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Commentary

Law and Regulatory Competition: Can They Co-Exist?

John C. Coffee, Jr.*

It is possible to read Stephen Choi's article with admiration and enjoyment—until a critical point is reached at its very end. In an analysis that is balanced, nuanced, and thorough, Professor Choi initially reviews the recent debate over the role of law in fostering the development of financial markets. As others have also concluded, he finds a correlation between quality of law and financial development. At a few points, he may accept too easily the claim that the common law is superior to the civil law in fostering economic growth, without adequately considering the problem of multicollinearity that usually confounds efforts to infer causation from correlation.¹ Still, his analysis is perceptive, reasonable, and well within the mainstream of contemporary scholarship. Nor do I wish to challenge the view that there are legal preconditions to the full development of financial markets.

But in his conclusion, Professor Choi leaps from description to prescription and focuses on “how to generate good law.”² Here he opines that the best way to strengthen the legal framework essential to financial development may be to encourage regulatory competition. He concludes by suggesting that policymakers should “expend their limited political capital in establishing policies to foster regulatory competition within their borders and among different countries.”³ Alas, this is an overbroad non sequitur. Not only does his prescription not follow from his diagnosis, but as discussed below, it would prove perversely counterproductive to his goal of strengthening law.

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1. I have elsewhere argued that the role of the state was more important than the quality of law in influencing the development of securities markets. In particular, only those countries in which an autonomous private sector had first developed were able to generate strong securities markets, while countries that centralized economic decision-making in the state tended to rely on and foster central banks as their preferred instrument of state-directed corporate finance. See John C. Coffee, Jr., *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).

2. See Stephen J. Choi, *Law, Finance and Path Dependence: Developing Strong Securities Markets*, 80 TEXAS L. REV. 1657, 1726 (2002).

3. *Id.* at 1727.

Unfair as it may seem to focus primarily on his concluding remarks, this is where his analysis most intersects the concerns of this Symposium: how can the law foster economic growth and development? Professor Choi has developed his preferred prescription for strengthening law through regulatory competition elsewhere at some length.⁴ His ideas have come to be known as “issuer choice”—a right on the part of the issuer to choose the regime of securities law and regulation under which it will operate.⁵ Under issuer choice, a Delaware corporation listed on the New York Stock Exchange could choose to have its disclosure and other securities regulation standards specified by the law of Taiwan, Italy, or some other jurisdiction. The basic premise is that each issuer has the right incentives to choose the legal rules that will maximize its share value.

Superficially plausible as Professor Choi’s premise sounds, it does not work—at least in this context—for a variety of independent reasons. In this brief Comment, I will review some, but not all, of the objections to his proposal. I will then turn to the broader topic of when, and to what extent, regulatory competition may make sense.

I. Issuers Do Not Necessarily Have the Right Incentives

The premise that issuers will act to maximize their share value is only sometimes valid. From a global perspective, it is clear that corporations in most jurisdictions are characterized by concentrated ownership, rather than by the dispersed ownership that characterizes most public corporations in the Anglo-American world.⁶ Firms with controlling shareholders (or at least with a cohesive control group) do not necessarily want to maximize their day-to-day share value, for at least two reasons: first, their controlling shareholders may prefer to maximize the private benefits of control, even if this implies a reduction in the price of the firm’s shares; second, the control group can remain indifferent to the firm’s share value in the market because they can sell their control block at a control premium well above that price in

4. See Stephen J. Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); see also Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 388 (2001) (praising “the absence of a uniform international regulatory scheme” as a benefit to investors).

5. For a critique of this position, see Merritt B. Fox, *Retaining Mandatory Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) [hereinafter Fox, *Retaining Mandatory Disclosure*] (advocating maintenance of the current system of mandatory disclosure); Merritt B. Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES L. 563, 564 (2001) [hereinafter Fox, *The Issuer Choice Debate*] (arguing that issuer choice would ultimately decrease welfare because “the issuer’s private costs of disclosure would be greater than the social costs of such disclosure”).

6. See Rafael La Porta, Francisco Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

the private market for corporate control. Indeed, control premiums vary enormously around the globe, suggesting that the private benefits of control extracted from corporations under different legal regimes also vary correspondingly. On this basis, it follows that corporations may not adopt the efficient legal rule that maximizes share value by opting into the most favorable legal regime because doing so might not be in the interest of controlling shareholders. Even within the Anglo-American world of dispersed ownership, persuasive evidence indicates that, in choosing their jurisdiction of incorporation, firms are motivated to seek the jurisdiction that offers their managers the greatest protection from takeovers.⁷ Such evidence hardly suggests that managers seek the most efficient legal rules, even absent a controlling shareholder. In sum, if controlling shareholders and managers often have the wrong incentives and will not choose the legal rules that maximize the corporation's share value, it makes little sense to allow them to opt out of the legal rules that regulators believe will best protect minority investors.

II. Even with the Right Incentives, Firms Will Pursue Private Wealth Maximization, Not Social Efficiency

Assume in the alternative that corporations will act so as to maximize shareholder value; that is, assume that no conflicts exist between shareholders and their managers or among majority and minority shareholders, so that all will opt for the legal rule that maximizes the firm's value. Will this lead to overall (or "social") efficiency? Not necessarily! Professor Merritt Fox has shown that private firms will prefer legal rules that allow them to make less than the socially optimal level of disclosure.⁸ Firms do so, he suggests, because they fear that further disclosure may permit their competitors to exploit or profit from proprietary information that is released under legal compulsion. Rational as this may sound for the firm, it produces a sub-optimal level of disclosure that reduces overall market efficiency. Only mandatory legal rules, he concludes, can produce the socially optimal level of disclosure.

More recently, Professor Fox and his co-authors have found that Securities and Exchange Commission rule revisions in the 1980s requiring additional forward-looking disclosures increased the accuracy of share

7. See LUCIAN ARYE BEBCHUK & ALMA COHEN, FIRMS' DECISIONS WHERE TO INCORPORATE (Ctr. for Law, Econ., & Bus., Discussion Paper No. 351, 2002), available at http://www.law.harvard.edu/programs/olin_center (criticizing the view that the market for corporate charters produces optimal corporate law rules and finding that the primary motivation for reincorporations has been to avoid hostile takeovers).

8. See Fox, *Retaining Mandatory Disclosure*, *supra* note 5, at 1339 (arguing that "issuer choice would lead U.S. issuers to disclose at a level significantly below this social optimum"); see also Fox, *The Issuer Choice Debate*, *supra* note 5, at 564 (contending that "each issuer would select a regime requiring a level of disclosure less than is socially optimal").

pricing in the U.S. market.⁹ If they are right, and mandating such additional disclosure improved market efficiency, then it seemingly follows that private incentives alone did not produce the socially optimal level of disclosure. In that case, deferring to private choice under a regime of issuer choice would not necessarily enhance economic efficiency.

III. Network Externalities Necessitate Harmonization

Assume next that investors not only wish to understand and appraise a corporate issuer but also to compare its performance to that of other companies. Such comparative evaluations are greatly facilitated by issuers subscribing to the same disclosure and accounting policies. For years, international groups—the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee in particular¹⁰—have worked to harmonize disclosure and accounting policies to achieve consistency and to facilitate comparisons. But this is precisely the kind of harmonization to which Professor Choi objects. The problem with regulatory competition in this context is that there are positive externalities in everyone using the same language. Under an issuer choice legal regime, some firms in the same market or on the same exchange might use German accounting standards, others American standards, and still others Japanese standards. The result is a Tower of Babel effect that impedes effective comparison. This assessment does not require the assertion that one accounting or disclosure language is superior to another, but only the more modest claim that the burdens on investors are reduced by a common language (or at least reconciliation to a common language).

The more persons using the same language, the greater the resulting positive network externality.¹¹ United States Generally Accepted Accounting Procedure (GAAP) or International GAAP (IAS) thus can have great value even without being inherently superior. Yet, an issuer seeking to hide a problem might still prefer to use a different language that was less

9. See Artyom Durney, Merritt Fox, Randall Morck & Bernard Young, *Share Price Accuracy and Economic Performance: The New Evidence*, Presentation at American Law and Economics Association Annual Meeting (May 12, 2001) (on file with the Texas Law Review). This research does not demonstrate that these SEC reforms were cost efficient, and it can still be argued that any enhancement in pricing accuracy came at too high a price. But at least this research seems to show that mandatory law can improve market accuracy (although possibly at too costly a price).

10. For overviews of the international efforts to harmonize accounting and disclosure standards, see Norman C. Poser, *The Stock Exchanges of United States and Europe: Automation, Globalization and Consolidation*, 22 U. PA. J. INT'L ECON. L. 407 (2001); Maureen Peyton King, Note, *The SEC's (Changing?) Stance on IAS*, 27 BROOK. J. INT'L L. 315 (2001).

11. The classic example of a positive network externality is the telephone network. If telephone networks have few subscribers, they have little value. But if everyone subscribes, the value of the network is much greater, and the value increases as each additional person hooks up to the network. See S.J. Liebowitz & Stephen E. Margolis, *Network Externality: An Uncommon Tragedy*, J. ECON. PERSP., Spring 1994, at 133, 139–40.

transparent. To be sure, the market may penalize it for doing so, but the discount might be either too much or too little, and in either event pricing accuracy suffers.

IV. Enforcement Is Feasible Only When Enforcers Are Enforcing a Common Set of Rules

Further evidence that mandatory law creates value comes from economic data showing that when insider-trading laws are enforced, the cost of equity capital goes down.¹² This is by itself an important finding that strong laws can enhance efficiency. But these studies also show that it is only the enforcement of the insider-trading prohibition, not its enactment, that reduces the cost of equity capital.¹³ Merely adopting laws does little or nothing.

In this light, an initial problem with issuer choice as the preferred approach to securities regulation is that an issuer could opt out of specific rules that seem desirable, including, for example, insider-trading prohibitions. To be sure, a company's stock might suffer a measurable market penalty as a result, which the minority shareholders would also bear even though they lacked access to such information. Still, the expected gain to the controlling shareholders from being able to engage in insider trading could more than offset their loss from a reduced market price. Moreover, if in one market some firms' managers and controlling shareholders could engage in insider trading, while the other firms' personnel could not, confusion and uncertainty would result, as investors could not be certain of the applicable legal standards, at least without a costly inquiry. Worse, the moral force of the law would be undercut, thus inviting evasion in cases where insider trading was still prohibited. Because an issuer choice regime would permit some firms to elect the laws of countries having no prohibition on insider trading and other firms to elect legal rules that only partially or weakly proscribe it, issuer choice seemingly enervates, rather than strengthens, the force of law.

Even if all nations came to prohibit insider trading, or if some limitation were placed on the scope of issuer choice, a problem would remain: as a practical matter, no single enforcer could simultaneously enforce a diversity of legal rules. Could the SEC or the Justice Department truly enforce the laws of Japan, Russia, Brazil, and Mexico on insider trading (or on any other issue)? It seems doubtful. Each case would require the agency to learn new law and introduce the possibility that the foreign law was itself still unresolved or internally inconsistent.

12. See Utpal Bhattachayra & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 97 (2002) (finding that the enforcement of insider-trading laws worldwide is associated with a 7% reduction in the cost of equity).

13. *Id.* at 104.

Beyond these simple points, there is a broader objection to regulatory competition. Regulatory arbitrage was originally conceived as a cure to overregulation. That is, if one jurisdiction regulated excessively, the subject corporation could move its seat or assets to another. Indeed, the original seminal article proposing regulatory competition focused on the possibility of excessive subsidies or taxation.¹⁴ Subsequent commentators in this tradition have sought to apply this model to very different contexts, without revising or qualifying its very simplified assumptions. Their premise has been that regulation, or at least monopolistic regulation by a single jurisdiction, typically produces overregulation and hence some form of confiscatory taxation. Even if this can happen, the commentators rarely defend the premise that it is inevitable.

The countervailing and underrecognized danger is systematic underregulation as a result of agency capture or interest group domination of the political process. More importantly, the recent scholarship that Professor Choi carefully traces argues that the optimal development of at least certain financial institutions requires the prior development of an adequate regulatory structure. This is the clear implication of the work of LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV), but it is also a central theme in the work of legal scholars such as Professor Bernard Black.¹⁵ In short, underregulation may be a greater danger to financial development than overregulation.¹⁶

In this light, there is a basic disconnect between Professor Choi's conclusion that law matters and his prescription for regulatory competition. Although regulatory competition may be a cure for overregulation, it tends to aggravate underregulation. So long as there is one laggard or outlier jurisdiction, some firms could elect its law under an issuer choice model. If we assume that some non-trivial level of regulation is optimal, issuer choice and regulatory competition will tend to impede its realization.

Admittedly, both overregulation and underregulation are dangers. Thus, because all generalizations have their limitations, it is worth asking whether there is any way in which regulatory competition could enhance the

14. See Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956) (discussing the argument that for local public goods, the "consumer-voter moves to that community whose local government best satisfies his set of preferences"). Tiebout's model has received considerable criticism on both the empirical and normative levels. See, e.g., David Lowery & William E. Lyons, *The Impact of Jurisdictional Boundaries: An Individual-Level Test of the Tiebout Model*, 51 J. POL. 73, 92-93 (1989); Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 COLUM. L. REV. 346, 415 (1990). Nonetheless, it remains highly influential within "law and economics" circles. See Frank Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 28-29 (1983).

15. See Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001) (discussing the laws and institutions necessary to a strong securities market).

16. I do not mean to argue this thesis, but it does seem to be implied by the LLSV research, *supra* note 6.

development of an optimal regulatory structure (if we assume that market forces alone may not achieve this result). That is, when is competition most likely to produce better regulation?

When firms voluntarily opt into additional regulation above that applicable in their host jurisdiction, the odds are strong that they are doing so to please or satisfy some constituency. Precisely such a pattern characterized the phenomenon of foreign firms cross-listing on the New York Stock Exchange and Nasdaq, a practice which soared during the 1990s.¹⁷ In listing on a U.S. exchange, a foreign firm subjects itself to U.S. securities law, agrees to restate its financial statements to comply with U.S. GAAP, exposes itself to public and private enforcement in the U.S., and submits to the scrutiny of U.S. securities analysts. By doing so, the foreign firm credibly commits itself to provide a higher level of disclosure. The firm thus reduces informational asymmetries, and in response, the firm's stock market price usually increases.¹⁸ In effect, the foreign issuer "bonds" its promise to fully disclose by exposing itself to the U.S. litigation and enforcement system. This is an example of a "race to the top." That is, issuers that wish to increase their share price enter the U.S. market at least in part to compensate for the weaker legal standards and enforcement mechanisms in their own countries. But not all firms will enter the U.S. market, in part because many firms have controlling shareholders who prefer to realize the private benefits of control. Hence, one cannot expect that the desire to maximize share value will alone prove adequate or self-enforcing.

The difference between opting into a superior regulatory structure as a form of regulatory competition and issuer choice is quite simply that in the former case the subject company does not escape one system of regulation in favor of another. Rather, it cumulatively subjects itself to both systems. This "exit-less" form of regulatory competition is in marked contrast to the market for corporate charters where the subject corporation reincorporates, hypothetically from California to Delaware, thereby escaping the former state's laws for the latter's. Although scholars continue to debate whether the market for corporate charters leads to efficient corporate-law rules,¹⁹ the evidence is clearer that firms that cross-list in the U.S. earn a significant

17. See John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 673 (1999) (describing the growing number of foreign firms listed on principal U.S. exchanges).

18. For the clearest finding that the stock market responds positively to cross-listing in the U.S., see Darius Miller, *The Market Reaction to International Cross-Listings: Evidence from Depository Receipts*, 51 J. FIN. ECON. 103, 104 (1999). Theoretical research has long predicted that a commitment to improved disclosure (and hence reduced informational asymmetries) would produce a lower cost of capital. See Douglas W. Diamond & Robert E. Verrachia, *Disclosure, Liquidity and the Cost of Capital*, 46 J. FIN. 1325, 1325-26 (1991).

19. Compare ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 12 (1993) (describing the growing number of foreign firms listed on principal U.S. exchanges), with Bebchuk & Cohen, *supra* note 7, at 37 (stating that recent research calls for a reconsideration of the view that is "positive on state competition").

stock price premium for so doing.²⁰ The point of this comparison is not to attempt to resolve the long-standing debate over regulatory arbitrage in the market for corporate charters, but to note that other forms of regulatory competition, such as cross-listing, unambiguously do create value. The best explanation for value creation through cross-listing is that these foreign issuers are opting into the U.S. system to compensate for their home country's weak legal protections for minority shareholders.²¹ In short, there is a demand for "strong" law, because it enhances the firm's market valuation.

So what is the bottom line? Precisely to the extent that one reaches the empirical conclusion that Professor Choi has reached—that "strong" law is a precondition to financial development—one should reject regulatory arbitrage as a means of creating stronger law. In contrast, regulatory competition—a broader concept—can sometimes create value, but it does so most clearly when it supplements "weak" law or regulation, without permitting the firm to escape or "exit" its home country's laws. Such "exit-less" regulatory competition is benign, because it cannot succeed as a law evasion strategy. In sum, opting into an additional legal regime is safe, but opting out from the original jurisdiction's law increasingly seems problematic to the extent that we recognize "strong" laws as a precondition to economic development.

20. See Miller, *supra* note 18, at 111–18.

21. For this interpretation, see Coffee, *supra* note 17.