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COMMENTARY: **SELF-REGULATION IN THE GLOBAL CONTEXT**

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SUMMARY:
... As the New York Stock Exchange ("NYSE"), the NASDAQ, and other American exchanges move from member-only ownership to broader control ("demutualization"), and eventually to public ownership, one of the major public policy questions is the future of self-regulation. ... In addition, as multiple markets seek to register as exchanges, we believe there exists the potential for fragmentation of regulation that would seriously undercut the overall quality of regulation and make a consolidated regulatory view of trading activity extremely inefficient and costly to achieve, to the ultimate detriment of the investor . . . . The time may therefore be right to consider whether it makes sense for regulatory units of all institutions choosing to register as exchanges to be combined in a single SRO governed by market participants and public representatives. ... The NYSE itself presents a good picture of the accelerating pace of globalization when it comes to actual stock transactions in the U.S. In the 1990s, the dollar value of Asian companies listing on the exchange went from virtually nothing to fifty billion dollars; for Latin American countries the jump was from zero to over one hundred billion dollars and for European countries from fifty-billion dollars to nearly three-hundred and fifty-billion dollars. ... Several Chinese companies are already listed in the U.S., and both the NYSE and the NASDAQ have vigorously courted China. ...

TEXT:
[*23] As the New York Stock Exchange ("NYSE"), the NASDAQ, and other American exchanges move from member-only ownership to broader control ("demutualization"), and eventually to public ownership, one of the major public policy questions is the future of self-regulation. Currently these exchanges have self-regulatory authority over their members' activities and over listing requirements of companies whose shares the exchanges trade. But if the exchanges themselves become publicly listed companies, will the competition between them undermine the standards of self-regulation today? For example, would there be a temptation to relax listing requirements or regulatory surveillance of listed companies in an effort to secure new business in a hyper-competitive environment, the new reflection of which would be the daily publicly-quoted stock price of the exchanges themselves? Would exchanges find it easier to attract new shareholders, many of whom might be traders of securities on those very exchanges, if the conduct of self-regulation was less, rather than more, vigorous? Would shareholders who do trade on their own exchanges put pressure on the exchanges to relax scrutiny?

These and other questions have led to a vigorous debate on the most desirable mechanism for self-regulation in the new era of capital markets, one characterized by blinding changes in technology and more intensive linkages of capital markets among national jurisdictions. A snapshot of the [*24] debate can be seen in presentations given by Securities Exchange Commission ("SEC") Chairman Arthur Levitt, NYSE Chairman Richard Grasso, and National Association of Securities Dealers ("NASD") Chairman Frank Zarb in the last week of September 1999. "Some have suggested *one* SRO [self-regulatory organization] that regulates all markets, alleviates conflicts and reduces redundancy, paperwork and operational costs," said Levitt in a speech at Columbia Law School. n2
Others line up behind a model where each market would maintain the regulatory and surveillance function for its own market-but member regulation, sales practices, and all other aspects of intermarket trading would be overseen by a single SRO. While I certainly am not

wedded to any particular model at this point-a great deal more thinking needs to be done-this latter approach is intriguing. n3

At a subsequent Senate hearing, Chairman Frank Zarb of the NASD expressed sympathy for Levitt's point of view.

In this wider market competition . . . we believe that there exists the potential for a conflict of interest, where markets could compete based on ease-rather than the rigor-of regulation. In addition, as multiple markets seek to register as exchanges, we believe there exists the potential for fragmentation of regulation that would seriously undercut the overall quality of regulation and make a consolidated regulatory view of trading activity extremely inefficient and costly to achieve, to the ultimate detriment of the investor . . . . The time may therefore be right to consider whether it makes sense for regulatory units of all institutions choosing to register as exchanges to be combined [*25] in a single SRO governed by market participants and public representatives. n4

Before the same Senate committee, however, NYSE Chairman Richard Grasso revealed strong disagreement with both men. After listing the various arguments in favor of stripping the exchanges of at least part of their self-regulatory powers, Grasso went on to say,

I believe these concerns are well-intentioned but ill-founded. Because of the long-standing importance of market integrity to the NYSE's competitive position, converting to for-profit status will, if possible, strengthen our resolve to maintain the highest standards of self-regulation. n5

In explaining his position, Grasso underscored the long history of self-regulation at the NYSE, the fact that self-regulation permeates every part of the Exchange, the centrality of effective self-regulation to the Big Board's "brand equity," the sizable expenditures that the NYSE has been spending on self-regulation, and the importance of linking technological improvements on the floor with improvements in self-regulation (*e.g.*, better audit trails), which could be done well, in his view, only if the NYSE had self-regulatory powers in-house.

There are many fine points to self-regulation, and many potential variants on a division of responsibility between a central SRO and what powers may remain with individual exchanges. This article does not address those nuanced but very important issues. Rather, it concludes more broadly that the SEC should lean towards more centralization of self-regulatory powers for at least one reason-the impact that globalization will have on the U.S. capital markets. [*26] The argument will be that (1) globalization is in its infancy, and that although America's exchanges have seen a phenomenal growth in foreign listings, this is just the beginning; (2) foreign companies present significant problems, and it is more important than ever that regulators are in a position to police American markets on behalf of U.S. investors; (3) sound self-regulation will become more difficult as more foreign companies seek to raise capital in our markets; and (4) fragmentation of our regulatory powers will not be the best way to do this. A key point is that many foreign companies ought not to qualify for listings because they do not follow U.S. accounting standards and they lack adequate corporate governance procedures. There is no argument here with the principle of self-regulation; indeed, it is a crucial underpinning of the U.S. market, the broadest, deepest and the one with the most integrity in the world-by far. The only issue is: what kind of self-regulation for the new era?

Globalization of Markets

Today nearly two trillion dollars of foreign exchange changes hands each day in global markets. In the past two decades, the growth of trading in equities around the world has been three times as great as the growth in global GDP. n6 But we are in the infancy of global trends. McKinsey&Co., for example, estimates that while some 20% of world output is consumed in global markets, the proportion could reach 80% in the next thirty years-a twelve-fold increase. n7 These are gross projections, of course, but it is clear that the upward trajectory in globalization is being fueled by a number of trends: deregulation of all kinds of markets from telecommunications to finance; privatization of state-owned companies in industries from energy to transportation; greater frequency of cross-border mergers such as the deals between BP and Amoco, Daimler and Chrysler, and Deutsche [*27] Bank and Bankers Trust; lower trade barriers; internationalization of banks and securities firms; linkages among stock exchanges; and a substantial movement towards American-style market-oriented capitalism.

The quest of countries and companies everywhere to access the private capital markets is due to the enormous increase in their needs to build modern infrastructure and finance everything from new technology to social security systems in the private capital markets. These requirements are leading to a dramatic change in financing techniques throughout most of the world. Under enormous fiscal pressure, governmental financing is drying up everywhere. Whereas commercial banks were once the predominant financiers in Europe and Japan-not to mention most emerging markets-they are being disintermediated by the capital markets, which are deeper, more liquid, longer term in their horizon and cheaper to access. Germany is a good example: in 1993 there were less than twenty initial public offerings ("IPOs") in the country; in 1999 there were over 160 of them. n8 But sizable capital markets are only just emerging in most parts of the world, and so the U.S. is and will remain the venue of choice.

The NYSE itself presents a good picture of the accelerating pace of globalization when it comes to actual stock transactions in the U.S. In the 1990s, the dollar value of Asian companies listing on the exchange went from virtually nothing to fifty billion dollars; for Latin American countries the jump was from zero to over one hundred billion dollars and for European countries from fifty-billion dollars to nearly three-hundred and fifty-billion dollars. n9 The number of foreign listings has more than tripled in the past five years and now stands at three-hundred seventy-nine, or thirteen percent of all listings. The Big Board forecasts that this figure will reach twenty-five percent by 2005 as [*28] foreign companies rush to tap U.S. markets and Americans' equity portfolios of non-U.S. shares double from five percent to ten percent. n10 NASDAQ illustrates the aggressiveness with which US exchanges are courting international business. In 1999 alone, it entered Japan with an Internet-based market that, among other things, aims to allow Japanese investors to invest in the U.S. and U.S. investors to invest in the Japanese IPO market. It also created a stock trading link-up in the UK, designed to go live in March 2000, to facilitate more cross-border trading between London and New York and established "NASDAQ Europe" to build a seamless low-cost trading system in part to channel more European capital to the U.S.

Need for Added Caution

There are many reasons to welcome the increase in globalization and the expansion of foreign listings in the United States. International commerce can bring greater efficiency to production and enhance consumer choice. In Europe, Japan, and many emerging markets, there will be massive economic restructuring in the coming decades with some excellent investment opportunities, and American investors ought to have the option to diversify their portfolios internationally. As businesses, American stock exchanges will have the opportunity to enhance their profits. New sources of funds, which stimulate economic activity abroad, will likely spill over to American firms and jobs. And there could also be sizable political benefits in a world where trade-and not armies-cross borders.

But with all this said, the job of U.S. regulators is to protect American investors by insuring a market that is competitive, fair, and transparent. When it comes to foreign listings, there are numerous difficult issues that regulators will have to deal with.

The general problem abroad is institutional and cultural, and was revealed in the recent Asian financial debacle-which [*29] spread to Russia and Latin America. Reflecting on the crisis late last September, Federal Reserve Chairman Alan Greenspan provided this analysis:
On the surface, financial infrastructure appears to be a strictly technical concern. It includes accounting standards that accurately portray the condition of the firm, legal systems that reliably provide for the protection of property and the enforcement of contracts, and

bankruptcy provisions that lend assurance in advance as to how claims will be resolved n11

He went on to say that many of these protections were simply not present in emerging markets not because these countries did not think of them, but rather because their cultures and institutions didn't allow for them at this time. n12 In late November, Federal Reserve Bank of New York President William McDonough reinforced many of the same warnings when he identified the enormous efforts being made to shore up the ability of financial institutions to better assess the wide range of risks inherent in global lending. n13 McDonough talked about how financial institutions have neglected prudent risk management procedures, failing to obtain the information needed to assess the leverage, risk concentrations, or liquidity risk profiles of their customers. These financial institutions, after all, are sophisticated financiers and already have much more knowledge than other institutions and certainly individual investors, but clearly were not equipped to assess the range of risks that exist in emerging markets. n14

[*30] Accounting Standards Vary Too Much

One specific problem for American regulators relates to the full adherence of foreign companies to U.S. accounting standards. A large number of countries do not meet these standards. While this makes them ineligible to list in the U.S., there is a strong movement afoot, backed by the NYSE, to allow listings for companies that follow International Accounting Standards, as opposed to U.S. standards. The SEC has so far resisted this option on the grounds that they are inferior to what we have, and they are not enshrouded in the institutional setting which allows for enough interpretation, due process, and dispute resolution. The SEC also believes that it would be too confusing, cumbersome, and costly for regulators to deal with two accounting systems-U.S. Generally Accepted Accounting Principles ("GAAP") and International Standards. n15 Edmund Jenkins, chairman of the U.S. Financial Accounting Board has said, "International standards don't meet the requirements needed in a global market environment, because they provide too many alternatives, they lack clarity, and their scope is not comprehensive enough." n16

The tension over accounting systems illuminates the growing pressure to allow foreign firms into the U.S., and also some of the challenges that will arise even when companies do meet U.S. accounting standards, but find that their home jurisdiction is characterized by a much different culture. For example, Daimler-Chrysler has listed on the NYSE. It has certainly qualified under U.S. GAAP. But American investors have been very disappointed at the minimal disclosure of financial information that the auto giant has provided. It meets U.S. legal requirements, for sure, but what about the spirit of the law? And Daimler remains one of the world's top companies by any measure. [*31] Of course, some of the crucial issues in American accounting go well beyond minimal standards, to quality issues-how earnings are stated and interpreted. n17 Suffice it to say, as more and more companies try to come into our markets, regulators looking at the books of foreign companies will have their hands full, trying to insure compliance with the letter and the spirit of our laws and regulations.

Global Corporate Governance Has A Long Way To Go, Too

A second specific issue is corporate governance. Very few countries are as preoccupied with some of the corporate governance issues that are meaningful in the U.S. context such as the importance of disclosure and transparency, general shareholder rights, and independence of directors. In Japan and many other developed countries, corporate governance is being fundamentally revised, although the process is slow. In countries like China, it does not yet exist. In evaluating the suitability of foreign companies to list in the U.S., regulators face a tricky challenge in passing judgment on whether the governing mechanism of a foreign company meets the test of protecting U.S. investors.

The relatively primitive state of the art in corporate governance around the world can be seen in the efforts of the Organization for Economic Cooperation and Development ("OECD") to formulate minimal standards. It has offered a suggested code of best practices and encouraged common principles for addressing the comparability, reliability, and enforcement of corporate disclosure. But it reflects how far [*32] away the world is from the kind of standards that American investors have a right to expect. n18

A Host of Other Problems

There are a host of other issues that require increased scrutiny and vigilance when it comes to the suitability of non-U.S. companies listing on U.S. exchanges. In many emerging markets, corruption is a widespread problem. Long ignored by international agencies, it has recently become the object of heightened scrutiny by the World Bank, the International Monetary Fund, and the World Trade Organization-all of which understand that the turn towards capitalism in so much of the developing world does not automatically equate to transparent, arms-length transactions in the way Adam Smith might have described.

Bankruptcy laws are also in short supply, putting creditors and owners at great risk. In the recent Asian crisis for example, neither Thailand nor Indonesia had any effective bankruptcy procedures for the private sector. Even Mexico has only recently turned to modernizing its system. Yet two of these countries have companies listed on U.S. exchanges. n19

The Case of China

China presents an intriguing example of some of the issues that surround the enormous growth of foreign issues in the American market. In December 1999, the National Audit Office in China revealed accounting abuses by two of China's four state banks. This came on top of an investigation that showed that of one-hundred state companies, which the office audited, eighty-one had falsified accounts, and sixty reported profits that didn't exist. Other abuses included off-book business, unlawful money laundering, [*33] false reports of assets, and improper use of funds raised from share offerings. n20 In fact the biggest China IPO to date-PetroChina, whose initial offering could top seven billion dollars-is scheduled for early 2000. It will be the main opportunity for foreign investors to buy into China's oil and gas industry. But already, most of the IPO proceeds seem to be earmarked for debt repayment and severance payments, with only a small portion left over for essential exploration and modernization. Three oil companies are planning to issue shares on international markets after PetroChina, for amounts totaling another fifteen billion dollars. n21 China might be seen as an extreme case, but it is the biggest of the big emerging markets. The shares of at least nine Chinese companies trade on the NYSE (as American depositary receipts, or "ADRs"), representing such industries as petrochemicals, airlines, trains and power plants. Several Chinese companies are already listed in the U.S., and both the NYSE and the NASDAQ have vigorously courted China. Indeed, the picture of the president of China ringing the bell at the Big Board is among the major images signifying the changing financial markets in the late 1990s.

The overall point is not that all foreign companies are not worthy of listing in the U.S., or that American investors automatically will be fleeced, but that in dealing with the growing pressure for foreign companies to list in the U.S., regulators will be tested time and again.

Case for a Central SRO

This brings us to the main reason why a central SRO is critical. The U.S. already has several exchanges and in the next twelve to eighteen months we could see three to four [*34] electronic exchanges ("ECNs") competing with them. n22 If each has its own self-regulatory powers and if there were no overall self-regulatory supervisory body, it is not far-fetched to envision that either or both of two conditions would evolve. First, extreme competition among them would result in regulatory laxity. Second, even if this competition did not happen, it is surely unlikely that so many SROs would be able to adequately deal with the deluge of foreign issues and the tricky problems and judgments they involve. There would be too much inconsistency, too many loopholes, and not enough expertise to staff all the exchanges on these matters. Moreover, we are likely to see, one of these days, the emergence of cross-border regulatory alliances to promote prudent globalization of equity markets. When that happens, a plethora of SROs would not put the U.S. in good stead.

While the U.S. must march to its own tune, given the obvious superiority of its markets, two precedents from abroad are nevertheless interesting. The London Stock Market, which plans to demutualize, has lost most of its self-regulatory functions including policing of listing requirements. n23 And in a bid to attract more companies, the Tokyo Stock Exchange is relaxing some of its requirements to make listing easier. n24

The bottom line is this: the pace of change demands extreme caution in protecting investors. As Arthur Levitt said in his speech at Columbia, "We are at a unique moment in our market's history-a point of passage between what they have been and what they will become." n25 Periods of such transition are always unsettling times for public [*35] policy, and the Chairman is right to be intrigued with some self-regulatory consolidation. The key question is how much. At a minimum, national centralization for listing requirements is an idea whose time has come.

FOOTNOTES:

n1 Jeffrey E. **Garten** is dean of the Yale School of Management. Formerly a managing director of Lehman Brothers and The Blackstone Group, he was Undersecretary of Commerce for international trade in the first Clinton Administration. A columnist for Business Week, he has written widely on global economic and financial issues and recently edited "World View: Global Strategies for the New Economy," (Harvard Business Press, 2000).

n2 SEC Chairman Arthur Levitt, "Dynamic Markets, Timeless Principles," Address at Columbia Law School (Sept. 23, 1999).

n3 *Id.*

n4 *Investor Ownership of Stock Exchanges, Hearing on Public Ownership of the U.S. Stock Markets: Before the Senate Comm. on Banking* (Sept. 28, 1999) (statement of Frank Zarb, NASD Chairman and CEO).

n5 *Id.* (statement of Richard Grasso, NYSE Chairman and CEO).

n6 *See Trick or Treat*, THE ECONOMIST, Oct. 23, 1999, at 149.

n7 *See* LOWELL BRYAN ET AL., RACE FOR THE WORLD 3 (1999).

n8 *See Frankfurt's Impatient Maestro*, THE ECONOMIST, Dec. 11, 1999, at 60.

n9 *See NYSE Is Center for Global Equities*, THE EXCHANGE, Nov. 1999.

n10 *See* NYSE Website, <http>://www.nyse.com> (visited Sept. 1999).

n11 Alan Greenspan, Chairman of the Federal Reserve, "Lessons from the Global Crisis," Address in Washington, D.C. (September 27, 1999).

n12 *See id.*

n13 *See* William J. McDonough, President of the Federal Reserve Bank of New York, "Global Financial Reform: A Regulator's Perspective," Address in New York (Nov. 17, 1999).

n14 *See id.*

n15 *See* Jeffrey E. **Garten,** *Global Accounting Rules? Not So Fast*, BUSINESS WEEK, Apr. 5, 1999, at 26.

n16 Elizabeth McDonald, *U.S. Accounting Board Faults Global Rules*, WALL ST. J., Oct. 18, 1999, at A1 (quoting Edmund Jenkins, Chairman of the Financial Accounting Standards Board).

n17 For an example of the kinds of accounting and auditing issues which are arising in the U.S.-and which have few parallels in Europe or Japan at this time, let alone in emerging markets-*see* JOHN C. WHITEHEAD AND IRA M. MILLSTEIN, REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999).

n18 *See* IRA M. MILLSTEIN, CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS, A REPORT TO THE OECD (April 1998).

n19 Mexico has 28 companies, Indonesia has four.

n20 *See* James Kynge, *China Uncovers Falsified Accounts at State Groups*, FIN. TIMES, Dec. 24, 1999, at 1.

n21 *See* Ho Swee Lin et al., *Investors To Tread Warily In China's Oil Fields*, FIN. TIMES, Dec. 23, 1999, at 3.

n22 *See* Lehman Brothers, *From Stock Exchanges to Financial Portal*, October 3, 1999 (on file with author).

n23 *See Stockmarket Regulation: Only Connect*, THE ECONOMIST, October 9, 1999, at 97.

n24 *See* Bill Spindle, *As NASDAQ Pushes Into Japan, Locals Snap Into Action*, WALL ST. J., November 29, 1999, at C1; Greg Ip & Randall Smith, *NYSE Sets Plans for Speedier Trade Execution*, Nov. 8, 1999, at C6.

n25 Levitt, *supra* note 2.