Foreign Issuers –The Great Fault Line in U.S. Securities Law

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The SEC's regulation of foreign issuers exposes a great fault line in U.S. securities law. As we proceed into a world of globalized markets, this fissure is rocking the regulatory foundation on which U.S. securities regulation is based.

As discussed in previous articles, U.S. securities law is based primarily on the principle that "sunlight is the best of disinfectants." The theory is that the U.S. securities markets will function best if investors receive all of the material information necessary to make a sound investment decision. The goal of the SEC for almost 75 years has been to mandate disclosure by issuers of securities and punish issuers who mislead investors by publishing false and misleading information.

The concept of disclosure is accomplished by means of registration with the SEC. Generally speaking, there are two forms of issuer disclosure registration, which end up in the same place. Disclosures made to investors in public offerings are accomplished under the Securities Act of 1933, while disclosure to market participants is governed by the Securities Exchange Act of 1934. However, both types of disclosure regimes refer to the same governing rule – Regulation S-K – so that the actual disclosures required by federal securities law under either statute are substantially identical.

When the Exchange Act was passed into law in 1934, only issuers of securities listed on a national securities exchange were required to register. Issuers of securities traded over-the-counter were not required to register their securities until 1964. As things now stand, an issuer with more than $10 million in total assets and a class of securities "held of record" by more than 500 holders of record at the end of its most recent fiscal year must register that class with the SEC within 120 days.

The Exchange Act registration form, in this case called "Form 10," consists of a one-page cover sheet followed by certain prescribed disclosures. These disclosures will be familiar to anyone who has ever plowed through an annual report – they generally are the same disclosures required on a Form 10-K. Registered issuers are then required to file certain reports prescribed by Section 13(a) of the Exchange Act. These are the familiar annual report on Form 10-K, quarterly report on Form 10-Q and periodic report on Form 8-K. All of these reports are posted on EDGAR, the SEC's publicly available Internet repository for reports relating to registered issuers, and are therefore instantly available to investors and the markets when filed.

Foreign issuers technically are subject to the same rules, with some modest differences in timing, except that foreign issuers of securities that are not listed on a national securities exchange are not required to register unless they have at least 300 holders of record in the United States. But there is one very important way that foreign issuers can lawfully avoid U.S. disclosure rules. Before it has more than 300 holders of record in the United States, the foreign issuer can file with the SEC all of the information that it makes publicly available in its home country, translated into English. This is called the "information supplying" exemption. Foreign issuers that make these filings, but don't make any public offerings in the United States or list on a national securities exchange, are never required to register under the Exchange Act.

The information filed under the information supplying exemption is not posted on EDGAR, but paper copies are available from the SEC's public reference room. Last year, Pink Sheets initiated its International OTCQX program. Those foreign issuers that decide to list on International OTCQX must post this information on an Internet site maintained by Pink Sheets, marking the first time that this information has been readily available for mainstream investors in the United States.

When the SEC adopted the information supplying exemption almost 50 years ago, it stated a belief that the disclosures made by foreign issuers in their home markets had improved to the point where these disclosures would be adequate to protect U.S. investors. Whether or not that was an accurate description of disclosure standards when the rule was adopted, a cursory look at the disclosures posted by International OTCQX issuers (www.otcqx.com) indicates that foreign issuers operating in at least some foreign markets provide substantial information to investors.

The fly in this carefully concocted ointment is enforcement. The SEC has brought enforcement actions against domestic issuers that have failed to register their securities. But, there is no record of any enforcement action brought against any foreign issuer that failed to register its securities under the Exchange Act. So, either foreign issuers are very careful to comply with the registration rules and the information supplying exemption or, as is more likely, the over-the-counter registration rules for foreign issuers are honored in their breach.

This is not surprising. A domestic issuer can be hauled into a U.S. court for non-compliance with federal securities laws. But, what can be done with a non-complying foreign issuer? The SEC has no jurisdiction on foreign soil. The SEC could seek to enlist the support of foreign governments to punish foreign issuers that fail to comply with federal securities laws. And, the SEC has received the support of foreign securities regulators where U.S. investors have been defrauded, since this usually means that foreign investors have also been defrauded. But, it is difficult to imagine a foreign government helping the SEC to prosecute a foreign issuer for registration violations. It is equally difficult to imagine the SEC supporting the prosecution of a U.S. issuer by a foreign regulator for failure to comply with the disclosure rules of the London Stock Exchange.

As a result, registration for a foreign issuer that does not wish to raise capital in the United States or list on a national securities exchange is largely a matter of voluntary compliance. This is equally true of the information supplying exemption.

The United States has traditionally been the best place to raise capital for all issuers. Capital is most available here, and it can be obtained at least cost. As long as this is true, foreign issuers have some incentive to comply with U.S. securities laws in the off-chance that they will one day wish to access our capital markets. Our robust capital markets lead many foreign issuers to sponsor ADR (American Depository Receipt) programs, which enable investors to purchase a dollar denominated equivalent of an underlying foreign security. ADR programs greatly simplify the effort involved in making an investment in a foreign security, but require that the issuer be in compliance with the information supplying exemption at the time the ADR program is established. As capital is more readily available elsewhere, the incentives to establish ADR programs or otherwise comply with U.S. registration rules diminish.

Globalization is reducing the incentives to comply with U.S. disclosure requirements by establishing competitive sources of capital. This has caused the SEC to rethink the registration rules for foreign issuers. It has also called into question the registration system for domestic issuers as well. Why impose a disclosure burden on U.S. issuers that is not imposed on their foreign competitors? But, if we pull the registration cornerstone out of U.S. securities laws, our entire system of securities regulation is up for grabs.

The solution to this conundrum that seems most popular with U.S. regulators and the securities bar is captured in the phrase "mutual recognition." The basic idea is that we will help other securities regulators enforce their laws against U.S. issuers, and in return, they will help us compel compliance with our laws.

It's a nifty concept, but loaded with political implications and extremely difficult to apply in practice. After all, there are still calls to impeach certain Supreme Court Justices who made references to foreign law in their opinions. What sort of hue and cry would be raised if the SEC assisted the Commission of European Securities Regulators (CESR) to sanction IBM or General Motors for European securities law violations?