

Law and the Market: The Impact of Enforcement

by John C. Coffee, Jr. *

Introduction

Are the U.S. capital markets losing their competitiveness? A fascinating question, but what does it mean and how can it be intelligently assessed?¹ This essay will explore the newly popular thesis that Draconian enforcement and overregulation is injuring the United States and offer a sharply contrasting interpretation. It will do so, first, by mapping the marked variation in the intensity of enforcement efforts by securities regulators in selected nations and, then, seeking to relate these variations to (i) the cost of equity capital; (ii) the extraordinary listing premium that non-U.S. firms exhibit upon cross-listing on a U.S. exchange;² and (iii) the flight of some foreign issuers from the U.S. markets. Once properly disaggregated, the impact of

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¹ See Interim Report of the Committee on Capital Markets Regulation (November 30, 2006) (hereinafter, the "Paulson Report"). The author is listed as a "Task Force member" on this report. The Paulson Report was swiftly followed by a study by New York City Mayor Michael Bloomberg and Senator Charles Schumer that reached similar conclusions. See Michael Bloomberg and Charles Schumer, "Sustaining New York's and the U.S.'s Global Financial Services Leadership" (January 22, 2007). The author also served as a consultant to this report.

² Data about the magnitude of this cross-listing premium is presented infra at notes 9 and 13 and in the text and notes at notes 101 to 129. Its source is less certain, but at least three complementary explanations are all plausible:

- (1) The act of cross-listing may be a signal that the corporation's future cash flows will be greater than the market previously perceived (possibly because the managers are so convinced of their superior investment prospects that they will take the costly and risky step of listing in the United States markets);
- (2) The act of cross-listing may also be a form of bonding that assures investors that agency costs will be reduced (or at least will be lower than they previously perceived), because the firm's managers have subjected themselves to SEC scrutiny and private and public enforcement systems that are unique to the United States; and
- (3) The act of cross-listing may decrease the discount rate on the market's expectation of future cash flows; this reduction in the discount rate (and hence increase in share price for any given expected level of future cash flows) is the product of reduced informational asymmetry (in part because of the increased enforcement risk), which in turn leads to a narrower bid/asked spread.

high intensity enforcement appears to yield both costs and benefits. In overview, high enforcement intensity may dissuade issuers from entering the U.S. market and thus may be responsible for some decline in the “competitiveness” of the U.S. capital markets. But, at the same time, active enforcement appears to lower a country’s cost of equity capital, and this may attract some foreign issuers, even while it deters others from cross-listing. In effect, firms go both ways,³ and this essay will seek to explain why.

More generally, enforcement may also be the hidden variable that explains much of the apparent difference in the impact of legal origins on financial development. For the last decade, academic theorists have been busily seeking to explain the differing pace of financial development and economic growth across nations. Although many theories have been offered, the best-known have assigned a leading role to law and legal origins in their causal story.⁴ These legal theories have

³ Recent surveys find that many foreign firms have been deterred from listing in the United States by Sarbanes-Oxley but that a distinct subset of foreign firms is bucking this trend and continuing to cross list in the U.S. See Joseph D. Piotriski and Suraj Srinivasan, “The Sarbanes-Oxley Act and the Flow of International Listings” (<http://ssrn.com/abstract=956987>) (January 2007). In effect, there is a separating equilibrium.

⁴ For the range of theories—some stressing geography, some colonial endowments, some openness to trade—see text and notes infra at notes 47 to 49. That financial development drives economic growth is, itself, an idea whose clear formulation traces back to only the early 1990s. See Robert King and Ross Levine, Finance and Growth: Schumpeter Might Be Right, 108 *Quarterly J. Econ.* 717 (1993). Still, in 1997, four young financial economists—Raphael La Porta, Francisco Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, whose work is discussed in detail infra in the text and notes at notes 35 to 56—revolutionized the field by introducing a provocative new thesis that legal origins were a prime factor in shaping financial development. See La Porta, et. al., Legal Determinants of External Finance, 52 *J. Fin.* 1131 (1997). Although their work has generated much controversy, a number of other theorists have agreed. See Paul Mahoney, The Common Law and Economic Growth: Hayek May Be Right, 30 *J. Legal Studies* 503 (2001); Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, “Law, Politics and Finance,” World Bank Policy Research Working Paper No. 2585 (<http://ssrn.com/abstract=269118>) (2001); Raghuram Rajan and Luigi Zingales, The Great Reversals: The Politics of Financial Development in the Twentieth Century, 69 *J. Fin. Econ.* 5 (2003) (finding nations with civil law origins to have initially led in race for financial development, but to have later abandoned the pursuit).

This author has long doubted that law, or at least specific legal rights or provisions, can provide a coherent theory of financial development and has previously argued that, in the early development of

been controversial, in particular because their proponents have been unable to identify any substantive legal differences that appear to be more than trivial, much less capable of explaining worldwide differences in financial development.

This essay does not seek to argue the primacy of law or to insist on law's causal role in financial development. It suggests only that one legal variable—the level of enforcement—does distinguish jurisdictions in a manner that can explain national differences in the cost of capital (especially between common law and civil law countries) and the valuation premium that foreign firms cross-listing into the U.S. (and only the U.S.) display. But whether relative enforcement intensity can explain differences in financial development presents a more complicated question involving the direction of causality. Here, the deeper issue is: does active enforcement precede or follow financial development? In either event, enforcement intensity appears to play a dual role: both enhancing share value for foreign issuers that cross-list into a high enforcement legal regime and deterring many foreign issuers from entering high-enforcement jurisdictions. Thus, reasonable persons can disagree about whether the best policy response is to increase or relax enforcement intensity. Indeed, the issue of the optimal level of enforcement intensity may be the common link among several ongoing and important debates, which need to be distinguished at the outset:

First, on the level of contemporary political discourse, a very public debate has begun over whether overregulation threatens the “competitiveness” of the

securities markets, the role of law was less important than the existence of an open, decentralized, and stable political economy. See John Coffee, The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L. J. 1 (2001). Strong centrist governments appear to have inhibited the growth of securities markets.

United States' capital markets. The Committee on Capital Markets Regulation (better known as the "Paulson Committee") issued an "interim report" in late 2006 concluding "that the United States is losing its leading competitive position as compared to stock markets and financial centers abroad."⁵ Weeks later, in 2007, the Paulson Committee's report was followed by a similar study commissioned by New York Mayor Michael Bloomberg and Senator Charles Schumer and prepared by McKinsey & Co., the consulting firm.⁶ Going beyond the usual criticisms of the Sarbanes-Oxley Act, both reports find that transactions, listings, and trading volume are migrating to less intensively regulated securities markets, most notably those in London and Hong Kong.⁷ Foreign issuers do not truly avoid the U.S. capital market, but instead access it through its private markets (most notably the Rule 144A market), thereby avoiding the public market and most of the SEC's mandated disclosure requirements.⁸ On this view of the data, Sarbanes-Oxley is a deterrent,

⁵ See Paulson Report at ix.

⁶ See Michael Bloomberg and Charles Schumer, *supra* note 1.

⁷ Particular emphasis is placed on where "new equity capital is being raised – that is, in which market initial public offerings (IPOs) are being done." Paulson Report at x. The Paulson Report finds: "As measured by value of IPOs, the U.S. share declined from 50 percent in 2000 to 5 percent in 2005. Measured by the number of IPOs, the decline is from 37 percent in 2000 to 10 percent in 2005." *Id.* Other studies have reached similar conclusions. See, e.g., Joseph D. Piotroski and Suraj Srinivasan, *supra* note 3; Xi Li, "The Sarbanes-Oxley Act and Cross-Listed Foreign Private Issuers" (<http://ssrn.com/abstract=952433>) (March 22, 2007) (finding that foreign private issuers experienced abnormal stock returns of -10%, on average, in response to Sarbanes-Oxley). At the same time, it should also be noted that these less intensively regulated markets are experiencing scandals and a lower rate of growth. AIM, the London Stock Exchange's lightly regulated market for smaller companies and initial public offerings, was slightly down in 2006, and half of its largest IPOs in 2006 are trading below their initial offering price. See Carrick Mollenkemp, Alistair MacDonald, and Ann Davis, "English Lesson: Uncertain AIM: A Hot Market in London Has Its Risks Too," *Wall Street Journal*, December 20, 2006 at p. 1.

⁸ The Paulson Report finds that in 2005, "foreign companies raised 10 times as much equity in the private U.S. markets as in the public markets (\$53.2 billion versus \$4.7 billion)." *Id.* at x. It adds that "of the global IPOs that raised money in non-U.S. markets, 57 percent of these companies (94 percent of the capital raised) chose to raise additional capital in the U.S. private markets." *Id.* Such funds are raised from large institutional investors pursuant to the exemption from registration provided by Rule 144A. See 17 C.F.R. 230.144A (permitting resale of privately placed securities to "Qualified Institutional Buyers").

A wave of "going private" transactions is, however, also currently causing a number of delistings

which has made the U.S. capital markets too costly for those issuers able to opt for other listings. More generally, overregulation appears to be a force that constrains and retards financial development.

But an alternative view is at least equally plausible. A growing body of academic research has found that foreign corporations that do cross-list on a U.S. exchange seem to reap extraordinary benefits: (1) a valuation premium compared to otherwise similar firms that do not cross-list in the U.S., which at least one study finds to average 37% for foreign firms cross-listing on a major U.S. exchange,⁹ and (2) a significant reduction in the cross-listing firm's cost of capital.¹⁰ Read together, this evidence gives rise to a double mystery: (a) What explains this positive market reaction?; and (b) Why do foreign firms appear to be increasingly spurning a premium that is not available elsewhere? The most plausible explanation for the existence of this premium is supplied by the "bonding hypothesis," which explains that by subjecting themselves to the SEC's higher disclosure standards and the

from the London Stock Exchange. See Norma Cohen and Peter Smith, "Delisting Wave Hits London," *Financial Times*, January 2, 2007 at p. 1 (value of companies taken private broke record in 2006 with overall U.K. equities market shrinking 3% as a result). Thus, it is uncertain whether this new preference for "going private" is the product of overregulation in the United States or the low cost of the capital available to the private equity firms that orchestrate such deals.

⁹ See C. Doidge, A. Karolyi, and R. Stulz, Why Are Foreign Firms Listed in the U.S. Worth More?, 71 *J. Fin. Econ.* 205 (2004). These authors find that foreign companies with shares cross-listed in the U.S. had Tobin's q ratios that were 16.5% higher (as of the end of 1997) than the Tobin's q ratios of non-cross-listed firms from the same country. This figure rises to 37% when the foreign firm cross-listed on a major U.S. exchange (i.e., the New York Stock Exchange, Nasdaq, or the American Stock Exchange). *Id.* at 206. In short, the valuation premium is twice as high over non-cross-listing firms when the foreign firm lists on a major U.S. exchange. In a later study, Doidge, Karolyi and Stulz find the historical average listing premium over 1997 to 2005 for foreign firms cross-listing onto major U.S. exchanges to have been 32.6% (but only 14.9% for all firms that cross-list in any way onto the U.S. market). See Doidge, Karolyi and Stulz, "The Valuation Premium for Non U.S. Stocks Listed in U.S. Markets: 1997-2005" (January 3, 2007) at 1. This longer term study, showing a consistent listing premium over eight years, greatly enhances the robustness of their findings.

¹⁰ See L. Hail and C. Leuz, International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?, 44 *J. Accounting Res.* 485 (June 2006) (finding that when non-U.S. companies cross-list in the U.S. market, they incur a cost of capital reduction that averages 13% and ranges as high as 25%).

greater prospect of enforcement in the United States, foreign firms thereby reduce their agency costs.¹¹ Although the finding of a listing premium for the stocks of foreign firms that cross-list in U.S. markets is now well documented and robust,¹² many remain skeptical of the bonding hypothesis, in large measure because the manner by which foreign firms “bond” themselves by listing in the United States remains uncertain.

Even if the source of this premium is uncertain, its absence elsewhere is revealing—much like Sherlock Holmes’ dog that did not bark in the night. The principal other stock exchange on which foreign firms cross-list (namely, the London Stock Exchange) does not offer any similar valuation premium.¹³ Although

¹¹ The term “bonding hypothesis” was coined by this author (although others may have had similar ideas contemporaneously). See Coffee, The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 Nw. U. L. Rev. 641, 707 (1999). See also Coffee, Racing Towards the Top?: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance, 102 Colum. L. Rev. 1757, 1829 (2002). For other studies, see R. Stulz, Globalization, Corporate Finance, and the Cost of Capital, 12 J. Appl. Corp. Fin. 8 (1999); W. Reese & M. Weisbach, Protection of Minority Shareholder Interests, Cross-listings in the United States, and Subsequent Equity Offerings, 66 J. Fin. Econ. 65 (2002) (finding post-listing behavior of cross-listing firms to corroborate the bonding hypothesis). “Bonding” can occur in a variety of ways and is not necessarily the product of increased exposure to liability. By entering the U.S. market, foreign issuers also may expose themselves to the greater scrutiny of securities analysts and institutional investors and may employ underwriters who perform greater due diligence. The relative significance of these various means has not yet been seriously explored. However, the most recent review of the evidence finds that, although the Sarbanes-Oxley Act “increased the expected reporting, regulatory and legal costs of a U.S. listing,” the Act “should strengthen the credibility of listing on U.S. exchanges as a bonding mechanism, thus increasing the expected benefits of a U.S. listing.” See Piotroski and Srinivasan, *supra* note 3, at 4. Indeed, they find that a distinct subset of foreign issuers does cross-list on a U.S. exchange, rather than on the London Stock Exchange, apparently for these reasons.

¹² See *infra* at note 13. For a chart showing the magnitude of this valuation premium for firms cross-listing in the U.S. market for the years 1997 to 2005, see text and note *infra* at note 126.

¹³ Doidge, Karolyi and Stulz have reviewed data covering listings on the New York Stock Exchange and the London Stock Exchange from 1990 to 2005. At no time over this period do they find cross-listings on the London Stock Exchange to have been associated with a listing premium, but at all times over this period, cross-listings on the NYSE were associated with a listing premium, whose magnitude varied from time to time. See Craig Doidge, Andrew Karolyi, and Rene Stulz, “Has New York become less competitive in global markets? Evaluating foreign listing choices over time,” (April 2007) (<http://www.ssrn.com/abstract=982193>). They also have found that U.K. firms that cross-list in the U.S. incur a valuation premium. See Doidge, Karolyi and Stulz (2007), *supra* note 9. Earlier studies have found that companies cross-listing on the London Stock Exchange did not outperform a control of non-cross-

foreign securities markets can compete with U.S. markets by offering increased liquidity and visibility with less regulation, they seemingly cannot offer valuation premiums. Nor do they appear to try, as they market their services instead by stressing that they avoid imposing additional governance requirements on foreign issuers beyond those of the issuer's home jurisdiction. But this only deepens the mystery. Even if Sarbanes-Oxley did impose significantly increased costs for internal accounting controls, a valuation premium on the order of 30% or more would seemingly motivate rational issuers to accept very significant transaction costs.¹⁴ To spurn this premium seemingly implies that these issuers are not seeking to maximize the value of their shares. Does this seem plausible?

An obvious answer is: it all depends on whose self-interest is to be maximized! The maximization of share value is not the only rational goal. The firm's interest in increasing its share value can be overridden, for example, by the interest of its controlling shareholders in maintaining unfettered access to the private benefits of control or of its managers in avoiding enforcement penalties. Simple as this answer sounds, its implication is that the U.S. might be the listing venue for higher quality issuers that wish to pursue strategic plans that require them to obtain low-cost equity financing or to bond with their shareholders, while London (and other markets) provide instead a comfortable refuge for firms with a control group intent on enjoying the private benefits of control (or a management pursuing other self-interested aims). The result is a separating equilibrium, as some foreign

listing firms from the same jurisdictions (whereas firms cross-listing in the U.S. did outperform the control group). See M. Pagano, A. Roell, and J. Zechner, "The Geography of Equity Listing: Why Do European Companies List Abroad?" (October 1999) (<http://ssrn.com/abstract=209313>).

¹⁴ 32.6% appears to have been the average premium for foreign firms cross-listing to the three major U.S. exchanges over the period 1997 to 2005. See Doidge, Karolyi and Stulz (2007), *supra* note 9, at 1.

firms list in the U.S. to bond and more migrate to London to enjoy “business as usual.”¹⁵

Of course, this answer may be oversimple. Corporations could well prefer to list in London for efficiency-enhancing reasons as well.¹⁶ But to posit such a theory one must explain why the market rewards only a listing on a U.S. exchange. That there is such a premium and that it is being spurned by many foreign companies presents a puzzle that leads one to ask: what is distinctive about the U.S. markets? Economists have tended to focus on differences in disclosure or corporate governance standards.¹⁷ Although the U.K. regulates the foreign issuer considerably less rigorously than does the U.S. and also less rigorously than it regulates its own

¹⁵ This author originally advanced this interpretation in 2002 that securities markets would compete through specialization by tailoring their market to different clienteles. See Coffee, Racing Towards the Top?, supra note 11, at 1798-99. Hence, convergence should not be the norm, at least with respect to securities exchanges and their listing requirements; rather, competition produces specialization, not convergence. No suggestion is here intended that the only explanation for why many foreign corporations prefer to list in London is that controlling shareholders wish to continue to receive private benefits of control. It is presented as a partial explanation, but not the exclusive one.

¹⁶ Undoubtedly, some foreign corporations listed on the London Stock Exchange in the belief that they were avoiding inefficient and costly regulation that the U.S. imposed on cross-listed firms. The market generally may have perceived the impending enactment of Sarbanes Oxley in this way. See Piotrski and Srinivasan, supra note 3, at 2 (citing self-reporting studies). More particularly, Kate Litvak has found that the stock prices of non-U.S. companies listed on the major U.S. exchanges declined in comparison to the stock prices of matching, non-cross-listed companies from the same industry and country and similar in size. In addition, the decline was more severe for non-U.S. companies listed on exchanges than for non-U.S. companies that had only made a more limited entry into the U.S. via private placements or Rule 144A. See Kate Litvak, “The Effect of the Sarbanes-Oxley Act on Non-U.S. Companies Cross-Listed in the U.S.” (<http://ssrn.com/abstract=876624>) (January 2007); see also Xi Li, supra note 7 (finding negative 10% abnormal stock returns). This research suggests at least that Sarbanes-Oxley and U.S. regulation was perceived as harmful to investors in foreign firms (and hence lighter regulation in London was perceived as beneficial). For a further analysis, see text and notes infra at notes 141 to 142.

¹⁷ Economists have argued not only that improved disclosure reduces uncertainty and informational asymmetries, but that it can also reduce non-diversifiable risk. For a brief review of this literature, see Hail and Leuz, supra note 10, at 487. Studies have found that foreign firms cross-listing on U.S. exchanges do provide superior financial disclosures to otherwise similar non-cross-listing firms. See T. Khanna, K.G. Palepu, and S. Srinivasan, Disclosure Practices of Foreign Companies Interacting With U.S. Markets, 42 J. Accounting Research 475 (2004). Others have developed indices to measure differences in the quality of the corporate governance at cross-listing versus non-cross-listing firms and have reported that firms cross-listing in the United States (but only in the United States) rank significantly higher on these indices. See Gordon L. Clark and Dariusz Wojcik, THE GEOGRAPHY OF FINANCE at 133-161 (forthcoming 2007). This author has no dispute with either assertion, but believes that the enforcement variable may be the underlying force that drives issuers to improve their disclosure.

domestic companies,¹⁸ it is still difficult to believe that these differences are alone sufficient to explain the existence of a significant listing premium on the major U.S. exchanges and none on the London Stock Exchange. The exemption of most foreign issuers from the U.K.'s "comply or explain" disclosure policies regarding corporate governance or from the U.K.'s Takeover Code might explain some modest difference, but not the enormous disparity in Tobin Q ratios that recent studies have

¹⁸ The relevant comparison here is not the general listing standards of the New York Stock Exchange ("NYSE") and the Financial Services Authority ("FSA"), which adopts the listing standards applicable to the London Stock Exchange ("LSE"), but their special rules applicable to foreign issuers. In the United States, a foreign issuer need not file periodic disclosure reports with the SEC on a quarterly basis, but need only file an Annual Report on Form 20-F (plus copies of its press releases). This is the only major concession that the SEC makes to foreign issuers, and Section 301 of Sarbanes-Oxley requires the foreign issuer to have an independent audit committee. See 15 U.S.C. 78(f)(m).

In contrast, the FSA goes well beyond the minimum standards required by the major EC directives and requires "super-equivalency" for U.K. issuers; that is, U.K. domestic companies are required to meet "gold-plated" standards to provide investor protector, but these same standards are not made applicable to most foreign issuers. See FSA Handbook, "Listing, Prospectus and Disclosure, United Kingdom Authority listing rules," available at <http://fsahandbook.info/FSA/html/handbook>. For example, the FSA's listing rules subject domestic companies to special rules with regard to related party transactions (see U.K. Listing Rule 11.1) and to the U.K.'s "comply or explain" disclosure standards for corporate governance (see U.K. Listing Rules 9.25 and 9.26). However, the Listing Rules require far less of a foreign company which applies for a "secondary listing" of its equity securities, and most foreign issues apply for such a secondary listing (based on having a primary listing in their home country). Section 14 of the U.K. Listing Rules covers these companies, and thus the U.K. Listing Rules governing preemptive rights (Listing Rule 9.3.11 and 9.3.12) are inapplicable to such "overseas listed companies." In general, the provisions of the U.K. Listing Rules seeking to protect minority shareholders do not apply to "overseas listed companies" with a secondary listing. See Iain MacNeil and Alex Lau, International Corporate Regulation: Listing Rules and Overseas Companies, 50 *International and Comparative Law Quarterly*, 787, 802-803 (2001). Such "overseas listed companies" with a secondary listing on the LSE are required only to: (1) maintain a listing in a recognized market (Listing Rule 14.3.1); (2) ensure a minimum proportion of shares remain in public hands (Listing Rules 14.2.2 and 14.3.2); (3) seek listings for further tranches of securities of the same class as listed (Listing Rule 14.3.4); and (4) provide certain documents and notifications to the FSA (Listing Rules 3.3.2 to 3.3.8). In addition, overseas listed companies are not subject to the City Code on Takeovers and Mergers promulgated by The Panel on Takeovers and Mergers. See Introduction, Section 3, to The City Code on Takeovers and Mergers at p. A2. This differential in regulation has produced some recent concern in the U.K. that foreign firms are regulated too lightly. See Jill Treanor, "Fears Over Light-Touch Regulation of Foreign Firms," *The Guardian*, February 27, 2007, at p. 33.

Otherwise, both the SEC and the FSA observe disclosure standards that comply with IOSCO's disclosure standards, which were first adopted in 1990. The SEC does go marginally beyond the IOSCO standards, and its accounting rules are also different. See R. Karmel, Will Convergence of Financial Disclosure Standards Change SEC Regulation of Foreign Issuers?, 26 *Brooklyn J. Int'l L.* 485, 492-94 (2000). But it is open to debate which country's accounting rules are today more rigorous.

found.¹⁹ In contrast, the failure of the U.K. to effectively enforce its own insider trading restrictions could account for much of this difference.²⁰ Further, even domestic U.K. firms show a higher Tobin's Q ratio when they cross-list in the U.S. This suggests that the disparity cannot be explained simply in terms of the U.K.'s lighter regulation of foreign firms.

In addition, the one formal legal difference between the two markets that has received the most analysis and debate has been the more costly accounting controls mandated in the U.S. by Section 404 of the Sarbanes-Oxley Act.²¹ But if these additional costs are wasteful (as much commentary has suggested²²), the valuation premium should attach instead to a London listing, not an NYSE listing. Moreover, whatever Sarbanes-Oxley did or did not do, it cannot be used to explain trends and developments that began well before its passage. As discussed later, both a decline

¹⁹ See text and notes *supra* at notes 9 and 14.

²⁰ Insider trading does appear to be relatively pervasive on the London Stock Exchange and to have increased significantly between 2000 and 2004. See Nuno Monteiro, Qamar Zaman and Susanne Leitterstorff, "Updated Measurement of Market Cleanliness," FSA Occasional Paper at 4-5 (March 2007). This report further finds that "no major enforcement action had taken place in the period under examination." *Id.* at 4. Other research has found that the prevalence of insider trading does measurably affect the cost of equity capital, widening bid/asked spreads and reducing liquidity. Moreover, enforcement of insider trading laws does appear to reduce the cost of equity capital. See Utpal Battacharya and Hazem Daouk, The World Price of Insider Trading, 57 *J. Fin.* 75 (2002).

²¹ Section 404 of the Sarbanes-Oxley Act, 15 U.S.C. § 7262, requires that the corporation's management shall assess in the corporation's annual report "the effectiveness of the internal control structure and procedures of the issuer for financial reporting" and that its auditor "shall attest to, and report on, the assessment made by the management of the issuer." In Auditing Standard No. 2, the Public Company Accounting Oversight Board ("PCAOB") issued detailed rules that required the auditor to undertake a full scale audit in making this "assessment" and to find that the corporation had a "material weakness" if there was more than a "remote" prospect of a financial statement restatement. Auditing Standard No. 2 proved to be very costly and was revised significantly in 2006. For an overview, see Securities Exchange Act Release No. 34-8672 ("Management's Report on Internal Control Over Financial Reporting") (December 27, 2006), 71 FR 77635.

²² The Paulson Report estimated that Section 404 gave rise to compliance costs which totaled between \$15 and \$20 billion in 2004. See Paulson Report at p. 115, This was based in turn on studies by Financial Executives International and Charles River Associates that placed the average cost per company in 2004 at \$4.36 million or between \$1.24 million and \$8.51 million, depending on the size of the company, respectively. *Id.* at 126.

in the valuation premium and the flight of foreign issuers from the U.S.'s markets appeared well prior to the passage of Sarbanes-Oxley.²³

At this point, this essay's thesis crystallizes: disparities in enforcement may be able to explain what marginal differences in formal legal rules cannot. Such a thesis also intersects with a second major debate: what factors best explain financial development? Once again, intensity of enforcement may be the factor that best distinguishes the U.S. from other international market centers and that explains the interconnected phenomenon of issuer flight from the U.S. and the valuation premium assigned to those foreign firms that do enter the U.S. Although financial economics has (belatedly) become interested in the impact of legal rules on financial development, most of this research has been on a global comparative level, with little attention being given to the possibility of "American exceptionalism." To an unfortunate extent, this research has been obsessed with finding differences between countries with common law origins and those with civil law origins—and therefore it has missed the striking fact that the United States is an outlier, differing more from other common law countries than they in turn do from civil law countries.

Beginning in the late 1990s, a talented team of financial economists—known universally today as "LLS&V"²⁴—reported that countries with "common law" legal origins experienced rapid financial development, while countries with "civil law origins" did not. It is an understatement to say that these findings generated

²³ See text and notes *infra* at notes 126 to 128.

²⁴ "LLS&V" stands for Raphael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny. Their most cited article is probably La Porta, et. al., Law and Finance, 106 J. Pol. Econ. 1113 (1998). Their first paper to state their common law origins thesis was La Porta et. al., The Legal Determinants of External Finance, 52 J. Fin. 1131 (1997).

controversy. Under the LLS&V interpretation, small and (to lawyers) inconsequential legal differences were assigned great weight and presented as the minority shareholders' shield against exploitation by the majority.²⁵ Others joined in this search to find the hidden legal rules that facilitate development, and at times this inquiry resembled the medieval quest for the philosopher's stone that could turn lead into gold.

Nonetheless, the intent of this quest was far from silly. It was (and is) logical to believe that there are legal preconditions to financial development. As LLS&V posited, financial development requires not only that property rights be respected and contracts enforced, but also that investors and minority shareholders be protected against exploitation by controlling shareholders. Initially, LLS&V announced that the common law accomplished this, vastly outperforming the civil law in encouraging financial development, with French civil law performing particularly poorly.²⁶

Provocative and polarizing as this conclusion was, LLS&V were less successful at identifying the specific legal rights that fostered minority protection and hence financial development. Although their core idea that there must be an

²⁵ LLS&V developed an "Antidirector Rights Index" of shareholders protection rules, based on data from 46 countries, to serve as a measure of legal protection for minority shareholder rights. See La Porta, et al., Law and Finance, supra note 24. Only six factors were included in this index: "proxy by mail allowed"; "shares not blocked before meeting;" "cumulative voting or proportional representation;" "oppressed minorities mechanism;" "preemptive rights"; and "percentage of share capital to call an extraordinary shareholders' meeting." Corporate lawyers would generally view several of these protections as having only modest value; for example, preemptive rights and cumulative voting are generally dispensed with in the United States. Some critics have also charged that LLS&V obtained their results by inconsistent coding of these variables. See Holger Spamann, "On the Insignificance and/or Endogeneity of La Porta et al.'s, 'Anti-Director Rights Index' Under Consistent Coding." (<http://ssrn.com/abstract=894301>)(March 2006).

²⁶ For a concise summary, see Edward Glaeser and Andrei Shleifer, Legal Origins, 117 Q. J. Econ. 1193, 1194 (2002) ("On just about any measure common law countries are more financially developed than civil law countries.").

institutional and legal basis for economic development has gained wide acceptance, they have persuaded few as to the identity of the specific legal rights critical to financial development.

Why has the search for significant legal differences proven so elusive? Here, this essay intersects with a third debate: in studying the differences between legal systems, on what should one focus? LLS&V have largely focused on substantive doctrinal differences—i.e. “law on the books.” Others have looked at the law in operation, and particularly at enforcement.²⁷ In fact, this essay will suggest that the leading difference between civil and common law systems and between the U.S. and the rest of the world over much of the last century has been enforcement intensity. This difference was hardly hidden, and might have been detected by researchers early on, but was missed, largely because of researchers’ steadfast focus on “law on the books” – that is, on formal and substantive legal rules. Understandably, formal legal rules are easier for economists to code, measure, and incorporate into their regression equations, but they may have little to do with reality of actual practice, particularly in developing countries.

In fairness, students of economic development, including LLS&V, have begun to shift their attention to enforcement.²⁸ Are rules and rights enforced in actual practice and at what cost? How significant is the deterrent threat to those who might violate a legal rule? Although these are better questions than “what does the

²⁷ At least one economic study has departed from this focus on “law on the books” and indeed found that it is the enforcement, not the enactment, of statutes that yields measurable results. See Utpal Battacharya and Hazem Daouk, *supra* note 20 (finding that actual prosecutions for insider trading did reduce the cost of capital in a jurisdiction, but that the passage of an insider trading law did not).

²⁸ See La Porta, López-de-Silanes, Shleifer, What Works in Securities Laws?, 61 J. Fin. 1 (2006) (hereinafter, “What Works?”).

law on the books say?,” enforcement can still be measured in different ways. Unfortunately, LLS&V chose, once again, to measure enforcement largely in terms of a formal analysis of statutes: what was the legal status and powers of the securities regulator across different countries.²⁹ In so doing, they continued to focus on the more easily measured “law on the books.” Even if a regulator is endowed with ample power and authority, it may still lack an adequate budget to be effective, or it may be constrained by political forces that preclude it from taking action, or it may simply be indolent and prefer to enjoy the quiet life.

In any event, the more satisfactory approach to measuring enforcement is to focus on inputs and outputs: what was the size of the regulator’s budget and staff in comparison to some objective, market-adjusted benchmark (such as market capitalization or gross domestic product)? How many enforcement actions were actually brought in the jurisdiction (both in absolute numbers and again on a market-adjusted basis)? This data is less easily assembled, but preliminary attempts at cross-country measurement of enforcement efforts have now been conducted. What they show are two outstanding and unambiguous facts:

(1) “Common law” and “civil law” countries differ markedly in their regulatory intensity, with the former expending vastly greater resources on enforcement by any measurement standard; and

(2) In terms of actual enforcement actions brought and sanctions levied, the United States is an outlier, which, even on a market-adjusted basis, imposes financial penalties that dwarf those of any other jurisdiction.

²⁹ As discussed *infra* in the text and notes at notes 41 to 44, this is the approach taken in “What Works?,” which evaluates enforcement in terms of the power and independence of the securities regulator, but contains no data on budgets or prosecutions.

The United States is exceptional in other ways as well. In the United States, public enforcement of law is supplemented by a vigorous, arguably even hyperactive, system of private enforcement. Relying on class actions and an entrepreneurial plaintiff's bar motivated by contingent fees, the United States's system of private "enforcement by bounty hunter" appears in fact to exact greater annual aggregate sanctions than do its public enforcers. This system has no true functional analogue anywhere else in the world.³⁰ Finally, the U.S. prosecutes securities offenses criminally—and does so systematically.³¹ In contrast, even in the U.K. and even in the case of "core" offenses, such as insider trading, criminal sanctions appear to be rarely invoked.

How then do the pieces of this puzzle fit together? Arguably, the greater institutional commitment of the United States to enforcement – administered by multiple and often competing enforcers, private and public – may be the underlying motor force that explains both the "bonding hypothesis" and the reluctance of some foreign issuers to enter the United States, even if they thereby fail to maximize their share value. The deterrent threat generated by the U.S. commitment to enforcement does not, however, affect all foreign issuers equally. Rather, it will disproportionately repel particular classes of issuers: most notably those with controlling shareholders who find it more advantageous to consume the private benefits of control than to maximize their firm's share price. In contrast, companies

³⁰ Canada and Australia come the closest because they recently have authorized class action-like proceedings. See Phillip Anisman and Garry Watson, Some Comparisons Between Class Actions in Canada and the U.S.: Securities Class Actions, Certification and Costs, 3 *The Canadian Class Action Review* 467 (2006). Securities class actions covering the secondary market in Canada date only from December 31, 2005. *Id.* at 499.

³¹ See text and notes *infra* at notes 83 to 92.

with attractive investment or merger opportunities, but requiring either equity capital or listed stock that can be used as a currency for acquisitions, may still find it necessary or desirable to bond themselves and thereby lower their cost of capital.

As a result, while competition is often thought to lead to convergence, competition among securities exchanges may instead lead not to uniformity, but to increased specialization. That is, some exchanges (most notably in the United States) will offer the valuation premia and cost of capital reductions that strong enforcement encourages, while other exchanges (most notably outside the United States) may attract foreign listings by offering “lighter” regulation. Although “lighter” regulation may not improve the cross-listing firm’s cost of capital, it could still attract foreign issuers by offering heightened liquidity and visibility without impeding their controlling shareholders’ enjoyment of private benefits. The ironic bottom line here could be that the policies that maximize the private wealth of the exchanges could minimize social wealth for the nation. Indeed, U.S. exchanges may be seeking to outflank the stricter legal controls imposed on them by U.S. law by acquiring foreign exchanges that are beyond the reach of U.S. regulators.³²

This essay views the migration of foreign issuers to non-U.S. market venues in a very different light than does the Paulson Report or the conventional critiques of Sarbanes-Oxley. From the U.S.’s perspective, it could even be desirable that some foreign issuers not list in the United States nor have easy access to U.S. retail investors. To be sure, this counter-view could be Panglossian. Arguably, there are

³² The New York Stock Exchange has merged with Euronext, N.V., the largest European exchange, but a condition of this merger was that Euronext would remain subject to European regulation. Meanwhile, Nasdaq is pursuing a tender offer for the London Stock Exchange. Some commentators believe that a motive underlying these acquisition efforts is to induce the SEC to modify its rules so as to harmonize them with Europe. See “Flying in Formation: Stock exchanges,” *The Economist*, February 3, 2007.

efficiency arguments in favor of allowing controlling shareholders to receive special private benefits.³³ At some point, the possibility of overenforcement must also be acknowledged; more cannot always be better. When is it too much? Here, the line between public and private enforcement deserves special attention.

Other major questions also merit attention. For example, why do “common law” and “civil law” countries seem to diverge systematically over the intensity of their enforcement efforts? Why also is the U.S. the world’s unique outlier? Finally, what policy options do U.S. regulators truly have? Here, even provocative studies, such as the Paulson Report, tend to pull their punches. Although there is little prospect that the U.S. will abandon its commitment to enforcement, it could conceivably consider alternative policies for foreign issuers. For example, an opt-in approach could be formulated that would give them the choice of whether or not to become fully subject to U.S. standards in order to achieve the “bonding” valuation premia. Alternatively, the U.S. could simply devote less enforcement resources to pursuing violations by foreign issuers (who are in any event not fully subject to the U.S.’s disciplinary reach).

As is by now obvious, this essay will necessarily cut across a variety of debates, conducted on a variety of levels. To set the stage, Part I will begin with a summary of the voluminous debate over the LLS&V thesis that the common law outperforms the civil law. Part II will then turn to the evidence that common law and civil law systems do diverge significantly in their approach to enforcement. Part III will examine the evidence supporting the “bonding” hypothesis and the

³³ For such an argument, see Ronald Gilson, Controlling Shareholders and Corporate Governance: Complicating Corporate Taxonomy, 119 Harv. L. Rev. 1641 (2006).

significance of its recent fluctuations. The Paulson Report notes that the valuation premia incident to a U.S. listing have recently declined and suggests that it is a response to Sarbanes-Oxley.³⁴ The data, however, show that this decline preceded Sarbanes-Oxley, and listing premia are again increasing. Part IV will move to the more abstract level of political economy to ask: what factors explain the significant variation across countries in the level of enforcement activity? Finally, Part VI will return to the policy level: what options are feasible for U.S. policy-makers? Can we disaggregate the concept of enforcement and find contexts where less might be better?

I. The Legal Origins Debate

Our story begins with the work of LLS&V. Prior to their trail blazing articles in 1997 and 1998, it was already accepted that a strong financial sector acted as an engine of economic growth.³⁵ But LLS&V redirected this research by focusing on “legal origins.” Using a sample of some 49 countries, they found a statistically significant relationship between the origins of a country’s laws and its level of financial development.³⁶ Dividing the world into three categories of legal origins –

³⁴ See Paulson Report at 47-48.

³⁵ See, e.g., Levine and Zervos, Stock Markets, Banks, and Economic Growth, 88 American Econ. Rev. 537 (1998); see also King and Levine, supra note 4.

³⁶ See La Porta, López-de-Silanes, Shleifer and Vishny, Law and Finance, 106 J. Pol. Econ. 1113 (1998). This methodology has attracted considerable criticism. The most amusing of these critiques has been offered by Professor Mark West. See Mark D. West, in "Legal Determinants of World Cup Success" (2002), Michigan Law and Economics Research Paper No. 02-009, available at SSRN: <http://ssrn.com/abstract=318940> or DOI: 10.2139/ssrn.318940. He argues that if factors such as “rule of law” and legal origin matter, they might also matter in other areas of human endeavor, such as success in soccer. Using primary independent variables identical to the ones used by LLS&V in their 1997 regressions (among which are legal origin and rule of law), and basing his study on the same 49 countries, Prof. West controls for the number of professional soccer players per capita, whereas LLS&V controlled for GDP growth and the logarithm of real GNP. He discusses the possibility that teams from countries based on the French civil law system are likely to play better football, because, where vestiges of the Napoleonic Code survive, discretion is typically removed from coaches and managers in the same manner that civil law system curtails judicial activism. However, he concedes, ‘maybe--just maybe--other forces

common law, German and Scandinavian civil law, and French civil law – they ranked the common law countries first and French civil law countries last. According to their findings, “common law origin” countries had grown at a faster rate (4.3% per capita) than “French civil law origin” countries (3.18%).³⁷

But what does a country do that has an inferior “legal origin?” Is it condemned for eternity to a limbo of limited financial development? By 2000, LLS&V were ready to move from diagnosis to prescription and offer advice to policy planners. They wrote:

“[T]he evidence on the importance of the historically determined legal origin in shaping investor rights ... suggests at least tentatively that many rules need to be changed simultaneously to bring a country with poor investor protection up to best practice.”³⁸

In short, “civil law origin” countries should quickly convert to “common law” corporate governance rules.

But can the leopard change its spots simply by means of legislative reform? If the common law is superior to the civil law, one must ask what are the key characteristics of the common law. The usual, if oversimplified, answer is that the common law is judge-made, while the civil law is legislatively derived. If so, then legislative reform of a “civil law” jurisdiction’s corporate and bankruptcy laws could hardly establish the same strong English tradition of independent judges, able to resist the other branches of government in defense of property rights. Thus, it is debatable whether the LLS&V prescription truly follows from their research.

are at work’.

³⁷ See La Porta, et. al., Legal Determinants of External Finance, 52 J. Fin. 1131, 1138 table 11 (1997).

³⁸ See La Porta, et. al., Investor Protection and Corporate Governance, 58 J. Fin. Econ. 3, 20 (2000).

At this point, the question of what is being measured becomes even more tangled. LLS&V primarily focused on the substantive legal protections afforded minority shareholders and creditors. But, even in common law systems, these bodies of law are primarily statutory, and relatively little room is left for judicial law making – the supposed defining characteristic of common law.³⁹ Ironically, it is the most statutory (and thus “civil law-like”) aspects of corporate governance in common law countries whose value the LLS&V research seems to affirm.

LLS&V also gave relatively little attention to the issue of enforcement. In Law and Finance, their most cited paper, they purport to consider what they call “enforcement variables,” but by this term, they mean more generalized factors describing the legal environment, such as “the efficiency of the legal system” and the “rule of law.”⁴⁰ But they never consider measures of enforcement inputs (such as budget or staff size) or measures of enforcement output (such as actions brought or penalties levied). Such data is not easily available, whereas more generalized measures (such as efficiency ratings) can be conveniently borrowed from ratings by independent organizations.

Nonetheless, what is most easily measured is not necessarily what is most relevant. Take, for example, using measures of judicial corruption as a proxy for strong enforcement. In some legal systems – Germany or Scandinavia – judges are recruited early in their careers and are trained and promoted within a judicial bureaucracy. Instances of corruption in such a system are exceedingly rare. In

³⁹ For this criticism, See Pagano and Volpin, The Political Economy of Corporate Governance, 95 Amer. Econ. Rev. 1005 (2005). For the same critique (and others), see Kenneth W. Dam, THE LAW-GROWTH NEXUS: The Rule of Law and Economic Development, at 32-33 (2006).

⁴⁰ See La Porta, et. al., Law and Finance, supra note 36, at _.

contrast, in the United States, judges in state courts are largely elected, and they therefore need to raise funds through political contributions. Worse still, in some states, judicial candidates come from within political machines, with their loyalty to the machine being a prime criterion for advancement. Not surprisingly, the danger of corruption is non-trivial in U.S. state courts. This evidence says little, however, about the level of enforcement. In Germany and Scandinavia, the courts may be pure and unconflicted, but neither prosecutors or private plaintiffs may have sufficient incentive or budgets to bring enforcement actions. Thus, enforcement is an issue to which LLS&V were largely oblivious by instead focusing on independence and integrity.

In a 2006 paper, What Works in Securities Law?,⁴¹ the first three authors of the LLS&V quartet did examine the issue of enforcement in more detail, but again, they failed to incorporate data about enforcement inputs or outputs. Instead, they developed a public enforcement index based on formal characteristics of the regulator, assigning weight to such factors as the regulator's independence from the executive branch, its investigative powers, its capacity to impose civil sanctions, and the range of criminal sanctions available.⁴² These individual weights were then added to generate a comparative index of public enforcement. Ignored by all this is

⁴¹ See supra note 28.

⁴² In analyzing public enforcement, the three authors "focus on four broad aspects of public enforcement." What Works?, supra note 28, at 10. First, they evaluate the "attributes" of the securities regulator: Who appoints its members? Can they be removed by a higher authority? Does it focus on securities markets alone? Does it have the power to regulate primary offerings and listing rules on stock exchanges? Id. at 11. Second, they rate the investigative powers of the securities regulator. Can it subpoena documents and witnesses? Id. at 12. Third, they evaluate the civil sanctions that the regulator can levy. Finally, they examine the criminal penalties that are authorized and rank the regulator in terms of the severity of these penalties. Although they find that securities regulators in common law countries have both "more extensive investigative powers" and harsher "criminal and non-criminal sanctions" (Id. at 15), which seems correct, they never assess or attempt to measure if these powers are actually used.

the possibility of a lazy, corrupt or incompetent regulator, who has broad formal powers, but does nothing in fact. Interestingly, the three authors found that their index for public enforcement did not correlate well with their measures of financial development.⁴³ Accordingly, they reached the breathtakingly overbroad conclusion that public enforcement was relatively unimportant (at least in comparison to private enforcement) to the development of securities markets.

Any attempt to summarize all the methodological criticisms levied at LLS&V could fill an entire article that would be much longer than this one. Still, the principal objections raised by critics include the following:

(1) Although French inefficiency is assumed, France in fact experienced greater economic growth than the U.K. over most of the period since 1820;⁴⁴ French civil law seems then to have worked adequately, at least for France;

(2) The data supporting the conclusion that “common law” countries have outperformed “civil law” countries economically is largely driven by the spectacular economic failure of Latin America over the prior century, but whether Latin America should be deemed to be of “French civil law origin” is highly debatable;⁴⁵

(3) The LLS&V coding system is suspect, with some critics charging that it has been inconsistently applied;⁴⁶

⁴³ Id. at 19-20.

⁴⁴ For a summary of evidence on this point, see K. Dam, *supra* note 39, at 38-39.

⁴⁵ The Napoleonic influence over Latin America was short-lived, while the U.S. influence may have had a far longer duration. See K. Dam, *supra* note 39, at 42-44.

⁴⁶ See Holger Spamann, “On the Insignificance and/or Endogeneity of La Porta et. al’s ‘Anti-Director Rights Index’ Under Consistent Coding” (<http://ssrn.com/abstract=894301>) (March, 2006).

(4) Vivid counter-examples can be given both of economies that have developed rapidly from “civil law origins” and others that have stagnated, notwithstanding common law origins;⁴⁷ and

(5) Many doubt that law ranks anywhere near as high as structural factors, such as geography,⁴⁸ openness to trade,⁴⁹ or colonial endowments,⁵⁰ in explaining post-Colonial economic growth; from this perspective, the “failure” of “French civil law” was more the product of its adoption in too many tropical climates (whereas the common law found its way to adoption in healthier, more temperate regions).

Still, to the extent that law does matter, the most telling criticism of LLS&V may be that they ignore public law, focusing almost exclusively on private law. As this author has previously argued,⁵¹ the first securities markets developed more or less contemporaneously in Amsterdam and London, the former a civil law country and the latter the archetypal example of a common law country. What was critical to their origins in both countries was the open, pluralistic, and decentralized nature of the society in which they took root, in particular the absence of a dominant centralized bureaucracy that exercised control over all significant economic initiatives.⁵² In England at the time when the first securities market arose, an

⁴⁷ South Korea, Japan, China, and Costa Rica have civil law origins (largely Germanic), while some of the poorest countries in Sub-Saharan Africa have common law origins (e.g., Kenya, Liberia, Nigeria, etc.).

⁴⁸ See generally, Jared Diamond, *GUNS, GERMS AND STEEL: The Fates of Human Societies* (1997). The dominant theme of this analysis is that tropical countries faced severe health problems that limited economic development and limited the effort made to direct capital to them.

⁴⁹ Ragan and Zingales, *supra* note 3 (arguing that free trade discourages dominant industries from seeking to block development of securities markets).

⁵⁰ See, e.g., Daron Acemoglu, Simon Johnson, and James Robinson, *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 *Amer. Econ. Rev.* 1369 (2001).

⁵¹ See John Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 *Yale L. J.* 1, at 62 (2001).

⁵² *Id.* at 59-64 (arguing in part that self-regulation was more easily accepted in common law countries). For a similar and very detailed assessment of English culture and its shared characteristics with Dutch culture

entrepreneur could, over the course of a career, open a brewery, expand it, and grow rich (and ultimately be knighted for his success), all without the intervention or approval of any state bureaucracy. In contrast, on the Continent, strong statist bureaucracies (particularly in France) might have required the same entrepreneur to secure their favor and approval. Although England and France may have been poles apart in this regard, the difference was not their private law, but their public law – the degree of economic freedom and authority that they gave the entrepreneur. Whatever best explains the absence of an overarching, centralized bureaucracy in England and the Netherlands at the time that both witnessed the first appearance of securities markets, it is probably not their private law, but rather their public law that (1) had already strengthened the position of the merchant middle class and made them relatively independent of any absolutist monarch, (2) encouraged decentralization and self-regulation, and (3) tolerated and encouraged individual initiatives.⁵³

At their outset, securities markets were autonomous and self-regulating. Not until the late 19th Century (in the U.K.) and the early 20th Century (in the U.S.) was securities regulation enacted to control these markets.⁵⁴ That they were granted such autonomy is, of course, a function of the basic political economy of the broader society in which they were embedded. Above all, individual autonomy was the norm. To explain this preference for autonomy requires, however, a broader

of the same era, see Alan MacFarlane, *THE RIDDLE OF THE MODERN WORLD* (2000) at 280-285.

⁵³ On these themes, see further A. MacFarlane, *supra* note 52, at 285-90, and Coffee, *supra* note 51, at 59-64.

⁵⁴ In the United Kingdom, the Directors Liability Act of 1890 liberalized the law of deceit (and was later copied by the Securities Act of 1933). In the United States, “Blue Sky” statutes were enacted in most states to govern securities transactions, beginning with a Kansas statute in 1911. For a fuller discussion of how U.S. securities markets developed prior to the existence of any comprehensive law governing securities transactions, see Coffee, *supra* note 51.

explanation of the structure of these societies. As Max Weber long ago recognized, one must look beyond narrow legal rules to the more fundamental conceptions that differentiated Protestant from Catholic Europe and strongly centralized states from constitutional democracies.⁵⁵

All that said, LLS&V still deserve much credit for recognizing the arresting fact that financial development seems to have occurred earlier and more easily in common law countries than in civil law ones. But what else distinguishes these rival systems besides their legal origins? At this point, it is necessary to move away from the simplifying assumption that the world can be divided into a simple dichotomy of common law versus civil law.

II. The Comparative Research on Enforcement

If differences in substantive legal rules seem unlikely to explain the gap between civil and common law countries in terms of the development of their securities markets, an obvious alternative theory is that countries with more developed markets may invest more in monitoring and regulating them. This hypothesis might sound obvious, but it is precisely contrary to the hypothesis that several recent commentators have advanced. In general, commentators have argued that civil law countries experience a lower rate of growth because they are “overregulated” by bureaucrats.⁵⁶ The premise then is that civil law jurisdictions are more “regulatory” than common law ones. These theories may still be salvageable,

⁵⁵ For a representative account of Weber’s view of the relationship between law and economic growth, see D. Trubek, Max Weber on Law and the Rise of Capitalism, 1972 Wisc. L. Rev. 720 (1972). Weber, however, regarded the common law, itself, as backward and resistant to systematization. See 2 Max Weber, *Economy & Society* 767-68 (Guenther Roth & Claus Wittich, eds. 1978).

⁵⁶ See, e.g., Glaeser & Shleifer, Legal Origins, 117 Q. J. Econ. 1193 (2002); Paul Mahoney, The Common Law and Economic Growth: Hayek Might Be Right, 30 J. Legal Stud. 503 (2001).

but they will have to contend with hard evidence, grounded on both comparative expenditures and comparative use of sanctions, which seems to show that common law countries both expend more on regulation and punish more emphatically.

To be sure, it is not a simple matter to measure the comparative investments made by different countries in financial regulation. National regulatory systems are diverse; fluctuating exchange rates compound the problem; financial markets also differ across countries; and adjustments must be made for market size before comparisons become meaningful. At the outset, it is useful to distinguish “input” measures from “output” measures. “Inputs” are essentially the resources (budget and staff) given the securities enforcer, and “outputs” are what they do with those resources: i.e., actions brought and sanctions imposed.

A. Enforcement “Inputs”

The first serious, if still preliminary, effort to measure the intensity of the regulatory efforts made by the major industrialized nations with regard to securities regulation appears to be a 2005 paper by Harvard Law Professor Howell Jackson.⁵⁷

Basically, Jackson found that:

“[T]he common law countries ... report markedly higher levels of regulatory intensity on all dimensions that I have been able to study.... [T]hese indices on regulatory intensity in financial areas suggest that it is the common law countries that carry the bigger stick and swing it with greater frequency and force.”⁵⁸

A key problem in comparing regulatory intensity across nations is that many financial regulatory agencies have comprehensive jurisdiction over the three basic

⁵⁷ Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications. (John M. Olin Center for Law Economics, and Business Discussion Paper No. 521) (August, 2005) (<http://ssrn.com/abstract=839250>).

⁵⁸ Id. at 3.

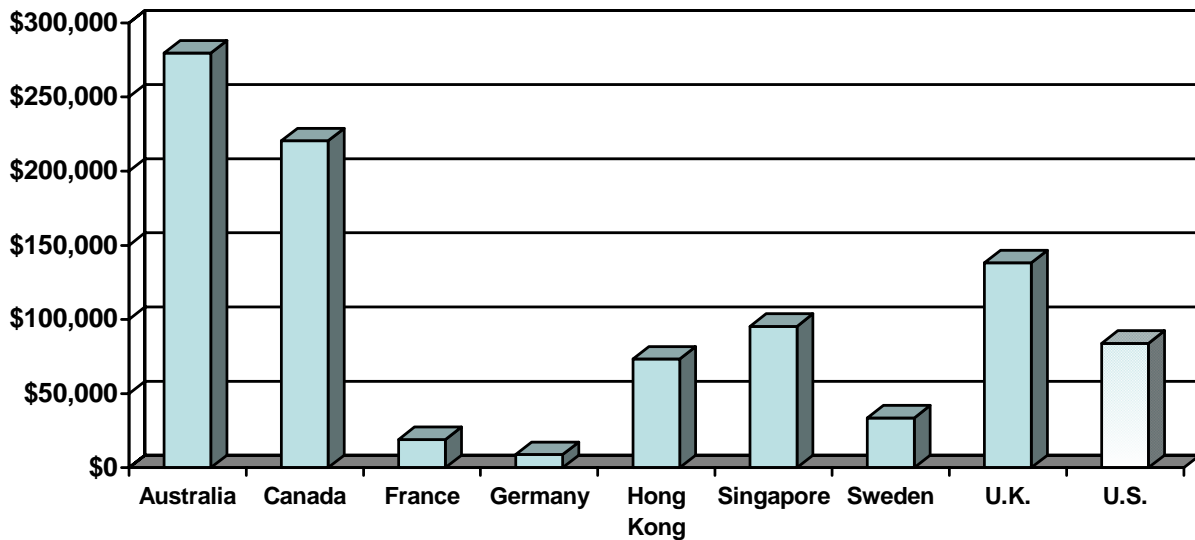
sectors of the financial services industry: banking, securities, and insurance. This can confound any effort to examine how they specifically supervise and enforce securities markets. Fortunately, the U.K.'s Financial Service Authority (the "FSA") compiles data on comparative regulatory costs for ten major jurisdictions and allocates these costs in its annual report among these three sectors. Using this data, Jackson adjusted it for the relative size of the securities market to obtain securities regulation costs per billion dollars of stock market capitalization. On this basis, he found that the adjusted regulatory costs for the United States (\$83,943 per billion dollars of stock market capitalization) fell well below Australia (\$279,587), Canada (\$220,515) and the United Kingdom (\$138,159), and were roughly comparable with Hong Kong (\$73,317) and Singapore (\$95,406)—all "common law origin" countries.⁵⁹ But the adjusted costs for all these countries dwarfed those for France (\$19,041), Germany (\$8,896) and Sweden (\$33,573).⁶⁰ Jackson prepared the following chart summarizing his data:⁶¹

Securities Regulation Costs Per Billion Dollars of Stock Market Capitalization

⁵⁹ Id. at 19-20.

⁶⁰ Id. at 20.

⁶¹ Id. at 19 (Figure Three).



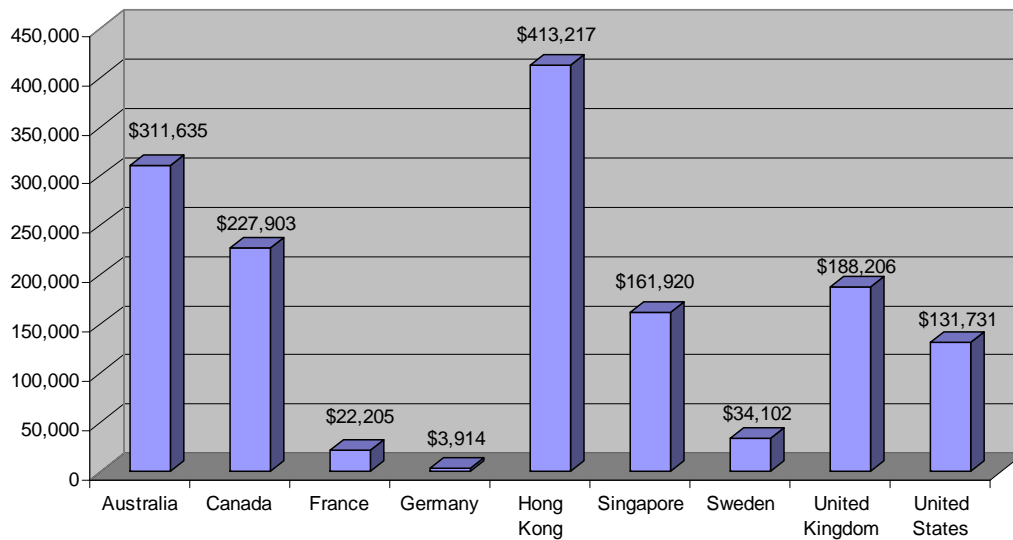
Source: FSA 2003/2004 Annual Report, Appendix 5

The modest ranking given to the U.S. on this chart is partially the result of the enormous size of the U.S. securities market, which, estimated for this purpose at \$17 trillion, is more than seven times the next largest market, which is the U.K.'s market, which was estimated at \$2.4 trillion.⁶² Yet, if we use instead gross domestic product as the denominator, the U.S. expenditure becomes only marginally greater (and Hong Kong replaces Australia as the leader), but little else changes, as the following chart shows.⁶³

⁶² Id. at 20.

⁶³ This chart has been prepared by Professor Coffee and Dr. Pretto-Sakmann based on Jackson's data. The cost of securities regulation was calculated on the basis of the data on securities budget per billion dollars of stock market capitalization, as described by Professor Jackson in his Discussion Paper, Table 2, page 18. The market capitalization data in British Pounds Sterling were then taken from the FSA 2003/2004 report, pages 100-101, and converted into USD at the conversion rate (daily average) of April 7, 2004, the date chosen by Prof. Jackson in his footnote 12. Historical currency exchange rates are available at <http://www.oanda.com/convert/fxhistory>. By multiplying the two numbers, we obtained the total securities budget in dollars. We then divided that number by the value of the GDP for each country in 2003 (in \$ bn), available on the World Bank website at <http://devdata.worldbank.org/data-query/>. One cautionary note is necessary: because the GDP data are only available in current dollars, the absolute values of the results may be slightly inaccurate. However, that does not affect the comparison between countries. All websites cited in this footnote were last consulted on January 12, 2007.

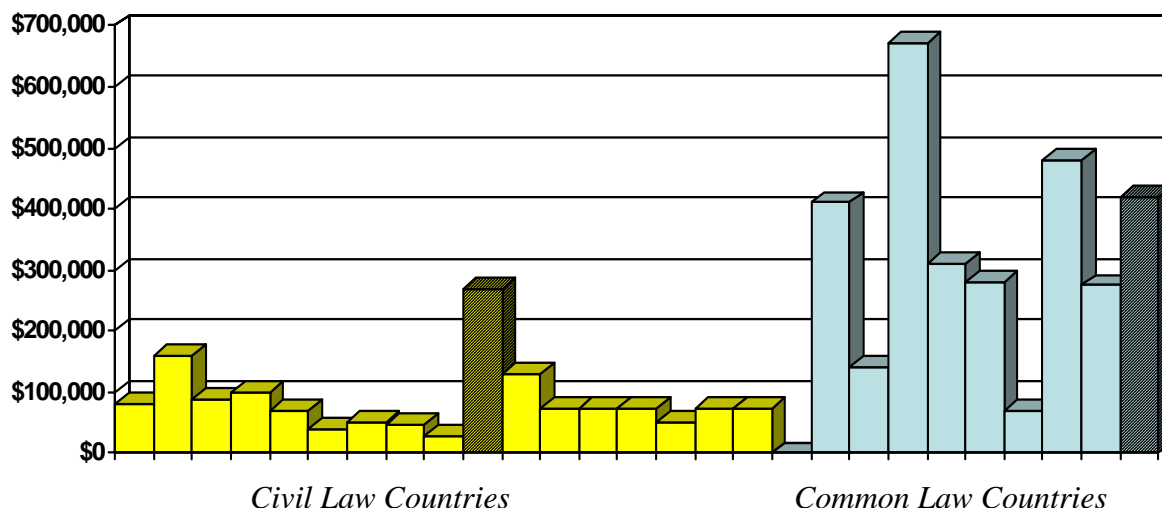
Securities Regulation Costs in Dollars Per Billion Dollars of GDP (2003/2004)



This pattern was not limited to securities regulation. Using a different data base, Jackson estimated the overall financial regulatory costs for 18 civil law jurisdictions and 10 common law jurisdictions. Presented in terms of relative GDP, the results again show the “common law” countries vastly outspending “civil law” countries:⁶⁴

Civil Law Versus Common Law Countries:
Regulatory Costs Per Billion Dollars of GDP

⁶⁴ Id. at 23 (Figure Seven). The shaded country in the middle of the civil law countries is South Korea, which obviously has been subject to substantial U.S. influence. The U.S. is at the far right of this chart.



Source: FSA 2003/2004 Annual Report, Appendix 5

Only South Korea—the striped bar on the left side of the above chart—approached the GDP-adjusted expenditures of the common law countries. Although it has a “civil law origin,” South Korea was heavily influenced by the United States, particularly with regard to its securities laws. The same pattern persisted when Jackson compared regulatory staff sizes; once again, the common law countries employed staffs that dwarfed those of civil law countries.⁶⁵

Differences in direct governmental regulatory expenditures between common law and civil law jurisdictions have implications for the firms incorporated in these jurisdictions. In all likelihood, greater governmental expenditures on financial regulation in turn imply greater private expenditures, as firms in common law countries must expend more in order to comply with the closer and more exacting oversight that larger and better funded regulatory staffs can exercise.

B. Enforcement “Outputs”

⁶⁵ Id. at 24 (See Figures Eight and Nine).

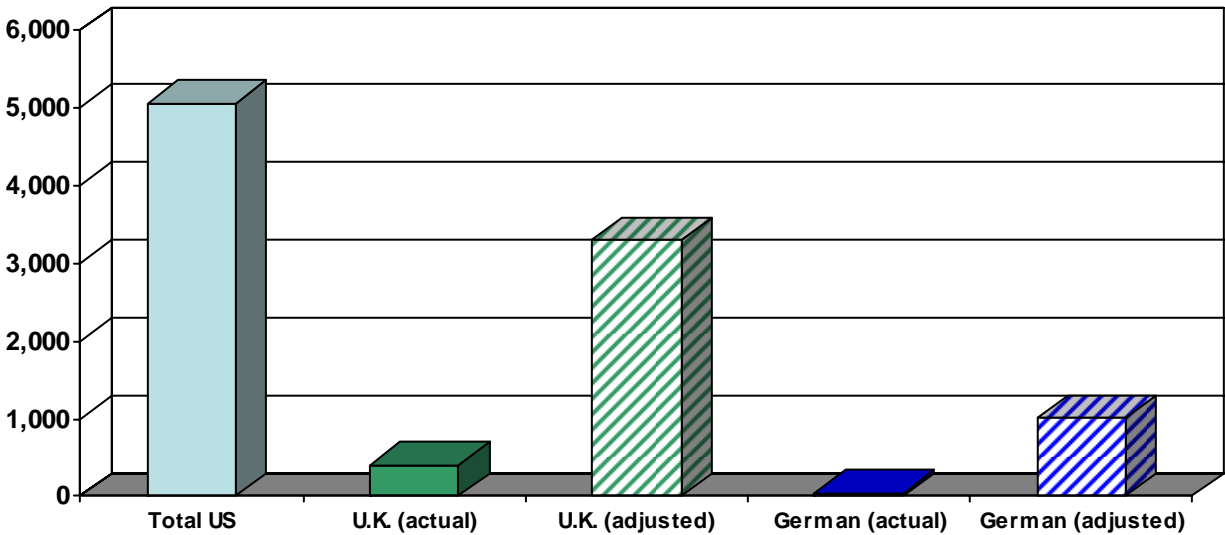
Input data has its limitations. Conceivably, a well-funded enforcement agency could still be “captured” by its regulatory subjects so that it imposed few or only trivial penalties. Alternatively, different regulatory styles may exist. Some agencies might opt for an advisory and consulting relationship with the regulated entities, so that the typical contact between the public regulator and the private company would be ex ante. This might be the case, for example, of a securities regulator that wished to maximize foreign cross-listings on its principal exchange. Alternatively, a regulator may act more on an ex post basis, emphasizing enforcement actions and the imposition of sanctions as the principal means by which to cause regulated entities to comply. Conventional wisdom probably views the FSA as exemplifying the first style (in order to maximize foreign listings) and the SEC as the exemplar of the latter “deterrent” approach.

Nonetheless, Jackson’s data initially suggests the same basic pattern governs at the output level: “common law” jurisdictions appear to be much more active enforcers than civil law jurisdictions. Enforcement can be measured either in terms of the number of actions brought or the aggregate financial sanctions levied. Comparative data is, however, more available with respect to the number of enforcement actions. Comparing U.S. “public securities actions” with enforcement actions brought by the Financial Services Authority in the U.K. and the Federal Financial Supervisory Body (“BaFin”) in Germany, Jackson derived the following chart showing the annual average number of actions over the 2000 to 2002 period:⁶⁶

Public Securities Enforcement Actions
U.S. Compared to U.K. and German

⁶⁶ Id. at 28 (Figure Ten).

(Annual Averages: 2000 to 2002; Number of Actions)



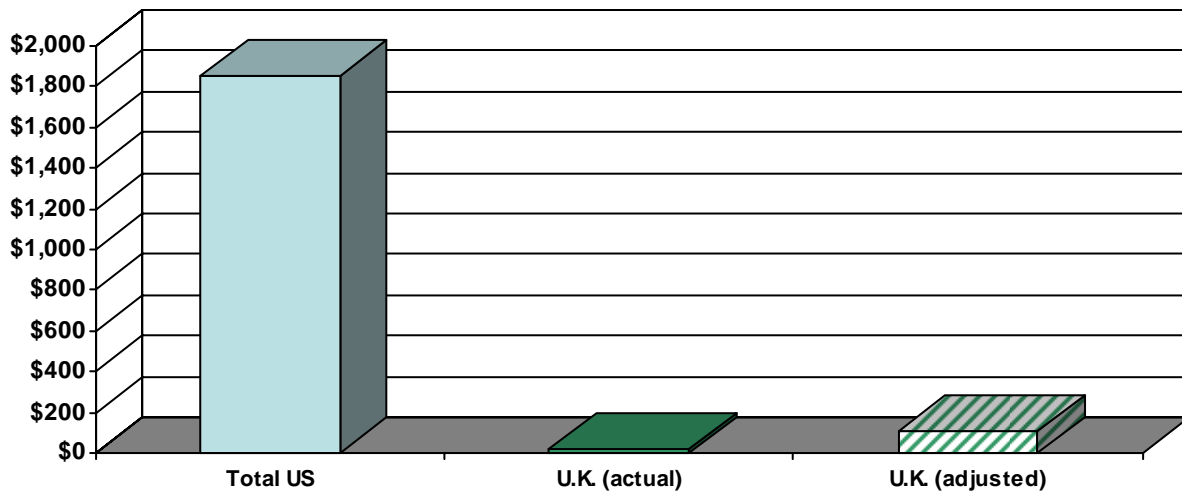
Source: Howell E. Jackson, Compilations

Even when the data is market adjusted to reflect relative market size, the disparity between the United States and Germany is roughly 5:1.

Turning from the number of actions brought to the aggregate monetary sanctions imposed, Jackson was only able to secure data comparable for the U.S. and the U.K. Over the 2000 to 2002 period, public securities enforcement monetary sanctions imposed in the U.S. exceeded those imposed in the U.K., even after adjusting for relative market size, by a more than ten to one margin:⁶⁷

Public Securities Enforcement Monetary Sanctions U.S. Compared to U.K.
(Annual Averages: 2000 to 2002; US \$ million)

⁶⁷ Id. at 29 (Figure Eleven).



Source: Howell E. Jackson, *Compilations*

C. Private Enforcement

The full magnitude of the enforcement disparity between the U.S. and the rest of the world with regard to sanctions only comes adequately into view when we add to this picture the further dimension of private enforcement. Class actions are basically unknown in Europe (including the U.K.);⁶⁸ contingent fees are not permitted; and a “loser pays” fee shifting rule further discourages aggregate litigation in any form.⁶⁹ As a result, the entrepreneurial system of private law enforcement that characterizes the United States is simply not present in Europe. How much of a difference does this make? The following chart, based on Jackson’s

⁶⁸ Europe is beginning to consider the adoption of the class action, but has not yet done so. For a survey, see Christopher Hodges, Europeanization of Civil Justice: Trends and Issues, 26 Civil Justice Quarterly 96 (2007).

⁶⁹ Contingent fees are now permitted to a very limited degree in Great Britain in personal injury cases. See Richard Painter, Symposium on Fee Shifting: Litigating On a Contingency: A Monopoly of Champions Or a Market for Champerty?, 71 Chi-Kent. L. Rev. 625, 626-627 (1995). In the United States, 95% of personal injury litigation appears to be conducted on a contingent fee basis. For the fullest critique of contingent fees in the class action context, see Lester Brickman, Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark, 37 UCLA L. Rev. 29 (1989). For a more balanced description, see Patricia Danzon, CONTINGENT FEES FOR PERSONAL INJURY LITIGATION (1980).

data, shows that private enforcement in the U.S. imposes greater financial penalties than public enforcement:⁷⁰

PUBLIC vs. PRIVATE ENFORCEMENT IN THE U.S.

Average Payments 2000-2002

<u>Public Monetary Sanctions</u>	<u>Private Monetary Sanctions</u>
SEC Monetary Sanctions: \$801,333,333	Class Action Settlements: \$1,906,333,333
State Monetary Sanctions: \$931,212,489	Class Action Trial Awards: \$17,626,000
NASD Disciplinary Sanctions: \$126,110,622	NASD Arbitration Awards: \$104,000,000
NYSE Disciplinary Sanctions: \$5,752,833	NYSE Arbitration Awards: (not available)
<u>\$1,864,409,277</u>	<u>\$2,027,959,333</u>

Once private enforcement is added to public enforcement, the United States becomes an extraordinary outlier—for better or worse. Moreover, as next discussed, there has been a hyperbolic increase in private enforcement in the United States, which overshadows even the significant increase in public enforcement.

D. Updated Data: The Surge in U.S. Enforcement

In 2007, Howell Jackson and his Harvard colleague, Mark Roe, extended his 2005 study, using new data bases. Once again, they focused primarily on public enforcement, looking primarily at staffing and budgets of securities regulators in common law versus civil law jurisdictions. Again, they found that the

“amount of public resources devoted to financial regulation appears to be systematically higher in countries from common law origins as compared with countries with civil law origins.”⁷¹

More importantly, they developed a series of enforcement variables that had superior explanatory power to common law origins in explaining stock market

⁷⁰ See Jackson, *supra* note 57, at 27 (Table Three).

⁷¹ See Howell E. Jackson & Mark J. Roe, “Public Enforcement of Securities Laws: Preliminary Evidence,” (Working Paper January 16, 2007) at 20.

capitalization. Indeed, they found that common law origins no longer had any significant relationship with stock market capitalization once they controlled for their various enforcement variables.⁷²

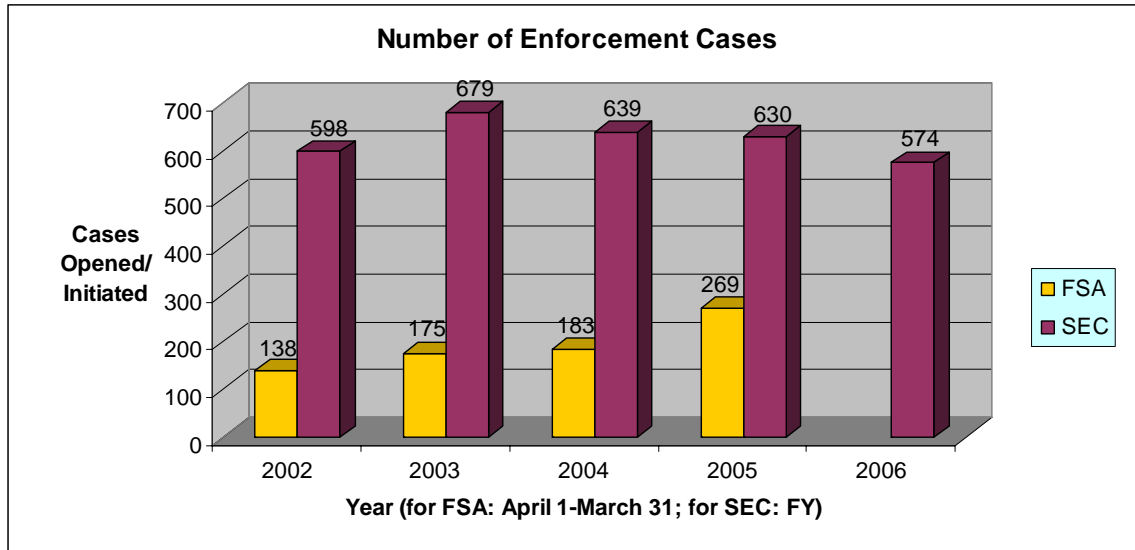
In short, enforcement seems more important than common law origins in explaining the development of robust securities markets. One could stop at this point if one were only interested in refuting LLS&V. But, focusing simply on common law versus civil law origins ignores the unique position of the United States. Viewed in terms of input data (i.e., staffing levels or budgets, which is Jackson and Roe's perspective), the United States is not a notable outlier. Once one adjusts for its greater market capitalization and GDP, one finds that other countries spend more and staff more heavily on such an adjusted basis.

When, however, one turns to outputs—that is to enforcement activity, whether measured by number of enforcement actions or total monetary sanctions imposed—the U.S. becomes a dramatic outlier, occupying a truly polar position. To show this, we have updated some of the data in Jackson's 2005 study to cover more recent years. Initially, our focus is simply on public enforcement activity, comparing only the FSA and the SEC. Set forth below is a table of the enforcement cases opened by the FSA and the SEC over the years 2002 to 2006:⁷³

⁷² Id. at 21. In fact, they found that “not only does the common law dummy lose significance, but the sign of its coefficient changes to negative.” Id.

⁷³ The period of reference for SEC data is the calendar year from January 1 to December 31. By contrast, FSA data covers the period April 1–March 31. In each set of columns, therefore, FSA data is three months more recent than corresponding SEC data. For the last column (year 2006), only SEC data is available. The last-but-one set of columns, however (year 2005), includes FSA cases up to and including March 31, 2006.

The data on the decline of SEC enforcement actions is summarized in Sarah Johnson, ‘SEC Enforcement Declines 8.9%’, in CFO.com, November 3, 2006, available at http://www.cfo.com/article.cfm/8127167/c_2984409?f=archives (last accessed 01/23/07). The data is also available in the U.S. Securities and Exchange Commission's Performance and Accountability Reports, all



Although the SEC opened more actions in each year, the difference might be explained, at least partially, by the larger market capitalization in the United States. The problem with such an explanation is two-fold: (1) the FSA’s numbers for enforcement actions cover all aspects of the financial services industry (i.e., banking, pensions, and insurance), not simply securities regulation; and (2) actions

available at www.sec.gov. See 2006 Report, at 8; 2005 Report, at 7; 2004 Report, at 25. SEC numbers sum up all civil and administrative proceedings initiated during the calendar year indicated along the X axis and exclude mere investigations. For 2006, 218 civil actions and 356 administrative proceedings were brought; for 2005, the two components amounted to, respectively, 335 and 294; for 2004, they were 375 and 264.

The sources for the FSA data are the Financial Services Authority’s Annual Reports, all available at www.fsa.gov.uk. See Annual Report 2005/06, at 141; Annual Report 2004/05, at 140; Annual Report 2003/04, at 140; Annual Report 2002/03, at 213. FSA numbers refer to all cases *opened* during the period April 1–March 31, as opposed to cases already open or closed during that time. Categories of cases include the following: pensions and endowments, investment management, unauthorized activities, systems and controls, non-compliance with ombudsman, market protection, listing rule breaches, money laundering controls and financial fraud, fitness and propriety issues and/or threshold conditions (by far the most numerous category in the last three years).

As a note of historical interest, we should point out that in previous years, FSA numbers were substantially higher (666 cases in 1999/00; 519 in 2000/01). The sharp decline appears to be explained, at least in part, by the fact that in 2001 the FSA introduced several changes in its enforcement practices in response to consultation. In particular, in order to cut costly tribunal hearings, the FSA implemented a pilot mediation scheme which helped reduce litigation numbers in the following years. The aim was to free resources in view of the coming into force of the Financial Services and Markets Act 2000. The latter is usually viewed as prescribing a more rigorous and selective discipline of the enforcement process.

Finally, for the purpose of this chart, we have assumed that the terms ‘initiated’ and ‘opened’, as referred to proceedings, had equivalent meanings.

brought by the NASD and the various states are not included in the above table, even though they have traditionally brought more enforcement actions than the SEC (although generally in less serious cases). Further, it is not clear that “enforcement actions” are equivalent units; the SEC typically pursues multiple individuals in its enforcement actions.

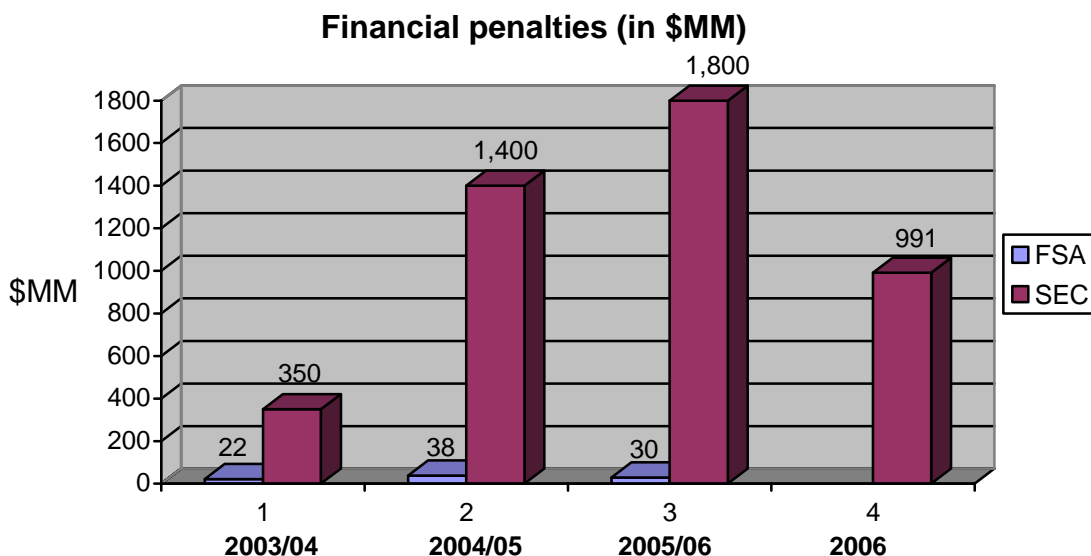
Thus, the best measure of the disparity between the SEC and the FSA is probably a comparison of the aggregate annual financial penalties exacted by each. Initially, in the next table, we set forth the aggregate financial penalties imposed by the FSA and SEC for the years 2003 to 2006.⁷⁴

⁷⁴ The FSA data are from the Financial Services Authority’s Annual Report 2005/06, page 142, chart entitled ‘Number and Total Amount of Financial Penalties’. The FSA figures appearing in the last annual report, originally in GBP, were converted at the rate in force on March 31, 2006 (1 GBP=1.73980 US \$), the date on which the report closed. The SEC data are from the U.S. Securities and Exchange Commission’s 2006 Performance and Accountability Report, page 54, Exhibit 2.20, or ‘Monetary Disgorgement and Penalties Ordered and the Amounts and Percentages Collected by the SEC’.

Some additional explanation is necessary. Each FSA Annual Report covers the period April 1—March 31, whereas each SEC Report covers the corresponding calendar year. In each set of columns, therefore, the FSA data are three months more recent than the SEC ones. For the last column, corresponding to the year 2006, only SEC data are available.

In the case of the SEC, the number of penalties ordered, rather than those collected, was considered. Collection has been increasingly but never completely successful over the years: the rate was 40% in 2003, 86% in 2004 and 96% in 2005. The reported percentage of collection for 2006 has declined to 82%.

In the case of the FSA, the amounts were ‘concentrated’ in a relatively low number of individual penalties, or 22 in 2003/04, 31 in 2004/05, and 17 in 2005/06.



These statistics are conservatively biased, because the SEC also recovers disgorgement for investors in addition to penalties; in 2006, the SEC reports that the total of penalties plus disgorgement came to \$3.3 billion.⁷⁵ Next, we adjust this data to reflect the difference in market capitalization between the U.S. and the U.K.:⁷⁶

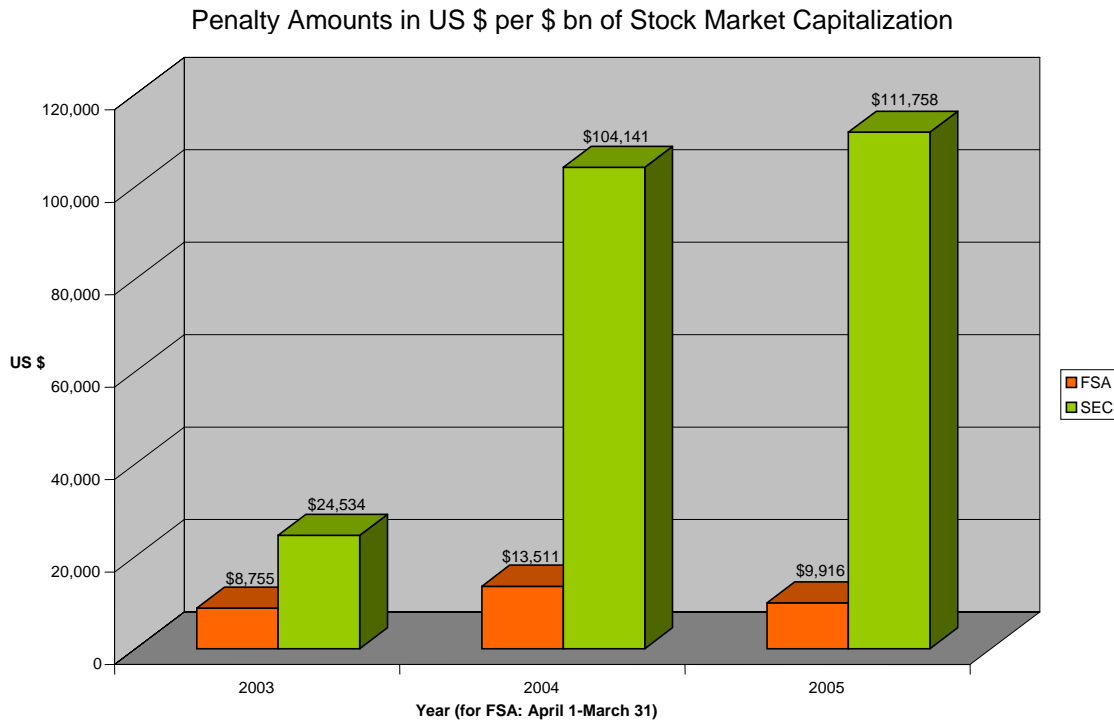
⁷⁵ See SEC, 2006 Performance and Accountability Report, p. 8. This \$3.3 billion was “ordered” in 2006, but may never be fully recovered.

⁷⁶ Sources for the number of penalties imposed by the FSA is the Financial Services Authority’s Annual Report 2005/06, page 142, chart entitled ‘Financial Penalties Split by Issue’, available at www.fsa.gov.uk. Penalties imposed in the various areas of FSA activities (see footnote to previous chart) were added up to obtain yearly totals. The FSA figures appearing in the last annual report, originally in GBP, were converted at the rate in force on March 31, 2006 (1 GBP=1.73980 US \$), the last day covered by the report’s time span. Historical currency exchange rates are available at <http://www.oanda.com/convert/fxhistory>.

The SEC data is from the U.S. Securities and Exchange Commission’s 2006 Performance and Accountability Report, page 54, Exhibit 2.20, or ‘Monetary Disgorgement and Penalties Ordered and the Amounts and Percentages Collected by the SEC’. See www.sec.gov.

Market capitalization data are available on the website of the World Federation of Exchanges, at www.world-exchanges.org, in the section on annual statistics. The London Stock Exchange capitalization (in billion dollars) amounted to \$2,460bn in 2003; \$2,865bn in 2004; and \$3,058bn in 2005. For the purposes of this chart we considered U.S. domestic capitalization to be a sum of AMEX, NASDAQ, and NYSE capitalizations for each year. Thus calculated, domestic capitalization amounted to \$14,266bn in 2003; \$16,324bn in 2004; and \$17,001bn in 2005. Data for 2006 were not available on the website at the time of writing.

It should be noted that, for the FSA, there is not a perfect correspondence between the duration of the year in which the penalties were imposed (April 1, 2003-March 31, 2004, etc.) and the duration of the year during which market capitalization was assessed (January-December). We do not believe that this has any significant effect.



These adjustments, however, understate the disparity between the FSA and the SEC, because the FSA's numbers cover the entire financial services industry, not simply the securities industry. In addition, the SEC's numbers do not include penalties levied by self-regulators (such as the NASD and NYSE) or the states (whose penalties can exceed those of the SEC).⁷⁷ Even on this adjusted and incomplete basis, however, it is apparent that the SEC imposes financial penalties that exceed those of the FSA by a nearly ten to one margin (at least in 2004 and 2005). Thus, even if their inputs are comparable (and, that staffing and budgetary levels for the FSA and SEC do seem roughly similar after adjustment for the relative size of their markets), their outputs are markedly different. By style and temperament, the U.S. punishes more severely.

All websites herein quoted were last consulted on January 25, 2007.

⁷⁷ In fact, over 2000 to 2002, the aggregate penalties imposed by the states exceeded the SEC's penalties in Jackson's study. See text and notes supra at note 70.

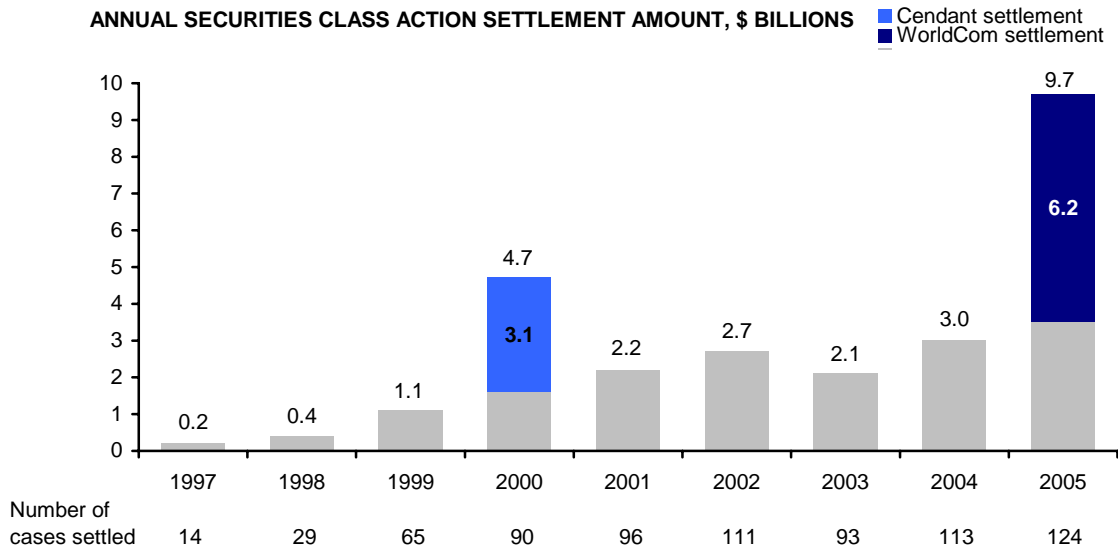
This same pattern is at least as evident when one turns from the U.K. to Canada. Canada's system of securities regulation closely resembles that of the United States, and, once adjusted for relative market size, budgets and staff size between securities regulators in the two countries seem roughly comparable.⁷⁸ But all similarities end when we turn from inputs to outputs. Howell Jackson found that over the period from 2002 to 2004, "the SEC alone imposed 384 times as many sanctions as Canadian provincial authorities..., and total sanctions from U.S. governmental agencies were 718 times as large as provincial sanctions."⁷⁹

Not only has public enforcement (as measured by SEC sanctions) become increasingly punitive over recent years, but this shift has been more than paralleled by increases in private enforcement in the United States. Set forth below is a table showing the aggregate payments in securities class action settlements over this period:⁸⁰

⁷⁸ Jackson found U.S. budgets to be "in the range of 9 times larger than Canadian budgets, whereas staffing levels are in the range of 5 to 6 times larger." See Howell Jackson, "Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches" (June 30, 2006) at p. 43.

⁷⁹ Id at 45.

⁸⁰ See Bloomberg and Schumer, *supra* note 1, at p. 75, table 19.



Although the Cendant settlement in 2000 and the WorldCom settlement in 2005 produce some discontinuity, the basic pattern is one of a relatively steady increase in the aggregate amounts paid in securities class action settlements. Although the number of class actions fell sharply in 2006, the message that may be better remembered by foreign issuers is that seven out of the ten largest securities class action settlements in history occurred in 2005-2006.⁸¹ Nothing remotely comparable occurs in Europe or Asia, where the class action and the contingent fee remain unknown.

Aggregating private and public civil enforcement, we find that, for the year 2005, the total monetary sanctions imposed in the U.S. by the SEC and class action plaintiffs came to either \$5.3 billion or \$11.5 billion (depending on whether one excludes the WorldCom class action settlement).⁸² Moreover, this number is more

⁸¹ See Todd Foster, Ronald Miller, Stephanie Planchich, “Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar,” (NERA January 2007) at p. 5.

⁸² SEC penalties in 2005 were \$1.8 billion and class action settlements were either \$3.5 billion or \$9.7 billion (depending on the status of the WorldCom settlement. See charts at notes 73 and 80 supra.

than double the 2003 figure (in which year class action settlements came to \$2.1 billion and SEC penalties to \$350 million, for a total of \$2.45 billion).

E. Criminal Enforcement

Finally, the prospect of criminal enforcement radically distinguishes securities regulation in the United States from the rest of the world. To illustrate the interplay of SEC enforcement, Department of Justice criminal prosecution, and private class actions, it is useful to begin with the admittedly extreme case of WorldCom. The SEC imposed a fine of \$2.25 billion on WorldCom (which was later reduced by the bankruptcy court to \$750 million). In addition, it barred four of WorldCom's executives from serving as officers or directors of a publicly held company and suspended others from practicing or appearing before the SEC as accountants. The Department of Justice fined WorldCom another \$27 million and criminal prosecuted its CEO (Bernard Ebbers), its CFO (Scott Sullivan), and four others, resulting ultimately in combined sentences of 32.4 years and \$49.2 million in restitution. A parallel private class action settled in 2005 for \$6.8 billion, which was mainly paid by banks and financial institutions that worked with WorldCom.⁸³

WorldCom is, of course, an extreme case, but penalties equal to or exceeding \$100 million have been imposed by the SEC in other recent cases as well.⁸⁴ Moreover, WorldCom is representative of the tendency for public and private penalties to be imposed on a cumulative and overlapping basis. Karpoff, Lee and Martin have studied the public and private penalties imposed for "financial

⁸³ This summary is taken from J.M. Karpoff, D. S. Lee, and G. S. Martin, "The Legal Penalties for Financial Misrepresentation" (<http://ssrn.com/abstract=93333>) (January 2007) at p. 1.

⁸⁴ Karpoff, Lee and Martin point to such recent examples as Qwest Communications Int'l (\$250 million), Bristol-Myers Squibb Co. (\$100 million) and Royal Dutch/Shell Group (\$100 million). *Id.* at 2.

misrepresentation”—a narrow category that essentially involves corporate financial fraud, not insider trading, broker-dealer misconduct, or other frequently prosecuted securities violations.⁸⁵ Thus, this is the bulls-eye of the target if we are interested in the deterrent threat facing issuers and their agents for misstating their financial results. Between 1978 and 2004, the authors identified some 697 enforcement actions brought by the SEC and the Department of Justice. In nearly one half of these cases (323), the SEC enforcement action was accompanied by a private class action. These 697 enforcement actions produced a total of 4,469 sanctions against individuals and 719 against firms.⁸⁶ Some 987 administrative actions—i.e., cease and desist orders, censures, suspensions from practice—were imposed, and courts entered some 2,262 permanent injunctions against agents and some 321 against firms.⁸⁷ 574 executives were barred from serving as officers and directors of public corporations, and 415 were barred from work as financial professionals. In 52.8% of these enforcement actions, the SEC or the Department of Justice imposed monetary penalties on individuals (but much less frequently on the firm itself—only in 69 cases).⁸⁸ The median monetary penalty for an individual was \$280,000.⁸⁹ Finally, some 755 individuals and 40 firms were indicted (of whom 543 pleaded guilty while only 10 were acquitted).⁹⁰ A total of 1,230.7 years of incarceration and 397.5 years of probation were imposed (with the average sentence being 4.2 years).⁹¹ More recently, the pace has increased. Since the Department of Justice’s Corporate Fraud

⁸⁵ Id. at 1.

⁸⁶ Id. at 8.

⁸⁷ Id.

⁸⁸ Id. at 10.

⁸⁹ Id.

⁹⁰ Id. at 8-9. The figure for acquittals is as of December 31, 2005. Some 232 individuals were awaiting trial.

⁹¹ Id. at 9.

Task Force was formed in 2002 in the wake of Enron, it has charged over 1,300 defendants and obtained over 1,000 guilty pleas and convictions.⁹² In short, financial fraud by issuers, their agents and employees is both heavily punished in the United States and punished by multiple and overlapping enforcers, and the anecdotal evidence suggests that the level of punishment has recently increased exponentially.

F. Enforcement Styles

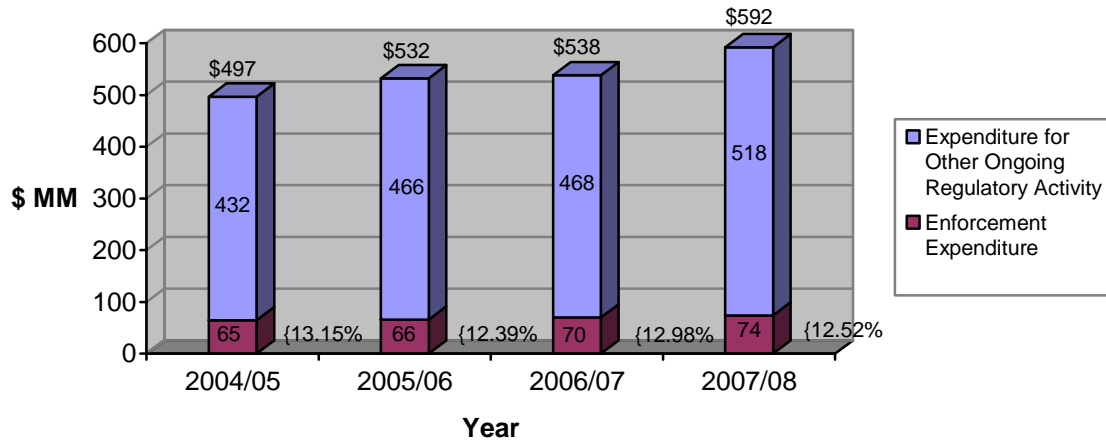
Regulators behave very different, even independently of the budgetary resources available to them. Some regulators may advise, request and even admonish, but are slow to punish. Others may believe that punitive fines generate a desirable general deterrent effect and that the greater danger lies in using overly mild penalties that can be easily absorbed as a cost of business. In this regard, the FSA and the SEC appear to be located at opposite ends of the continuum.

The best measure of their difference is the percentage of each's budget that goes to enforcement activity. Set forth below is the FSA's enforcement budget as a percentage of its total budget for the years 2004 to 2007:⁹³

⁹² See Department of Justice, "Fact Sheet: Corporate Fraud Task Force (August 9, 2006), available at <http://tinyurl.com/yhj2v2>.

⁹³ The data is found in the FSA Business Plan 2007/08, at 39 (Table 4.3, Expenditure by Business Unit) and FSA Business Plan 2006/07, at 42 (Table 4.1, Ongoing Regulatory Activity by Business Unit). While the figures for early years are actual, that for 2006/07 is an estimate and that for 2007/08 is a budgetary allocation. The amounts, originally stated in British Pounds Sterling, were converted at the going rate as of 02/26/07 (1GBP=1.963 USD).

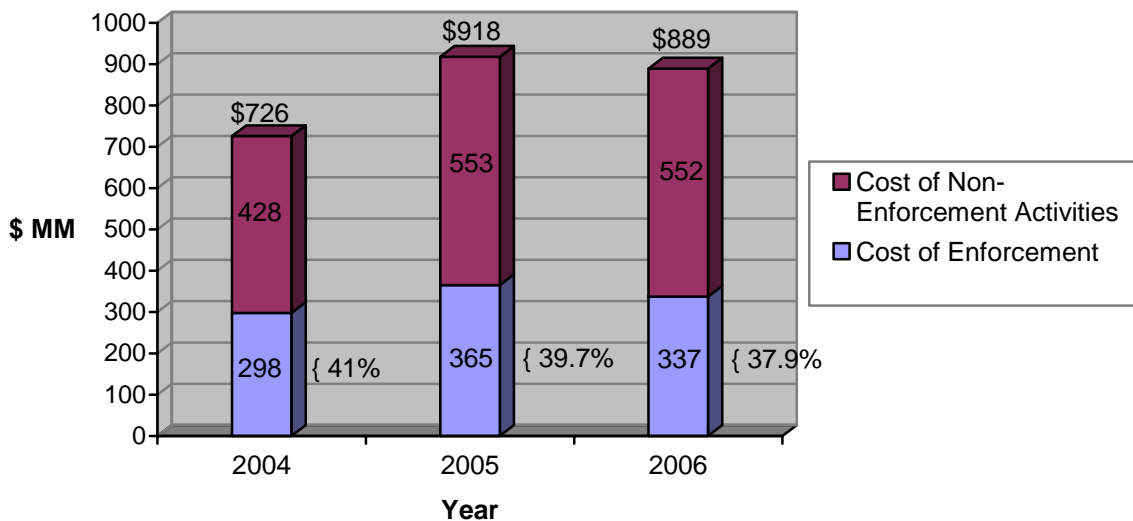
FSA Enforcement Activity as a Percentage of the FSA's Total Budget 2004/05 to 2007/08



As this chart shows, enforcement expenditures at the FSA ranged between 12.5% and 13.15% of its total budget over this period.

In contrast, as the next chart shows, enforcement expenditures at the SEC ranged between 37.8% and 41%:⁹⁴

SEC Enforcement Activity as a Percentage of the SEC's Total Budget



Both agencies then were stable and consistent in their behavior, but the SEC

⁹⁴ The cost of enforcement data is taken from the SEC's 2006 Performance and Accountability Report, at 61 (Table on the Statement of Net Cost as of September 30 of each year) (and see notes 12 and 13 at 82-84), as well as from the SEC's 2005 Performance and Accountability Report, at 53.

devoted a percentage of its budget to enforcement that was roughly three times that devoted by the FSA.

Still, the United States is not entirely unique and isolated. Although Australia has substantive corporate and securities laws closely resembling those of the U.K., its approach to enforcement appears to be at least as aggressive as that of the United States. Between 2003 and 2006, the percentage of the budget allocated to enforcement activities of the Australian Securities and Investment Commission (“ASIC”), Australia’s securities regulator, appears to have exceeded that of the SEC:⁹⁵

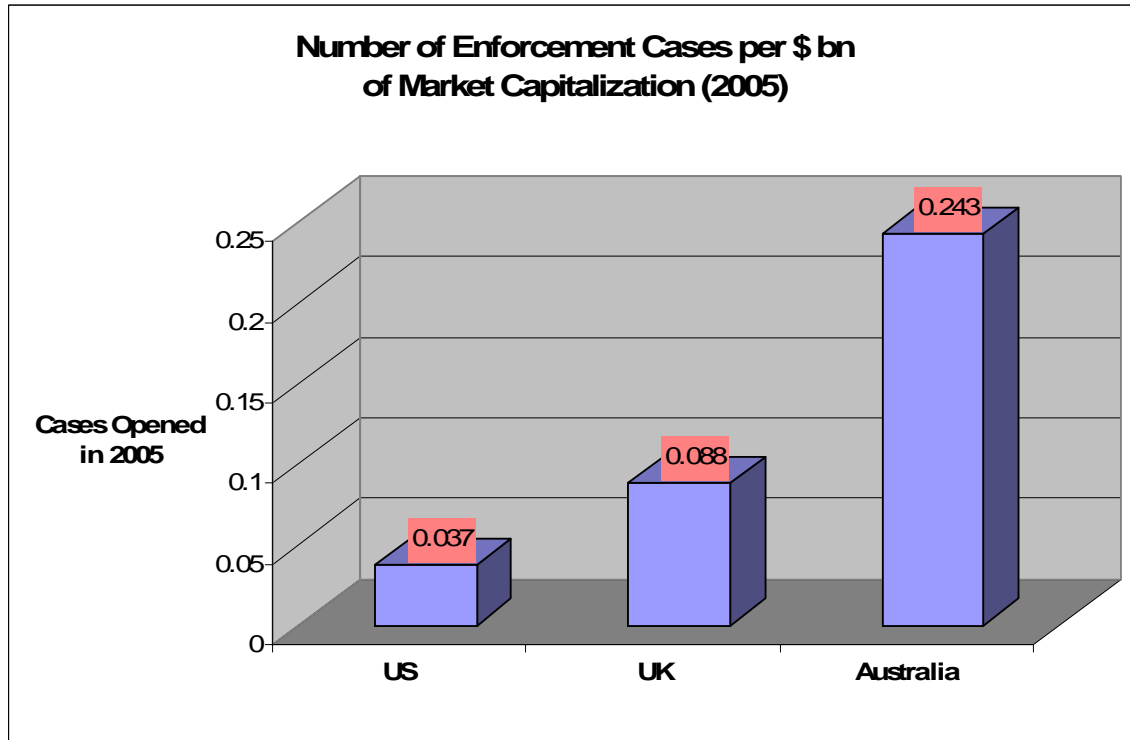
<u>Year</u>	<u>Total Budget</u>	<u>Amount Spent on Enforcement</u>	<u>Percentage</u>
2003-04	\$196 million	\$84 million	42.85%
2004-05	\$208 million	\$101 million	48.55%
2005-06	\$218 million	\$102 million	46.78%

This translates into an average percentage of 46%—almost four times that of the U.K.

The number of enforcement actions brought by ASIC also appears to exceed the numbers in both the U.S. and the U.K., once adjustment is made for the smaller

⁹⁵ For enforcement expenditure relative to total budget, as illustrated in the table in the text, see ASIC Annual Report 2005-06, Financial Summary, at 14 and six year summary, at 51; ASIC Annual Report 2004-05, Financial Summary, at 12; and ASIC Annual Report 2003-04, at 10. In terms of dedicated staff, ASIC had 373 enforcement personnel out of a total staff of 1394 (or 26.75%) in 2005-06 (see ASIC Annual Report 2005-06, Operational Summary at 17); 420 enforcement personnel out of a total staff of 1497 (or 28.05%) in 2004-05 (see ASIC Annual Report 2004-05, Operational Summary, at 14-15); and 385 out of a total staff of 1466 (or 26.26%) in 2003-04 (see ASIC Annual Report 2003-04, Operational Summary, at 12-13). In addition, some 100 additional personnel are employed in a consumer protection office to handle complaints from the public made against Australian public corporations. Hence, the percentage may be even higher. This data was provided to the author by Professor Ian Ramsay of the University of Melbourne and is available on the website of the Australian Securities and Investments Commission, at <http://www.asic.gov.au> (last consulted April 9, 2007).

size of the Australian market. In 2005-06, ASIC commenced 195 criminal, civil, and administrative actions against some 391 defendants, and, after adjustment for relative market capitalization, Australia leads both the U.K. and the U.S.⁹⁶



Australia has also used the criminal sanction aggressively, although more recently it has given greater emphasis to civil litigation.⁹⁷

⁹⁶ This data has again been supplied to the author by Professor Ian Ramsay of the University of Melbourne and is available on the website of the Australian Securities and Investments Commission, at <http://www.asic.gov.au> (last consulted on April 9, 2007). Also, in 2005-06, ASIC resolved by settlement or verdict some 189 criminal, civil, and administrative proceedings and reported that 94% of its total litigation was successful, with 72% of its criminal cases and 98% of its civil cases being “successfully” resolved. See ASIC Annual Report 2005-06, sections “Enforcing the Law,” at 18; and “Effectiveness,” at 13. The adjustments for relative market size were based on market capitalization figures taken from the website of the World Federation of Exchanges (<http://www.world-exchanges.org>), Annual Statistics on Domestic Market Capitalization for 2005 (last consulted in March, 2007). Although the U.S. comes in last on this market-adjusted chart, only SEC enforcement actions, not actions by other regulators with overlapping jurisdiction, are being here counted.

⁹⁷ See Helen Bird, David Chow, Jarrod Lenne and Ian Ramsay, *Strategic Regulation and ASIC Enforcement Patterns: Results of an Empirical Study*, 5 J. Corporate Law Studies 191 (2005) (finding ASIC to make “predominant” use of criminal penalties during 1997-99).

The differences among these three agencies go even deeper than these numbers reveal. In its Business Plan for 2007/08, the FSA explains that it outsources enforcement, hiring outside attorneys and accountants because “it is not economical to retain permanent staff to handle all cases.”⁹⁸ In contrast, the SEC and ASIC rarely outsource their cases to private law firms. For the SEC, with an over 1200-person enforcement staff, enforcement is its core mission.⁹⁹

This higher level of enforcement intensity almost certainly has implications for firms that list on its markets. For every dollar expended on enforcement by public and private enforcers, private issuers must likely spend more—both on legal defense costs and, when unsuccessful, in payment of sanctions and settlements. Domestic firms have no practical choice but to accept this burden, but the same is not true for the foreign firm that cross-lists. They are thus a very self-selected sample that differs significantly from those firms in their home jurisdiction that do not cross-list in these high-enforcement markets.¹⁰⁰

From this perspective, the cross-listing foreign issuer is entering a strange, forbidding and different legal environment when it lists on a U.S. market. Whether its entry reflects a form of bonding or signaling, such an entry is not without meaning. Arguably, the enforcement disparity explains, at least in part, why cross-

⁹⁸ See Financial Services Authority, “Business Plan 2007/08” at p. 39. (“The unpredictable size, timing and complexity of enforcement cases means that it is not economical to retain permanent staff to handle all cases.”).

⁹⁹ Arguably, a permanent and substantial enforcement staff could create an incentive to bring enforcement actions to keep the staff fully employed. Although this author does not believe that the SEC’s enforcement staff has ever been underoccupied in the modern era so as to give rise to this temptation, the claim is at least plausible, and some may feel it helps explain the difference in regulatory styles.

¹⁰⁰ Reese and Weisbach have in fact shown that firms cross-listing in the United States behave very differently from non-cross listing firms in their country, both in their behavior before and after cross-listing. See Reese & Weisbach, *supra* note 11. Not only do they make equity offerings in the U.S. as a result of cross-listing, but they are significantly more likely thereafter to make equity offerings in their home market, which appear to be facilitated by the bonding that the U.S. listing represents.

listing premiums are observed only for the New York Stock Exchange and not the London Stock Exchange.

III. The Bonding Hypothesis

Theories about the motives underlying cross-listing and its impact on the cost of capital date back at least to 1987.¹⁰¹ Generally, these theories stressed investment barriers and segmented markets. By cross-listing, the corporation leaped these barriers and obtained access to lower cost capital.¹⁰² But as more comprehensive event studies emerged in the late 1990s, economists were surprised by the magnitude of the stock market reaction to cross-listing.¹⁰³ A 1999 study by Darius Miller found a positive 1.15 percent average abnormal return in a broad sample of ADR-listing announcement dates; even more interestingly, the stock market reaction was greater for emerging market firms (1.54 percent) and for firms listing on the major U.S. exchanges (2.63 percent).¹⁰⁴ Given the general decline of investment barriers and market segmentation during the 1990s, it seemed curious both that (1) the number of firms seeking to cross-list rose exponentially in the 1990s when barriers were falling, and (2) the majority of firms did not cross-list. In principle, the cost of capital disparity should have declined as market barriers eroded, and thus fewer issuers should have been motivated to cross-list. In reality, however, the race to cross-list intensified in the 1990s, as market barriers fell. Moreover, in the face of

¹⁰¹ See R. Merton, "Presidential Address: A Simple Model of Capital Market Equilibrium with Incomplete Information," 42 J. Fin. 483 (1987).

¹⁰² For reviews of these traditional theories, see Doidge, Karolyi and Stulz, *supra* note 4, at 207-210; A. Karolyi, "The World of Cross-Listings and Cross-Listings of the World: Challenging the Conventional Wisdom" (<http://ssrn.com/abstract=577021>) (August 2004).

¹⁰³ Two 1999 studies were especially noteworthy: Darius Miller, *The Market Reaction to International Cross-Listing: Evidence from Depositary Receipts*, 51 J. Fin. Econ. 103 (1999) and S. R. Foerster and A. Karolyi, *The Effects of Market Segmentation and Investor Recognition on Asset Prices: Evidence from Foreign Stocks Listing in the United States*, 54 J. Fin. 981 (1999).

¹⁰⁴ See Miller, *supra* note 103.

a high positive stock market reaction to cross-listing in the U.S., one would also expect most firms to cross-list. In short, a simple “market barriers” story then no longer worked well as an explanation for cross-listing. In addition, it was also clear that U.S. firms were contemporaneously sharply reducing their own cross-listings abroad.¹⁰⁵ This suggested that U.S. firms had discovered that widening their shareholder base did not reduce their cost of capital.

Thus, in 1999, this author proposed a bonding explanation:¹⁰⁶ managers “bonded” themselves not to divert excessive private benefits to themselves by deliberately subjecting themselves to a stricter regulatory standard (i.e., the U.S.) under which the firm would be (1) subject to the enforcement powers of the SEC; (2) exposed to private enforcement through class actions; and (3) required to provide fuller financial disclosures by reconciling its financial statements to U.S. GAAP. This theory could explain (1) why the stock market responded more favorably to an exchange listing than other forms of entry into the United States (because only the cross-listing firm would become subject to the reporting requirements of the Securities Exchange Act in the former case); (2) why the stock price movement was greater when the issuer was from an emerging market country (because its home country investor protections were weaker, thus increasing the impact of cross-listing); and (3) why many firms did not cross-list (because they wanted to continue to consume private benefits).

¹⁰⁵ See Marco Pagano, Alisa Roell, and Joseph Zechner, “The Geography of Equity Listing: Why Do European Companies List Abroad?” (October 1999) (<http://ssrn.com/abstract=209313>).

¹⁰⁶ See Coffee, *supra* note 11.

Although empiricists quickly found additional evidence of bonding,¹⁰⁷ doubt persisted that these findings were robust enough to make this hypothesis stronger than other explanations. Then, more recent the Tobin's q studies found an average disparity exceeding 30% between the Tobin's q of firms that cross-listed on a major exchange and that of similar firms that did not cross-list.¹⁰⁸ This evidence compelled a greater acceptance of the bonding hypothesis.¹⁰⁹

Add to this picture the new evidence that there has consistently been a valuation premium associated with a U.S. listing and none with a listing on the London Stock Exchange, and the inadequacy of the traditional explanations seems apparent. Critics of the U.S.'s emphasis on enforcement cannot explain the simultaneous existence of a listing premium in the U.S. and its absence on the London Stock Exchange. The truly puzzling aspect of this disparity is that few firms appear to be motivated by it. In theory, all large foreign firms should be expected to cross-list in order to obtain a lower cost of capital. Yet, the evidence is that only "one in 10 large public corporations from outside the U.S. choose to cross-list their shares on U.S. markets."¹¹⁰ Only the bonding hypothesis can explain this puzzle by responding that the costs of bonding fall disproportionately on controlling shareholders, who therefore often find such a strategy unattractive.

To be sure, other evidence also supports the bonding explanation. Empirical studies have found that firms cross-listing in the U.S. make better financial

¹⁰⁷ See Reese and Weisbach, *supra* note 11.

¹⁰⁸ See studies discussed *supra* at note 9. Tobin's Q is calculated as the market value of the company divided by the replacement value of the company's assets. A ratio above one thus shows that management has caused the firm's market value to exceed its asset value. A high ratio suggests a strong management that is maximizing shareholder value.

¹⁰⁹ For this conclusion, see G. Clark and D. Wojcik, *supra* note 17, at 139-40.

¹¹⁰ Doidge, Karolyi, and Stulz, *supra* note 9, at 206.

disclosures¹¹¹ and rank higher on indexes measuring the quality of their corporate governance.¹¹² Still, the fact that firms with controlling shareholders, particularly controlling shareholders enjoying high private benefits of control, are less likely to cross-list provides possibly the most persuasive evidence for the bonding hypothesis. One recent study finds that the probability that a firm will cross-list on a U.S. exchange is inversely related to (i) the level of the control rights held by the control group, and (ii) the margin by which these control rights exceed the controlling shareholders' cash flow rights.¹¹³ The controlling shareholder whose control rights exceed its entitlement to dividends (which is typically achieved through the use of a dual class capitalization) has elaborately structured the governance of the corporate to allow it to receive private benefits. Thus, it is little surprise that it is reluctant to cross-list in a market that may restrict such benefits.

Similarly, many foreign issuers enter the U.S. market by means of Rule 144A,¹¹⁴ which allows them to sell their shares to sophisticated institutional investors, but not to retail investors. This “private” entry into the U.S. means that these foreign issuers need not register under either the Securities Act of 1933 or the Securities Exchange Act of 1934.¹¹⁵ As a result, such issuers do not become subject

¹¹¹ See T. Khanna, K. G. Palepu, and S. Srinivasan, *supra* note 16.

¹¹² See G. Clark and D. Wojcik, *supra* note 17, at 133-161.

¹¹³ See C. Doidge, A. Karolyi, K. Lins, D. Miller and R. Stulz, *Private Benefits of Control Ownership, and the Cross-Listing Decision*, (Working Paper April, 2006) (<http://ssrn.com/abstract=679321>).

¹¹⁴ See 15 C.F.R. 230.144A (“Private Sales of Securities to Institutions”). Rule 144A was principally designed to permit foreign issuers to access U.S. institutional investors without listing on an exchange or registering under the Securities Exchange Act, as issuers already having their common stock listed on a U.S. exchange may not use Rule 144A for a common stock offering. See Rule 144A(d)(3)(i).

¹¹⁵ The Rule 144A offering will not be deemed a public offering of securities, but rather is exempt from registration under Section 4(2) of the Securities Act of 1933. So long as fewer than 300 holders resident in the U.S. acquire the class of stock sold by the foreign issuer pursuant to Rule 144A, the foreign issuer will not be required to register under the Securities Exchange Act of 1934. See Rule 12g3-2(b).15 C.F.R. 240.12g3-2(b).

to SEC scrutiny and face little prospect of either public enforcement or private class action litigation. But the listing premium associated with such a “private” entry into the U.S. is much smaller than the listing premium incident to entry onto a major exchange (and sometimes it may even be negative).¹¹⁶ Why then make such a limited entry? The most logical explanation is that the controlling shareholders optimize their own position by obtaining some valuation premium but little exposure to regulatory oversight or enforcement risk.

The bonding hypothesis has its critics. One recent article focuses on the cross-listing by Israeli firms (which is a major subcategory of U.S. cross-listings) and argues that there can be little bonding because Israeli corporate law has essentially the same substantive provisions as U.S. law.¹¹⁷ Although this study concludes that “law does not matter” (at least for Israeli companies), it does recognize that Israeli courts are “very slow” in processing corporate cases and are “unable to develop expertise or robust precedence in matters pertaining to securities law.”¹¹⁸ Ironically, the bottom line reached here that “law does not matter” again makes the same mistake as LLS&V (for whom law matters greatly); both are focusing on “law on the books” and ignoring the greater prospect of enforcement—public and private—in the U.S.

¹¹⁶ This is best shown by the diagram set forth *infra* in the text at note 123. Another recent study finds that cross-listings in the over-the-counter market are associated only with minor reductions in the firms’ cost of capital and that Rule 144A private placements even have adverse effects. See L. Hall and C. Leuz, Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-Listings, (Working Paper October 2006) (<http://ssrn.com/abstract=938230>).

¹¹⁷ See Ariel Yehezkel, Foreign Corporation Listing in the United States: Does Law Matter? Testing the Israeli Phenomenon, 2 N.Y.U. J. L. & Bus. 351, 393 (2006).

¹¹⁸ *Id.* at 392.

A related objection has been that U.S. enforcement—both private and public—seldom focuses on foreign issuers.¹¹⁹ Because the deterrent threat incident to cross-listing is thus asserted to be illusory, it might follow, if this premise were accurate, that bonding is largely a fiction. In truth, the data here is hard to assess. Because virtually all securities class actions settle, there are fewer reported decisions than in other comparable areas of law. Still, this criticism overstates. That its author could not find cases involving foreign issuers does not mean that none exist. NERA Economic Consulting, a specialist in securities litigation, publishes an annual report that shows among other things the “Top Ten Shareholder Class Action Settlements.” Its 2006 study shows that three out of this top ten involved foreign defendants, and all three such cases were resolved in 2006.¹²⁰ Similarly, in 2006, the SEC brought and settled a significant enforcement actions against TV Azteca, a major Mexican broadcasting company,¹²¹ and European former officers and directors of Spiegel, Inc.¹²² Also in 2006, the Department of Justice criminally

¹¹⁹ See Jordan Siegel, Can Foreign Firms Bond Themselves Effectively By Renting U.S. Securities Laws?, 75 J. Fin. Econ. 319, 321 (2005).

¹²⁰ Two of these three cases involved Nortel Networks, a Canadian issuer, which settled separate securities class actions covering different time periods for \$1,143,000,000 and \$1,074,000,000, respectively, both in 2006. The other foreign defendant was Royal Ahold NV, a Dutch company, which settled for \$1,100,000,000 in 2006. These settlements rank fifth, sixth, and seventh, respectively, on the list of the ten largest class action settlements. See Todd Foster, Ronald I. Miller, and Stephanie Plancich, “Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar,” (January 2007, NERA Economic Consulting) at p. 5. A major securities class action also remains pending in federal court against Royal Dutch Shell. See In re Royal Dutch/Shell Transport Securities Litigation, 380 F. Supp. 2d 509 (D.N.J. 2005) (affirming jurisdiction over foreign defendants not resident in U.S. and including foreign shareholders in the class).

¹²¹ See In the Matter of TV Azteca, S.A., Securities Exchange Act Release No. 54445, 2006 SEC LEXIS 2041 (September 14, 2006). Pursuant to this settlement, TV Azteca’s registration under the Securities Exchange Act was revoked, and certain of its senior officers were barred from serving as officers or directors of a public company.

¹²² See Judith Burns, “Eight Former Spiegel Executives Settle SEC Accounting Charges,” Wall Street Journal, November 3, 2006 at p. A-8. Spiegel had been acquired by a European corporation which allegedly caused it to conceal its deteriorating financial performance. The penalties ranged from \$100,000 to \$170,000 each and some defendants were barred from serving as officers or directors of a U.S. public

prosecuted several officers of foreign issuers¹²³ and extradited three British investment bankers from Great Britain to stand trial in connection with the Enron criminal prosecution (despite an angry national protest in Great Britain).¹²⁴ Thus, it may be true that U.S. enforcers allocate disproportionately fewer resources to cases involving foreign defendants, but, even if this effort is modest by U.S. standards, it may still far exceed the limited attention that securities fraud receives abroad.

Critics of U.S. enforcement have also sought to use the listing premium associated with foreign cross-listings in the U.S. to prove their overregulation thesis. The Paulson Report notes that the valuation premium incident to a foreign company's cross-listing in the United States has recently declined and argues that this decline is a consequence of Sarbanes-Oxley and U.S. overregulation.¹²⁵ In truth, there has been a recent decline but most of it occurred prior to the passage of Sarbanes-Oxley in 2002. Subsequent to that Act's passage, the listing premium has modestly risen over the years 2003-2005. The following chart shows the cross-listing premium for the years 1997-2005:¹²⁶

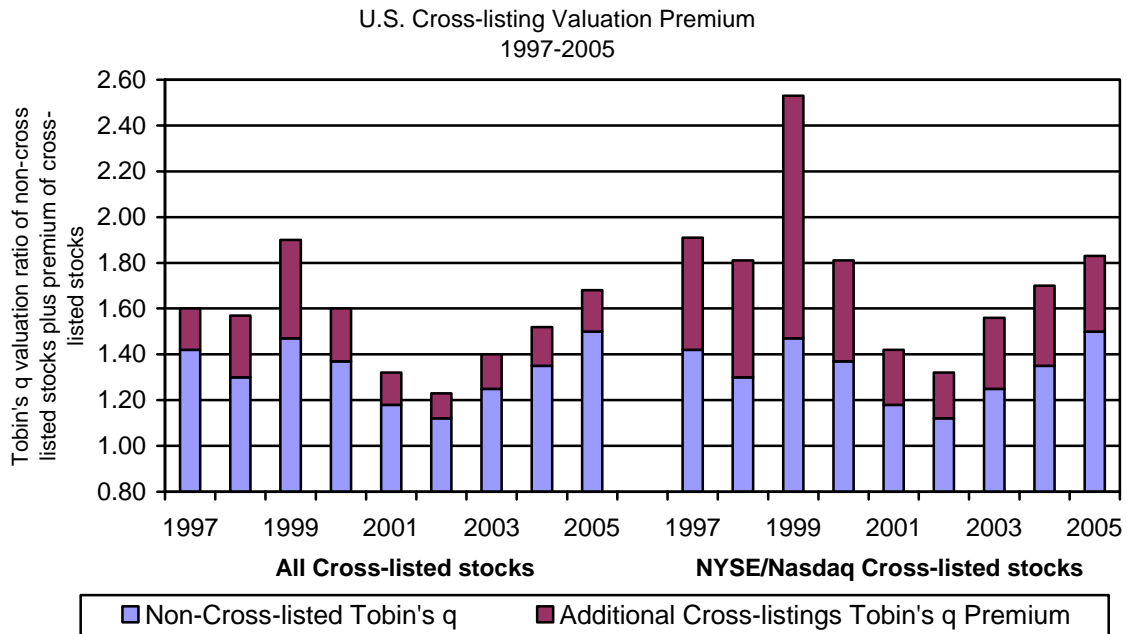
company.

¹²³ For example, Royal Ahold's chief financial officer was criminally prosecuted by the Department of Justice, and lower-ranking officers settled with the SEC.

¹²⁴ See Kate Murphy, "3 Britons in Enron Case Are Told To Remain in U.S.," New York Times, July 27, 2006, at C-3 (describing extradition of three British investment bankers who were indicted in the Enron prosecution).

¹²⁵ Paulson Report at 47-48

¹²⁶ See Doidge, Karolyi, Stulz, *The Valuation Premium For Non-U.S. Stocks Listed in U.S. Markets: 1997-2005* at p. 1 (Working Paper January 3, 2007). For a similar examination of the cross-listing premium over an overlapping period, see Kate Litvak, [Sarbanes-Oxley and the Cross-Listing Premium](http://ssrn.com/abstract=959022), (http://ssrn.com/abstract=959022) (December 2006). This paper also finds the cross-listing premium to have declined from year-end 2001 to year-end 2002 and interprets this as in part an indication that investors perceived Sarbanes-Oxley to have greater costs than benefits. Professor Litvak does not discuss the period after 2002.



What caused the decline in 2000 through 2002? No one could reasonably argue that the market in 2000 anticipated Sarbanes-Oxley. But an epic stock bubble did burst in 2001; then Enron failed in 2001, and WorldCom followed in 2002. More generally, a wave of financial statement restatements in the U.S. shook investor confidence and depressed the equity market.¹²⁷ Thus, the most plausible inference is that, as of 2000 and 2001 when the average listing premium fell dramatically, both U.S. investors and foreign investors reevaluated the strength of the U.S.'s system of corporate governance and assigned less of a premium to entry into this now scandal-ridden market. But then, after 2002, investors again saw increased value in a cross-listing. Such a pattern does not prove that Sarbanes-Oxley

¹²⁷ For a concise discussion of the wave of financial statement restatements that began to accelerate in 1997 and has continued through 2005, see Paulson Report at 119-121. As it notes, the United States Government Accountability Office has found that the annual frequency of restatement rose seven-fold over this period from 0.9% in 1997 to 6.8% in 2005. *Id.* at 120.

strengthened U.S. corporate governance, but it is at least consistent with such an interpretation of investors' perception.

If most objections to the bonding hypothesis can be dismissed as requiring no more than modest qualifications, one significant problem remains that starts from a seeming paradox. Considerable evidence shows that the bonding premium is greatest for companies incorporated in jurisdictions with the weakest investor protections.¹²⁸ But other studies find that corporations from such countries are the least likely to cross-list.¹²⁹ Both tendencies make sense. Investors receive greater protection from cross-listing when the home jurisdiction's law is the weakest, and precisely in those cases the controlling shareholder gives up the most (and so is the least likely to cross-list).

Hence, who does cross-list? As Reese and Weisbach found, it is disproportionately firms with investment projects that need equity financing.¹³⁰ These firms cross-list to access the U.S.'s deep market and obtain its lower cost of capital. But, if only firms with superior investment projects cross-list (and the market senses this), then cross-listing by a foreign company becomes as much a form of signaling as a form of bonding. That is, if a firm that believes that it possesses superior investment opportunities wants to convince the market of its claim, it might cross-list in the U.S. to signal to investors, not that it has adopted superior protections for minority shareholders, but that its investment project was superior. The market's reaction might in effect be: "You wouldn't do anything that

¹²⁸ See L. Hail and C. Leuz, "Cost of Capital Effects and Changes in Growth Expectations around U.S. Cross-Listings," (ECGI Finance Working Paper No. 46/2004) (<http://ssrn.com/abstract=938230>).

¹²⁹ See Doidge, Karolyi, Lins, Miller & Stulz, *supra* note 113.

¹³⁰ See Reese and Weisbach, *supra* note 11.

dangerous unless you were very certain of your investment opportunities”—in effect, one bonds in order to signal. The relative contribution of the two—bonding and signaling—to the valuation premium seems indeterminate.

Clearly, self selection plays a large role. Few firms simply cross-list to obtain a valuation premium; rather they seem to have investment or acquisition plans that they want to pursue and to convince the market to value highly. Cross-listing gives them credibility. The greater the risk of liability, the more the implicit promise of “fair” treatment for minority shareholders seems credible. Thus, the puzzle here becomes whether foreign firms cross-list in the U.S. because they have better disclosure and corporate governance ratings or whether they have these higher ratings because they cross-list. Again, this is the issue of the direction of causality. Some light is shed on it by Clark and Wojcik, who find that foreign firms that cross-list in the U.S. increase the disparity between their higher governance ratings and those of non-cross-listing firms subsequent to the time that they cross-list.¹³¹ As they suggest, such post-listing governance reform looks more like bonding than simple self-selection.

Nonetheless, even if these firms do appear to be “bonding” themselves, they are a relatively small proportion of the potential population of firms eligible to cross-list. As a result, it may be more profitable for the value-maximizing securities exchange to focus instead on the much larger number of firms that do not wish to bond (as London arguably has done).

IV. Political Economy: Why Do Civil Law and Common Law Countries Disagree Over Enforcement?

¹³¹ See Clark and Wojcik, *supra* note 17, at 149.

Civil law jurisdictions seem to invest less resources in regulation and to impose far less in financial penalties. Why? In turn, the U.S. is unique in its enthusiastic use of both public and private enforcement and criminal penalties. Again, why?

At least three different types of theories seem plausible. First, it is arguable that dispersed ownership corporate governance systems (which includes the U.S., the U.K., and few, if any, others) need greater enforcement, because their agency cost problems are more intractable. In particular, it can be argued that the U.S. expends more on enforcement than the U.K. because its corporate law gives shareholders less control rights than does the U.K. – in effect, enforcement might be a substitute for weaker corporate governance.

Second, a political theory can be advanced that various corporate constituencies—labor in particular—have agreed to acquiesce in the receipt of private benefits of control by controlling shareholders in return for the controlling shareholder’s tacit agreement to pursue shareholder wealth maximization less aggressively than do U.S. or U.K. corporate managers. This implicit social contract argument is similar to theories that Mark Roe has repeatedly advanced.¹³²

Third, the political demand for enforcement may follow from the creation of a deep, retail-oriented securities market. This is the opposite of a LLS&V-style theory, because the causality is reversed: economics determines politics. In this view, once a nation achieves dispersed ownership, those individual owners become a potent political force. Following scandals, they demand reforms and retribution. In

¹³² For example, see M. Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: Political Context, Corporate Impact (2006); M. Roe, Legal Origins, Politics, and Modern Stock Markets, 120 Harv. L. Rev. 460 (2006).

the United States, the 1929 Market Crash led directly to the adoption of the federal securities laws in 1933 and 1934, and the 2000-2002 bubble and associated scandals produced Sarbanes-Oxley. Although the stock market decline in 2000 was just as abrupt in Europe, the economic loss in Europe fell more on institutional investors than individual shareholders (because European markets are dominated by institutions). Hence, the 2000 market decline produced less of a political demand for protection and retribution in Europe.

Each of these theories is briefly reviewed below:

A. The Relative Need for Enforcement.

Why would common law countries need to invest more in regulation and enforcement? First, their stock markets are larger, more valuable national assets. But the data reviewed earlier shows that, even after adjustment for relative market size, common law jurisdictions invest and expend more on regulation than do civil law jurisdictions. One explanation might be that common law and civil law jurisdictions face characteristically different types of fraud and fiduciary abuse.¹³³ The U.S. and the U.K. are characterized by dispersed shareholder ownership, while civil law jurisdictions (and most of the world) is characterized by concentrated ownership. In common law (or dispersed ownership systems), where there typically is a separation of ownership and control, the principal agency cost problem involves managers. In contrast, in civil law (or concentrated ownership systems), shareholders must instead fear exploitation by controlling shareholders.

¹³³ This follows from their very different characteristic structure of shareholder ownership. For the argument that the structure of ownership determines the prevalent type of fraud, see Coffee, A Theory of Corporate Scandals: Why U.S. and Europe Differ, 21 Oxford Review of Economic Policy 198 (2005)

No claim is here made that fiduciary abuse by controlling shareholders is less serious than fiduciary abuse by managers. But the former may be more easily monitored by regulators, who therefore have less need to engage in “ex post” enforcement. For example, when a controlling shareholder proposes a squeeze-out merger or a self-dealing transaction, it will typically be an open and visible matter, and complaints may be made by minority shareholders to the regulator. The regulator might then take a variety of actions (e.g., warnings, refusal to give a “no-action” letter, to accelerate a registration statement, or to issue other required clearances, etc.) which do not involve an enforcement proceeding and do not levy any financial penalty, but which could force the modification or cancellation of the transaction. In contrast, actions taken by individual corporate managers may be more secretive and even furtive (such as insider trading). In these cases, the regulator learns of the abuse (if at all) ex post and can only respond with an enforcement action, rather than with cautionary advice. As a result, one plausible hypothesis is that regulators in common law jurisdictions need to depend more on enforcement actions.

Controlling shareholders are also more likely to be repeat players than managers; hence, they may have a greater interest in preserving their reputational capital. To be sure, both managers and controlling shareholder can face “final periods” in which their desire to protect their reputational capital is overcome by the possibility of enormous gains. But these occasions seem more likely to arise in the manager’s career. Controlling shareholders cannot as easily bail out, dumping their shares into the market (both because thin markets cannot absorb controlling blocks

without enormously reducing the share price and because controlling shareholders typically wish to sell only in privately negotiated sales of control blocks at prices above the market price). The recent shift to equity compensation in the U.S. may have exacerbated the agency costs relating to managerial conduct because stock options are a high octane fuel that can create perverse incentives.

More importantly, the abuses that controlling shareholders can commit (i.e., largely self-dealing transactions) may be better addressed through corporate law restrictions than by ex post enforcement. Depending on the jurisdiction, regulators may be able to simply inform a major financial institution or the well-known family that controls a company that they will not permit the parent to effect a merger that eliminates the public minority (or that they will only give permission at a higher price). Such regulation through informal contacts could be both cheaper and involve less public confrontations that give rise to measurable events, such as enforcement actions.

To present this interpretation is not to argue that the evidence confirms it, but at least there is some supporting evidence. Kate Litvak has found that as Sarbanes-Oxley came closer to enactment, and in particular as its application to foreign issuers became clearer, the stock prices of non-U.S. firms cross-listed in the U.S. declined relative to a sample of non-cross listed, but otherwise similar, firms from the same jurisdictions.¹³⁴ Given the tendency of foreign firms to have controlling shareholders who consumed substantial private benefits of control, one might have predicted that shareholders in such controlled firms would have benefited from Sarbanes-Oxley's increased rigor. But apparently, the public shareholders in these

¹³⁴ See Litvak, *supra* note 132.

firms perceived SOX's enhanced enforcement as involving more costs than benefits for them. This suggests that there could be a mismatch between U.S. style regulation (with its heavy emphasis on independent directors) and the agency problems of firms in concentrated ownership legal regimes.

Not only might U.S. corporate governance be poorly designed for firms in concentrated ownership legal regimes, it might also be less rigorous and shareholder friendly than the governance system of the U.K. In the U.K., the positions of the CEO and the chairman of the board are typically separated; shareholders vote on executive compensation; and institutional investors generally both own a higher percentage of the stock and exercise closer oversight than in the U.S.¹³⁵ If so, the U.K. arguably might have less need to invest in enforcement. In general, if shareholders can protect themselves adequately, less need exists for regulators to invest heavily in enforcement or to use stock exchange listing rules as a leverage point by which to impose higher governance standards. This would explain both why the LSE, unlike the NYSE, has never felt pressure to raise its listing standards and also why foreign firms incur no listing premium when cross-listing on the London Stock Exchange.

B. The Social Contract Theory

Mark Roe has long sought to explain European corporate governance in terms of an ongoing political contest between the left and the right. Social democracies press managers to stabilize employment and to forego some profit-maximizing opportunities. Concentrated ownership arose, he has argued, because it

¹³⁵ For an overview, see Bernard Black and John Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 Mich. L. Rev. 1997 (1994).

could better resist the power of labor than could dispersed owners.¹³⁶ Where labor is powerful (as in Europe), democratic governments will be less likely to support a strong system of investor protection that might contest labor's attempts to gain a greater share of the corporation's cash flow.

Lurking in this analysis is an implicit social contract between labor and controlling shareholders. The controlling shareholders grant labor a stronger claim on the firm's cash flow than they could negotiate in dispersed ownership systems, but in turn ask labor to accept their diversion to themselves of the private benefits of control. Labor, in turn, has little reason to object because these benefits come not out of their own pocket, but those of the minority shareholders. Stated approvingly, this thesis sees a social contract. Viewed skeptically, however, this thesis is essentially describing a coalition of the rich and the poor against the middle class.

This explanation faces some problems. In a globalizing world, where firms compete in international markets, a corporation cannot permit both controlling shareholders and labor to raid its treasure—without suffering some competitive disadvantages. Still, neither controlling shareholders nor labor should be seeking protections for minority shareholders or demanding greater public expenditures on enforcement. Minority shareholders might, but they could be a relatively weak force in countries characterized by thin equity markets.

C. The Political Consequences of Dispersed Ownership

In earlier work, this author has suggested that LLS&V have their causality reversed. LLS&V argue that pre-existing legal rules enabled strong capital markets to develop. The alternative theory is that a dispersed ownership system of corporate

¹³⁶ See sources cited supra at note 130.

governance developed first, and this in turn created a political demand for investor protection.¹³⁷ Once ordinary citizens entered the equity securities markets and invested their life savings in stocks, they demanded legal protections against fraud and fiduciary abuse.

U.S. history is easily reconciled with this latter theory. Retail investors invested heavily in the stock market in the 1920s, experienced the Crash of 1929, and demanded (and received) new legal protections in the form of the federal securities laws enacted in 1933 and 1934. Less noticed has been the fact that British history is also consistent with this same story. A recent British study finds that its securities markets developed prior to the enactment of any strong comprehensive system of investor protection.¹³⁸ Indeed, they doubt that Britain had a strong system of investor protection, comparable to that of the United States, prior to 1980. Today, China seems to be following the same trajectory. Its securities markets have grown rapidly since 1990, but it still lacks strong laws or a well-funded enforcement system.¹³⁹

This hypothesis that the law follows, rather than leads, economic developments finds it simple to explain the “enforcement gap” between common law and civil law countries. Securities markets in Europe were historically thin and never succeeded in winning broad retail participation. Absent extensive citizen involvement in the market, there was no interest group to lobby for more investment

¹³⁷ See Coffee, *supra* note 4, at 65 to 67, 80-81.

¹³⁸ See Julian Franks, Colin Mayer and Stefano Rossi, *Ownership, Evolution and Regulation* (Working Paper 2006) (<http://ssrn.com/abstract=354381>).

¹³⁹ For such an assessment, see Zhong Zhang, “Legal Deterrence: The Foundation of Corporate Deterrence—Evidence from China” (Working Paper 2007).

in enforcement. In contrast, in the United States, Congress learned long ago that the SEC is a popular agency with voters, and both parties have generally supported it.

Phrased more generally, in a democracy, there is usually a competition for public funds. Investment in enforcement rises only after the securities market first convinces the middle class to invest in it. Thin markets create no such political demand, because the principal investors are financial institutions, who, even if defrauded, hesitate before demanding new laws, stronger regulation, and more enforcement (which could some day be applied to them). Even the enforcement disparity between the U.S. and the U.K. can be explained on this basis: although the U.K. has dispersed ownership, shareholders in the United States are more “retail” in character, while the U.K.’s market is dominated by institutions. Hence, there is a greater political demand in the U.S. for strong enforcement.

Under Ockham’s Razor, the simpler, more parsimonious theory should be preferred over the more complex. The explanation that dispersed ownership produces a political demand for enforcement is simpler than Roe’s theory of a hidden political coalition between labor and controlling shareholders to restrain shareholder wealth maximization. Although both could be correct in part, more needs to be shown on behalf of the Roe theory before it should be preferred.

D. An Initial Summary

Potentially, the foregoing theories are complementary. Each could explain to some degree the observed pattern of different levels of enforcement intensity between common law and civil law jurisdictions. That the U.S. is an outlier is also explained by multiple factors, including (1) the enormous size of its equity markets;

(2) the broad retail participation in those markets; (3) the federal structure of the U.S. government, which results in multiple enforcers (and invites a competition among them), and (4) the U.S. public's apparent preference for retributive punishment in securities cases.¹⁴⁰

Will these differences persist? To the extent that either the efficiency arguments for greater use of deterrence in dispersed ownership regimes or the political "social contract" explanation are accepted, they should. But if dispersed ownership is the driving force, the disparity in enforcement levels between the U.S. and Europe may decrease as retail participation in the stock market continues to grow across Europe.

IV. The Policy Trade-offs

The foregoing arguments have an obvious policy implication: if U.S. regulators were to listen to the siren call of those who favor reduced regulation (and less deterrence), they might unintentionally both increase the cost of capital in the United States and reduce the bonding premium that attracts current cross-listing firms. Ironically, this could result in reducing the incentive for ambitious firms with high quality governance to list in the U.S., while decreasing the barrier to firms with controlling shareholders intent on enjoying the private benefits of control. That would be perverse.

¹⁴⁰ The political preference of U.S. voters for strong enforcement and punitive punishments is shown not just by the Sarbanes-Oxley Act, which vastly elevated penalty levels, but by earlier legislation as well. Congress moved to a sentencing guideline system in 1991, in part to increase actual penalty levels. The United States Sentencing Commission repeatedly increased the then mandatory sentencing guidelines through the 1990s. See C. R. Alexander, J. Arlen, and M. Cohen, Regulating Corporate Fraud Sanctions: Evidence on the effect of the U.S. Sentencing Guidelines, 42 Journal of Law and Economics 393 (1999). Earlier, in 1988, Congress elevated the penalties for insider trading in response to popular demand in the Insider Trading and Securities Trade Enforcement Act of 1988, 15 U.S.C. of 78a-1 (which also introduced a new private cause of action). In short, the popularity of "get tough" measures on white collar crime (and particularly securities fraud) shows the impact of a retail shareholder culture on the political process.

But one cannot simply stop at this point. The next question must be faced: Should the U.S. increase further its unique emphasis on enforcement? Or has it already hit the point of diminishing returns so that some relaxation, would not affect its cost of capital (but might attract some listings by firms that today face significant costs in conforming their firm's governance to U.S. standards)? Kate Litvak's data shows that foreign firms cross-listed in the U.S. declined in value as Sarbanes-Oxley's approaching application to foreign issuers became clear.¹⁴¹ If these already cross-listed firms constituted a population of firms that were, on average, seeking to bond themselves, their shareholders arguably should have seen Sarbanes-Oxley as a serendipitous benefit because it increased the degree to which these companies were subject to strong financial controls. Why then did their stock prices respond negatively to its passage? Conversely, other data shows that the U.S. listing premium began to rise again the next year and has continued to rise.¹⁴² Why in the wake of Sarbanes-Oxley has this premium growing risen?

A. Should the U.S. Relax Enforcement?

The premise of the recent debate has been that foreign firms are fleeing the U.S. because of overregulation. This essay has presented some evidence that only a limited number of foreign firms ever came to the United States, and they were significantly motivated by the lower cost of capital available here. That suggests in turn that relaxing U.S. enforcement efforts, which never targeted the foreign issuer to begin with, would have a modest (and possibly even counterproductive) impact.

¹⁴¹ See Litvak, *supra* note 16.

¹⁴² See Doidge, Karolyi and Stulz (2007), *supra* note 9.

But how can we reconcile the inconsistent evidence that (i) the stock prices of cross-listed foreign firms went down as Sarbanes-Oxley advanced through Congress (at least in comparison to non-cross-listed similar firms), and (ii) the listing premium has increased from 2003 on? The simplest explanation is that investors in cross-listed foreign firms perceived Sarbanes-Oxley to involve more costs than benefits for them. Grafting “independent” audit committees onto the two-tier Continental board seemed cumbersome and might have little beneficial impact where a controlling shareholder would still elect the board.¹⁴³

The subsequent increase in the listing premium is a more speculative matter. If we assume that cross-listing firms come to the U.S. to raise equity and/or do acquisitions, however, it is relevant that 2000, the year in which the premium began to fall, was also the year that the “high tech” bubble burst and the IPO market essentially dried up in the United States (for both domestic and foreign firms alike).¹⁴⁴ This implied that a primary purpose underlying the decision of foreign firms to cross-list was no longer attainable, at least in the short run. No surprise then

¹⁴³ At the time, the implications of Section 404 of Sarbanes-Oxley were not understood, because its statutory language is not demanding, and it was not until with PCAOB’s adoption of Auditing Standard No. 2 a year later that its high costs came into view. See text and notes supra at notes 21 to 22.

¹⁴⁴ According to Thomson Financial, U.S. initial public offerings declined after 2000, reaching bottom in 2003, and have more recently risen (but not back to the earlier level):

Year	Number	Value (in billions)	
2000	387		\$61 billion
2001	99		\$38 billion
2002	95		\$28 billion
2003	84		\$16 billion
2004	252		\$48 billion
2005	213		\$39 billion
2006*	182		\$40 billion
2007 (est.)	225		\$42 billion

See “Back of the Envelope,” N.Y. Times, December 22, 2006 at p. C-5. The data for 2006 was as of December, 2006.

that these firms' premium over non-cross-listed firms decreased. But by the same token, as the IPO market re-awakened in subsequent years, that premium began again to increase modestly. At least, this analysis furnishes a testable prediction, under which a rise in IPOs should produce an increased listing premium.

If the U.S. IPO market does awaken, one would expect some increased migration of foreign firms to the U.S. This does not mean that the NYSE or Nasdaq can outcompete the LSE for cross-listings (as the vast majority of foreign firms have no expectation of being able to utilize the U.S. IPO market), but it suggests that the current unattractiveness of the U.S. market to foreign firms may be a temporary phenomenon; 2003 was the nadir from which there already has been an upturn.

B. Public Enforcement Versus Private Enforcement

Even if a general relaxation of enforcement makes doubtful sense, more selective relaxation may. The securities class action represents an especially dangerous threat for the foreign issuer. If it stays offshore and does not cross-list, it is not subject to the securities class action, because class actions are not recognized in Europe and U.S. courts would be unlikely to certify a wholly extraterritorial class of foreign investors. But if the foreign issuer does cross-list in the U.S., it now faces the prospect that, even though it lists only 1 or 2% of its shares in the U.S., a global class action might be certified covering investors around the world.¹⁴⁵ Indeed, in the recent Royal Ahold class action, the settlement was for approximately \$1.1 billion, paid by a foreign corporation incorporated in The Netherlands, and an estimated

¹⁴⁵ See, e.g., In re Royal Dutch/Shell Transport Sec. Litig., 380 F. Supp. 2d 509 (D. N.J. 2005); In re Royal Ahold Sec. & ERISA Litig., 437 F. Supp. 2d 467 (D. Md. 2006).

80% of the class resided outside the United States.¹⁴⁶ Any rational foreign issuer is likely to regard this disparity between a small issuance of shares in the U.S. and a potentially much larger global liability to all investors worldwide because of the worldwide reach U.S. class action law as forbidding. Such an issuer may know that its stock price is volatile, and that a sudden stock price drop could trigger a U.S. securities class action. Although U.S. courts will not certify a class including foreign investors simply because some shares are listed in the U.S. and will require that some conduct occur in the U.S.,¹⁴⁷ this requirement is easily satisfied in many cases because most cross-listed firms typically have extensive U.S. operations.

The obvious remedy here is not to bar all securities litigation aimed at foreign firms, but to restrict the plaintiff class to U.S. nationals and foreign residents. Allowing foreign non-resident investors to be included within the class not only forces U.S. courts to serve as “policeman to the world,” but also dissuades foreign issuers from cross-listing. Important as reducing one’s cost of capital may be, it is not worth risking potential liability in the billions.

¹⁴⁶ The Royal Ahold litigation, which is the largest securities settlement to date involving a European corporation, is the subject of multiple reported decisions. For the decision preliminarily certifying the settlement, see In re Royal Ahold N.V. Securities & ERISA Litigation, 2006 WL 132080 (D. Md. January 9, 2006); see also In re Royal Ahold N.V. Sec. & ERISA Litigation, 437 F. Supp. 2d 467 (D. Md. 2006). The defendants estimated that 80% of the class consisted of foreign investors. See “Memorandum of Law In Support of Lead Plaintiffs’ Motion For Final Approval of Certification of Settlement Class and Final Approval of Settlement and Plan of Allocation of Settlement Proceeds,” May 12, 2006 at p. 12 (copy on file with author).

¹⁴⁷ This “conduct” test was initially formulated by Second Circuit Judge Henry Friendly. See, e.g., Bersch v. Drexel Firestone, Inc., 519 F. 2d 974 (2d Cir. 1975); Leasco Data Processing Equipment Corp. v. Maxwell, 468 F. 2d 1326 (2d Cir. 1972). Its premise is that Congress would not have “intended to allow the United States to be used as a base for manufacturing fraudulent securities devices for export, even when they are peddled only to foreigners.” See ITT v. Vencap Ltd., 519 F.2d 1001, 1017-18 (2d Cir. 1975). Absent significant conduct by the defendant in the U.S. that extends beyond merely “preparatory” efforts, the class action is likely to be dismissed. See In re Nat’l Austl. Bank Sec. Litig., 2006 U.S. Dist. LEXIS 94163 (S.D.N.Y. November 8, 2006) (dismissing such a proposed class action).

More generally, the securities class action seems poorly designed as a shareholder remedy for the familiar secondary market “stock drop” case, because it essentially involves shareholders suing shareholders. Inevitably, the settlement cost imposed on the defendant corporation in a securities class action falls principally on its shareholders. This means that the plaintiff class recovers from the other shareholders, with the result that secondary market securities litigation largely generates pocket-shifting wealth transfers among largely diversified shareholders. To illustrate, imagine that a hypothetical pension fund owns a portfolio of companies of which, over a period of time, one hundred become defendants in securities class actions. In fifty of these cases, the pension fund is in the plaintiff class and receives the recovery; in the other fifty, it is not in the plaintiff class and thus bears the recovery. The payments would thus balance out, except for the fact that the recovery received in the fifty cases in which the pension fund is a plaintiff is diminished by the legal fees of the plaintiffs’ attorneys (probably 25% or so on average), the fees of the defense attorneys, and other related costs (including liability insurance). As a result, from a compensatory perspective, the odds are high that shareholders are made systematically worse off by securities class actions.

Redesign of the “secondary market” securities class action is possible,¹⁴⁸ but almost certainly not imminent. In the interim, it must be recognized that private enforcement in the United States is working significantly sub-optimally, achieving little, if any, compensation and only limited deterrence, because its costs fall on

¹⁴⁸ For specific proposals, see John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence And Its Implications, 106 Columbia L. Rev. 1534 (2006).

innocent shareholders, not the culpable corporate officers actually responsible for “cooking the books” and other misdeeds.¹⁴⁹

Thus, if in the U.S. private enforcement under the federal securities laws seldom imposes penalties on the culpable, it makes sense to place greater reliance on public enforcement. This is a prescription quite at odds with LLS&V, who favor private enforcement (but do not understand it), and traditionalists who still rely, like a crutch, on the Supreme Court’s statement in J. I. Case Co. v. Borak¹⁵⁰ that private enforcement is “necessary” for the effective enforcement of the securities laws. At present, we have both too little private enforcement and too much—too little in that the outside professional are rarely sued and corporate officers pay nothing, and too much in that the corporation, itself, is regularly sued and settles at the shareholders’ expense. If private enforcement is to work, it will have to be refashioned and directed at the corporation’s officers and gatekeepers, and this would require legislative action.¹⁵¹

C. Reconsidering Public Enforcement

The number of enforcement cases brought by the SEC fell significantly in 2006, as did the total amount of the financial penalties that it exacted.¹⁵² It is not entirely clear what is behind this reduction in enforcement intensity, but one factor would appear to be a new SEC policy, announced in January 2006, under which the

¹⁴⁹ Because of a variety of factors, corporate officers almost never contribute funds from their own pockets to settle securities class actions. See Coffee, *supra* note 148, at 1550-51.

¹⁵⁰ 377 U.S. 426, 432 (1964) (“Private enforcement of the proxy rules provides a necessary supplement to Commission action.”).

¹⁵¹ Most importantly, it would be necessary to overturn Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), which exempts those who “aid and abet” a securities law violation from civil liability under Rule 10b-5.

¹⁵² The number of enforcement actions fell from 630 in 2005 to 574 in 2006, and the total penalties fell from roughly \$1.8 billion to \$991 million. See text and notes *infra* at notes 73 to 74.

Commission will not impose significant financial penalties on corporate issuers unless “the issuer’s violation has provided an improper benefit to shareholders ...”¹⁵³ This policy is now being followed, for example, in the contemporary stock option backdating investigation, as the Commission has slowed settlements until it determines what, if any, “improper benefit” was provided to the corporation through the backdating of stock options.¹⁵⁴

The SEC’s premise here is that large penalties imposed on the corporation fall on innocent shareholders and so should be used only when the corporation (and its shareholders) have received an improper benefit from the violation. Indeed, much evidence shows that most forms of corporate misconduct primarily benefit the corporate executives.¹⁵⁵ Analyzing a large sample of class actions, Arlen and Carney report that managerial self-interest seems to be the dominant motivation underlying securities fraud, with managers frequently engaging in behavior resembling insider trading.¹⁵⁶ If so, the obvious policy prescription is to move from a system of enterprise liability (under which penalties are principally imposed on the corporation) to a system of agent and managerial liability. Such a shift may be in progress today, but it has gone largely unnoticed. In truth, the SEC is better positioned to shift its target in this fashion than is the plaintiffs’ bar because it alone has authority to sue and sanction aiders and abettors.¹⁵⁷

¹⁵³ See Press Release, U.S. Sec. & Exch. Comm’n, “Statement of the Securities and Exchange Commission Concerning Financial Penalties” (Jan. 4, 2006), at <http://www.sec.gov/news/press/2006-4.htm>.

¹⁵⁴ See Brooke Masters and Jeremy Grant, “SEC Finalising Penalties for Option Backdating,” FT.com, February 6, 2007.

¹⁵⁵ For a fuller version of this argument, see Jenifer H. Arlen and William J. Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. Ill. L. Rev. 691, 721-24.

¹⁵⁶ Id. at 702-03, 720-40.

¹⁵⁷ See Section 20(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t (authorizing the SEC, but not private plaintiffs, to sue any person who “knowingly provides substantial assistance to another person” in

How would a shift from an enforcement policy of enterprise liability to one of agent or managerial liability affect the “competitiveness” of U.S. markets? Assuming that the latter policy could be pursued with the same level of enforcement intensity, it should not affect the cost of capital, but it might reduce the fear of investors in foreign firms that cross-listing could subject them to Draconian penalties. To be sure, the managers of these firms might want indemnification or insurance or might demand a risk premium in their compensation, but the SEC has long resisted indemnification of securities law liabilities and the prospect of excess compensation to managers seems far less likely in concentrated ownership regimes. Today, when either the SEC or private plaintiffs impose punitive penalties on a public corporation because its managers have overstated earnings (or otherwise “cooked the books”), a system of enterprise liability is at work that resembles punishing the victim of a burglary because the victim negligently suffered a burglary. Such punishment may deter, but among those likely deterred are foreign firms considering cross-listing in the U.S.

D. Cross-Border Securities Regulation

Currently, the SEC is considering whether to permit foreign brokers to access U.S. investors through web sites and other means and solicit them to buy the securities of foreign issuers that do not comply with U.S. disclosure requirements.¹⁵⁸ Under a trial balloon floated by the SEC, foreign brokers who misbehave would instead be disciplined by foreign regulatory authorities under an approach that SEC

connection with a securities law violation).

¹⁵⁸ See Floyd Norris, “Should U.S. Markets Be Wide Open,” N.Y. Times, February 9, 2007 at C-9.

officials have termed “substituted compliance.”¹⁵⁹ But would foreign regulators behave in a fashion even remotely resembling that of the SEC? The foregoing survey of enforcement efforts obviously raises questions about whether foreign compliance systems would impose anything resembling U.S.-style enforcement discipline. Certainly, foreign regulators do not appear to be doing so at present.

Moreover, if this proposal were to be adopted, the significance of listing on a U.S. exchange might decline, as foreign issuers could directly access U.S. investors. Potentially, this could have an adverse impact on the competitiveness of U.S. markets and could cost the U.S. securities industry some business. In response, some have suggested that the SEC should also permit U.S. exchanges to list foreign issuers who do not comply with U.S. disclosure or governance standards.¹⁶⁰ Here, a distinct problem surfaces: even if foreign brokers are permitted to solicit U.S. investors, it does not follow that listing standards should be abandoned or relaxed. Such a step would complicate and possibly constrain the ability of foreign issuers to “bond” by opting into higher disclosure and governance standards. Even with unfettered access to foreign stocks that did not comply with U.S. disclosure standards, U.S. investors could still understand that a NYSE or Nasdaq listing carried with it some assurance of higher disclosure or superior governance. Arguably, the brand name should not be diluted. Nor can it be argued that an efficient market solves this problem, as the listing of foreign securities that do not

¹⁵⁹ See Ethiopis Tafara and Robert J. Peterson, A Blueprint for Cross-Border Access to U.S. Investors: A New Institutional Framework, 48 Harv. Int’l L.J., __ (forthcoming 2007).

¹⁶⁰ See Edward F. Greene, Beyond Borders: Time to Tear Down the Barriers to Global Investing, 48 Harv. Int’l L.J. __ (2007). Others have preceded Greene in making this suggestion. See, e.g., Merritt B. Fox, The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities, 97 Mich. L. Rev. 696, 730-57 (1998); Franklin R. Edwards, Listing Foreign Securities on U.S. Exchanges, 5 J. Applied Corp. Fin. 28 (1993).

comply with U.S. standards subjects at least undiversified retail investors to a risk from which accurate share pricing does not protect them.¹⁶¹

More generally, the ability of the SEC to rely on “substituted” foreign enforcement logically requires as a prerequisite better information and some assurances about the level of enforcement that the foreign regulator will supply. In any foreign jurisdiction, it is not the first priority of the local regulator to protect U.S. investors who, for example, purchased securities from foreign brokers in international transactions. Even if the foreign regulator gave the same level of attention to complaints from U.S. investors as it did to those of its own citizens, the enforcement resources allocated and the sanctions levied might likely fall well below what the SEC would have done. If, however, the ability of the local broker to access U.S. investors were conditioned on a commitment as to enforcement, foreign regulators might be prepared to expend greater resources. More work here remains to be done before the SEC’s trial balloon is near ready for adoption.¹⁶²

CONCLUSION

Enforcement intensity matters—for better or for worse. The United States pursues securities law violations with a regulatory intensity unmatched elsewhere in the world (except possibly in Australia). This intensity probably contributes to the

¹⁶¹ That the market may be efficient and share prices accurate does not protect retail investors from the misappropriation of private benefits of control by controlling shareholders. Market efficiency might mean that the market has accurately priced the expected level of benefits that the average controlling shareholder will divert to itself and discounted the stock’s price for this mean value. But this mean value will be surrounded by considerable variance, as all controlling shareholders are not alike. If all investors were fully diversified, this variance would not hurt them, because excessive misappropriation in one case would be balanced by subnormal misappropriation in another. But all retail investors are not diversified, and they will be predictably injured by such variance. Thus, the stock price can be accurate, but retail investors can still suffer injury.

¹⁶² One alternative might be to require that the foreign broker subject itself to private litigation in the United States by consenting to service of process and posting a bond. Private enforcement here might be a more effective “substitute” than foreign public enforcement.

U.S.'s lower cost of equity capital and probably explains (at least in part) the valuation premium that cross-listing foreign firms experience.¹⁶³ Even more certainly, it also explains the unwillingness of many foreign firms to enter the U.S. market. This pattern of greater enforcement intensity in the United States may extend beyond securities or financial regulation and characterize other fields as well,¹⁶⁴ but this article will not attempt to cover that broader waterfront.

But what explains the unique level of enforcement intensity in the United States? The most likely hypothesis is that enforcement intensity varies with the level of retail ownership in the jurisdiction. If so, this is an example of reverse causality, with developments in the market shaping the evolution of law, not the reverse.

That said, there is much that we do not yet understand. Above all, the optimal level of enforcement remains unknown and highly debatable. Among securities regulators, probably the most striking contrast is the difference between their inputs and outputs. U.S. regulators are roughly comparable to those of other common law countries in their budget and staffing levels, but not in the number of enforcement actions brought or the magnitude of the sanctions imposed. Here, they inhabit a world largely of their own. This raises at least the possibility that, outside the United States, more is done through “ex ante” regulation than through “ex post” enforcement. Although the SEC also uses “ex ante” regulation,¹⁶⁵ it seems more

¹⁶³ Because so little data is available about the penalties imposed on other countries (with only the U.K. and Canada in addition to the U.S. making data generally available), regressions cannot yet be run.

¹⁶⁴ Political scientists have, for example, noticed sharp contrasts in the “regulatory style” of environmental regulation between the U.S. and Japan. See Robert Kagan, *ADVERSARIAL LEGALISM: The American Way of Law* (2001) at 192-206 (harsher, more adversarial style characterized U.S. enforcement). This article will, however, stop well short of offering universal generalizations about U.S. regulatory style.

¹⁶⁵ The SEC certainly uses “ex ante” controls, such as “no action letters,” control over the acceleration of registration statements, and advance approval of other transactions. But these controls are not employed by their Division of Enforcement, which is committed to “ex post” enforcement.

committed than other regulators to a policy of general deterrence through large penalties. Whether other nations can in fact achieve functionally equivalent results by different means remains a topic for further research.

The U.S. also outdistances the rest of the world in its commitment to private enforcement and its prodigious use of the criminal sanction in securities cases. Again, the disparity is not subtle, but involves orders of magnitude. Multiple factors may explain this, but one is troubling. The U.S.'s reliance on private enforcement may have developed an uncontrolled momentum of its own, as private enforcers have no incentive to curb their activism, at least so long as a profit looms. Even if private enforcement can be an effective complement to, or substitute for, public enforcement, it is not subject to budgetary controls or prosecutorial discretion, and the incentives of the private enforcer can easily lead to settlements that produce large fee awards, but little deterrence or compensation. Here, the basic problem with the contemporary system of private enforcement in the U.S. is that the culpable escape penalties, while the victims of the fraud pay them. Because of the circularity of the securities class action, with diversified shareholders essentially suing diversified shareholders, greater private enforcement essentially implies more "pocket-shifting" wealth transfers, with each such transfer being heavily taxed by the legal system.¹⁶⁶ Moreover, with seven out of the ten largest securities class actions having settled in the last two years,¹⁶⁷ the visibility of this dysfunction is growing.

¹⁶⁶ See Coffee, *supra* note 148, at 1556-1561.

¹⁶⁷ See text and notes *supra* at note 81.

These disparities in the level of both public and private enforcement may suggest that the United States has a problem – or that the rest of the world does. Here, this essay will not attempt to pass judgment. Much about enforcement styles is still not understood. What is clear, however, is that integration of securities regulation on a cross-border basis requires greater agreement about the expectations of all the participants regarding enforcement. Today, they are not speaking the same regulatory language.

Proposals that the U.S. downsize its enforcement efforts will likely fall on deaf ears – at least once the next scandal surfaces. Too many factors—including a populist political tradition and a federal system that inherently creates multiple potential enforcers—ensure that scandals, when they occur, will be followed by intense enforcement. Against this backdrop, if one policy shift can be recommended, it would be that U.S. enforcement policy should shift from an enterprise liability model to a managerial liability model. Not only would such a policy deter at least as well, but it involves less waste and circularity than a legal system that visits punitive penalties on shareholders in order to protect shareholders. Finally, it may prove less frightening to foreign corporations with controlling shareholders.

As Clemenceau said about war and the generals, enforcement policy is too important to be left to the discretion of the prosecutors.