absence of requirements, firms would voluntarily provide investors with sufficient information. They point, for example, to the voluntary disclosure that now takes in the private placement market, which is exempt from SEC requirements, as well as to the disclosures that firms commonly made prior to enactment of the SEA in 1933. Further, although SEC requirements may result in firms disclosing more information than they otherwise would, it is not self-evident that the additional information is either useful or cost-effective. Even assuming that the additional information has value, at least for some firms, the costs borne by all firms in having to report this information may exceed its social benefits. The SEC, many economists contend, does not properly weigh the costs associated with greater disclosure. In addition, experience shows that SEC requirements are not an effective deterrent to fraud. Nor are they needed to give defrauded investors legal recourse. Finally, while uniformity of reporting can be beneficial, it also limits the flexibility that firms have in how and what they report and, in so doing, may lead to less useful disclosures.

These contentious issues are unlikely to be resolved in the near future. In the meantime, the application of SEC disclosure requirements to foreign firms is an effective deterrent to U.S. exchanges competing in world securities markets, and could eventually lead to the erosion of our preeminent position in world markets. Only a short time ago many

6. See, for example, Richard C. Breeden, Chairman, Securities and Exchange Commission, "Remarks at the American Stock Exchange Perspectives Conference," Washington, D.C., Nov. 4, 1992.

of us believed that the U.S.'s dominant positions in automobiles, electronics, computers and other industries were impregnable. We do not want to make the same mistake with our financial industries.

Do Listing Requirements Protect U.S. Investors?

How does the SEC's requirement that foreign firms whose shares are traded on a U.S. exchange register under the SEA protect U.S. investors? More particularly, how does the requirement that foreign firms reconcile to U.S. GAAP protect U.S. investors? U.S investors already hold and trade the shares of unregistered foreign firms in large volume. As already shown in Table 1, the aggregate purchases and sales of U.S. investors in foreign equity markets amounted to $230.3 billion in 1989, and this trading is growing rapidly. In addition, it is not necessary for foreign firms to register with the SEC to have their shares traded in the United States; this requirement *applies only to trading on U.S. exchanges and NASDAQ.* As a consequence, unregistered shares of foreign firms are increasingly being traded in the U.S. in the over-the-counter market, either through the Electronic Bulletin Board (EBB) or the "pink sheets." In these over-the-counter markets, there is no last sale reporting, no volume reporting, no real-time price quotes, and little readily-available financial information about the companies traded. In a word, these markets are lightly-regulated in comparison to that of exchange-traded securities.

During the last decade SEC requirements have continued to push more and more trading of foreign shares into these less regulated markets. Currently, there are 722 unregistered American Depository Receipts (ADRs) traded over-the-counter in the United States, compared with 492 foreign "reporting" (or registered) companies.[7] But the more telling statistic is what has happened since October 6, 1983. On that day, the SEC amended Rule 12g3-2 to provide that both securities traded on a national exchange *and* those traded in the NASDAQ over-the-counter quotation system must be registered.[8] Prior to that time the securities of foreign firms could be traded on NASDAQ without section 12 registration by availing themselves of the "information-supplying" exemption of Rule 12g3-2(b).[9] In the seven years preceding the elimination of this exemption, from 1977 to 1983, the number of foreign securities traded on NASDAQ tripled, growing from 85 to 294. Since the exemption was eliminated in 1983, the number of foreign securities traded on NASDAQ has declined to 213 (as of the end of 1991). In contrast, since 1983 the number of foreign securities traded in the Electronic Bulletin Board or pink sheets, where the SEC exemption still applies, has grown noticeably. As of the end of 1991, 376 foreign, unregistered companies were traded either in the over-the-counter EBB or pink sheets.[10]

Clearly, American investors are already trading unregistered foreign securities—in the U.S. as well as in foreign countries—in markets in which there is less regulatory oversight and where transactions costs are considerably higher. Transactions costs are significantly lower in the U.S. than in either the U.K. or Japan, where most of the trading of foreign securities by U.S. investors occurs. Figure 2 shows the average transactions costs for an institutional investor in 1989 for four different size transactions and for four major foreign markets versus the United States. These figures also do not reflect the higher bid-ask spreads and execution costs that are characteristic of the foreign markets and the over-the-counter markets in the U.S. where unregistered foreign securities are traded. The SEC registration requirement, therefore, does not protect U.S. investors by preventing them from trading foreign securities; instead it forces them to transact in more costly and less regulated markets.

Nor can we take much solace from the contention that the SEC requirements protect small U.S. investors. Although these requirements may make it more difficult for small, unsophisticated investors to find out how to trade foreign securities and to learn about the business activities and financials of foreign companies, small investors are nevertheless harmed by their inability to trade foreign stocks in U.S.

7. Of the 492 reporting foreign issuers, 119 are listed on the NYSE, 67 on AMEX, and 213 are quoted through NASDAQ. In addition, 107 companies are traded in over-the-counter markets. I am indebted to James Shapiro of the N.Y.S.E. for providing these figures.

8. See Sec. Act Rel. 6493, 28 SEC Dock. 1265 (1983).

9. Exempted foreign companies still had to provide specified information to the SEC. The required information was limited to whatever during the last fiscal year had been made public by the issuer pursuant to the law of the country of its domicile or in which it is organized or by a stock exchange on which its securities are traded, or has been distributed to its securities holders. Issuers were required to furnish whatever information was deemed material to an investor's decision to purchase the company's securities.

10. For estimates of the foreign stocks traded in the United States prior to 1983, see Paul Aron, "New Disclosure Requirements for Foreign Issuers," *Financial Analysts Journal*, Nov.-Dec., 1983.

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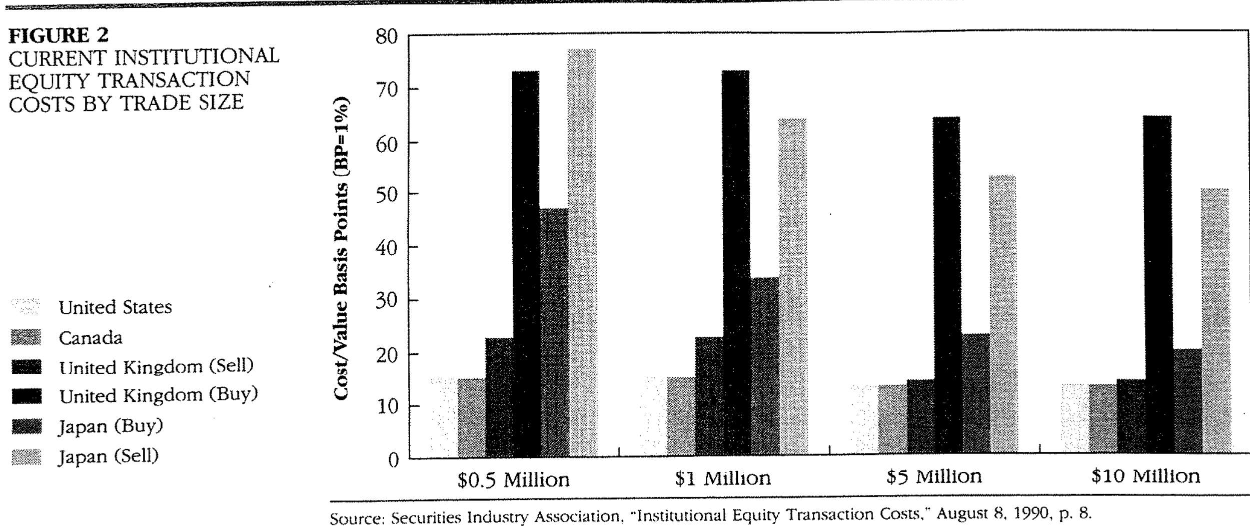

FIGURE 2
CURRENT INSTITUTIONAL EQUITY TRANSACTION COSTS BY TRADE SIZE

Source: Securities Industry Association, "Institutional Equity Transaction Costs," August 8, 1990, p. 8.

markets. The U.S. investors now trading foreign securities are largely pension funds and mutual funds, so that the higher costs of trading in foreign markets, as well as in the over-the-counter markets, are passed through to fund beneficiaries and shareholders, most of whom are the very same small investors that the SEC seeks to protect.

THE EFFICIENCY OF FOREIGN STOCK PRICES AND INVESTOR PROTECTION

The SEC's refusal to accept home-country reporting as a basis for permitting foreign firms to be traded on U.S. exchanges is premised on the implicit assumption that foreign securities markets are less price-efficient than U.S. markets because of poorer reporting standards in foreign countries. Stated in another way, the SEC's implicit view is that the prices of foreign securities are unlikely to reflect the future prospects of firms as accurately as U.S. security prices because SEC disclosure requirements result in more information being available about U.S. firms.

This view is difficult to verify, one way or the other. Even accepting the argument that more information is always better than less, there is no evidence to suggest that foreign stock markets are not price efficient in the sense that resources are not allocated efficiently among firms. Empirical studies, for example, generally show that accounting information disclosed by foreign firms is used by foreign investors to value stocks in foreign markets in much the same way that U.S. investors use the information disclosed by U.S. companies to value shares in U.S markets.[11] Whether foreign stock values are as "macro-efficient" (or as efficient in an "absolute" sense) as U.S. stock values, we do not know.[12] Even if more information is disclosed by firms in the United States, it is possible that some of this information may be without value—that "too much" information is disclosed by U.S. firms.

Foreign stock values may be as efficient as U.S. stock values for other reasons as well. In many foreign countries the structure of firm ownership is characterized by a greater role for "large owners," so that information asymmetries (or the information "gap") between managers and stockholders may be much less of a problem. As a consequence, foreign stocks may be even more efficiently priced, despite the fact that less information is disclosed by foreign firms than American firms.

Although it is clearly very difficult to determine the efficiency of U.S. versus foreign equity markets

11. See, for example, Trevor S. Harris and Mark Lang, "Relations Between Security Market Prices, Returns and Accounting Measures in Germany," Working Paper, Columbia University, August, 1992. For a contrary view, see Charles Hall, Yasushi Hamao, and Trevor S. Harris, "A Comparison of Relations Between Security Market Prices, Returns and Accounting Measures in Japan and the United States," Working Paper, Columbia University, September 30, 1992.

12. For a discussion of the alternative concepts of price efficiency, see Stewart Myers, "Fuzzy Efficiency," *Institutional Investor* (December, 1988). This article, written in the wake of the market crash of '87, argues that although the market is highly "efficient" in valuing securities in relation to each other, such "efficiency" may not extend to the absolute value or level of a given company's price.

in a macro or absolute context, several studies of the "relative" (or "micro") efficiency of foreign equity markets suggest that these markets are as efficient as U.S. equity markets. (By "relative" efficiency, I mean the extent to which security prices are efficient *relative* to each other, or to previous securities prices.) Academic studies of relative efficiency can be grouped into four types: (1) studies of security price behavior—that is, tests of serial correlation, price randomness, etc.; (2) studies of the effects of public announcements—tests of the reactions of securities prices to the disclosure of accounting information, such as SEC reports; (3) studies of investment performance—for example, whether professional investment managers such as mutual funds earn abnormal returns; and (4) studies of whether private (or "insider") information has value.[13] Over the past decade, hundreds of these studies have been done on foreign securities markets (mostly European), with the general finding that foreign markets are as efficient as U.S markets, especially in the case of large firms.[14]

In addition, a few studies have examined the specific question of whether the restatement of earnings by foreign firms in accordance with U.S. GAAP provides useful information to investors. Specifically, if accounting data stated according to U.S. GAAP were more informative than data commonly disclosed by foreign firms, we would expect to observe a closer association between the stock prices of foreign firms and their disclosures according to U.S. GAAP.[15] While the results of these studies are subject to alternative interpretation, the general finding is that the SEC's current U.S. GAAP reconciliation requirement may not provide investors with useful information (even though it may result in the disclosure of different information). More studies, however, must be done before we can draw definitive conclusions.

In summary, most of the evidence on the relative efficiency of foreign equity markets suggests that the efficiency of these markets is quite similar to that of U.S. markets. Further, as foreign trading volume expands relative to U.S. markets, both the liquidity and efficiency of foreign markets is likely to increase. It is still possible, of course, that the SEC may be right—that foreign markets are not as efficient in an absolute value sense as are U.S. markets, but at present there is little evidence to support this view.

INSIDER TRADING AND INVESTOR PROTECTION: A BOGUS ISSUE

Another SEC concern is that poorer disclosure policies in foreign countries may result in more "insider trading" in foreign stocks, to the detriment of U.S. investors in these stocks. Even if foreign markets were efficient, greater insider trading could result in greater market unfairness; that is, U.S. investors would be at a disadvantage vis-a-vis insiders.

It is important to recognize, however, that there are insiders in all countries and in all markets—managers and "tippees" who at times possess information that public stockholders do not have. In the United States the ability of insiders to take advantage of other investors is controlled by various laws. Specifically, insiders are prohibited from trading on, or otherwise exploiting, their superior information under penalty of both substantial fines and prison terms. These laws apply equally to foreign companies whose shares are traded in the United States.

Further, to the extent that insiders in foreign companies are able to take advantage of public stockholders by trading ahead of them, the requirement that foreign companies reconcile to U.S. GAAP will in no way curb this abuse. Even with the disclosure of more or better information, U.S. investors, as well as foreign public investors, will still be vulnerable to trading-ahead by insiders.

Thus, insider trading is a separate issue, independent of the question of what the proper level of disclosure is for foreign firms. Indeed, if foreign stocks were traded on U.S. exchanges, the SEC would be in a better position to monitor and restrict insider trading in these stocks.

13. See Jeffrey N. Gordon and Lewis A. Kornhauser, "Efficient Markets, Costly Information, and Securities Research," *New York University Law Review* 60: 761-833, 775.

14. For surveys of these studies, see Donald R. Lessard, "The Implications of Market Efficiency for U.S. Disclosure by Non-U.S. World-Class Issuers," Working Paper, Massachusetts Institute of Technology, September 24, 1990; and Gabriel Hawawini, *European Equity Markets: Price Behavior and Efficiency*, Monograph Series in Finance and Economics, Salomon Brothers Center for the Study of Financial Institutions, Graduate School of Business, New York University, 1984.

15. See, for example, G. Meek, "U.S. Securities Market Responses to Alternate Earnings Disclosures of Non-U.S. Multinational Corporations," 58 *The Accounting Review*, 394-402 (1983); P. Pope and W. Rees, "International Differences in GAAP and the Pricing of Earnings," paper presented at the 1991 Annual Meeting of the American Accounting Association, Nashville, Tenn., August, 1991; and Frederick D.S. Choi and S.B. Hong, "The Decision Utility of Restating Accounting Information Sets: Korea," in 4B *Advances in Financial Planning and Forecasting*, 123-142, eds. by Raj Aggarwal and Cheng-Few Lee. 1990.

The SEC's argument implicitly assumes that its present disclosure requirements are *not* optimal; that is, it implicitly assumes that investors are unwilling to pay for the additional information U.S. firms are required to disclose.

DO U.S. INVESTORS NEED TO BE PROTECTED AGAINST FOREIGN ISSUERS?

If the securities of foreign companies were permitted to be traded on U.S. exchanges without having to meet the current SEC registration requirements (as is now the case in the EBB and pink-sheet over-the-counter markets), how might we expect U.S. investors to react? Suppose that foreign firms did not provide information to investors that was as complete or as accurate as that furnished by American firms. Under these conditions it is unlikely that U.S. investors would be willing to value foreign stocks on the same basis as the shares of American firms. With less information available, foreign stocks would undoubtedly be viewed as more risky, and therefore subject to a higher discount rate. This is especially likely in today's markets, where the dominant U.S. stockholders in foreign firms are sophisticated institutional investors. Stated another way, U.S. investors would demand a higher risk premium for holding foreign stocks, or a higher rate of return in compensation for not being kept as well-informed.

The effect of this investor reaction would be to impose a higher cost of capital on foreign firms. To prevent this from happening, of course, foreign firms need only disclose more information; indeed, they could disclose fundamentally the same information as do American firms. They would then no longer be penalized by investors.

There is some evidence that this in fact happens. In the private placement market, for example, foreign firms provide investors with information similar to that disclosed by U.S. firms. Similarly, they frequently provide rating agencies with more complete information. In short, foreign firms can be expected to respond voluntarily to the needs of U.S. investors for more information if by supplying that information they can reduce their cost of capital.

Whether the equilibrium level of information that is ultimately provided by foreign firms will be optimal in a "welfare" sense is difficult to determine. But it must be recognized as well that there is no way of determining whether the SEC's current disclosure requirements provide the optimal amount of information. Since SEC requirements are not subject to a market-based, cost-benefit evaluation, it is not unreasonable to think that they may result in firms having to produce too much information.

In addition, the U.S. exchanges on which foreign shares are listed have a direct interest in requiring adequate disclosure. The more trading of foreign securities that takes place on an exchange, the better for exchange members. If, because of inadequate disclosure, an embarrassing episode were to occur with respect to the foreign securities traded on that exchange, customers might be driven away from the exchange, and the exchange's trading volume reduced. The result could be lost revenues for the exchange for many years into the future. Major U.S. exchanges have been in business for many years, and can be expected to protect their long-run interests.[16]

Finally, suppose that foreign firms did not disclose adequate information and, as a result, some U.S. investors suffered losses; suppose that there were even a scandal involving a foreign company. Would such an event significantly harm the market for U.S. securities in the United States? Would U.S. investors stop trading the securities of U.S. companies because of inadequate disclosure by foreign firms? It seems doubtful. A more likely response is that U.S. investors would stop trading the securities of foreign firms, not American firms. Thus, the fear that inadequate disclosure by foreign firms could undermine U.S. equity markets seems unwarranted.

A TWO-TIERED DISCLOSURE POLICY AND COMPETITIVE EQUALITY

The final SEC argument is that to accept different disclosure standards for foreign issuers would be to establish a two-tiered reporting system that favors foreign firms. With less onerous disclosure requirements, the SEC argues, foreign firms will have lower costs than American firms, and will have a competitive advantage. Further, if this cost advantage proves to be significant, it will not be long before U.S. firms agitate for less burdensome disclosure standards for themselves, which could eventually result in the wholesale undermining of the SEC's current disclosure standards.

16. The New York Stock Exchange, for example, had disclosure standards for firms long before they were required by federal legislation in 1933 and 1934. For a description and analysis of the information reported by firms prior to the SEA, see George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934," *American Economic Review*, vol. 42 (March 1973), pp. 130-55; and George J. Benston, *Corporate Financial Disclosure in the U.K. and the U.S.A.*, (Saxon House: Hampshire, England), 1976, pp. 28-30.

Several points are worth noting in response to this argument. First, to the extent that foreign countries currently impose less burdensome reporting standards on firms, U.S. firms now operate at a competitive disadvantage. U.S. investors are already trading the securities of unregistered foreign firms in volume in foreign markets. Second, the SEC's argument implicitly assumes that its present disclosure requirements are *not* optimal; that is, it implicitly assumes that investors are unwilling to pay for the additional information U.S. firms are required to disclose. Stated another way, if a foreign firm reports less information and investors recognize this as a deficiency, the firm's cost of capital will be higher than for a similar American firm. Alternatively, if by providing the information required by the SEC, an American firm's cost of capital is lower, there will be no incentive for U.S. firms to abandon the current disclosure policy. Third, to the extent that neither U.S. firms nor U.S. investors value the additional information required by the SEC, but seek to relax disclosure standards to make them more compatible with those of foreign countries, current SEC requirements can be said to be suboptimal—or too burdensome.

Thus, if our current disclosure policies are superior to those of foreign countries, it is not clear why either U.S. investors or U.S. firms would want to abandon these policies in favor of inferior disclosure standards. It is clearly in the interests of investors to have securities priced accurately; and, as a general proposition, having their shares accurately priced is also in the interests of companies. To contend otherwise is to assume either that U.S. investors and firms behave irrationally or that there are significant externalities that are not being internalized. It is difficult to see what these externalities might be. If, on the other hand, our current disclosure policies are not superior, or are more costly than the provision of the additional information warrants, we should be happy to abandon them in favor of a better policy. Thus, at least in the case of reporting standards, world-wide competition among exchanges, as well as among alternative government disclosure policies, may result in the establishment of optimal global disclosure standards.

POLICY CHOICES

The feasible policy choices now facing the United States are as follows: (1) to require foreign companies to adhere to current U.S. disclosure and registration requirements; (2) to accept home-country reporting by foreign companies from some or all foreign countries; or (3) to attempt to harmonize accounting standards and disclosure requirements across all major countries, perhaps under the auspices of the International Organization of Securities Commissions (IOSCO). A variation on (2) above would be for the SEC to relax its registration requirements for only a certain class of foreign firms; for example, it could decide not to require foreign "world-class" issuers to reconcile their financial statements to U.S. GAAP.[17]

My analysis suggests there is little danger to U.S. investors in the SEC relaxing its reporting requirements for foreign companies traded on U.S. exchanges. A continuation of the present SEC policy threatens to jeopardize the long-run competitiveness of U.S. exchanges and possibly their long-term viability as well. Simply dropping the requirement that foreign firms reconcile their financial statements to U.S. GAAP may be sufficient to deal with the competitive problem in the short run. In the long run, however, we must squarely face the question of what our disclosure policies should be in an environment of competitive and global capital markets—one in which a firm's securities can be traded anywhere in the world.

17. The NYSE's proposal would relax these standards for only "world-class" issuers: those with capitalizations in excess of $1 billion, substantial foreign share ownership, and a listing on at least one major world exchange in addition to a home-country exchange.

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