Capital Market Regulation in Developing Countries: A Proposal

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TABLE OF CONTENTS

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I. INTRODUCTION

The flow of capital to developing countries is important to the welfare of billions of people, and a lack of capital continues to be one of the major obstacles to development around the world.[1] Developing countries, aware of the importance of capital, are eager to attract this sort of investment from international markets.[2] This article considers how developing countries can make portfolio investment in their country more attractive to both local and foreign investors.[3]

Developing countries' need for capital is not new, but the world of international capital has undergone radical changes in the last two decades, altering the stakes for these countries. Improvements in technology combined with good relations among many countries in the world have created important links among capital markets. These links may initially have been limited to the major

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1. *See, e.g.*, William C. Philbrick, *The Paving of Wall Street in Eastern Europe: Establishing the Legal Infrastructure for Stock Markets in the Formerly Centrally Planned Economies*, 25 LAW & POL'Y INT'L BUS. 565 (1994). Poorly functioning capital market regulations, combined with markets that are not fully efficient, can cause high return projects to go without capital because those in need of capital are unable to credibly demonstrate the value of the project or because the costs imposed by inefficient regulatory structures reduce the value of the project. At the same time, some low return projects may be funded because investors cannot accurately discern the quality of potential investments. Of course, this is simply the traditional problem of asymmetric information that securities laws attempt to resolve in the United States.

2. *See* Marc I. Steinberg, *Emerging Capital Markets: Proposals and Recommendations for Implementation*, 30 INT'L LAW. 715, 716 (1996) ("Emerging economies look with ardor to establishing attractive capital markets in order to procure sought-after capital from private sources, frequently from abroad."); Jack Glen & Ananth Madhavan, PRIMARY SECURITIES MARKETS IN EMERGING NATIONS: A CASE STUDY OF PERU 8 (1998) (unpublished manuscript) (on file with author) (discussing Peru's increasing reliance on capital markets to help fuel its GDP growth).

3. In the interest of simplicity, I will use the term "developing country" to include what are sometimes referred to as "emerging markets" such as Russia and Poland. This article does not attempt to identify those countries that should be considered "emerging markets" and those that should not. The proposals in the article apply to virtually any country that has an underdeveloped capital market. Certainly Brazil, China, India, Mexico, Russia, and Indonesia should be considered part of the relevant group. Many other countries, however, could easily be added to the list, including some of the world's poorest countries which are also eager to develop a well functioning capital market. *See, e.g.*, Bishwambhar Pyakuryal & Kishor Uprety, *Nepal: The Emerging Security Market (Legal and Policy Aspects)*, 9 TRANSNAT'L LAW. 421 (1996) ("[Nepal's] eighth Five Year Plan 1992-1997 . . . states [that] '[i]n order to develop capital markets during the plan period and to make capital available to industry, commerce and all other areas by mobilizing internal resources on an institutional footing, it will be essential to make appropriate institutional arrangements and to properly activate financial institutions in capital markets as well as to set up a stock exchange and prepare a legal basis for its operations.'")

economic centers—New York, London, and Tokyo—but they now reach into almost every corner of the globe. Investors around the world can participate not only in securities transactions in the United States, but also in Brazil and Russia.[4]

Contemporaneously, the size of capital markets has undergone rapid growth. From 1986 to 1997, for example, global stock market capitalization grew from USD 4.7 trillion to USD 15.2 trillion.[5] In addition, the share of global capital markets enjoyed by developing countries increased from less than 4% to 13% between 1986 and 1996.[6] Recognizing that the rapid growth in both the size of global capital markets and the role of developing countries in those markets represents a tremendous source of funds,[7] many developing countries have sought to improve their local capital markets in order to attract a larger share of global portfolio investment.[8]

The development of truly international capital markets presents both opportunity and risk to developing countries. A country that successfully establishes a regulatory regime that meets the needs of investors and issuers will encourage investment in that country—generating capital inflows and encouraging development. A country that adopts a regime that fails to attract investors and issuers, however, will not merely fail to attract foreign portfolio in-

4. *See* Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. FIN. SERVICES RES. 349 (1990); Kelly Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927 (1994).

5. *See* Asli Demirgüç-Kunt & Vojislav Maksimovic, *Stock Market Development & Corporate Finance Decisions*, FIN. & DEV., June 1996, at 47. *See also* HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 54 (5th ed. 1998).

6. *See* Demirgüç-Kunt & Maksimovic, *supra* note 5, at 47.

7. Net portfolio investment in developing countries and countries in transition increased from US$0.4 billion in 1980 to over US$90 billion in 1993. *See* MALCOLM KNIGHT, DEVELOPING COUNTRIES AND THE GLOBALIZATION OF FINANCIAL MARKETS 6 (International Monetary Fund Working Paper, July 1998).

8. Portfolio investment is not the only source of capital for developing countries. Among the alternative ways in which capital can flow into a country are foreign direct investment, government lending, and foreign aid. It should be noted that growth of global capital markets has not caused a reduction in direct foreign investment flows, which themselves have increased dramatically in recent years. *See* Andrew T. Guzman, *Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639, 640-41 (1998). Rather, what has taken place in developing countries has been an across the board increase in private investment – both direct and portfolio – and a contemporaneous increase in the interest of developing countries in attracting such investment.

vestment, it will also cause local investors and issuers to seek other markets for their capital.

The development of a local capital market provides a developing country with greater access to both domestic and foreign capital.[9] In addition, a domestic capital market facilitates the task of privatization that continues in many countries around the world.[10] The creation of a well-functioning and liquid secondary market for the shares in newly privatized firms increases the value of the new shares and allows a privatization program to proceed more easily.[11] A domestic capital market also offers domestic consumers a vehicle for savings—savings that can be then directed toward investment. By channeling savings to productive uses, the market encourages local economic activity and reduces the cost of local projects. Finally, the presence of a capital market may make the country more attractive for direct foreign investment.[12]

Although it is possible for a foreign investor to invest in an emerging market through securities issued in the investors' own country,[13] developing countries are justified in their desire to offer issuers and investors the ability to transact on local markets.[14] This is so for several reasons. First, some issues may find complying with the securities requirements of the investor's home country prohibitively costly. Second, strong empirical evidence exists that firms prefer to raise funds in the same location as they plan to carry out their investments.[15] The existence of a well functioning

9. *See* Joseph J. Norton & Hani Sarie-Eldin, *Securities Law Models in Emerging Economies*, *in* EMERGING FINANCIAL MARKETS AND THE ROLE OF INTERNATIONAL FINANCIAL ORGANIZATIONS 335, 336 (Joseph J. Norton & Mads Andenas, eds., 1996) [hereinafter EMERGING] ("[T]he development of capital markets may provide a 'funding bridge' connecting the developmental needs of an emerging economy with capital sources in the domestic and external private sector.").

10. *See* Steven M. Fries, *Financial Reform and Development in Transition Economies and the Role of IFIs*, *in* EMERGING, *supra* note 9, at 65-66 (1996).

11. *See* Pyakuryal & Uprety, *supra* note 3, at 457.

12. *See* Norton & Sarie-Eldin, *supra* note 9, at 336-37.

13. In the United States, for instance, ADRs have become a popular vehicle for such investments.

14. *See* Fries, *supra* note 10, at 57 ("A well functioning domestic financial system is the linchpin of high domestic savings, private investment and growth in a market economy.").

15. *See* RICHARD E. CAVES, MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS 160 (2d ed. 1996). Among the causes of this empirical regularity are exchange rate reasons, a desire to increase the shareholder base, the existence of legal requirements of the host country (such as local ownership requirements), the fact that local investors may be better able to evaluate the firm's activity and, therefore, will price the securities more accurately, the fact that employees can more easily be compensated with stock op-

local capital market, therefore, promotes foreign direct investment. Third, the development of local capital markets has a positive spillover effect. As local markets become more efficiently regulated and more liquid, local investors—many of whom may be sufficiently small that it is costly for them to invest abroad—will face a lower cost of investment. This savings, in turn, will increase the size and liquidity of the market and will reduce the costs of capital for firms seeking to tap the local market.[16]

Major obstacles, however, face developing countries in their attempt to establish effective and attractive capital markets. This article identifies three problems that are especially severe in developing countries, and considers how the appropriate use of choice of law and choice of forum rules might resolve them. These problems are: the creation of a set of desirable substantive rules and policies; the establishment of a reliable and effective system for the resolution of disputes; and the development of a system to ensure the enforcement of court judgments and arbitral awards.

In order to address these problems, this article advocates giving the parties to a securities transaction the ability to select, from a menu of existing national laws, the substantive law that governs their transaction; and permitting parties to resolve their disputes through international arbitration rather than through the domestic court system. By allowing the parties to choose the law and forum that applies to their transaction, many of the regulatory problems associated with the capital markets of emerging markets can be avoided at low cost.

The article proceeds as follows. Part II discusses the impact of globalization on capital markets and on national regulators. Part III describes the additional challenges that globalization presents to developing countries. Part IV proposes an approach to the regulation of securities markets in developing countries, focusing on the opportunities presented by global markets and choice of

tions if the stock is traded locally, and marketing reasons (listing a security on a local exchange may raise its profile among local consumers).

16. For there to be an impact on the cost of capital, the local market must have only imperfect access to global markets. Otherwise, the global cost of capital would apply. Assuming less than perfect access to world markets is reasonable because, despite the considerable globalization of capital markets in recent years, barriers to capital movement remain.

law and choice of forum clauses.[17] Part V comments on how adoption of the regulatory strategy discussed in the article might yield benefits in other areas of concern to developing countries. Part VI concludes that by allowing parties to select a foreign law, and by permitting them to select a desirable arbitration system, including procedural rules and the location of the arbitration, a developing country can make itself a more attractive market for both issuers and investors.

II. THE CHALLENGE OF GLOBALIZATION

The legal regime that governs securities activities in a country plays an important role in determining the efficiency of that capital market.[18] A disclosure based regime, for example, is designed to solve the asymmetric information problem that exists between an issuer and potential investors. In other words, the issuer and its insiders know the value of the security better than other investors. The issuer has an incentive to disclose some of the inside information it possesses in order to increase the price investors will be willing to pay. The issuer and insiders, however, may have only a limited incentive to release information and may, as a result, release too little.[19] On the other hand, a regulatory regime that demands too much disclosure may impose costs on issuers that exceed the value of the disclosure.[20] If there is too little disclosure in the market, investors will take this into account and reduce their willingness to pay.[21] Too much disclosure will increase the cost of issuing securities. In either case, the disclosure dilemma will increase the cost of capital in the market. As a result, investors will

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17. The analysis in Part IV draws from Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998).

18. *See* GERHARD POHL ET AL., CREATING CAPITAL MARKETS IN CENTRAL AND EASTERN EUROPE 3 (World Bank Technical Paper No. 295, 1995); Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855 (1997).

19. *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722-23 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 675 (1984).

20. These costs may take the form of direct costs of compliance, the cost of revealing proprietary information to the market, and therefore to competitors, and the attendant cost of liability.

21. *See* KNIGHT, *supra* note 7, at 23 ("[M]arkets will be well-informed only if all potential participants are in a position to obtain information at a reasonable cost.").

overlook some valuable projects and seek other vehicles for their funds.

The internationalization of capital markets has changed the impact of regulation on local markets and generated a new set of concerns for policy makers. Historically, regulators could choose a legal regime with little fear that domestic issuers and investors would frustrate local regulations by taking their transactions abroad. The high cost of cross-border financial activity and the difficulty of avoiding regulation meant that even significant policy changes would have only a small effect on the volume of transnational activity.

The growth of international capital markets gives an investor the option of leaving the local jurisdiction and investing in a jurisdiction in which the investor can hope for higher returns. Technological and regulatory developments have made it possible for investors in capital markets to engage in international transactions at low cost. Similarly, the issuer can look to another jurisdiction in order to raise capital. The globalization of capital markets, therefore, can lead to a greater and faster movement of capital away from investment projects in response to a suboptimal regulatory scheme—or towards such projects in response to an optimal regime—than is the case when each national market is isolated from the global market.

In other words, globalization implies that all countries, including developing countries, face a much more elastic supply of capital than they would if capital markets were constrained by national borders.[22] An increase in the elasticity of the supply of capital implies that regulatory differences between countries can cause large capital flows. A country with a regulatory system that does not appeal to investors and issuers will fail to attract foreign capital and local capital will flow to other countries.[23] A country with a system that satisfies the needs of market participants, on the other hand, will enjoy capital inflows.

22. A detailed development of this result is provided in Choi & Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, *supra* note 18, at 1859-65.

23. The ability to escape local laws can be limited by those same laws. In the United States, for example, a transaction that takes place abroad may still find itself subject to registration under the Securities Act. *See* Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207 (1996).

The increase in the elasticity of supply of capital has intensified the competition among regulatory systems in two important ways.[24] First, the risk exists that domestic issuers and investors will choose to carry out their transactions beyond the jurisdictional reach of national regulators. Second, regulators have an interest in attracting transactions that exit other jurisdictions.[25] There are two ways in which a country can attempt to maintain or establish regulatory control over transactions: it can seek to extend its jurisdiction to a wider set of transactions, or it can seek to attract capital by establishing a regulatory environment that will appeal to investors and issuers of securities.[26] Some observers believe that this sort of regulatory competition is a good thing, generating a race to the top.[27] Others, however, believe that it creates a harmful race to the bottom.[28]

In the United States, for example, regulators have responded to each of the above forces. In an attempt to prevent issuers and investors from escaping local jurisdiction, the United States extends the extraterritorial reach of American securities laws aggressively.[29] In order to attract foreign issuers, meanwhile, the United States has adopted a series of regulatory changes to reduce the burden that these issuers face when their transactions fall under American law. These changes include the adoption of Rule 144A,[30] the relaxation of registration and reporting requirements

24. There is some debate about whether this competition generates a race-to-the-top or a race-to-the-bottom. *See* Choi & Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, *supra* note 18, at 1869-74; Choi & Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, *supra* note 17, *passim*; Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, *passim* (1997).

25. In the United States, for example, there is concern that the country will lose its preeminent status among capital markets. *See* James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58, S58-59 (1994).

26. Regulators can also establish controls on the movement of capital – thereby forcing domestic capital to remain within the jurisdiction – an option which is not discussed in this paper.

27. *See* Choi & Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, *supra* note 18, at 1869-74; Choi & Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, *supra* note 17, *passim*.

28. *See* Fox, *supra* note 24, *passim*.

29. *See* Choi & Guzman, *The Dangerous Extraterritoriality of American Securities Law*, *supra* note 23, at 211-19. The primary tools for the extension of jurisdiction have been the expansive reach of Regulation S and the even greater reach of Rule 10b-5. *See id.*

30. Rule 144A, adopted in 1990, exempts from the registration requirements of Section 5 certain resales of securities to "qualified institutional buyers." The exemption increases the liquidity of the secondary market for private placements, thus making the primary market more attractive to issuers. It is especially appealing to foreign issuers because

imposed on foreign issuers making public offerings,[31] the permission to use shelf registration, and the easing of U.S. generally-accepted accounting principles (U.S. GAAP) regarding reconciliation requirements for foreign issuers.[32]

In addition to an increase in regulatory competition, globalization makes enforcement more difficult. In transnational transactions, both information and assets can be spread around the world. If, for example, regulatory authorities wish to investigate a particular transaction, they must gather relevant information often from the parties to the transaction. If one of those parties is located outside the jurisdiction, it may be difficult to gain access to information held by that party. The inability to use domestic legal structures for the gathering of such information may represent a significant impediment to enforcement. The SEC has pursued various avenues in an attempt to improve the international enforcement of securities laws. These efforts have included, for example, Memoranda of Understanding in which the regulatory authorities in the United States and another country agree to share certain information. The United States has also supported IOSCO, the International Organization of Securities Commis-

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large American issuers are likely to already be engaged in periodic reporting under the Exchange Act. Foreign firms that had previously found the costs of disclosure and liability under American law as too costly to justify private placements in the American market can avoid those costs through Rule 144A, making the American market more attractive. Rule 144A has achieved significant success: by the winter of 1996, over 180.2 billion of securities had been sold in 1,414 Rule 144A placements. *See* Fred A. Little & Jennifer W. Lewis, *International Offers, Sales, and Resales of Securities: Regulation S and Rule 144A*, SC61 ALI-ABA 259, 261 (1998). A popular approach to avoiding registration is to purchase securities abroad in reliance on the Regulation S safe harbor and then to resell those securities in the United States in reliance on the Rule 144A safe harbor. *See id. See also* Glenn M. Reiter, *International Securities Offerings – Recent Developments and Current Issues*, *in* 29th ANNUAL INSTITUTE ON SECURITIES REGULATION 865-70 (PLI Corporate Law and Practice Course Handbook Series No. B4-7206, 1997).

31. Specifically, the SEC has made Form S-3 available to foreign issuers. *See* Simplification of Registration and Reporting Requirements for Foreign Companies, Securities Act Release No. 33-7053, 59 Fed. Reg. 21645 (Apr. 26, 1994). Form S-3 includes information on the security being registered and the plan of distribution. Financial and other information is incorporated by reference to other filed reports such as annual reports. To qualify, a foreign issuer must: (1) have filed at least one previous annual report on Form 20-F; (2) have filed periodic reports with SEC for at least 12 months; and (3) have a public float of at least $75 million. *Id.* The previous requirements were more onerous: 36 months of periodic filings with the SEC and a public float of at least $300 million. *Id.*

32. Foreign issues are now permitted to file cash flow statements prepared under International Accounting Standards without reconciliation to U.S. GAAP. For a more detailed discussion of the SEC's acceptance of the International Accounting Standards, see SCOTT & WELLONS, *supra* note 5, at 77.

sions, an international body attempting to increase cooperation among securities agencies.

III. ADDITIONAL CHALLENGES FACING DEVELOPING MARKETS

The previous section discussed how the globalization of capital markets, and the attendant increase in competition among regulatory regimes, affects national regulatory policies. As international capital markets become more integrated, the impact of this competition will grow and the regulatory authorities in all countries are likely to take further steps to adapt to competition from other jurisdictions. In attempting to deal with the increased internationalization of capital markets, developing countries face all of the problems discussed above. In addition, the challenge of globalization presents issues for developing countries that developed countries do not have to face or that are less severe in developed countries.[33] In this section, the article considers how the internationalization of capital markets affects attempts by developing countries to improve their capital markets.

Because developing countries typically have relatively small capital markets, small changes in the share of global capital they receive can translate into very large percentage changes in their capital market activity.[34] Greater capital mobility, and the resulting increase in the elasticity of supply of capital, offers a developing country the possibility of developing a relatively large, liquid, and successful capital market in a short time if it succeeds in establishing an attractive regulatory regime. If a developing country can make itself attractive to issuers and investors, both domestic and foreign, its capital market will grow far beyond what one would expect based on the size of the national economy alone. Capital mobility, however, also creates the risk that the local capital market will all but vanish as capital flees to foreign markets if

33. Many developing countries must also overcome "periods of financial repression, intervention in financial markets, and restrictions on current capital account transactions." KNIGHT, *supra* note 7, at 9.

34. Although some developing countries have larger capital markets than others, none represent a large market when compared to large developed country markets. This is demonstrated by the size of equity markets in various countries. In 1997, the capitalization of equity markets in the United States was USD 12.8 trillion. In Japan it was USD 2.2 trillion and in the United Kingdom it was USD 2.0 trillion. In the same year, the capitalization for all countries outside of the G-7 was only USD 1.7 trillion. This figure includes many developed countries, implying that developing countries have an even smaller capitalization. *See* SCOTT & WELLONS, supra note 5, at 54 tbl.A.

the regulatory regime is unpopular with issuers and investors.[35] Local issuers and investors may take advantage of international capital markets to trade their securities abroad, and foreign investors who may prefer to carry out their transactions outside of the country's jurisdiction will be able to do so on international markets. In other words, the impact of globalization on underdeveloped capital markets may be a drastic reduction in the amount of business that takes place on those markets.

In order to attract capital to their markets, developing countries must compete both with one another and with countries that already have fully developed capital markets and that offer an established and proven set of rules, procedures, and practices. To be successful in this competition, a developing country must establish both effective securities regulations and a reliable set of legal institutions within which those regulations can function properly.[36] The challenges facing a developing country as it strives to develop its capital market are accordingly different—and typically more severe—than the problems faced by developed countries. Although a complete investigation could no doubt identify more issues, this article considers three important challenges faced by countries seeking to develop their capital markets.[37] These are the substantive legal rules in place, the dispute resolution system, and the enforcement of judgments.[38]

A. *The Need For Substantive Legal Rules*

In order to attract capital, it is necessary to have a set of substantive legal rules in place that meets the needs of issuers and investors. In other words, a market needs a set of clear, well functioning, and reliable securities laws.[39] These rules can take many forms. Indeed, in some markets, the best set of rules may allow

35. To see how sensitive capital flows can be, consider that total net private capital flows to Latin America and Asia in 1996 alone exceeded the total flows for the decade of the 1980s. *See* BANK FOR INTERNATIONAL SETTLEMENTS, 67TH ANNUAL REPORT (1997).

36. *See* Glen & Madhavan, *supra* note 2, at 13 (attributing Peru's recent primary capital market's growth to, among other factors, successful legal reform).

37. Issues that affect investment decisions but that lie beyond the control of the regulatory regime, such as political unrest or civil war, are beyond the scope of this article and will not be discussed. The regulation of intermediaries, such as broker-dealers and investment advisors, is also beyond the scope of this article.

38. *See* Norton & Sarie-Eldin, *supra* note 9, at 338 (discussing these and other challenges facing the creation of financial markets in developing countries).

39. *See* POHL ET AL., *supra* note 18, at 25.

the parties to define their own obligations through contract.[40] Such rules must not only be clear and predictable, the interested parties must also perceive that the rules are stable over time.[41] Rules that are expected to change with each new government or with each crisis offer no comfort to would-be issuers and investors.

Developing and developed countries alike recognize the obvious need for well functioning and stable rules.[42] The best strategy for developing such rules, however, is the subject of significant uncertainty. Developing countries have considered two competing strategies, the domestication of a foreign regime and the development of an indigenous set of local rules.

The more straightforward approach, adopted by many developing countries, consists simply of adopting the securities laws of a country that has a successful market.[43] For example, a developing country could adopt laws patterned on the securities law of the United States. This approach has the advantage that the chosen legal regime has demonstrated its ability to function in at least one other country. Furthermore, many of the important questions and challenges relating to these laws have been worked out already. This strategy of domesticating a set of foreign legal rules is a popular approach to legal reform. The most common present day examples are attempts by formerly communist countries to adopt legal structures borrowed from Europe or the United States. In the securities context, the domestication of foreign laws is commonplace. For example, following the Second World War, Japan adopted securities laws that were modeled on those of the United

40. *See* Choi & Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, *supra* note 18, at 1855; Easterbrook & Fischel, *supra* note 19, at 669.

41. For example, in Russia, considerable problems have developed because the laws that have been passed are not easily-obtained or widely-distributed, leaving many interested parties uncertain of the content of the law. *See* Alfred F. Belcuore, *Meeting the Founders: Russians and Kazakhs Work for Democracy*, 25 LAW & POL'Y INT'L BUS. 461, 463-64 (1994); Philbrick, *supra* note 1, at 565 (1994). Even if the regulations could be identified, they are often complicated and inconsistent. *See* Cecilia R. Taylor, *Capital Market Development in the Emerging Markets: Time to Teach an Old Dog New Tricks*, 45 AM. J. COMP. L. 71, 84 (1997). *See also* Norton & Sarie-Eldin, *supra* note 9, at 338 ("[I]f the operational and regulatory 'rules of the road' are not made transparent to the various interested parties . . . then long-term prospects for the capital market to serve any constructive economic purpose will be sharply curtailed.").

42. *See* Howell E. Jackson, A Concept Paper on the Selective Incorporation of Foreign Legal Systems to Promote Nepal as an International Financial Center 33-36 (1997) (unpublished manuscript, on file with author).

43. *See* Norton & Sarie-Eldin, *supra* note 9, at 339.

States.[44] Similarly, Malaysian and Singaporean securities laws were based on Australian law.[45] An example in domestic American law is Delaware's adoption of New Jersey's corporate laws at the turn of the twentieth century — a decision that helped Delaware become the leader in U.S. corporate law.[46]

The direct adoption of a foreign country's legal regime, however, has certain problems. Most obviously, every country possesses unique characteristics that may make a foreign set of laws unsuitable for domestic use. Even among developed countries, differences in national laws reflect in part local culture and practice. Differences between developed and developing countries are typically even more pronounced than those among developed countries. Developing countries may lack enforcement structures and corruption may make the creation of such structures difficult.[47] Further, a lack of familiarity with the legal rules may create confusion and uncertainty among participants in financial markets.[48]

Even if a developing country is able to domesticate a set of foreign laws successfully, the country still must deal with the evolution of those laws over time. Although a country that has chosen to adopt the rules of another country avoids many of the problems it would face if it drafted its own laws, it also fails to develop expertise and experience in the operation of the law. These skills are necessary for the ongoing development and possible reform of the legal regime.[49] Without the experience of having developed the laws locally, without a history of applying those laws to domestic conduct, and without a familiarity developed through ongoing review of the laws, the developing country is likely to find it difficult to keep such imported laws up to date and may not have a good sense of when reform of those laws is needed or appropriate. As a

44. *See* Mark Gillen & Pittman Potter, *The Convergence of Securities Laws and Implications for Developing Securities Markets*, 24 N.C. J. INT'L L. & COM. REG. 83, 89-90 (1998).

45. *See id.*

46. *See* POHL ET AL., *supra* note 18, at 21.

47. *See* Cheryl W. Gray & Daniel Kaufman, *Corruption and Development*, FIN. & DEV. (Mar. 1998).

48. *See* Jackson, *supra* note 42, at 33-36. An additional problem may arise in the interface between the legal rules adopted from another country and other home country laws. An imported securities regime, for example, may interact imperfectly with banking laws, bankruptcy laws, and so on.

49. *See* Paul H. Brietzke, *Designing the Legal Frameworks for Markets in Eastern Europe*, 7 TRANSNAT'L LAW. 35, 60 (1994).

result, regardless of how well suited to local needs the foreign law is at the time of adoption, it may, over time, fail to keep pace with the changing needs of the country or, alternatively, may change too fast and in undesirable ways. In addition, the developing country risks that the chosen laws will prove inappropriate for its needs. This difficulty may arise, for example, because the country is at a different stage of development than the country from whom the law is borrowed. Further, significant local norms and practices may differ from the country of origin. Each of these problems makes the adoption of an existing legal framework difficult.

On the other hand, the difficulty with developing a complete set of securities rules from scratch is obvious.[50] It has taken developed countries many years to develop their capital market regulations and there is little reason to think that a developing country could develop its own rules more quickly or without confusion, uncertainty, and crises.[51] Among the pitfalls for a country that seeks to develop an indigenous set of laws are: the risk that political forces within the country will lead to an outcome that is poorly suited to the needs of capital markets, the difficulty of getting market participants to expend the resources necessary to learn the new law, the danger that a lack of experience in the drafting of securities laws will lead to serious mistakes and oversights, and the problem of creating institutions for effective enforcement for a new and untested regime.[52] The development of a home grown regime, therefore, is a strategy that would take many years to bear fruit—a delay that developing countries would like to avoid.

In addition to the problem of choosing a strategy to develop a set of substantive rules, developing countries face the problem of funding the enforcement of these rules. Whatever rules are chosen, they must be enforced. An initial problem is that the institutions required to support the rules cost money. Developing countries may simply lack the funds to ensure that the rules remain effective. Furthermore, the public bodies charged with enforcing regulations may suffer from an understaffing of regulatory offices, a lack of expertise and training, or corruption.[53] The result in

50. *See* Jackson, *supra* note 42, at 10.

51. *See* Steinberg, *supra* note 2, at 715-18.

52. *See* Gillen & Potter, *supra* note 44, at 110-16.

53. *See Paolo Clarotti, The EU as a Model for Financial Reform, in* JOSEPH J. NORTON & MADS ANDENAS, EMERGING FINANCIAL MARKETS AND THE ROLE OF INTERNATIONAL FINANCIAL ORGANIZATIONS 15, 22 (1996) ("Without a well-functioning supervisory body even the most advanced regulations will make no sense.").

many developing countries is that the existing securities laws are systematically underenforced.[54] The enforcement of securities regulations in developed countries typically relies on sophisticated administrative oversight and review which requires considerable expertise and funding. Any attempt to develop local regulatory systems requires consideration of the administrative actions that are necessary to enforce the substantive laws.

B. *The Need for a Reliable Dispute Resolution System*

The presence of an effective, efficient, and reliable system of dispute resolution is taken for granted in most discussions of securities regulation in the United States and other developed countries. Such a system ensures that the rights and responsibilities imposed by the substantive laws will be enforced. In the United States, for example, a combination of administrative action, court decisions, and arbitration provide much of the necessary infrastructure. These institutions resolve disputes between private parties or between the government and a private party reasonably quickly and predictably. Furthermore, institutions resolve disputes in an open and respected fashion, deciding cases based on the pertinent law and the facts of the case. The consistency and reliability of the dispute resolution in the United States provides a high degree of predictability to the parties to a transaction and, accordingly, a clear understanding of the legal rights of each party. This clarity not only encourages business activity by reducing uncertainty, it also reduces the burden of litigation on the system because the parties to a dispute are able to anticipate the decisions of the dispute resolution bodies. This predictable outcome, in turn, leads to settlement in the vast majority of cases. This stable, consistent, and expedient method for resolving disputes is a necessary condition for the substantive laws of the land to function effectively.

In many developing countries, however, government created institutions are simply not able to settle disputes in a sufficiently predictable, efficient, and affordable manner. Administrative bodies are often under-funded and under-staffed, they may have ambiguous responsibility and authority, and suffer from wide-

Using Russia as an example again, the securities regulations that were passed were not implemented by the relevant Ministries. *See* Taylor, *supra* note 41, at 84-85.

54. *See* Fries, *supra* note 10, at 67 (1996).

spread corruption.[55] Under these conditions, administrative bodies may regularly overlook violations of the securities laws. When a violation is discovered, parties may simply bribe the relevant official in order to avoid further prosecution. Political motives may cause selective enforcement rather than an attempt to enforce the securities laws fairly and uniformly.

If a case does find its way to trial, further problems await. The court system in many developing countries is bogged down with extremely long delays. Further, judges may lack an understanding of all but the most straightforward financial transactions and a corrupt judiciary may also confuse the process.[56]

In addition to the problems of delay, corruption, and lack of executive action, great uncertainty exists in these developing capital markets. Because the individuals making the decisions are likely unfamiliar with complex financial transactions and may have very little time to devote to the case, the outcome of a dispute is difficult to predict. The final ruling may depend heavily on the identity of the individuals making decisions about pursuing the case or the choice of judge. The overall political climate in the country may also affect the outcome if the judiciary is not sufficiently independent from the government—as is the case in many developing countries—or simply corrupt.[57]

From the perspective of a potential issuer or investor, a dispute resolution system that takes many years to resolve a case, and whose ultimate decision is unpredictable and may not reflect the merits of the case, is a powerful deterrent to entry into that market, even if the substantive rules are attractive to capital market participants. Without an effective dispute resolution system, the rights provided by the substantive rules are hollow and investors and issuers cannot rely on them.[58] As a result, investors will demand a higher expected return in order to accept that risk imposed by the inadequate dispute resolution system. Issuers, in turn, may avoid the local capital market both because they cannot get investors to purchase their securities and also because they cannot be certain that their rights and responsibilities will be judged in a manner that is consistent with the law, regardless of the quality of the substantive legal regime. Therefore, the inability

55. See Gray & Kaufman, *supra* note 47.
56. *See id.*
57. *See id.*
58. *See* Pyakuryal & Uprety, *supra* note 3, at 452.

to achieve the remedy that is prescribed by law, in a reasonable time frame, at reasonable cost, and in a reasonably consistent fashion renders even the most desirable substantive rules almost worthless.[59]

C. *The Need for Effective Enforcement of Judgments*

Finally, parties to a securities transaction may have concerns about their ability to enforce a court judgment, administrative decision, or arbitral ruling in their favor. This problem is distinct from the issue of dispute resolution and the enforcement of the legal rules, focusing instead on the ability of a party to collect damages owed following a favorable court decision.[60] Once a court hands down a decision, for example, the party that has been awarded a judgment has to collect the amount owed. Doing so is not always easy. If the losing parties refuse to pay, legal procedures are necessary to compel payment. In the United States, for example, a judgment debtor can, by taking the appropriate steps, have the sheriff levy on assets of the judgment creditor. Those assets are then sold and the proceeds used to pay the judgment.[61] In this way, a judgment is enforced.

Enforcement of a judgment, however, is not always so easy. For a developing country, there are two important dimensions to this problem. First, significant obstacles to the enforcement of a judgment may exist within the country. For example, the legal mechanisms for the collection of a judgment may be weak or the laws may protect debtors from having their assets seized. Even if the legal rules allow for the collection of debts, a party pursuing the legal steps to enforce a judgment will face the same problems of delay and uncertainty that the party overcame to get the original judgment. In this environment, parties may avoid local securities markets because they recognize that collection of a judgment is so costly and/or time consuming that the value of any potential judgment is greatly diminished.[62]

59. *See id.*

60. To be precise, the problem also relates to the collection of amounts owed following any resolution of a dispute, including an arbitration.

61. For a brief overview of the collection rights of a judgment creditor, see JOHN O. HONNOLD ET AL., CASES, PROBLEMS, AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY 13-15 (2d ed. 1992).

62. In principle, the enforcement of judgments problem could be alleviated through reform of the debt collection system. If such reforms are possible, they should certainly be undertaken – not only to improve the capital markets, but also to improve the overall

The second enforcement problem is that the assets from which value may be extracted may not be within the country. Because capital markets are international, the fact that a transaction takes place within the jurisdiction of a country does not guarantee that there are assets in that same country.[63] This is especially true for developing countries because both local and foreign firms that do business in the country are likely to hold their financial and even their physical assets abroad.[64] A party with a judgment from a developing country, therefore, is much more likely to have to look abroad in order to collect than a party with a judgment from a country such as the United States in which firms typically keep substantial value. In that case, a judgment creditor may collect on a decision from a local court only by gaining access to assets located abroad.

The problem of using a domestic judgment to collect assets located abroad is a familiar one. Enforcing a judgment in a foreign country can be difficult, expensive, and time consuming, especially if one's local judicial system is viewed with skepticism by the courts of other countries.[65]

IV. EMBRACING GLOBALIZATION

The discussion to this point demonstrates that any attempt to reform the capital market in a developing country faces significant challenges. The choice of legal rules may represent the easiest part of the task. The problems of dispute resolution and the enforcement of judgments are, respectively, problems endemic to the

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functioning of the legal system. If such reforms are unlikely in the foreseeable in the future, however, other solutions – like the ones proposed in this article – need to be found.

63. Even where capital is raised in the same jurisdiction as the investments take place, firms may hold a large share of their assets abroad. This observation is especially true for financial assets, which are the most liquid and, therefore, the most desirable for a judgment creditor.

64. It is common for parties to hold financial assets abroad both for tax reasons and because they wish to hold their wealth in the form of foreign currency. Many physical assets may also be abroad. For example, foreign investors may strategically keep as many valuable assets as possible in their home countries in order to reduce their exposure in the event of an expropriation. *See* David W. Leebron, *A Game Theoretic Approach to the Regulation of Foreign Direct Investment and the Multinational Corporation*, 60 U. CIN. L. REV. 305, 319 (1991) ("Multinational Enterprises may choose the technology that . . . minimizes the expropriability of the investment.").

65. For a detailed treatment of the problems associated with the recognition and enforcement of judgments, see GARY B. BORN, INTERNATIONAL CIVIL LITIGATION IN UNITED STATES COURTS 935-87 (3d ed. 1996); ANDREAS F. LOWENFELD, INTERNATIONAL LITIGATION AND ARBITRATION 368-457 (1993).

entire country's legal system and problems inherent in the existing international legal system. Such large scale reforms, even when appropriate, are extremely difficult to carry out effectively and one cannot expect the reforms to be achieved in any significant number of developing countries in the near future. If the capital markets of developing countries are to be improved, therefore, one must take the existing legal structures and problems into account. Rather than simply advocating a large scale, extremely expensive, and highly unlikely reform of every aspect of a country's legal system, or simply ignoring the problems and imagining that the adoption of desirable substantive legal rules is enough to reform capital markets, this article proposes the adoption of choice of law and choice of forum rules which would allow the parties to a securities transaction to avoid the most significant drawbacks of the local legal system. Developing nations can resolve the above challenges facing them by allowing participants in local securities markets greater flexibility in their choice of law and forum. Adopting a modified version of a regulatory approach known as "portable reciprocity" will achieve this goal.[66] This section explains how developing countries may adapt portable reciprocity, and how the use of modified portable reciprocity addresses each of the problems discussed in this article.

A. *Choice of Law*

The first question that this article must answer is which legal rules should apply to a securities transaction that falls within the jurisdiction of a particular developing country. As stated above, the mobility of issuers, investors, and their capital has generated a more acute international competition among national capital markets. International competition among regulators has eroded the monopoly that national regulators have traditionally enjoyed over the securities transactions of their residents. As a result, regulators must be more responsive to the needs of issuers and investors if they wish to attract transactions to their regulatory system.[67]

In previous work, Professor Choi and I have argued that the best response to this heightened regulatory competition, at least in

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66. *See* Choi & Guzman, *The Dangerous Extraterritoriality of American Securities Law*, *supra* note 23, at 207 (introducing the concept of portable reciprocity); Choi & Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, *supra* note 17, at 903 (developing the concept of portable reciprocity).

67. *See* Choi & Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, *supra* note 18, at 1855.

the context of efficient and liquid markets, is a policy termed "portable reciprocity."[68] Under portable reciprocity, issuers are free to select the securities regime they prefer and, once they comply with that regime, are free to engage in transactions involving that security. Once the issue is completed, the chosen regime continues to regulate it. Trading in the security is permitted anywhere in the world, rather than simply within the jurisdiction of the chosen regime.[69] Investors, in turn, are free to trade in any securities that have selected and complied with a regime. Sanctions for failure to comply with the chosen regime would be determined exclusively by that regime. Thus, a British firm that issues securities in the United States and chooses the Australian legal regime will face only those sanctions provided by Australian law.[70]

The key to this proposal lies in the recognition that issuers and investors seek to minimize the transaction costs of their trading. Issuers, therefore, will select the regime that is most suitable for the particular issue, knowing that investors will draw conclusions about the issue based on the choice of regime. For example, a firm that is unknown in investment circles but that has a high quality issue may select a very strict regime. By committing itself to high disclosure and liability standards, it is able to demonstrate the quality of the issue, in a credible fashion, to potential investors. The issue may merit the high cost of the regime because investors will pay more for the security if they know that the issuer has subjected itself to a very strict regime. In contrast, a low quality issue may choose a weak securities regime because the negative infer-

68. *See generally* Choi & Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, *supra* note 17.

69. Of course, one of the regimes the issuer might select is a "regime" without any obligations imposed on the issuer. There is no requirement that the issuer select a national securities regime for its disclosure, but for a variety of reasons, we focus on national regimes. *See id.* at 903.

70. The SEC has also sought to negotiate reciprocity arrangements in order to attract foreign issuers. To date, only one such arrangement has come to fruition, the Multijurisdictional Disclosure System (MJDS). The MJDS is an agreement with Canada under which both the United States and Canada have agreed to recognize registration statements prepared under the other's disclosure requirements as long as certain conditions are met. In the United States, for example, a Canadian firm can rely on registration materials provided under Canadian law provided that it has been reporting with a securities regulatory body in Canada for twelve months, that it has a minimum public float of US$75 million dollars, and that it provided U.S. GAAP reconciliation. Note that the MJDS does not represent full reciprocity as various aspects of the American securities laws continue to apply to Canadian issuers who use the MJDS system. These include civil and criminal liability for fraud.

ence that investors will draw about the issue based on the choice of regime will be accurate and would be revealed under the disclosure requirements of a stricter regime or, alternatively, the cost of the strict regime exceeded the benefits gained by the firm in the form of higher prices for its security.[71] By choosing a weak regime, the issuer can reduce the cost of the issue. Ultimately, each issuer will select the regime under which the marginal cost of disclosure equals the marginal benefit of disclosure. As long as additional disclosure would increase the net revenues generated by the issue, the issuer will select a regime that provides for such disclosure. Portable reciprocity, therefore, encourages firms to self-select into regimes in such a way as to reveal information regarding the quality of their issue. The market can then use that information to determine the value of the securities.

Portable reciprocity also changes the behavior of national governments and regulatory agencies. It increases the competition among regulatory regimes by enhancing the ability of investors and issuers to select the regime they prefer. This enhanced competition will drive regulators to try to adopt optimal regulations in order to attract investors and issuers. Indeed, the competition is likely to cause countries to adopt regulations targeted to specific segments of the market. For example, a country wishing to adopt regulations that will appeal to high quality firms may select very stringent standards, knowing that low quality issuers will choose a different regime. Another country, meanwhile, may elect to adopt regulations that appeal to low quality issuers, knowing that high quality issuers will avoid that jurisdiction.[72]

For the purposes of this article, it is important to recognize that portable reciprocity requires an efficient securities market in order to function well. That is, the market must be capable of pricing securities accurately. In inefficient markets, investors may not fully and accurately take into account the value of the regime under which the security is issued. If the value of the applicable regime

71. Because high quality firms are able to comply with a strict regime at a lower cost (because, for example, they have less bad news that will have to be disclosed), high quality firms have a strong incentive to select a regime that is sufficiently strict that low quality firms will find it too costly to adopt.

72. The labels "high quality" and "low quality" should not be taken to represent judgments about the merit or desirability of the issuers. As long as the market is aware of the risks it faces with a particular security, it will price that security appropriately. For this reason, having a jurisdiction designed to regulate low quality issuers is not problematic – indeed it is desirable as it allows the market to identify the securities issued under that regime as low quality and to price them accordingly.

is not accurately priced, issues governed by a weak regime may be priced too high while those governed by a strict regime may be priced too low. The result is a reduction in the incentives given to issuers to self-select into regimes identifying their quality, a reduction in the accuracy of the pricing of issues, and a reduction in the quality of incentives provided for regulators.

The capital markets of developing countries are, of course, much more likely than those in developed countries to evidence significant inefficiencies. Efficient markets require a cadre of securities professionals who gather and distribute information on the state of securities markets and specific securities. This class of information providers is underdeveloped in emerging market economies.[73] Efficient markets also require a certain scale in order to maintain a high degree of liquidity. Liquidity allows participants in the market to buy and sell securities in an attempt to take advantage of perceived under-pricing or over-pricing. Developing country markets feature considerably less liquidity than those of developed countries, reducing the efficiency of those markets.

Recognizing that capital markets in developing countries may not be fully efficient, a full-fledged application of portable reciprocity, in which issuers can choose any securities regime, including a private, custom regime tailored for that particular issue, may be inappropriate. If capital markets are not sufficiently efficient, issuers may have an incentive to chose a low disclosure regime in the hope that the market will not fully take into account the differences between those that comply with a strict regime and those that select a weak regime. By choosing a weak regime, an issuer reduces its cost of compliance, including its exposure to sanctions. If the market does not discount the value of the security to reflect the additional risk imposed on investors, issuers may choose a weaker regime than they would in an efficient capital market. This will reduce the risk adjusted return earned by investors.

Rather than grant issuers complete freedom to select the regime they prefer, therefore, regulators may wish to restrict the set of available choices. A simple and effective solution would be to require issuers to select from a menu of approved regimes.[74] Limit-

73. *See* Taylor, *supra* note 41, at 76 (1997) ("The emerging markets, however, do not support this class of professionals currently and certainly cannot yet be characterized as anywhere near efficient.").

74. A similar menu approach has been advocated for the United States in both corporate and bankruptcy law. *See* Robert K. Rasmussen, *A New Approach to Transnational*

ing the issuer's options to a specified list of regimes obviously reduces the flexibility available to the market. Nevertheless, a well chosen menu is likely to represent a significant improvement over local regulations.

It is important to note that the menu is intended to prevent a race to the bottom. As long as the country allows potential issuers to select the local substantive law, there is no harm in also allowing them the option of choosing any other law that is stricter than local law.[75] Thus, a menu that includes the local law could also include a wide range of alternatives from many countries. One would expect, for example, that the regimes of most developed countries would be sufficiently strict to be included on the menu.[76] Of course, there is no requirement that a local law be included on the menu. A country that wants to ensure a high level of disclosure by all issuers within the jurisdiction can limit the menu to regimes that have sufficiently demanding rules.

Allowing the issuer to choose from a menu of approved regimes will not be materially different from a set of mandatory rules if all issuers choose the weakest of the options. The very existence of a broad range of options, however, makes this outcome unlikely. As long as the market is capable of some adjustment in response to positive information, a high quality firm will have an incentive to demonstrate its quality by disclosing information. Even if the market does not adjust perfectly, the gains from disclosure will outweigh the costs for some firms—leading those firms to select a stricter regime.

There is a second reason why a reasonably broad range of options could be included on the menu. As was discussed in *Portable Reciprocity*,[77] the choice of regime itself communicates a great deal

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Insolvencies, 19 MICH. J. INT'L L. 1, *passim* (1997); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Reorganization*, 72 TEX. L. REV. 51, 78-79 (1992).

75. In principle, there is no reason why issuers should be limited to the selections provided by a menu. As long as the regime that is chosen is more stringent than the local regime, it should be permitted. Nevertheless, a menu regime is desirable because government authorities are not required to evaluate the regimes chosen by specific issuers. This reduces the burden on the regulators and, perhaps more importantly, reduces the danger of corruption in the approval of regimes.

76. Using a menu approach will, however, introduce one important limitation on the choices of issuers because they will not be permitted to adopt a custom, contract-based regime as they would under the purest form of portable reciprocity. *See* Choi & Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, *supra* note 17, at 922-24.

77. *Id.*

to the market. For example, an issuer that selects the regime that is least protective of investors is signaling that it is a low quality issuer and that investors face greater risks. Thus, the market may in fact be made more efficient merely by the introduction of a menu because potential investors will be able, at low cost, to make quality assessments based on the choice of regime. If there is a broad range of options available, high quality issuers will seek out ways to distinguish themselves from low quality issuers. By selecting a relatively strict regime, they signal quality. A strict regime imposes a lower compliance cost on high quality firms than on low quality firms, allowing the high quality firms to distinguish themselves from the low quality firms.

This exact pattern occurs in Europe, where the Listing Directive allows securities that have been issued in one EU member state to be listed in any state without any additional regulatory requirements.[78] Despite the fact that Britain has a strict regime, many issuers choose to comply with the British rules, presumably for the signal such compliance sends, when they issue in their home countries.[79]

Even if a country wants to protect its investors from low quality firms out of a fear that the market is inefficient, the country can include weak regimes on its menu by restricting the pool of investors eligible to invest in issues that select such regimes. Issuers that select a weak regime, for example, could be allowed to sell securities only to institutional investors, thereby protecting individual investors from those issues.

Portable reciprocity has the advantage that regulators in developing countries are not required to determine whether the country should adopt a foreign regulatory model or develop its own system—those decisions are left to the parties who are best able to determine the value of each alternative.[80] Local authorities can, if

78. *See* Giovanni Nardulli & Antonio Segni, *EU Cross-Border Securities Offerings: An Overview*, 19 FORDHAM INT'L L.J. 887 (1996). *See also* SCOTT & WELLONS, *supra* note 5, at 334-43.

79. The EU situation is an excellent example because compliance with British law is not a prerequisite for listing in Britain. The decision of some non-British issuers to comply with British rules even though they have the option of complying only with their weaker local rules demonstrates that issuers will at times select a strict regime in order to signal quality to potential investors.

80. A developing country seeking to adopt its own regulatory monopoly over local transactions faces an series of complex decisions. A few of these are discussed in Steinberg, *supra* note 2, at 715 (considering whether regulatory oversight should be carried out directly by the government, by self-regulatory organizations, or some other form of over-

they wish, develop or reform a local securities regime. They may develop a regime from scratch or a regime based on an existing system of regulation borrowed from another country. If, indeed, the local regime is preferred, issuers and investors will select it. If not, it will be ignored, giving the local authorities an incentive to improve it.

The result, then, of this modified version of portable reciprocity is that issuers and investors can enjoy the advantages of a well developed set of securities laws and the developing country can attract those parties to its capital market.[81]

B. *Choice of Forum*

Allowing issuers and investors to choose the law that will apply to their transactions is, however, not enough to ensure a well functioning capital market. An inadequate dispute resolution system and an ineffective system for the enforcement of judgments can undermine even the best legal rules. Even a liberal choice of law regime, such as that discussed above, will fail if dispute resolution must rely on an inadequate system of local courts.

Indeed, the lack of a fair and efficient system for resolving civil cases may represent the largest impediment to the development of capital markets in developing countries. In principle, contracts can determine the substantive rules governing capital markets, so a deficiency in these rules need not be fatal to the market. Issuers that wish to demonstrate quality can bind themselves through contract, either directly to investors or indirectly by committing to a reputa-

sight; whether civil or criminal liability should be used; whether private suits should be allowed; and whether the system should rely on disclosure or should adopt merit regulation).

81. Adopting the proposal in this article would require some changes to the laws of developing countries and an acceptance of the fact that different rules may apply to different transactions. For example, many countries, including some with developing markets, rely mainly on criminal enforcement for certain violations of the local securities laws. Criminal enforcement can certainly represent a continuing part of the local law, but the local law also must recognize that when a foreign law is selected that has only civil penalties, the local criminal penalties are not applicable. In order to function, the modified portable reciprocity discussed in this article would require a certain level of international cooperation. For example, the regulatory authorities in the country whose regime is chosen would have to agree to enforce the relevant laws. The details of the necessary international cooperation are beyond the scope of this paper. For a discussion of the key issues, see Choi & Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, *supra* note 17, at 914. *See also* Jackson, *supra* note 42, at 40 (discussing the economic incentives that first world regulators might have in overseeing compliance in foreign countries).

ble intermediary, to certain behavior, including full disclosure of all relevant information. The market will perceive issuers that do not undertake such actions as low quality and will price the issues accordingly. Furthermore, reform of existing substantive rules can be accomplished by legislative action, whereas reform of the dispute resolution system requires changing embedded and decentralized norms of conduct—a much more difficult task. Similarly, problems with the enforcement of judgments are not necessarily fatal. Successful litigants can often collect court judgments, although harder to enforce internationally than arbitral awards, in a foreign country.[82]

A working system of dispute resolution, however, is a necessary condition for substantive legal rules to function and for money judgments to be awarded. If that system is so slow or corrupt as to deny a claimant the opportunity to be compensated for the improper activity of a defendant, parties to a transaction have a strong incentive to breach their contracts and to ignore the law. In response, investors will refuse to participate in the capital market, or will demand a large premium in order to accept the risks imposed by the dysfunctional dispute resolution system.

1. *Public and Private Disputes*

There are two important components to the problem of dispute resolution—private disputes and public enforcement disputes. That is, in regimes that allow for private actions under their securities laws, such as the United States, some disputes arise between the issuer and an investor (or investors). Other disputes, however, arise between the issuer and the regulatory authority—the SEC in the United States.

82. *See* S.I. Strong, *Intervention and Joinder as a Right in International Arbitration: An Infringement of Individual Contract Rights or a Proper Equitable Measure?*, 31 VAND. J. TRANSNAT'L L. 915, 918 (1998) ("[E]nforcement of arbitral awards is far more certain and well-regulated than enforcement of judgments from domestic courts."); W. MICHAEL REISMAN ET AL., INTERNATIONAL COMMERCIAL ARBITRATION 1215 (1997) ("[A]rbitral awards as a whole enjoy a higher degree of transnational certainty than judgments of national courts."). To the extent that it is difficult to enforce a judgment locally, a problem remains. This problem may be alleviated if the judgment can be enforced against property abroad. What remains of the problem results from the difficulty in resolving disputes – state institutions for doing so simply may not work well.

a) Private Disputes

Consider first the set of private disputes. Several possible fora exist for the resolution of such disputes. Reform of the local judicial process is one possible strategy that could correct the failings of the dispute resolution system. In principle, if one could eliminate the backlog of cases, reduce corruption to low levels, and ensure that judges are competent and fair, the judicial system could function as an effective forum for the resolution of disputes, including those that arise in capital markets. The problems with such a solution are obvious. The severe financial constraints faced by developing countries make it difficult to identify and punish corruption and to provide sufficient resources to resolve all disputes quickly. Even with more resources, the courts would have to clear the enormous backlog of cases before they could decide new cases. In addition, it is difficult to change a legal culture that is accustomed to a certain level of corruption.

An obvious alternative forum that may allow the parties to avoid local courts is the court system that corresponds to the chosen regime. Thus, if the parties selected French law, they would pursue litigation in French courts. This approach has the merit of competent application of the relevant law and the avoidance of unreasonably long delays.[83] This approach also has disadvantages, however. In particular, the parties must travel to a distant forum and litigate in a location, culture, and perhaps language with which they are not familiar.[84] Because of these disadvantages, a third alternative is desirable.

The third and final alternative is to offer a private alternative to the judicial system—arbitration. A well structured arbitration system has a variety of advantages over a domestic court system. First, it offers the party the ability to select the forum that will resolve their dispute. This is extremely important in the context of developing countries because well-founded concerns about the

83. Some otherwise desirable legal regimes may have long delays in their court system, but the parties are able to observe this trait when they select a regime and, therefore, will take it into account. As is the case with the substantive law, a developing country with less than efficient capital markets may wish to restrict the choice of available regimes in order to protect local investors.

84. Even with these disadvantages, giving the parties the ability to choose the court system corresponding to the regime would be an improvement, as it would increase the range of choice available to the parties, thus giving greater scope to maximize the value of the transaction.

domestic court system may exist.[85] Through arbitration, the parties can avoid a forum that is perceived to have a bias, that has long delays in its court system, or that is corrupt. Arbitration may offer the parties the ability to resolve their disputes at a lower cost than would be the case if national courts were used.[86] Second, it gives the parties considerable control over the procedural rules under which they will litigate. Third, it improves the ability of the winning party to enforce its judgment. Finally, it allows the parties to ensure the competent application of a wide range of substantive laws through a careful selection of arbitrators.

Allowing the parties to a transaction to select arbitration proceedings to resolve their disputes gives them the ability to select the dispute resolution scheme in much the same way as they select the substantive law. *Ex ante*, parties could ensure that they are satisfied with the procedures to resolve disputes—reducing the risk of corruption and unfairness. In addition, arbitration associations would compete to be the forum of choice for such cases. This competition would encourage these institutions to structure their procedures optimally—balancing the need for speed, accuracy and low cost in a manner that appeals to the parties purchasing the service.

In light of the advantages offered by arbitration over national courts, the parties engaged in securities transactions should at a minimum have an option to resolve their disputes through arbitration. In fact, as long as it is possible to ensure that the arbitration is carried out fairly, countries may wish to adopt arbitration as the default rule for private disputes in securities transactions. The option of having a dispute heard by national courts should remain, however, so that parties who feel arbitration is unfair or who otherwise prefer to rely on national courts can do so. Retaining the option of a court resolution also ensures a minimum level of quality in the arbitration proceedings—unless arbitration is of greater value to the parties than the court system, the parties will not select it.

85. *See* Steinberg, *supra* note 2, at 727.

86. There is at least a perception that arbitration reduces the cost of litigation. Whether this cost savings actually exists is uncertain. *See* LOWENFELD, *supra* note 65, at 333.

b) Public Enforcement Disputes

The second type of dispute—between the enforcement agency and the issuer—is more difficult to resolve through a choice of forum clause. When a regulatory body chooses to take action against an issuer, an arbitration clause in the issuer's documents typically will not be effective to avoid the national court and administrative proceedings of that country. Rather, the regulatory authority is likely to demand that courts settle the dispute.

The nature of public enforcement, therefore, constrains the forum selection available to the investor and the issuer, once the legal regime is chosen. More accurately, it links the choice of law decision and the choice of forum decision. Issuers and investors will have to take into account both the substantive rules of a regime as well as its public enforcement provisions. As a result, the parties will have a more limited set of choices.[87] Nevertheless, permitting the parties to choose the applicable law (and its corresponding forum for public enforcement purposes) represents a considerable expansion of their choice set. Furthermore, because the parties can take into account the convenience and reliability of the forum that will apply, they will select the optimal combination of substantive rules and court system in light of the specific transaction.

If portable reciprocity were implemented, some governments may find that their public enforcement system is a serious handicap in the competition to attract issuers and investors. In reaction, they may decide to allow disputes with their public enforcement authority to be decided in arbitration. They may wish to restrict the form of the arbitration, its location, or the identity of the arbitrators, but this option would nevertheless constitute a significant expansion in the choices being provided to the securities market. Providing such choices would, of course, make the local regime much more attractive—potentially even attracting issuers and investors who consider an alternative regime to offer superior substantive laws, but who value the ability to select their forum enough that they prefer the local regime.[88]

87. They cannot, for example, choose U.S. laws and French courts, or even U.S. laws and arbitration of the public enforcement provisions.

88. Although it may seem unlikely that public regulators would submit to arbitration, it is not without precedent. *See China Appoints Securities Arbitration Panel*, 6 WORLD ARB. & MEDIATION REP. 76 (1995) (stating that China had appointed an arbitration panel for securities disputes).

Finally, a developing country or private body could establish a form of pseudo-public enforcement that would allow for arbitration. Imagine, for example, that a developing country finds that the U.S. regime is preferred by many of its issuers and investors. Suppose further that these same issuers and investors would prefer to avoid U.S. courts. The developing country could offer issuers the option of issuing under a set of local laws that are identical to U.S. law. Indeed, the laws could specifically state that U.S. law governs. Because the issuer is formally not issuing under U.S. law, of course, the SEC would not oversee the transaction. Instead, the developing country could allow the establishment of a private firm, staffed with experienced participants in the US market, to engage is private enforcement designed to mimic the public enforcement carried out by the SEC. This firm would have an incentive to enforce US laws faithfully in order to develop its reputation and attract more business. By contract, the issuer would agree that the enforcement firm would apply the rules of the United States to its activities and would apply them in the same manner as the SEC would if the transaction were formally under US law. One could even stipulate that changes in US law or SEC rules are binding on the issuer to the same extent as they are binding on firms issuing in the United States. Parties could then refer disputes to arbitration and resolve them using substantive US law.

Using arbitration as a solution to the dispute resolution problems in a country also makes the local substantive rules a viable option for the parties to transactions. If the selection of local substantive rules required the use of national courts for the resolution of disputes, investors and issuers would have a strong incentive to avoid those rules. If, on the other hand, arbitration is available to resolve disputes, the choice of law decision can be made entirely on the substance of the law rather than on the basis of the quality of the court system.[89]

89. Note that this solution gives the local regulatory authority an incentive to allow even public enforcement to be governed by arbitration. At the time of the initial issue, for example, the regulatory authority could give the issuer the choice between resolution of public enforcement disputes through the courts and resolution through arbitration under a specified set of rules, such as those of the American Arbitration Association. If a dispute later arose, that choice would be binding on both the issuer and the regulatory authority. By submitting to arbitration in this way, the regulators make their own regime more attractive, thereby increasing the number of issues under local law. One drawback of this approach is that to the extent public enforcement disputes are resolved through arbitration, the incentive to improve the court system may be reduced.

Absent a creative solution, public enforcement will tie the regime choice to the forum choice. Parties will have to take both into account when they select a regime. Although, as discussed above, there may be ways around the link between choice of law and choice of forum, in the absence of such solutions, public enforcement will lead to selection of the forum based upon the enforcement regime.

2. *Benefits of Forum Selection*

The ability of issuers and investors to select the forum under which disputes will be resolved—even if that selection cannot be separated from the choice of law decision—does more than simply improve the dispute resolution system. It also helps to resolve many of the problems facing capital markets in developing countries.[90] This section discusses how each of the previously discussed problems is alleviated by forum selection.

a) Selection of Legal Regime is Made Effective

Giving private parties the ability to select the forum in which their disputes will be resolved increases the number and variety of substantive legal rules that apply to a transaction. Imagine, for example, that Costa Rica adopted a system that included a liberal choice of law regime, but did not allow for the selection of a foreign forum.[91] An issuer then could select, for example, the laws of Japan, while stipulating that the courts of Costa Rica would adjudicate any dispute. This arrangement would introduce significant and obvious problems of competence. Although it is not unusual for the courts of one country to apply the laws of another, it would be naïve to assume that a foreign court could accurately and predictably apply a complex body of securities laws. The problems are obvious—the court would lack experience with the laws, attorneys qualified to appear before the court may also lack knowledge, language problems may exist if the laws have not been translated into a common language, the basic features of the two

90. Although a party is not able to choose a forum that differs from the chosen substantive regime, it is nevertheless able, to a large degree, to select its forum. Put simply, the party can select from a set of regimes that combine a substantive law and a forum. If the forum is sufficiently undesirable, the party will not select the corresponding regime, even if that regime is favorable. Similarly, if the forum is very attractive to the party, it may select the corresponding regime even if substantive law is not the best available.

91. For the purposes of this example, ignore the fact that the public enforcement bodies of a foreign regime are unlikely to submit to local courts.

legal systems may be different and contradictory.[92] All of these problems will generate considerable uncertainty regarding the rights of the parties and the likely behavior of a court. This uncertainty will reduce the value of choosing Japanese law.

If the parties are able to select the courts of the chosen regime or, in the case of private disputes, arbitration, they can ensure that the judges or arbitrators deciding the case will be competent in the relevant law. With respect to arbitration, a careful *ex ante* selection of arbitrators or a procedure for choosing arbitrators can ensure competence. Because an arbitration agreement can choose its arbitrators from anywhere in the world, the selection of a particular country's legal regime accompanied with a selection of arbitrators clause ensures that an accurate version of that country's laws is applied.

In addition, the parties have the ability to determine how to balance the need for competence with any other concerns they may have. For example, if the parties want the arbitrators to be familiar with the local business practices of the jurisdiction in which the securities are being issued, they can tailor the procedures for the selection of arbitrators to achieve that goal. If it is necessary to trade off familiarity with the relevant substantive law in order to achieve this objective, the parties can choose to do so. Importantly, it is the parties who make this decision, so they are able to internalize the costs and benefits of that decision.

Imagine, for example, a system in which the parties to a transaction in Brazil choose to have their transaction governed by the substantive law of the United States. If the courts of Brazil represented the only available dispute resolution, it would be difficult to find a judge competent to hear the case. Brazil has a civil law system, the United States has a common law system; Brazil is Portuguese speaking, the United States is English speaking; American judges are accustomed to dealing with American law and applying it to a variety of situations, Brazilian judges may know virtually nothing of the American legal system. Parties negotiating in the shadow of the law would recognize these facts, of course, and would realize that the application of US law by a Brazilian court may yield results that do not resemble the laws of the United States as they are normally applied. Thus, despite the ability to select US law, the parties would know that the rights they can ac-

92. For example, common law courts might do a poor job of adjudicating a claim that arises under a civil law system.

tually enforce are quite different from those that exist in the United States. Parties would not only expect that the application of the law would deviate from US law as a US court would apply it, they would expect unpredictable application of the law.

The public enforcement authorities in the United States would, of course, look to US courts to handle any dispute between themselves and the issuer. Although this arrangement lacks the flexibility that is available for private disputes, it does ensure competent, consistent, and predictable application of the law.

For private disputes, of course, the option of arbitration would offer the greatest range of choice. Not only could a party guarantee competence, the party could also make sure that the arbitrators are familiar with local business practices and could locate the arbitration in a convenient location.[93]

If a foreign legal regime is made available to the parties, therefore, one must consider the efficacy of the dispute resolution regime that will apply.[94] Because unsophisticated parties may be present and the market may not be sufficiently efficient to protect these parties from deceitful practices, the legal regime may find it desirable to limit the ability of the parties to select a forum. Specifically, to the extent the choice of law is constrained, the menu of permissible legal regimes should be limited to those with effective dispute resolutions systems. Where arbitration is selected for the resolution of private disputes, the developing country may wish to limit the flexibility of the arbitration agreement, perhaps requiring parties to select from respected arbitration associations with respected procedures.

b) Selection of Effective Dispute Resolution Procedures is Possible

The ability to select the forum for one's disputes also addresses the problem posed by the local court system in many developing countries. When selecting a legal regime, the parties will include the desirability of the forum in the assessment of the potential regimes. As discussed in the previous section, the inability to separate the choice of law decision and the choice of forum decision

93. Any other concerns that the parties may have regarding the arbitration can also be addressed in the selection of arbitrators.

94. For more discussion of the selection of a dispute resolution forum, see Choi & Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, *supra* note 17, at 903.

with respect to public enforcement regimes implies that the parties will find both the substantive rules and the court system relevant to their decision. Based on their assessment of these institutions, the parties will select a regime that offers the best combination of forum and substantive rules for the particular offering.

For private disputes, the benefits of the ability to choose one's forum are even greater. The parties can select a national court system that offers them procedures that have value. For example, if the parties prefer, *ex ante*, to avoid having their dispute tried before a jury, they can choose to avoid the procedural rules of the United States. One way to avoid U.S. juries, of course, is to select a different set of national laws. An alternative solution—and one that would allow the selection of U.S. laws if those laws are preferred—is the selection of arbitration.

By selecting arbitration, the parties have the ability to exercise considerable control over the procedures to govern the dispute resolution process. Rather than being forced to accept the cumbersome procedures of the local legal system, for example, the parties might select a faster and cheaper set of procedures. Giving the parties the ability to determine the procedural rules, and having them pay the cost of those rules, ensures that they will internalize the costs of the rules—both in terms of monetary cost and delay.

Allowing the parties to select the procedures that will govern the dispute resolution system gives the parties the opportunity, *ex ante*, to satisfy themselves of the fairness and efficiency of the relevant procedures. The selection of procedures and arbitrators minimizes the problems of delay, corruption, and competence.

The parties also have the ability to influence the forum and the composition of the arbitral panel. Suppose, for example, that both parties are residents of France, that they are carrying out their transaction in Russia, and that they have chosen the laws of the United States to govern their transaction. Arbitration gives them the ability to select France as the location in which disputes will be resolved, greatly reducing the inconvenience of such procedures.

In addition, suppose that the transaction involves a high tech product and a full understanding of the issues surrounding the case requires specialized knowledge. Unlike domestic court systems that assign a judge to a case—typically without regard for the level of complexity of the issues or the judge's particular skills and interests[95]—an arbitration agreement can specify the arbitration panel in advance, taking into account the human capital needed to understand the issues. Alternatively, the parties may not wish to specify the arbitrators, but could specify the background that the arbitration panel should possess. Finally, the parties can choose to provide for the selection of the panel *ex post*, in which case the parties will know the specific question at issue and the appropriate arbitrators required to resolve the conflict.

Arbitration not only ensures competent adjudication, it guarantees selection of a credible and reliable arbitration system. It further reduces concerns about corruption, competence, costs, and delay of local courts.[96] Arbitration even provides a collateral benefit to local courts by reducing the number of cases that they are required to handle.

c) Enforcement of Judgments is Made Effective

The third problem facing a developing country is the need for an efficient method for parties to enforce judgments. If the collection of judgments requires drawn out court proceedings, if too many local assets of the debtor are protected by local laws, or if the collection system is corrupt,[97] the benefits of a good substantive law and an effective system dispute resolution system are lost.[98]

The proposal advanced in this article addresses the enforcement of judgments problem in several different ways. The ability to choose the legal and dispute settlement regime that will apply to a transaction allows the parties to avoid jurisdictions in which collection is too difficult. Specifically, in selecting a forum for the resolution of disputes, the parties can take into account the ability to collect on a judgment in that forum.[99] First, the parties can select a forum in which the issuer has assets. In this way, if a judg-

95. In the United States, of course, a jury may decide the facts of a case. Juries may be even less able to evaluate complex issues and technical questions than a judge.

96. *See* Jackson, *supra* note 42, at 56.

97. *See* Gray & Kaufman, *supra* note 47.

98. The problem of enforcing judgments is not unique to the proposal advanced by this paper. It is an inevitable problem if international transactions take place. The proposal advanced herein, however, reduces the significance of the problem significantly by giving the parties the ability to take into account the enforcement problem when they select the applicable law and forum.

99. In the case of public enforcement, therefore, the single choice of regime will take into account all of the issues discussed in this paper – the choice of law, choice of forum, and collection of judgments.

ment is handed down, the judgment creditor will not have to go to another jurisdiction in order to collect. When developing countries attract issuers and investors from abroad, the issuer may not have substantial assets within the local jurisdiction. If the parties are able to select a jurisdiction in which assets are located, the enforcement problem is simplified.

Furthermore, a forum is more desirable if it has an effective set of institutions for the collection of the judgment. The forum should have legal structures that can compel the payment of amounts owed following a judgment. Finally, a fair and unbiased forum is important for the collection of judgments just as it is for the resolution of disputes. Because the legal institutions of developing countries will often be weak, the parties will value the option of selecting a different forum for the resolution of disputes and the collection of judgments.

In addition, if it is necessary to try to enforce a court judgment in another country—perhaps because that is where the assets are located—the judgment creditor will find the task easier if the court system from which the judgment came is well respected internationally. The enforceability of foreign judgments is not governed by a single multilateral agreement, and the practice of states is not uniform.[100] Many, if not most, countries, however, demand that a certain standard of fairness exists in the original judgment.[101] In addition, countries may consider other reasons for non-enforcement such as a lack of notice, the public policy of the enforcing jurisdiction, the presence of fraud, and so on. Recognizing that other countries may challenge the enforcement of a judgment, the parties will prefer adjudication in a jurisdiction whose decisions are likely to survive such a challenge. Put differently, the parties will prefer a forum that is recognized as fair and unbiased, and one that provides procedural protections for both parties. In this way, it is more likely that the judgment will be enforceable abroad. To the extent the developing country's court decisions are vulnerable to non-enforcement, therefore, the parties will value the opportunity to have their disputes resolved before a foreign court.

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100. *See* BORN, *supra* note 65, at 942 (citing RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 481, Reporters Note 6 (1987)).

101. In the United States, for example, a judgment will not be enforced if the foreign proceedings were "biased or unfair." Hilton v. Guyot, 159 U.S. 113, 202-03 (1895); UNIFORM FOREIGN MONEY JUDGMENTS RECOGNITION ACT § 4, 13 U.L.A. 269-70 (1980 & 1991 Supp.).

With respect to private disputes, as opposed to public enforcement disputes, the ability to choose arbitration for the resolution of disputes provides a great advantage with respect to the enforcement of judgments (or, more accurately in the case of arbitration, the enforcement of arbitral awards). According to the New York Convention,[102] national courts are required to recognize and enforce foreign arbitral awards on the same basis as domestic awards, subject to only very narrow exceptions.[103] For present purposes, it is sufficient to note that the New York Convention makes an arbitral award enforceable around the world. The recipient of the awards, therefore, can turn to virtually any jurisdiction in which the other party has assets to collect an award. Whatever the difficulties of collecting in the developing country, they are avoided through arbitration.

V. COLLATERAL DEVELOPMENT BENEFITS

The central claim of this article is that developing countries can improve their capital markets by adopting a modified version of portable reciprocity and by making arbitration the default dispute resolution system for securities transactions. Adopting this proposal, however, would also yield benefits in other areas of development.

First, the local regime will face the test of international competition, forcing regulators to adopt appropriate rules. All issuers will find these rules beneficial—including local issuers who would find it difficult to raise capital abroad.

Second, the adoption of a modified portable reciprocity approach would not only improve the functioning of local capital markets in the short term, it would also provide a useful environment in which to increase local expertise and human capital. With portable reciprocity in place, the market will inform local regulators of the value of local laws. Attempts to improve the quality of

102. *See* United Nations Convention on Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 38 [hereinafter New York Convention]. The current signatories of the New York Convention number over one hundred and include virtually every significant commercial state. *See* LOWENFELD, *supra* note 65, at 343; David W. Rivkin, *International Arbitration And Dispute Resolution*, *in* INTERNATIONAL JOINT VENTURES: 1998, 183, 217 (PLI Commercial Law and Practice Course Handbook Series No. A-765, 1998).

103. *See* New York Convention, *supra* note 102, at Arts. III, V. A detailed discussion of the New York Convention and the requirements it places on states is beyond the scope of this article. For a more detailed discussion, see BORN, *supra* note 65, at 987-1052.

local laws will develop the human capital of local regulators and other participants in the regulatory process. Over time, the participants in the process can translate these skills into increased participation by nationals in the market as they are called upon to serve on arbitration panels, regulate issues that choose the local regime, and advise firms seeking to raise capital in the local market. Modified portable reciprocity would encourage the growth of the financial industry in the country—yielding clear benefits for the developing country.

A further benefit of the approach advocated in this article is that it encourages the parties to a transaction to bear the full costs of their agreement, including oversight and arbitration. A foreign regulatory system will presumably demand the payment of a fee in order to carry out the regulatory task of overseeing a transaction. The parties will have to pay this fee. If there is a dispute, the parties will also bear the costs of an arbitration. The internalization of costs has several positive effects. First, transactions will only take place if they generate value that exceeds their costs—there is no subsidy from the state. Second, a developing country always suffers from severe resource constraints. By having private parties pay the costs of oversight for their own transactions, the public purse gains some relief and can direct its resources to other areas. The proposal in this article, therefore, provides some measure of fiscal relief to the country. In addition, by taking disputes out of the local court system and into either foreign courts or arbitration, modified portable reciprocity could ease the burden on court systems in developing countries. Finally, whatever regulatory oversight takes place in the country, the authorities responsible for that oversight will have a reduced workload as they will not have to monitor transactions that have elected a foreign legal regime.

VI. CONCLUSION

By allowing parties to select a foreign law, and by permitting them to select a desirable arbitration system—including procedural rules and the location of the arbitration—a developing country can make itself a more attractive market for both issuers and investors. The ultimate benefit from this system, of course, is a reduction in the cost of capital within the country and an accompanying increase in economic activity.

With modifications to account for the risk that local capital markets are not fully efficient, portable reciprocity lets investors and issuers avoid severe legal disincentives to local transactions. The parties are able to select a set of substantive rules that are effective and that meet the needs of the particular issue. They can also select a forum that will ensure a fair and predictable resolution of disputes at reasonable cost and with limited delays. Finally, they can make a choice of law and forum which provides that court judgments and arbitral awards are enforceable—ensuring the rights provided by the substantive rules have corresponding remedies.