Coase and the Reform of Securities Markets: Discussion

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I read with interest Simon Johnson's paper on "Coase and the Reform of Securities Markets." As one who spends considerable time trying to formulate sound regulatory policy for the U.S. markets, I am gratified with the paper's conclusion that the securities laws do, in fact, matter. And that the approach adopted by the Congress almost 70 years ago remains relevant today—protect investors and maintain fair and orderly markets.

The Johnson paper concludes that law definitely matters, that legal origin is not destiny, and that legal reform works. I believe that the conclusions are sound. Further, I believe that the underlying theme of the paper is correct. Specifically, regardless of the legal environment, for a securities market to be successful, investors must have confidence in the fundamental fairness of the market.

Unlike many of the conference participants, I am not an economist by training, so I will not attempt a technical economic analysis of the issues presented in the paper. But I would like to share with you some examples of where I believe securities regulation has had a positive effect—specifically, where our regulatory framework has furthered the Securities and Exchange Commission (SEC) goal of promoting vibrant and competitive markets that have substantial investor confidence in their integrity. I will also discuss more generally the way I see securities regulation developing in the international arena.

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In the paper, Johnson outlines the Coasian arguments for the irrelevance of legal rules, but then he cites substantial empirical research that indicates otherwise. Countries with highly developed legal systems of investor protection have better-developed financial markets and more growth, and they may be less prone to economic collapse. Private sector institutions appear unable to perform effectively the role played by laws, and improvements in legal systems have a demonstrable impact on capital market development. In light of this, the author foresees countries around the world adopting investor protection measures modeled, along important dimensions, on U.S. securities law and regulation.

Success of U.S. Markets

It is easy to understand why many would want to emulate the U.S. regulatory approach, particularly in light of the performance of our securities markets, which have been flourishing. For example, 25 years ago—just as the SEC was beginning its efforts to create a modern national market system—there were approximately 3,000 exchange-listed stocks with annual trading volume of 6.4 billion shares; in 1999, there were more than 3,800 exchange-listed companies with annual trading volume of approximately 259 billion shares. In 1975, Nasdaq was still a fledgling automated market with approximately 2,600 issues and an annual trading volume of 1.4 billion shares; in 1999, Nasdaq included more than 4,800 companies with annual trading volume of 273 billion shares.[1] Investor transaction costs have dropped dramatically in the last 25 years; commissions have fallen and execution quality has risen. But most important, investor confidence in the fairness and integrity of the securities markets has been enhanced. By 1998, nearly one-half of U.S. families held stock, directly or indirectly, in publicly traded companies, and their stockholdings represented more than one-half of their total financial assets (Rennickell, Starr-McLuer, and Surette 2000).

I believe the SEC's approach to securities regulation—based on core principles of competition, transparency, investor protection, and market integrity—has been instrumental in establishing confidence in the U.S. securities markets. Because it is impractical for individual investors to band together to effectively protect their interests, the government must step in and do so. Accordingly, prudent regulatory intervention is indispensable for instilling broad public confidence in the markets, and this in turn promotes financial stability. In fact, I think most would agree

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[1] Sources of the data are the *42nd Annual Report of the SEC* 194 (1976); NASD Economic Research, <www.marketdata.nasdaq.com>; the New York Stock Exchange; and the American Stock Exchange.

that a high-quality regulatory structure complements, much more than it conflicts with, private initiative and fair competition in the marketplace.

Examples of Effective Regulatory Intervention

Let me offer a few examples of where market competition and private initiative alone could not achieve desired goals for our securities markets. One important focus of the work of my Division has been the establishment of price transparency in the U.S. securities markets. Prior to the 1970s, no statute or SEC rule required market centers to disseminate market information to the public or to consolidate their information. Each market center acted individually and disseminated information on its own terms. Each decided what information to disseminate, who would be entitled to receive the information, and the amount of fees to charge. The result was that dominant market centers, with the most valuable information, restricted public access to their information. And this interfered with the ability of investors to know where the best prices were and ensure the best execution of their orders.

To achieve the price transparency objective of a national market system, the SEC stepped in and adopted rules requiring that all market centers make their basic quotation and transaction information publicly available, that such information be consolidated, and that it be made available to investors on a real-time basis. As a result, investors have ready access to a "national best bid and offer" (NBBO) and a consolidated transaction stream for each of the thousands of equity securities actively traded in the U.S. markets. In addition, the SEC required that linkages be developed among competing market centers—such as the Intermarket Trading System and SelectNet—to help ensure that broker-dealers can access the best displayed prices for their customers. These initiatives have been quite effective in improving the quality of our markets and, nearly unanimously, market participants credit price transparency as being responsible for much of the success of the U.S. markets over the last 25 years.

The SEC also has stepped in to promote the opportunity for investor orders to interact without the participation of a dealer, particularly in the Nasdaq market. It may seem inconceivable today, but up through the early 1990s, Nasdaq market makers routinely traded ahead of public limit orders. As a result, it was nearly impossible for individual investors to use limit orders effectively in the Nasdaq market. Market makers accepted the limit orders of customers, but they generally did not execute them until they had become marketable and therefore were substantially equivalent to a market order. This effectively denied an opportunity for individual investor limit orders to compete with dealer quotations. At the SEC's strong urging, the National Association of Securities Dealers

changed its rules to prohibit this practice for customer orders held by a market maker.

One year later, the SEC took further action to enhance price discovery and transparency and the best execution of investor limit orders, when it adopted the Order Handling Rules.[2] Until then, the NBBO for Nasdaq securities generally reflected only market maker quotations. Such quotations did not reflect limit orders of any kind, whether submitted by investors to market makers or submitted by market makers or investors to limit order books of electronic communication networks (ECNs), even when these orders would improve the NBBO. In addition, the ECNs with the best prices did not make their prices publicly available in the consolidated quotation stream, but generally granted access only to their subscribers.

As a result of these practices, the NBBO disseminated to investors was not a truly "national" best bid and offer. Under the two-tiered market that had developed, it was retail investors who suffered—they frequently received prices at the published NBBO and were denied an opportunity for execution at the truly best price. To remedy these practices, the SEC intervened by requiring market makers to include in their quotes (or send to ECNs) customer limit orders that improve a market maker's published quotations. The SEC also required market makers to publish their best displayed prices either in their quote or through an ECN. The Order Handling Rules had an immediate impact on the securities markets. The spreads between bids and offers narrowed dramatically, which resulted in significant cost savings for investors—specifically, spreads in Nasdaq stocks narrowed by over 30 percent (Barclay et al. 1999; Smith 1998).

To further integrate ECNs into the national market system and promote price competition among markets, the SEC in 1998 adopted Regulation ATS. Regulation ATS provides a streamlined regulatory structure for ECNs that choose to be regulated as alternative trading systems rather than as national securities exchanges, and thereby it enhances the opportunity for innovative market center competition. In addition, Regulation ATS improves price transparency by requiring alternative trading systems with significant trading volume to display publicly their "top-of-book" trading interest in the consolidated national quote stream, regardless of whether that interest is associated with a market maker. Alternative trading systems also are required to provide reasonable access for executions against their best prices through intermarket linkage systems. Since the adoption of Regulation ATS, the competition generated by ECNs has increased dramatically. Through their successful creation of electronic agency trading venues, ECNs today

[2] See Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290.

have managed to capture approximately 30 percent of total share volume and 40 percent of the dollar volume traded in Nasdaq stocks (SEC 2000).

Finally, I would like to note two fundamental aspects of U.S. securities regulation that primarily are the responsibility of others at the SEC—disclosure requirements and accounting standards—because I believe they also demonstrate the way in which high-quality regulation, by instilling public confidence in the markets, complements private sector initiatives. One of the key regulatory goals of the SEC is to promote full and fair disclosure of information material to investment decisions, both nonfinancial and financial. After all, the best way to prevent fraud in the securities markets—which was widespread prior to the enactment of the federal securities statutes in the early 1930s—is to require issuers to tell the truth about the securities they are selling. Accordingly, before any company offers its securities for sale to the public, it generally must file a registration statement with the SEC and provide a prospectus to investors that contain material information on matters such as the nature of the business, the company's management, the securities being offered, and the risks involved in investing, as well as the company's audited financial statements. In addition, most companies must update this information quarterly and annually to ensure an informed trading market. With respect to financial disclosures, U.S. accounting standards provide a framework for reporting that seeks to deliver transparent, consistent, comparable, relevant, and reliable financial information to investors. The SEC not only prescribes the form and content of the financial statements provided to investors, but also monitors the activities of the accounting profession to address whether accountants are qualified and independent and apply high-quality auditing standards.

Global Issues

Having provided some examples that I believe support Johnson's conclusion that securities regulation is a positive force in the marketplace, I would like to touch upon some ramifications of this internationally.

The securities markets, like all businesses, are becoming increasingly global. With globalization has come a heightened need for regulatory convergence, at a high-quality level, to provide a coherent and effective framework within which competitive forces can operate. This has accelerated the movement, in international circles, to develop a commonality of standards. And my hope is that, with competition increasing among the more developed economies, there will be an incentive to develop the highest-quality regulatory system, which then can serve as the model internationally—in effect, a "race to the best."

I understand that many large foreign issuers, for example, now provide investors with quarterly reports—the U.S. standard—even when not required to do so under local law, because of institutional market

expectations. Also, as noted in Johnson's paper, the very successful Neuer Markt in Germany requires substantial regular public disclosure—one of the hallmarks of the U.S. regulatory approach—by start-up issuers that list on that market, as well as U.S. GAAP or International Accounting Standards Committee (IASC) accounting standards. In essence, in order to encourage investors to commit capital to new enterprises, it may be necessary for issuers to provide more transparency—U.S.-style—than exists for established companies in some jurisdictions. And new issuers, perhaps less resistant to change, seem to be willing to play by these new rules of heightened disclosure. Finally, the contrast between the Czech and Polish markets noted in Johnson's paper emphasizes the importance not only of high-quality regulation, but also of stringent enforcement of those regulations, for the successful development of securities markets.

In addition to the private sector-driven convergence noted by scholars such as Coffee, regulators are working to promote functional convergence as well. For example, the Financial Stability Forum—an organization in which I participate—has put together an extensive compendium of internationally accepted economic and financial standards that cover a wide range of areas, including securities regulation. With respect to disclosure standards for securities, the International Organization of Securities Commissions (IOSCO) has endorsed a core set of disclosure standards for the nonfinancial statement portions of disclosure documents, and these standards have been widely adopted, including in the United States. Work also is progressing on financial statement convergence, with IOSCO recently recommending that its members permit the use of certain IASC standards for cross-border offerings and listings (as supplemented by reconciliation, disclosure, and interpretation where necessary).

Finally, we have seen how international dialogue can play a role in promoting regulatory convergence in developing areas of the law. For example, IOSCO issued a report two years ago that contained recommendations on various regulatory and enforcement issues posed by securities activities conducted over the Internet. The principles set forth in that report have been widely utilized by jurisdictions as they revise or interpret their securities laws to reflect the impact of the Internet. These are but a few examples of the legal convergence we are seeing today, and with the continued emergence of transnational issuers, financial institutions, and exchanges, I would expect the pace of convergence to continue to accelerate.

Much work remains to be done, however, particularly in promoting legal certainty across borders. Promoting legal certainty is crucial because, without it, innovation will be stifled. Areas where greater convergence of standards would be helpful in this regard include the following: (1) the cross-border enforceability of contracts (for example, with derivatives contracts, the clarification of the treatment of netting, collateral,

rights of set-off, events of default, and other provisions); (2) the development of effective bankruptcy regimes with clear jurisdictional lines; and (3) a rationalization of company takeover law.

Conclusion

As I see it, the challenge before us is complex. The myriad issues confronting us at times seem overwhelming, but at the SEC our task is made easier because of our clear mandate to protect investors and maintain fair and orderly markets. To do anything less would erode investor confidence and ultimately destroy our vibrant securities marketplace.

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