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LAW AND THE MARKET: THE IMPACT OF ENFORCEMENT

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INTRODUCTION

Are the U.S. capital markets losing their competitiveness?[1] A fascinating question, but what does it mean and how can it be intelligently assessed? This Article will explore the newly popular thesis that draconian enforcement and overregulation are injuring the United States and will offer a sharply contrasting interpretation: higher enforcement intensity gives the U.S. economy a lower cost of capital and higher securities valuations. This higher intensity attracts some foreign listings, but deters others.

This Article will proceed by first mapping the marked variation in the intensity of enforcement efforts by securities regulators in selected nations and then relating these variations to (1) the cost of equity capital, (2) the extraordinary listing premium that non-U.S. firms ex-

[1] For the suggestion that there has been a decline in their competitiveness, see COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 2-6 (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf [hereinafter PAULSON REPORT]. The author is listed as a "Task Force Member" on this report. *Id.* at ii. 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 R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP 10-14 (2007) (arguing that global macroeconomic trends are threatening the United States' historical preeminence in capital markets). The author also served as a consultant to this report. As will be evident, this author is not in full agreement with either report, but does believe that the issue of capital market competitiveness is serious and justifies continuing attention.

hibit upon cross-listing on a U.S. exchange,[2] and (3) the alleged flight of some foreign issuers from the U.S. markets.[3] Once properly disaggregated, the impact of high-intensity enforcement appears to yield both costs and benefits. In overview, high-intensity enforcement may dissuade some issuers from entering the U.S. market and, thus, could be responsible for some of the asserted decline in the "competitiveness" of the U.S. capital markets. But, at the same time, other firms

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[2] Data about the magnitude of this cross-listing premium are presented *infra* at notes 11, 16, and 157-184, and in the accompanying text. The source of this premium 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.

This Article will argue that increased enforcement risk associated with entry into the U.S. market affects all three of these explanations.

[3] Although a number of commentators have opined that the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. (2000 & Supp. III 2004)), and high enforcement intensity, including private enforcement through securities class actions, have damaged the competitiveness of the U.S. economy, the latest empirical survey finds that the market share of foreign listings held by U.S. exchanges (e.g., the New York Stock Exchange (NYSE), NASDAQ, and American Stock and Options Exchange (AMEX)) has "increased from 1998 to 2005 relative to the market share of the [London Stock Exchange]'s Main Market." Craig Doidge et al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time* 4 (Charles A. Dice Ctr. for Research in Fin. Econ., Working Paper No. 2007-9, 2007), *available at* http://ssrn.com/abstract=982193. Although the evidence is clear that the London Stock Exchange has lost ground in its ability to attract foreign issuers, its subsidiary, the Alternative Investment Market (AIM), which is a market that specially caters to small and start-up firms that are not eligible to list on the major U.S. exchanges, has had considerable success in attracting IPO listings. *Id.* If, however, one focuses on firms with characteristics that qualify them to list on a U.S. exchange, there is little evidence that such firms are less likely to so cross-list today. *Id.* at 4-5; *see also* Stavros Peristiani, *Evaluating the Relative Strength of the U.S. Capital Markets*, CURRENT ISSUES ECON. & FIN. (Fed. Reserve Bank of N.Y., New York, N.Y.), July 2007, at 1, 3, *available at* http://www.newyorkfed.org/research/current_issues/ci13-6.pdf (finding evidence of the decline of U.S. equity markets to be mixed and generally agreeing with Doidge et al.).

are attracted to U.S. markets. In effect, there is a separating equilibrium as foreign issuers go both ways.[4] The critical issue for the controlling shareholder of the foreign issuer (who is the real decision maker in most cross-listing decisions) is whether the private benefits of control that it will sacrifice by entering the U.S. market exceed (or fall below) the value to it of the higher securities valuation and reduced cost of capital that it will gain from cross-listing in the United States.[5]

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.[6] These legal theories

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[4] Recent surveys find that some foreign firms report themselves as having 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 United States. *See, e.g.*, Joseph D. Piotroski & Suraj Srinivasan, The Sarbanes-Oxley Act and the Flow of International Listings 31 (Apr. 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=956987.

[5] Most non-U.S. firms that are eligible to cross-list in the United States have a controlling shareholder, and typically the law in the jurisdiction of incorporation for that foreign firm permits a controlling shareholder to extract some level of private benefits from the controlled corporation at the expense of minority shareholders. Doidge et al., *supra* note 3, at 3. By entering the U.S. market, the foreign firm likely reduces the ability of a controlling shareholder to maximize these private benefits of control. *See* Craig Doidge, *U.S. Cross-Listings and the Private Benefits of Control: Evidence from Dual-Class Firms*, 72 J. FIN. ECON. 519, 550 (2004) (providing empirical evidence of this impact). For a controlling shareholder intent on maximizing its own interests, entry into the U.S. market by its controlled firm makes sense only if it anticipates either that (1) the gain in the share value of its own block of shares will exceed the value of the foregone private benefits, or (2) the prospective ability to raise capital in the United States at lower cost is of greater value to it (typically because of a specific business plan or strategy) than the foregone private benefits.

[6] For the range of theories—some stressing geography, some stressing colonial endowments, some stressing openness to trade—see *infra* notes 53-55 and the accompanying text. That financial development drives economic growth is itself an idea whose clear formulation traces back only to the early 1990s. *See, e.g.*, Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, 108 Q.J. ECON. 717, 734-35 (1993). Still, in 1997, four young financial economists—Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, whose work is discussed in detail in Part I—revolutionized the field by introducing a provocative new thesis that legal origins were a prime factor in shaping financial development. *See* Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1149 (1997) (concluding that legal rules and enforcement impact the size and extent of a country's financial market). Their work has generated much controversy. *See, e.g.*, Paul G. Mahoney, *The*

have 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 Article does not seek to resolve the causal role of law in financial development. More narrowly, it suggests only that one legal variable—the level of enforcement intensity—distinguishes 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 United States (and only the United States) exhibit. Still, before one can assert that relative enforcement intensity explains differences in financial development, one must face a complicated question involving the direction of causality. Here, the deeper issue is: does high enforcement intensity precede or follow financial development? In reality, enforcement intensity appears to play a dual role: both enhancing share value for those foreign issuers that do cross-list into a high-enforcement legal regime and deterring other foreign issuers from entering high-enforcement jurisdictions. Depending on their goals, reasonable persons can disagree about whether the best policy response is to increase or relax enforcement intensity. As a result, the issue of the optimal level of enforcement intensity may be the com-

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Common Law and Economic Growth: Hayek Might Be Right, 30 J. LEGAL STUD. 503, 504 (2001) (disagreeing with the claim of La Porta et al. and claiming that "legal origin does not affect economic growth . . . through its effect on financial markets"); Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5, 14-15 (2003) (finding nations with civil law origins to have initially led in the race for financial development, but later to have abandoned the pursuit); Thorsten Beck et al., *Law, Politics, and Finance* 32 (World Bank Policy Research, Working Paper No. 2585, 2001), *available at* http://go.worldbank.org/XOXL5CEGB0 (finding a "strong link between financial institution development and legal origin").

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 securities markets, the role of substantive law was less important than the existence of an open, decentralized, and stable political economy. Investors were protected less by courts than by self-help arrangements involving underwriters and stock exchanges. *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, 8-9 (2001) (arguing that the level of state control over the economy, rather than the nature of a country's legal system, most influences its financial development). Strong centrist governments appear to have inhibited the growth of securities markets, probably because securities markets are less easily controlled than large banks.

mon 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 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."[7] 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 the consulting firm McKinsey & Co.[8] Going beyond the usual criticisms of the Sarbanes-Oxley Act, both reports found that transactions, listings, and trading volume are migrating to less intensively regulated securities markets, most notably those in London and Hong Kong.[9] Foreign issuers do not truly avoid the U.S. capital market, they assert, but instead access it through the United States' private markets (most notably through the Rule 144A market), thereby avoiding the public market and most of the SEC's mandatory disclosure requirements.[10] On this view of the data, Sar-

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[7] PAULSON REPORT, *supra* note 1, at ix.

[8] BLOOMBERG & SCHUMER, *supra* note 1.

[9] 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, *supra* note 1, at ix-x. The Paulson Report found as follows: "As measured by value of IPOs, the U.S. share declined from 50 percent in 2000 to 5 percent in 2005. Measured by number of IPOs, the decline is from 37 percent in 2000 to 10 percent in 2005." *Id.* at x; *see also* BLOOMBERG & SCHUMER, *supra* note 1, at 10-14. Other studies have reached similar conclusions. *See, e.g.*, Xi Li, The Sarbanes-Oxley Act and Cross-Listed Foreign Private Issuers 28 (Jan. 18, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=952433 (finding that foreign private issuers experienced abnormal declines in stock price of 10%, on average, in response to Sarbanes-Oxley); Piotroski & Srinivasan, *supra* note 4, at 33 ("[T]he Sarbanes-Oxley Act has altered the flow of foreign listings across international exchanges."). 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 IPOs, was slightly down in 2006, and half of its largest IPOs in 2006 are trading below their initial offering price. Carrick Mollenkamp et al., *Uncertain AIM: A Hot Market in London Has Its Risks, Too*, WALL ST. J., Dec. 20, 2006, at A1.

[10] The Paulson Report finds that "[i]n 2005, foreign companies raised 10 times as much equity in the private U.S. markets as in the public markets ($53.2 billion vs. $4.7 billion)." PAULSON REPORT, *supra* note 1, 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 reg-

banes-Oxley is a deterrent that has made the U.S. capital markets too costly for those issuers able to opt for other listings. So viewed, 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 United States, which at least one study has found to average 37% for foreign firms cross-listing on a major U.S. exchange,[11] and (2) a significant reduction in the cross-listing firm's cost of capital.[12] Read together, this evidence gives rise to a double mystery: (1) What explains this positive market reaction? (2) Why do many foreign firms appear to be increasingly spurning a premium that is not available elsewhere? The most plausible explanation for

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istration provided by Rule 144A. *See* 17 C.F.R. § 230.144A (2007) (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 from the London Stock Exchange. *See* Peter Smith & Norma Cohen, *Delisting Wave Hits London*, FIN. TIMES (London), Jan. 2, 2007, at 1 (reporting that the value of companies taken private broke a record in 2006, with the 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 capital available to the private equity firms that orchestrate such deals.

[11] Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. FIN. ECON. 205, 206 (2004). Doidge et al. found 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. *Id.* This figure rises to 37% when the foreign firm cross-listed on a major U.S. exchange (i.e., the NYSE, AMEX, or NASDAQ). *Id.* 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, the same authors found the historical average valuation premium over 1990 to 2001 for foreign firms cross-listing onto U.S. exchanges to have been 17.5% over non-cross-listed firms, and for the period 2002 to 2005 to have been 14.3%. *See* Doidge et al., *supra* note 3, at 33, 62-63 tbl.9. This longer-term study shows both a consistent premium from 1990 to 2005 for listings on U.S. exchanges and the absence of any premium for listing on the London Stock Exchange (and indeed a discount for many years). *Id.* at 32-33.

[12] *See* Luzi Hail & Chritian Leuz, *Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-Listings* 36 (European Corporate Governance Inst., Working Paper No. 46/2004, 2006), *available at* http://ssrn.com/abstract=938230 (finding that, when non-U.S. companies cross-list on U.S. exchanges, their cost of capital reduces by 70 to 120 basis points); *see also* Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. ACCT. RES. 485, 524 tbl.1 (2006) (finding that countries with "more extensive disclosure requirements and stronger securities regulation" exhibit a lower cost of capital).

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 greater prospect of enforcement in the United States, foreign firms reduce their agency costs.[13] 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,[14] 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 conspicuous—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.[15] Although foreign securities

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[13] The term "bonding hypothesis" was coined by this author (although others may have had similar ideas contemporaneously). *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, 691-92 (1999) [hereinafter Coffee, *The Future as History*] ("The simplest explanation for the migration of foreign issuers to U.S. exchanges and NASDAQ is that such a listing is a form of bonding . . . ."); *see also* John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1830 (2002) [hereinafter Coffee, *Racing Towards the Top*] ("Cross-listing may in part be . . . a bonding mechanism to assure public investors that they will not be exploited . . . ."). For other studies, see William A. Reese Jr. & Michael S. Weisbach, *Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings*, 66 J. FIN. ECON. 65, 101-02 (2002) (finding that post-listing behavior of cross-listing firms corroborated the bonding hypothesis), and René M. Stulz, *Globalization, Corporate Finance, and the Cost of Capital*, J. APPLIED CORP. FIN., Fall 1999, at 8, 13 (arguing that globalization stimulates better governance, which lowers the cost of capital). Bonding can occur in a variety of ways and is not only 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 "increases the expected reporting, regulatory and legal costs of a listing on a U.S. exchange," the Act "should strengthen the credibility of U.S. listings as a bonding mechanism, thus increasing the expected benefits from a U.S. listing." Piotroski & Srinivasan, *supra* note 4, at 4. Indeed, Piotroski and Srinivasan 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. *Id.* at 5-7.

[14] *See* sources cited *infra* note 15 (reviewing studies showing a valuation premium associated with U.S. cross-listing). 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 *infra* Figure 12.

[15] Doidge et al. have reviewed data covering listings on the major U.S. exchanges and the London Stock Exchange from 1990 to 2005. At no time over this period do

markets can compete with U.S. markets by offering increased liquidity and visibility coupled 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 offer "light" regulation and 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.[16] To spurn this premium seemingly implies that these issuers are not seeking to maximize the value of their shares. Does this seem plausible?

This Article's answer is: it all depends on whose self-interest is to be maximized! Maximizing share value is not the only rational goal, particularly for a controlling shareholder who does not soon intend to sell. Although the corporation may have an interest in increasing its share value, this can be overridden by, for example, (1) the interest of its controlling shareholders in maintaining unfettered access to the private benefits of control; (2) a desire to retain business discretion and flexibility or to avoid specific governance norms required by U.S. exchanges; or (3) the fear (at least on the part of corporate managers) of enforcement penalties and the risk of private litigation in the United States. Simple as this answer sounds, its implication is that the United States 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) instead provides a comfortable refuge for firms with a control group intent on enjoying either the private benefits of control or unfettered discretion. The result is a separating equilibrium, as

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they find cross-listings on the London Stock Exchange to have been associated with a listing premium (and often there was a discount), but at all times over this period, cross-listings on the U.S. exchanges were associated with a listing premium, whose magnitude varied from time to time. Doidge et al., *supra* note 3, at 5, 32. Earlier studies have found that companies cross-listing on the London Stock Exchange did not outperform a control of non-cross-listing firms from the same jurisdictions (whereas firms cross-listing in the United States did outperform the control group). *See* Marco Pagano et al., *The Geography of Equity Listing: Why Do Companies List Abroad?*, 57 J. FIN. 2651, 2684 (2002).

[16] The average premium for foreign firms cross-listing to the three major U.S. exchanges was 37% in 1997. Doidge et al., *supra* note 11, at 206. From 2002 to 2005, the average premium fell to 14%. Doidge et al., *supra* note 3, at 33.

some foreign firms list in the United States to bond and others migrate to London to enjoy "business as usual."[17]

Of course, this answer may be oversimplified. Corporations could well prefer to list in London for efficiency-enhancing reasons as well.[18] 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? To explain the listing premium, economists have tended to focus on differences either in disclosure or corporate governance standards.[19] Al-

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[17] This author originally advanced the interpretation, in 2002, that securities markets would compete through specialization by tailoring their markets to different clienteles. *See* Coffee, *Racing Towards the Top*, *supra* note 13, 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.

[18] Undoubtedly, some foreign corporations list on the London Stock Exchange in order to avoid what they perceive as inefficient and costly regulation that the United States imposes on cross-listed firms. Nothing in this Article implies that U.S. enforcement policies are invariably wise or just, and some rational persons may consider them often arbitrary and capricious. The market generally may have perceived the impending enactment of Sarbanes-Oxley in this way. *See* Piotroski & Srinivasan, *supra* note 4, at 2-3 (describing surveys indicating that companies anticipated negative implications from Sarbanes-Oxley). 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 United States via private placements or Rule 144A. Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-U.S. Companies Cross-Listed in the U.S.*, 13 J. CORP. FIN. 195, 226 (2007) [hereinafter Litvak, *The Effect of Sarbanes-Oxley*]; *see also* Li, *supra* note 9, at 1-2 (finding negative 10% abnormal stock returns for cross-listed foreign companies as a result of the passage of Sarbanes-Oxley); Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. 1857, 1898 (2007) [hereinafter Litvak, *The Cross-Listing Premium*] (concluding that, in the period prior to the enactment of Sarbanes-Oxley, the cross-listing premium of foreign companies subject to Sarbanes-Oxley significantly declined relative to comparable companies not subject to the same regulation). This research suggests at least that Sarbanes-Oxley and U.S. regulation were perceived as harmful to investors in foreign firms (and hence lighter regulation in London was perceived as beneficial). For a further analysis, see *infra* text accompanying notes 202-203.

[19] Economists have argued not only that improved disclosure reduces uncertainty and informational asymmetries, but that it can also reduce nondiversifiable risk. For a brief review of this literature, see Hail & Leuz, *supra* note 12, at 487. Studies have found that foreign firms cross-listing on U.S. exchanges do provide superior financial

though these differences exist, the magnitude of their effect seems likely to be modest. To be sure, the United Kingdom regulates its issuers with a softer touch than does the United States, and in particular the United Kingdom regulates its foreign issuers much less rigorously than it regulates its own domestic companies.[20] But when one focuses

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disclosures relative to otherwise similar non-cross-listing firms. *See, e.g.*, Tarun Khanna et al., *Disclosure Practices of Foreign Companies Interacting with U.S. Markets*, 42 J. ACCT. RES. 475, 503 (2004). Others have developed indices to measure differences in the quality of the corporate governance between cross-listing and 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, e.g.*, GORDON L. CLARK & DARIUSZ WÓJCIK, THE GEOGRAPHY OF FINANCE: CORPORATE GOVERNANCE IN THE GLOBAL MARKETPLACE 152-54 (2007). This author has no dispute with either assertion, but believes that the enforcement variable may be the underlying force that most drives issuers to improve their disclosure.

[20] The relevant comparison here is not between the general listing standards of the NYSE and those of the United Kingdom Listing Authority, which is a subsidiary of the Financial Services Authority (FSA) that adopts the listing standards applicable to the London Stock Exchange, but rather between the special rules of both bodies that are 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). *See* Requirements of Annual Reports, 17 C.F.R. § 240.13a-1 (2007); Quarterly Reports on Form 10-Q and Form 10-QSB, 17 C.F.R. § 240.13a-13 (2007); SEC Form 20-F, *available at* http://www.sec.gov/about/forms/form20-f.pdf. This is the only major concession that the SEC makes to foreign issuers. For example, section 301 of Sarbanes-Oxley requires even the foreign issuer to have an independent audit committee. 15 U.S.C. § 78j-1(m)(3) (2000 & Supp. III 2004).

By contrast, in the United Kingdom, the listing rules applicable to foreign issuers are considerably more relaxed than those applicable to domestic issuers. With respect to domestic issuers, the FSA goes well beyond the minimum standards required by the major European Commission directives and requires "super-equivalency" for U.K. domestic issuers; that is, U.K. domestic companies are required to meet "gold-plated" standards to provide investor protection. But these same standards do not apply to most foreign issuers. For example, the FSA's Listing Rules subject domestic companies to special rules with regard to related party transactions, and to the United Kingdom's "comply or explain" disclosure standards for corporate governance. *See* FSA, FSA Handbook: Listing Rules R. 9.25, 9.26, 11.1 (Nov. 2007), http://fsahandbook.info/FSA//handbook/LR.pdf [hereinafter U.K. Listing Rules]. However, the Listing Rules require far less of a foreign company that applies for a secondary listing of its equity securities—and most foreign issuers apply for such a secondary listing (based on having a primary listing in their home country). *See generally id.* at R. 9.1.1 (confining the application of the disclosure rules to companies with primary listings); *id.* at R. 11.1.1 (confining the related party rules to companies with primary listings). Rule 14 of the U.K. Listing Rules covers these companies, *id.* at R. 14.1, and thus the U.K. Listing Rules governing preemptive rights, Rules 9.3.11 and 9.3.12, are inapplicable to such "overseas listed companies." *See id.* at R. 9.3.11, 9.3.12. 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 & Alex Lau, *International Corporate Regulation: Listing Rules and Overseas Companies*, 50 INT'L & COMP. L.Q.

on the actual differences—for example, the exemption of most foreign issuers from the United Kingdom's "comply or explain" disclosure policies regarding corporate governance and also from the United Kingdom's Takeover Code—it is implausible that they could account for more than a marginal difference in valuations or for the enormous disparity in Tobin's *q* ratios found in recent studies.[21] Alternatively, the bonding premium might be explained by the higher level of scrutiny that firms cross-listed in the United States receive from securities analysts, underwriters, and institutional investors. But these same gatekeepers are also present in London. Thus, to explain the valuation premium that is associated with a U.S. listing and conspicuously absent from a London listing, one is compelled to assign at least considerable weight to the variable of enforcement. Here, as this Article will demonstrate, the disparity is large. Indeed, simply the failure of the United Kingdom to effectively enforce its own insider trading restrictions (as later discussed) could alone plausibly account for a significant portion of this difference.[22] In addition, because even

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787, 803-05 (2001) (noting that preemption rights do not apply to overseas companies listed on the London Stock Exchange). Such overseas-listed companies with a secondary listing on the London Stock Exchange are required only to (1) maintain a listing in a recognized market, U.K. Listing Rules, *supra*, at R. 14.3.1, (2) ensure that a minimum proportion of shares remain in public hands, *id.* at R. 14.2.2, 14.3.2, (3) seek listings for further tranches of securities of the same class as listed, *id.* at R. 14.3.4, and (4) provide certain documents and notifications to the FSA, *id.* at R. 3.3.2-3.3.7. 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* THE PANEL ON TAKEOVERS AND MERGERS, THE TAKEOVER CODE, at A3-A5 (8th ed. 2006), *available at* http://www.thetakeoverpanel.org.uk/new/codesars/DATA%5Ccode.pdf. This differential in regulation has produced some recent concern in the United Kingdom that foreign firms are regulated too lightly. *See* Jill Treanor, *Fears Over Light-Touch Regulation of Foreign Firms*, GUARDIAN (U.K.), Feb. 23, 2007, at 33 (describing fears associated with having "less stringent" regulation of foreign firms).

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

[21] *See supra* notes 11, 15, 16, and accompanying text (surveying studies that show a higher Tobin's *q* ratio for firms cross-listed in the United States).

[22] Insider trading does appear to be relatively pervasive on the London Stock Exchange and to have increased significantly between 2000 and 2004. Nuno Monteiro et al., *Updated Measurement of Market Cleanliness* 20 tbl.8 (FSA, Occasional Paper Series, Paper No. 25, 2007), *available at* http://www.fsa.gov.uk/pubs/occpapers/op25.pdf. This report further found that "no major enforcement action had taken place in the

domestic U.K. firms show a higher Tobin's *q* ratio when they cross-list in the United States,[23] the lighter, softer-touch regulation that the Financial Services Authority (FSA) accords foreign firms cannot explain why U.K. domestic firms also trade at a premium when they cross-list in the United States.

Rarely have the evidence and the rhetoric about securities regulation been more irreconcilable. If one listens to the rhetoric, the one formal legal difference between the U.S. and the U.K. markets that has received the most analysis and debate has been the more costly accounting controls mandated in the United States by section 404 of the Sarbanes-Oxley Act.[24] But if these additional costs are wasteful (as much commentary has suggested[25]), the valuation premium should

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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 appears to reduce the cost of equity capital. *See* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 78 (2002) (arguing that the enforcement of insider trading laws, rather than their mere existence, leads to "a significant decrease in the cost of equity").

[23] Between 1990 and 2005, some 129 U.K. issuers (i.e., domestic U.K. companies) cross-listed onto a U.S. exchange, whereas only 17 U.S. issuers cross-listed onto the London Stock Exchange's Main Market. Doidge et al., *supra* note 3, at 52-53 tbl.3. The foregoing authors have also provided this author with a country-by-country comparison of the cross-listing premiums for the year 2005. In 2005, they compared 479 U.K. firms that were not cross-listed with 74 U.K. firms that were cross-listed. The former had a Tobin's *q* of 1.65, and the latter a Tobin's *q* of 1.95, which went up to 2.05 for exchange-listed U.K. firms. Doidge et al., Chart of Tobin's *q* Values (2005) (on file with author).

[24] Section 404 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7262 (2000 & Supp. III 2004), requires the corporation's management to assess in the corporation's annual report "the effectiveness of the internal control structure and procedures of the issuer for financial reporting" and its auditor to "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 restatement. AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS, Auditing Standard No. 2, ¶¶ 4, 9 (PCAOB 2007). Auditing Standard No. 2 proved to be very costly and was significantly revised in 2006. For an overview, see Management's Report on Internal Control over Financial Reporting, Securities Act Release No. 8762, Exchange Act Release No. 54,976, 71 Fed. Reg. 77,635 (Dec. 27, 2006).

[25] As the Paulson Report noted, critics have estimated that section 404 gave rise to compliance costs that totaled between $15 and $20 billion in 2004. *See* PAULSON REPORT, *supra* note 1, at 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. *Id.* at 126.

attach instead to a London listing, not a New York Stock Exchange (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, declines in both the valuation premium and the presence of foreign issuers in the U.S. markets did occur, but these declines began well before the passage of Sarbanes-Oxley.[26]

At this point, this Article's thesis crystallizes: disparities in enforcement may be able to explain what marginal differences in formal legal rules or disclosure standards cannot explain. This thesis that enforcement intensity affects the cost of capital 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 United States from other international market centers and that explains the interconnected phenomena of issuer flight from the United States and the valuation premium assigned to those foreign firms that do enter the United States. Although financial economics has (belatedly) become interested in the impact of legal rules on financial development, most of this research has focused on the common law versus the civil law in general, with little attention being given to the possibility of "American exceptionalism." Because of this preoccupation with finding differences between countries with common law origins and those with civil law origins, researchers have missed the striking fact that the United States is an outlier, differing as much from other common law countries as they in turn do from civil law countries.

The modern debate over the causes of financial development essentially began in the late 1990s, when a talented team of financial economists—known universally today as LLS&V[27]—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 controversy. Under the LLS&V interpretation, small and (to lawyers) inconsequential legal differences were assigned great weight and presented as the mi-

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[26] *See infra* notes 183-186 and accompanying text. The decline began in 2000, continued in 2001, and hit bottom in 2002, the year that the Sarbanes-Oxley Act was passed.

[27] LLS&V stands for Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. Their most cited article is probably Rafael 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., *supra* note 6.

nority shareholders' shield against exploitation by the majority.[28] Others joined in this search to find the hidden legal rules that facilitate financial 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 asserted that the common law accomplished this, vastly outperforming the civil law in encouraging financial development, with French civil law performing particularly poorly.[29]

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 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 Article intersects with a third debate: in studying the differences between legal systems, on what should one focus? LLS&V

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[28] LLS&V developed an "antidirector rights" index of shareholder protection rules, based on data from forty-nine countries, to serve as a measure of legal protection for minority shareholder rights. *See* La Porta et al., *supra* note 27, at 1127-29. Only six factors were included in this index: "[p]roxy by mail allowed," "[s]hares not blocked before meeting," "[c]umulative voting or proportional representation," "[o]ppressed minorities mechanism," "[p]reemptive rights," and "[p]ercentage of share capital to call an extraordinary shareholders' meeting." *Id.* at 1122-23 tbl.1. 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, e.g.*, Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.'s "Anti-Director Rights Index" Under Consistent Coding* 68 (John M. Olin Ctr. for Law, Econ. & Bus. Fellows' Discussion Paper Series, Discussion Paper No. 7, 2006), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Spamann_7.pdf (finding that after recoding LLS&V's data, "there is . . . very little reason to think that the [antidirector rights index] validly measures legal shareholder protection").

[29] For a concise summary, see Edward L. Glaeser & 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." (citing La Porta et al., *supra* note 6, at 1149; La Porta et al., *supra* note 27, at 1151)).

have largely focused on substantive doctrinal differences (i.e., the "law on the books"), but others have urged looking at the law in operation, and particularly at enforcement.[30] Agreeing with this latter view, this Article will suggest that a leading difference between civil and common law systems and also between the United States 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 most 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 the 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.[31] 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 law on the books say?" enforcement can be measured in very different ways. Unfortunately, LLS&V chose, once again, to measure enforcement largely in terms of a formal statutory analysis, focusing on the legal status and powers of the securities regulators in different countries.[32] In so doing, they continued to focus on the more easily measured "law on the books." Yet, even if a regulator is endowed with great power and authority (as our analysis of the FSA will show), it might use little of that power. Why? Possibly, it may still lack an adequate budget to be effective; alternatively, it may be constrained by political forces, or it may simply be disinclined to employ its powers, preferring to enjoy the quiet life.

In contrast, this Article seeks to measure enforcement by focusing on inputs and outputs: What was the size of the regulator's budget

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[30] At least one economic study has departed from this focus on the "law on the books" and indeed found that it is the enforcement, not the enactment, of statutes that yields measurable results. *See* Bhattacharya & Daouk, *supra* note 22, at 104 (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).

[31] *See, e.g.*, Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 27 (2006) ("[S]ecurities laws matter because they facilitate private contracting rather than provide for public regulatory enforcement.").

[32] As discussed *infra* in notes 44-48 and the accompanying text, this is the approach taken in La Porta et al., *supra* note 31, at 11-13, which evaluates enforcement in terms of the power and independence of the securities regulator, but contains no data on budgets or prosecutions.

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)? What penalties were imposed? These data are 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.

(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.

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 plaintiffs' bar motivated by contingent fees, the U.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.[33] Finally, the United States prosecutes securities offenses criminally—and does so systematically.[34] In contrast, even in the United Kingdom 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

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[33] Canada and Australia come the closest because they have authorized class action-like proceedings. Securities class actions covering the secondary market in Canada date only from December 31, 2005. Philip Anisman & Garry Watson, *Some Comparisons Between Class Actions in Canada and the U.S.: Securities Class Actions, Certification, and Costs*, 3 CAN. CLASS ACTION REV. 467, 499 (2006); *see also id.* at 468 (noting Canada's recent authorization of class action-like proceedings). Class actions have been authorized for a longer period in Australia, but initially there was only a "low level[] of interest," which gradually increased over the last decade. *See* Bernard Murphy & Camille Cameron, *Access to Justice and the Evolution of Class Action Litigation in Australia*, 30 MELB. U. L. REV. 399, 400 (2006).

[34] *See infra* notes 129-131 and accompanying text.

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 themselves than to maximize their firm's share price. In contrast, companies with attractive investment or merger opportunities, but requiring either equity capital or listed stock that can be used as a currency for acquisitions, may prefer 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 premiums 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 would not improve the cross-listing firm's cost of capital, such exchanges could still attract foreign issuers by offering heightened liquidity and visibility without impeding their controlling shareholders' enjoyment of private benefits. The problematic bottom line here could be that the policies that maximize the private wealth of the exchanges could minimize social wealth for the nation.[35]

As is by now obvious, this Article will 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 sig-

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[35] This is said more with regard to foreign exchanges that are seeking to attract foreign listings through low-intensity enforcement. However, U.S. exchanges may also 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. The NYSE 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 merger candidate, having failed to acquire 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 those in Europe. *See, e.g.*, *Flying in Formation*, ECONOMIST, Feb. 3, 2007, at 76, 77 (noting that recent merger activity "has encouraged American and British regulators to co-operate more closely").

nificantly in their approach to enforcement. Part III will examine the evidence supporting the bonding hypothesis and the significance of recent fluctuations in the cross-listing premium. The Paulson Report, for instance, argues that the valuation premium incident to a U.S. listing has recently declined and suggests that it is a response to Sarbanes-Oxley.[36] The data, however, show that most (and possibly all) of this decline preceded Sarbanes-Oxley, and listing premiums are again stable and possibly increasing.[37] 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 V 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 trailblazing articles in 1997 and 1998, it was already accepted that a strong financial sector acted as an engine of economic growth.[38] But LLS&V redirected this research by focusing on "legal origins." Using a sample of some forty-nine countries, they found a statistically significant relationship between the origins of a country's laws and its level of financial development.[39] Dividing the world into three categories of legal

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[36] PAULSON REPORT, *supra* note 1, at 47-48.

[37] *See infra* note 184 and accompanying text (evaluating the average Tobin's *q* of non-cross-listed firms along with the cross-listing premium on U.S. exchanges). Doidge et al. dispute that the U.S. listing premium declined after the passage of Sarbanes-Oxley. Doidge et al., *supra* note 3, at 39. Others, including Kate Litvak and Luigi Zingales, disagree. *See* Litvak, *The Cross-Listing Premium*, *supra* note 18, at 1898 (noting a significant decline in the U.S. listing premium in 2002, particularly for high-profit firms); Litvak, *The Effect of Sarbanes-Oxley*, *supra* note 18, at 226 (finding that events leading to the enactment of Sarbanes-Oxley triggered drops in the stock prices of cross-listed companies); Luigi Zingales, *Is the U.S. Capital Market Losing Its Competitive Edge?* 13-14 (Univ. of Chi. Graduate Sch. of Bus. Initiative on Global Mkts., Working Paper No. 1, 2006), *available at* http://research.chicagogsb.edu/igm/research/papers/1LZingalescompetitiveness.pdf (concluding that after Sarbanes-Oxley was passed, the U.S. listing premium dropped especially significantly for companies from countries with good corporate governance). No position is taken here on this empirical issue.

[38] *See, e.g.*, King & Levine, *supra* note 6, at 719; Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537, 538 (1998).

[39] La Porta et al., *supra* note 27, at 1151. This methodology has attracted considerable criticism. The most amusing of these critiques has been offered by Professor Mark West. *See* Mark D. West, *Legal Determinants of World Cup Success* (John M. Olin Ctr. for Law & Econ., Paper No. 02-009, 2002), *available at* http://ssrn.com/

origins—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 (3.2% per capita).[40]

But what does a country that has an inferior "legal origin" do? 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 that "the 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."[41] 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 the key characteristics of the common law are. 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.

At this point, the question of what is being measured becomes even more tangled. LLS&V primarily focused on the substantive legal protections afforded to minority shareholders and creditors. But,

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abstract=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. *Id.* at 2. 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 forty-nine countries, Professor West controls for the number of professional soccer players per capita, whereas LLS&V controlled for GDP growth and the logarithm of real GNP. *Id.* at 3. 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 that civil law system curtails judicial activism." *Id.* at 5. However, he concedes that "maybe—just maybe—other forces are at work." *Id.* at 5.

[40] La Porta et al., *supra* note 6, at 1138 tbl.II.

[41] Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 20 (2000).

even in common law systems, these bodies of law are primarily statutory, and relatively little room is left for judicial lawmaking—the supposed defining characteristic of common law.[42] 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 judicial system" and the "rule of law."[43] 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 are 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 (such as Germany and 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 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 nontrivial 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 nor private plaintiffs may have sufficient incentive or budgets to bring enforcement actions. Thus, enforcement intensity was an issue that LLS&V missed by instead focusing on judicial independence and integrity.

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[42] For this criticism, see Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance,* 95 AM. ECON. REV. 1005, 1006 (2005) (noting that the possibility of "reforms of corporate law" contradicts the premise of the legal origin theory). For the same critique (and others), see KENNETH W. DAM, THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT 32-33 (2006).

[43] La Porta et al., *supra* note 27, at 1142 tbl.1, 1140.

In a 2006 paper, *What Works in Securities Laws?*, the first three authors of the LLS&V quartet did examine the issue of enforcement in more detail,[44] but again 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.[45] These individual weights were then added to generate a comparative index of public enforcement.[46] Ignored by all this is 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.[47] 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.[48]

Any attempt to summarize all of the methodological criticisms leveled 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 United Kingdom

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[44] La Porta et al., *supra* note 31, at 11-13.

[45] In analyzing public enforcement, the three authors "focus on five broad aspects of public enforcement." *Id.* at 12. 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/or listing rules on stock exchanges"? *Id.* Second, they determine whether the power to regulate is "delegated to the [regulator], rather than remain[ing] with the legislature or the Ministry of Finance." *Id.* Third, they rate the "investigative powers" of the securities regulator: can it subpoena documents and witnesses? *Id.* Fourth, they evaluate the civil sanctions that the regulator can levy. *Id.* Finally, they examine the criminal penalties that are authorized and rank the regulator in terms of the severity of these penalties. *Id.* at 12-13. Although they find that securities regulators in common law countries have both more extensive investigative powers and harsher criminal and noncriminal sanctions, *id.* at 15-16 tbl.II, which seems correct, they never assess or attempt to measure if these powers are actually used.

[46] *Id.* at 13.

[47] *Id.* at 19-20.

[48] *Id.* at 20.

over most of the period since 1820.[49] French civil law seems, then, to have worked adequately, at least for France.

(2) The data supporting the conclusion that common law countries have economically outperformed civil law countries are 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.[50]

(3) The LLS&V coding system is suspect, with some critics charging that it has been inconsistently applied.[51]

(4) Vivid counterexamples can be given of both economies that have developed rapidly from civil law origins and others that have stagnated notwithstanding their common law origins.[52]

(5) Many doubt that law ranks anywhere near as high as structural factors, such as geography,[53] openness to trade,[54] or colonial endowments,[55] in explaining postcolonial 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, the first securities markets developed more or less contemporaneously in Am-

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[49] For a summary of evidence on this point, see DAM, *supra* note 42, at 38-39.

[50] The Napoleonic influence over Latin America was short-lived, while the U.S. influence may have had a far longer duration. *See id.* at 42-45.

[51] *See, e.g.*, Spamann, *supra* note 28, at 1 (reviewing criticisms of LLS&V's coding method); *id.* at 19-20 ("For example, . . . both Norway and the U.S. have cumulative voting only as an optional rule, but . . . La Porta et al. coded Norway as 0 and the U.S. as 1 for that variable . . . ." (citing La Porta et al., *supra* note 27)).

[52] For instance, South Korea, Japan, China, and Costa Rica have civil law origins (largely Germanic), while some of the poorest countries in sub-Saharan Africa (e.g., Kenya, Liberia, Nigeria) have common law origins.

[53] *See generally* JARED DIAMOND, GUNS, GERMS, AND STEEL: THE FATES OF HUMAN SOCIETIES (1997). A 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. *Id.* at 28-32.

[54] *See* Rajan & Zingales, *supra* note 6, at 21-23 (arguing that free trade discourages dominant industries from seeking to block development of securities markets).

[55] *See, e.g.*, Daron Acemoglu et al., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 AM. ECON. REV. 1369, 1372-73 (2001) (emphasizing the impact of colonial conditions, rather than legal origins, on economic performance).

sterdam and London, the former in a civil law country and the latter in the archetypal common law country.[56] 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.[57] In England, at the time when the first securities market arose, an 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.[58] 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. The absence of an overarching, centralized bureaucracy in England and the Netherlands at the time that both witnessed the first appearance of securities markets cannot be attributed to their private law, but rather to their public law that (1) had already strengthened the position of the merchant middle class and made them relatively inde-

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[56] *See* Coffee, *supra* note 6, at 61-62 (explaining that the emergence of stock exchanges in Amsterdam and London was "neither accidental nor unrelated to the earlier appearance of a pluralistic society").

[57] *See id.* at 61-62 (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 of the same era, see ALAN MACFARLANE, THE RIDDLE OF THE MODERN WORLD: OF LIBERTY, WEALTH AND EQUALITY 280-85 (2000).

[58] By the early 1600s, English popular culture had originated and celebrated the "rags to riches" story of the poor boy who, through diligence and perspicacity, rose from poverty to great wealth and power. The classic such story was the children's tale of Dick Whittington and his cat, in which the feline famously advised the boy apprentice to return to London and not give up. The 400th anniversary of this folktale was duly celebrated in 2005. *See* Symposium, *The Power of Stories: Intersections of Law, Literature, and Culture*, 12 TEX. WESLEYAN L. REV. 1 (2005). This folktale was based on an actual historical figure, Sir Richard Whittington, who rose from the status of a poor apprentice to become a wealthy cloth merchant and eventually Lord Mayor of London. *See* Susanna Frederick Fischer, *Dick Whittington and Creativity: From Trade to Folklore, From Folklore to Trade*, 12 TEX. WESLEYAN L. REV. 5, 9-13 (2005). Folktales do not prove that such careers were common, but they do reveal that the popular imagination wanted to believe in, and was captured by, such stories. Three centuries later, the U.S. equivalent of the Dick Whittington story was the Horatio Alger story; again, at least on occasion, men such as Andrew Carnegie did achieve great wealth and power based on their individual entrepreneurial skill. Similar stories from the same era are much harder to identify on the Continent.

pendent of any absolutist monarch, (2) encouraged decentralization and self-regulation, and (3) tolerated and encouraged individual initiatives.[59]

At their outset, securities markets were autonomous and self-regulating. Not until the late nineteenth century (in the United Kingdom) and the early twentieth century (in the United States) was securities regulation enacted to control these markets.[60] 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. This preference for autonomy cannot be explained as the product of legal origins, but only in terms of the broader 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.[61]

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.

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[59] For more on these themes, see MACFARLANE, *supra* note 57, at 280-90, and Coffee, *supra* note 6, at 61-63.

[60] 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). *See* Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2000) (making "fraud or deceit" unlawful "in the offer or sale of any securities"); 1 LOUIS LOSS ET AL., SECURITIES REGULATION 7 (4th ed. 2006) (noting that the Directors Liability Act imposed "civil liability for untrue statements in the prospectus without proof of scienter" (citing Directors Liability Act, 53 & 54 Vict., c. 64)). In the United States, "blue sky" statutes were enacted in most states to govern securities transactions, beginning with a comprehensive Kansas statute in 1911. *Id.* at 53. By 1933, blue sky statutes had been enacted in 47 states and Hawaii. *Id.* at 58. 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 6, at 25-39.

[61] For a representative account of Weber's view of the relationship between law and economic growth, see David M. Trubek, *Max Weber on Law and the Rise of Capitalism*, 1972 WIS. L. REV. 720, 739-48. Weber, however, regarded the common law itself as backward and resistant to systematization. 2 MAX WEBER, ECONOMY AND SOCIETY 657 (Guenther Roth & Claus Wittich eds., 1978).

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. That is, countries could have relatively similar laws (or legal doctrines), but diverge widely in terms of how they enforce them. This hypothesis might sound obvious, but it is in considerable tension with a popular hypothesis that several recent commentators have advanced. These commentators have argued that civil law countries experience a lower rate of growth because they are overregulated by bureaucrats.[62] The key premise here is that civil law jurisdictions are more "regulatory" than common law ones in the sense that they require entrepreneurs to gain the prior approval of regulators before taking significant actions.

Both hypotheses—i.e., that the civil law is more "regulatory" than the common law and that the common law enforces more aggressively—could be correct and are not necessarily inconsistent—if we define our terms carefully. Here, an important distinction must be drawn between "regulation" and "enforcement." Regulation works on an "ex ante" basis, while enforcement operates "ex post." Thus, a given jurisdiction could at the same time rank high on a "regulatory" score in the sense that prior bureaucratic approval was generally required before private actors could take significant actions, but also low on an "enforcement" scale in that few disciplinary actions were brought ex post and only low aggregate penalties were levied. Conversely, another jurisdiction could seldom require advance approval by regulators, but could impose highly punitive sanctions ex post for violations of relatively clear-cut rules. Indeed, this Part will find considerable evidence that civil and common law jurisdictions do appear to divide along these lines in terms of how they supervise securities markets, with common law regulators being less intrusive on an ex ante basis, but imposing more frequent and, in the aggregate, far heavier penalties ex post.

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[62] *See, e.g.*, Glaeser & Shleifer, *supra* note 29, at 1194, 1224 (suggesting that the "heavy government intervention" that can occur in a civil law system can explain the difference between common law and civil law countries); Mahoney, *supra* note 6, at 504, 511-13 (discussing the structural differences between common law and civil law countries).

Any serious comparative assessment of the behavior of the major securities regulators requires that we subdivide our topic into three components:

(1) *Regulatory structure*: How much discretion and deference do different regulators give private actors, and the markets themselves, to determine their own rules?

(2) *Enforcement inputs*: How many resources do different countries invest (both in terms of budget and staff) in securities regulation?

(3) *Enforcement outputs*: How aggressively do securities regulators enforce their rules (both in terms of actions brought and sanctions imposed)?

The following survey is hardly exhaustive, but it is sufficient to reach two conclusions: (1) there are systematic differences between civil and common law jurisdictions (which have little to do with formal legal rules), and (2) the United States is at least as different from other countries as common law jurisdictions are from civil law ones.

A. *Regulatory Structure*

Worldwide, securities markets are regulated by a variety of bodies, operating on a hierarchy of levels: (1) the markets themselves engage in a substantial degree of self-regulation, typically adopting rules to govern listings and trading; (2) industry-wide self-regulatory bodies, such as the Financial Industry Regulatory Authority (FINRA) in the United States or the Investment Dealers Association of Canada, have developed, at least in theory, as private bodies, adopting rules on a consensual basis and requiring compliance with them as a condition of eligibility for professionals to trade in these markets;[63] (3) specialized securities regulators, such as the SEC in the United States or the Autorité des Marchés Financiers (AMF) in France, exercise governmental authority and also oversee subordinate, self-regulatory bodies; and (4) the central government, typically through the Ministry of Finance or a similar cabinet-level agency, retains authority over major policy issues. The allocation of regulatory authority among these dif-

[63] For good descriptions (and criticisms) of the role of self-regulation in the U.S. capital markets, see generally Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509 (1997); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997); Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985).

ferent bodies differs widely, but characteristically different patterns prevail in civil and common law jurisdictions.

The key contrast here is that in civil law jurisdictions the role of the central government is greater and more intrusive, with far less discretion being accorded to private or self-regulatory bodies. The most thorough recent survey concludes that, around the world, there are three basic models of securities regulation: (1) a "Government-Led Model" under which the central government retains significant authority over securities market regulation (typified by France, Germany, and Japan); (2) a "Flexibility Model," which grants greater authority to the market participants to determine basic policies, but relies on public agencies to set general policies and maintain some level of enforcement capacity (exemplified by the United Kingdom, Hong Kong, and Australia); and (3) a "Cooperation Model," which assigns a broad range of powers to market participants with respect to most aspects of policymaking, but also creates parallel and overlapping public oversight bodies with strong enforcement authority (the United States and Canada are the leading examples of this model).[64] Although it can be doubted whether the second and third of these models are truly distinguishable, the more important point is that all the civil law jurisdictions with major securities markets clearly fall into the first category—the Government-Led Model—while none of the common law jurisdictions do.[65]

In the Government-Led Model, the jurisdiction's laws "tend to require greater involvement of central governments in certain key actions and regulatory measures" and "restrain market institutions' regulatory role."[66] The central government protects its influence by structuring the securities regulatory framework "so as to maintain important channels of influence in the operation of market institutions."[67] By way of illustration, many of the rules of the Japanese securities regulator "require the Prime Minister's approval before entering into force,"[68] and in France, all the rules of the AMF "require the ap-

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[64] Howell E. Jackson & Stavros Gkantinis, *Markets as Regulators: A Survey* 21-22 (John M. Olin Ctr. for Law, Econ. & Bus., Faculty Discussion Paper No. 579, 2007), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_Gkantinis_579.pdf.

[65] Thus, France, Germany, and Japan are the paradigms of the Government-Led Model, while no common law jurisdiction falls into this category. *See id.* at 25.

[66] *Id.* at 22, 23.

[67] *Id.* at 26.

[68] *Id.* at 26-27.

proval of the Ministry of Finance."[69] Although there may be a specialized securities regulator under this model, the central government still exercises direct supervisory authority over the regulator, typically by appointing representatives to its board.[70] To the extent that private-market institutions have any regulatory role, it "consists largely in supplementing agency regulatory actions," rather than in developing new initiatives.[71]

All of these characteristics are consistent with the basic LLS&V story: civil law jurisdictions tend to resist private self-regulation, or assign it only a secondary role, such as determining listing rules and prospectus content requirements. But there is a corollary to the central government's retention of direct supervision that may be more surprising. Jackson and Gkantinis report that the jurisdictions complying with the Government-Led Model were characterized by "the lowest levels of enforcement intensity" in their study.[72] In effect, the more the central government retains the authority to approve all decisions, the less it invests in enforcement and the fewer and lighter the sanctions it imposes.

In contrast, under the Flexibility Model, the dominant philosophy is "to grant as much leeway as possible to market participants in structuring their activities,"[73] but "more intensive enforcement efforts are a necessary corollary of the greater flexibility they allow to market participants."[74] Translated into the language of LLS&V, this survey comes into focus as a confirmation that civil law jurisdictions do tend to insist on direct supervision of market institutions (indeed, to the point of micromanaging them), while common law jurisdictions defer to self-regulation, but rely on ex post enforcement as a safeguard.

These generalizations gloss over the significant differences among common law jurisdictions (particularly between the United States and the United Kingdom), but they do frame a basic hypothesis: enforcement intensity seems inversely related to the intrusiveness of the government's ex ante involvement in the market. The closer the central government supervises ex ante, the less it relies on sanctions and penalties ex post.

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[69] *Id.* at 27.
[70] *Id.*
[71] *Id.* at 26.
[72] *Id.* at 27.
[73] *Id.*
[74] *Id.* at 33.

B. *Enforcement Inputs*

Enforcement intensity is difficult to measure. One could focus on "input" measures—such as comparative budget and staff size data from securities regulators around the world. But such input data may be misleading for any of several reasons, including the possibility that the regulator might be "captured" by the industry and thus impose few or only minor penalties. Alternatively, a focus only on the enforcement actions brought and penalties imposed may omit much relevant detail, particularly if the regulator prefers to regulate through ex ante guidance and consultation and uses sanctions only as a last resort. In any event, because little comparative data exist with regard to penalty levels, it is necessary to begin with input data.

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 School Professor Howell Jackson.[75] Basically, Jackson found that

> the common law countries . . . report markedly higher levels of regulatory intensity on all dimensions [that] I have been able to study. . . . [T]hese indicia 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.[76]

A methodological problem in comparing regulatory intensity across nations is that many financial regulatory agencies have comprehensive jurisdictions that extend over all, or at least most, of the three basic sectors of the financial services industry: banking, securities, and insurance.[77] This can confound any effort to examine how the agencies supervise and enforce securities markets in particular.

Fortunately, the United Kingdom's FSA has compiled data on comparative regulatory costs for ten major jurisdictions and allocates

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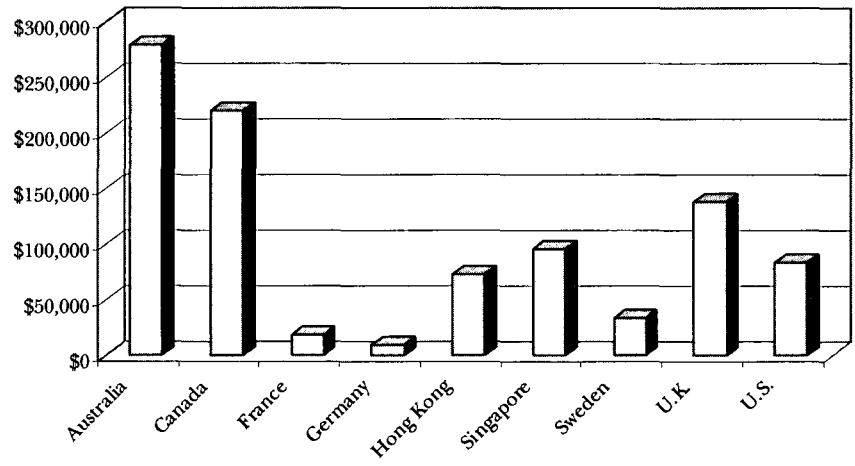
[75] Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* (John M. Olin Ctr. for Law, Econ. & Bus., Faculty Discussion Paper No. 521, 2005), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_521.pdf.

[76] *Id.* at 3.

[77] This is true, for example, in the United Kingdom, where the FSA supervises all three sectors; in Germany, where the BaFin (an abbreviation for "Bundesanstalt für Finanzdienstleistungsaufsicht," or "Federal Financial Supervisory Authority") does the same; and in Japan, where the Japan Financial Services Agency directly supervises the banking and insurance industries and monitors the securities markets in cooperation with the Securities and Exchange Surveillance Committee. Jackson & Gkantinis, *supra* note 64, at 46, 45, 42.

these costs among these three sectors in its annual report.[78] Using these data, Jackson adjusted for the relative size of the securities market to obtain securities regulation costs per billion dollars of stock market capitalization.[79] On that basis, he determined that the adjusted regulatory costs for the United States ($83,943 per billion dollars of stock market capitalization) fell well below those of Australia ($279,587), Canada ($220,515), and the United Kingdom ($138,159), and were "roughly comparable" to those of Hong Kong ($73,317) and Singapore ($95,406)—all common law origin countries.[80] But the adjusted costs for each of these countries dwarfed those of France ($19,041), Germany ($8896), and Sweden ($33,573).[81] Jackson prepared the following chart summarizing his data:[82]

Figure 1: Securities Regulation Costs per Billion Dollars of Stock Market Capitalization



The modest ranking given to the United States on this chart is largely the result of the enormous size of the U.S. securities market, which, estimated by Jackson at $17 trillion, was more than seven times that of

[78] Jackson, *supra* note 75, at 17.

[79] *Id.* at 19 fig.3.

[80] *Id.* at 19-20.

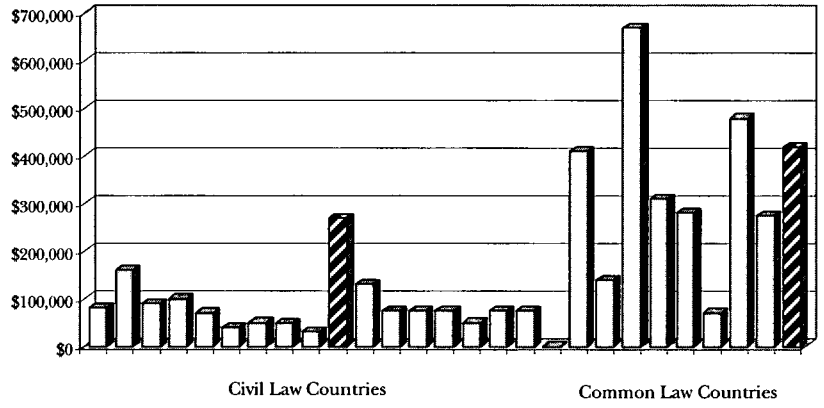
[81] *Id.* at 20.

[82] *Id.* at 19 fig.3 (relying on data from FSA, ANNUAL REPORT: 2003/04 app. 5, at 100-01 (2004), *available at* http://www.fsa.gov.uk/pubs/annual/ar03_04/ar03_04.pdf).

the next largest market, the United Kingdom's, estimated at $2.4 trillion.[83]

This pattern was not limited to securities regulation. Using a different database, Jackson estimated the overall financial regulatory costs for eighteen civil law jurisdictions and ten common law jurisdictions. Presented in terms of relative gross domestic product (GDP), the results again show the common law countries vastly outspending civil law countries.[84]

Figure 2: Regulatory Costs in Civil Law Compared to Common Law Countries (per billion dollars of GDP)



Only South Korea—the striped bar on the left side of the above chart—approaches 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 the civil law countries.[85]

Differences in direct governmental regulatory expenditures between common law and civil law jurisdictions have predictable implications for the firms subject to these differing levels of oversight. In all likelihood, greater public expenditures on financial regulation in

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[83] *Id.* at 20.

[84] *Id.* at 23 fig.7 (relying on data from FSA, *supra* note 82, app. 5, at 100-01). The United States is at the far right of this chart.

[85] *Id.* at 24 figs.8 & 9.

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. Thus, a firm considering whether to cross-list into the U.S. market, particularly if it is incorporated in a civil law jurisdiction, must anticipate increased scrutiny and, as a result, increased compliance expenses.

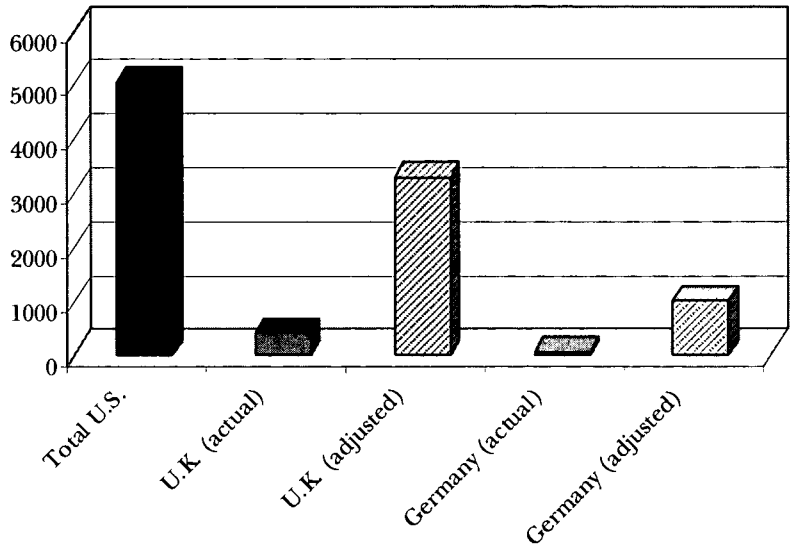
C. *Enforcement Outputs*

Input data have their limitations. Conceivably, a well-funded enforcement agency might be "captured" by its regulatory subjects so that it imposes few or only trivial penalties. Nor can input data inform us about the regulatory style of an agency. Some agencies might opt for a "soft" relationship with the regulated entities, with the public regulator giving guidance or advice much more frequently than it imposes penalties. This might particularly be the case, for example, if the securities regulator were seeking to maximize foreign cross-listings on its principal exchange. Alternatively, another regulator might view a detected violation as an opportunity to generate sufficient general deterrence to prevent future violations. The conventional wisdom views the FSA as exemplifying the first style (in part to maximize foreign listings) and the SEC as the exemplar of the latter, deterrent-type approach.

Nonetheless, Jackson's data suggest that 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. More comparative data are, however, available with respect to the number of enforcement actions. Comparing U.S. public securities actions with enforcement actions brought by the FSA in the United Kingdom and the BaFin in Germany, Jackson derived the following chart showing the average annual number of actions over the 2000–2002 period:[86]

[86] *Id.* at 28 fig.10.

Figure 3: Average Annual Number of Public Securities Enforcement Actions, 2000–2002: United States Compared to United Kingdom and Germany

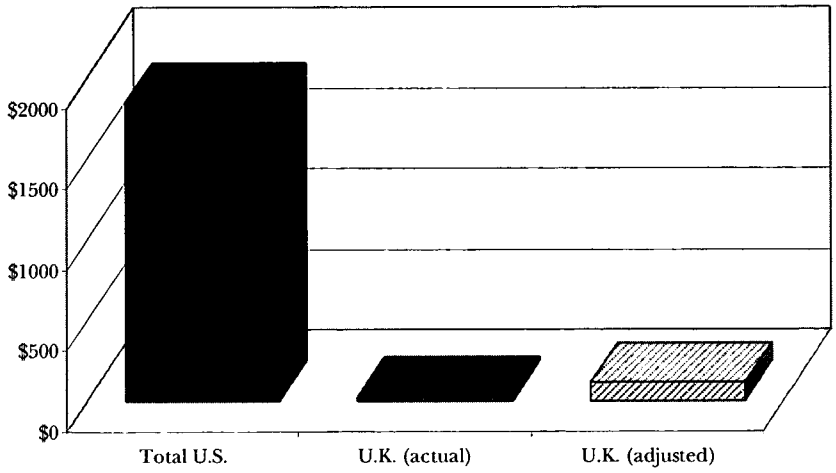


Even when these numbers are adjusted to reflect relative market size, the disparity between the United States and Germany remains roughly five to one.

Turning from the number of actions brought to the aggregate monetary sanctions imposed, Jackson was only able to secure comparable data for the United States and the United Kingdom. Over the 2000–2002 period, public securities enforcement monetary sanctions imposed in the United States exceeded those imposed in the United Kingdom, even after adjusting for relative market size, by a more than ten-to-one margin.[87]

[87] *Id.* at 29 fig.11.

Figure 4: Average Annual Public Securities Enforcement Monetary Sanctions, 2000–2002: United States Compared to United Kingdom (in millions of U.S. dollars)



As will be seen shortly, this disparity has persisted. But before continuing this comparison, it is useful to shift from a global survey of enforcement activity to a more focused examination of a specific area of enforcement activity: insider trading.

D. *A Special Case: Insider Trading*

Attempts to compare regulatory agencies in terms of the intensity of their enforcement activities are subject to an obvious problem: one may be comparing apples to oranges. In part, this is because securities regulators have very different jurisdictions and may have different priorities in terms of what they wish to prosecute. For example, the SEC supervises only the securities markets, while the FSA and BaFin oversee all financial markets and thus have broad jurisdiction over insurance and banking as well. If one assumes hypothetically that insurance and banking are more law-compliant industries than securities,[88] the FSA or BaFin might understandably devote less of its overall resources to enforcement than an agency such as the SEC, which has re-

[88] This is at least a plausible premise because banks and insurance companies are much larger in size than securities brokers and tend to have larger in-house compliance staffs as a result. Also, in their dealings with retail customers, banks may engage in transactions that are less risky than the activities of securities brokers.

sponsibility only for securities markets. The possibility also cannot be ignored that, for cultural or other reasons, the rate of legal noncompliance (i.e., law-breaking) might be higher in one country than in another. Lastly, priorities may differ, as one regulator may focus on broker fraud and ignore corporate accounting irregularities, while another may do the reverse.

Thus, to control for these problems, it is useful to focus on a specific form of illegal behavior that is contrary to law in virtually all countries, and yet appears to occur systematically. Insider trading satisfies both of these conditions. It has been criminalized by virtually all jurisdictions with securities markets.[89] Yet, it persists. Thus, it supplies an ideal context in which to examine relative enforcement intensity. Although few countries regularly report data on insider trading prosecutions, the United States and the United Kingdom do—and the contrast is striking.

Insider trading is common in both the United States and the United Kingdom.[90] The SEC's unequivocal response has been to pursue such cases zealously. Between 2001 and the fall of 2006, the SEC brought just over 300 insider trading enforcement actions against over 600 individuals and entities,[91] averaging about 50 insider trading actions per year. All told, insider trading prosecutions have amounted

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[89] For an overview, see generally Bhattacharya & Daouk, *supra* note 22, at 77 (finding that of the 103 countries with stock markets, 87 had insider trading laws).

[90] Testifying before the Senate Committee on the Judiciary on September 26, 2006, Mr. Christopher Thomas, the founder of Measuredmarkets, an economic consulting firm, presented data suggesting that more than 40% of the mergers with a value of $1 billion or more that were announced in the United States over the twelve-month period ending in early July 2006 were preceded by suspicious trading that appeared to be, in his words, "deviant trading behavior." *Illegal Insider Trading: How Widespread Is the Problem and Is There Adequate Criminal Enforcement?: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 12 (2006) [hereinafter *Illegal Insider Trading*] (statement of Christopher K. Thomas, President, Measuredmarkets, Inc.). He also cited a recent study done in the United Kingdom that found almost 30% of the takeover announcements in 2004 to have been preceded by "suspicious share price movements." *Id.* These two studies do not indicate the relative frequency of insider trading between the two countries because they do not use a common methodology, but they do show the problem to be common in both countries.

[91] *Illegal Insider Trading*, *supra* note 90, at 4 (statement of Linda Thomsen, Director, Division of Enforcement, SEC). Ms. Thomsen's testimony indicated the following numbers of enforcement actions involving insider trading over the period from 2001 to late 2006: 44 actions filed against 77 defendants in fiscal 2006 (through September 22, 2006); 49 actions against 93 defendants in fiscal 2005; 42 actions against 95 defendants in fiscal 2004; 50 actions against 104 defendants in fiscal 2003; 59 actions against 144 defendants in fiscal 2002; and 57 actions against 115 defendants in fiscal 2001. *Id.* at 137-38 n.2.

to between 7% and 12% of the enforcement actions filed annually by the SEC.[92]

In addition to the SEC's civil enforcement efforts, the U.S. Department of Justice criminally prosecutes insider trading—again, with steady enthusiasm. The following table lists only the Federal Bureau of Investigation's statistics on insider trading cases in which it has participated:[93]

Table 1: Annual U.S. Department of Justice Insider Trading Prosecutions

Fiscal Year	Pending Cases	Indictments	Convictions
2006	56	24	15
2005	67	19	19
2004	53	21	13
2003	51	14	15
2002	52	16	12
2001	53	16	14

From this multiyear perspective, insider trading prosecutions appear to be a regular, ongoing activity for the Department of Justice, without any notable peaks or valleys.

In sharp contrast, criminal prosecutions of insider trading are conspicuous by their absence in the United Kingdom. Even civil actions are rare. The *Times* of London reported this year that since 2001, the FSA "has successfully brought just eight cases" alleging insider trading.[94] Earlier, a 2006 in-house study conducted by the FSA's own staff economists reported a "statistically significant increase in the measure of informed trading between 2000 and 2004" and noted that

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[92] *Id.* at 137. This figure indicates that insider trading does not receive a disproportionate priority from the SEC.

[93] *Illegal Insider Trading*, *supra* note 90, at 124 tbl.1 (statement of Ronald J. Tenpas, Associate Deputy Att'y Gen., Department of Justice). In addition, some insider trading cases are initiated by the U.S. Postal Inspection Service, which claimed credit for some 23 indictments and 8 convictions between 2001 and 2006 (4 of which convictions were obtained jointly with the FBI). *Id.* at 124-25 & tbl.2.

[94] Grant Ringshaw, *Hot on the Trail of the Insider Dealers*, SUNDAY TIMES (London), May 13, 2007, Business 8. BaFin conducted many more insider trading investigations than the FSA, and these regularly resulted in some criminal prosecutions and convictions. *See infra* notes 146-148 and accompanying text.

one explanation for this rise was that "no major enforcement action had taken place in the period under examination."[95] Even when insider trading prosecutions are brought in the United Kingdom, the penalties imposed are modest by U.S. standards, generally averaging under $50,000.[96] The highest penalty imposed to date for insider trading appears to have been £750,000.[97] By comparison, after his 2007 conviction on insider trading charges in U.S. federal court, Joseph Nacchio, the former chief executive of Qwest, was sentenced to six years in prison, fined $19 million, and ordered to forfeit another $52 million (for a total penalty of $71 million).[98]

The FSA would clearly like to curtail insider trading. It has invested in improved market surveillance computer systems and has issued guidance to issuers advising them on how to protect material nonpublic information.[99] Characteristically, however, what it has not done is to aggressively enforce the law by bringing actions and imposing penalties. Whether this reflects a disinclination to enforce aggressively or simply a lack of enforcement capacity is debatable, but, as discussed later, it has not assembled the permanent enforcement team that such prosecutions seem to require.

E. *Private Enforcement*

The full magnitude of the enforcement disparity between the United States and the rest of the world only comes adequately into focus when we add to the foregoing data the further dimension of private enforcement. Class actions remain rare to unknown in Europe

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[95] Monteiro et al., *supra* note 22, at 4 (discussing Ben Dubow & Nuno Monteiro, *Measuring Market Cleanliness* (FSA, Occasional Paper Series, Paper No. 23, 2006), *available at* http://www.fsa.gov.uk/pubs/occpapers/op23.pdf). Both the 2006 study and a later 2007 study were conducted by members of the "Economics of Financial Regulation Department." Dubow & Monteiro, *supra*, at 2; Monteiro et al., *supra* note 22, at 2. The revised 2007 study concludes that the U.K. market may "have become cleaner" since the FSA's creation. Monteiro et al., *supra* note 22, at 5.

[96] In 2004, the *Financial Times* reported that the FSA fined a securities analyst £18,000 and a finance director £15,000. Kate Burgess, *FSA Hands Out £33,000 Fines for Insider Trading*, FIN. TIMES (London), Dec. 17, 2004, at 22. The FSA announced that these penalties showed that misuse of confidential information "will not be tolerated by the FSA." *Id.*

[97] *See* Ringshaw, *supra* note 94, at 8.

[98] Carrie Johnson, *Former Qwest Chief Gets 6-Year Prison Term*, WASH. POST, July 28, 2007, at D1.

[99] The FSA has spent over £15 million, "its largest-ever technology investment," on "a state-of-the-art surveillance system." Ringshaw, *supra* note 94, at 8. But criminal prosecutions for insider trading remain unknown in the United Kingdom.

(including the United Kingdom);[100] contingent fees are not permitted; and a "loser pays" fee-shifting rule further discourages aggregate litigation in any form.[101] 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 table, based on Jackson's data, shows that private enforcement in the United States imposes greater financial penalties than public enforcement.[102]

Table 2: Public Compared to Private Enforcement in the United States: Average Payments, 2000–2002

Public Monetary Sanctions	Private Monetary Sanctions
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)
Total: $1,864,409,277	**Total:** $2,027,959,333

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

[100] Europe is beginning to consider the adoption of the class action, but has not yet done so. For a survey, see Christopher Hodges, *Europeanisation of Civil Justice: Trends and Issues*, 26 CIV. JUST. Q. 96, 120-23 (2007).

[101] Contingent fees are now permitted to a very limited degree in Great Britain in personal injury cases. Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 627 & n.10 (1995). In the United States, 95% of personal injury litigation appears to be conducted on a contingent-fee basis. *Id.* at 626 n.3. 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 Munch Danzon, *Contingent Fees for Personal Injury Litigation*, 14 BELL J. ECON. 213 (1983).

[102] Jackson, *supra* note 75, at 27 tbl.3. NASD is the National Association of Securities Dealers, the predecessor to FINRA.

private enforcement in the United States, which overshadows even the significant increase in public enforcement.

F. *The Special Case of the United States*

General agreement exists that "the level of public resources devoted to financial regulation is higher in common law than in civil law countries."[103] But one cannot stop there. On closer inspection, the more powerful relationship proves to be between the size of the enforcement budget and the robustness of the securities market. Indeed, Professors Jackson and Roe have developed a series of enforcement variables that have superior explanatory power to legal origins in explaining stock market capitalization. After controlling for these enforcement variables, they found that common law origins no longer had any significant relationship to stock market capitalization.[104]

The special case of the United States illustrates particularly well that a preoccupation with legal origins causes one to miss the forest for the trees. Viewed in terms of input data (i.e., staffing levels or budgets, as in Jackson and Roe's case), the United States is not a notable outlier. After adjusting for its greater market capitalization and GDP, one finds that other countries spend more and staff more heavily.

When, however, one turns to outputs—that is, to enforcement activity, whether measured by number of enforcement actions or total monetary sanctions imposed—then the United States does become a dramatic outlier, occupying a truly polar position. To show this, it is useful to update 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 chart of the enforcement cases opened by the FSA and the SEC over the years 2002 to 2006:[105]

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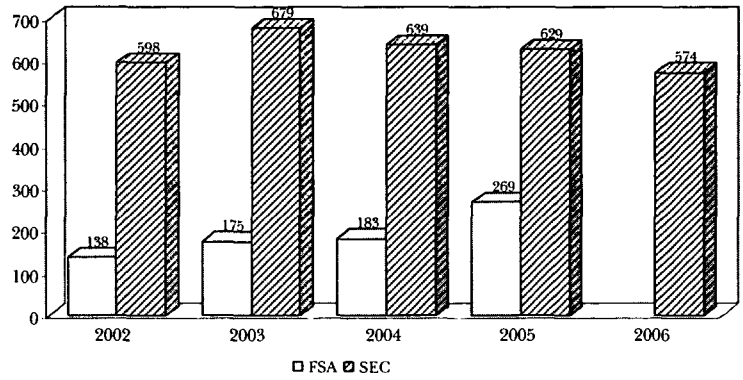
[103] Howell E. Jackson & Mark J. Roe, Public Enforcement of Securities Laws: Preliminary Evidence 23 (Aug. 8, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1000086.

[104] *Id.* at 24-25. In fact, they found that "not only does the common law dummy [variable] lose significance, but the sign of its coefficient changes to negative." *Id.*

[105] The period of reference for SEC data is its fiscal year from October 1 to September 30. By contrast, FSA data are based on its fiscal year, which extends from April 1 to March 31. In each set of columns, therefore, FSA data are six months more recent than corresponding SEC data. For the last column (Year 2006), only SEC data are available. The next-to-last set of columns, however (Year 2005), includes FSA cases up to and including March 31, 2006.

Figure 5: Number of Annual Enforcement Cases: SEC Compared to FSA



FSA Year: April 1-March 31; SEC Year: October 1-September 30

The data on the decline of SEC enforcement actions are summarized in Sarah Johnson, *SEC Enforcement Declines 8.9 Percent*, CFO.COM, Nov. 3, 2006, http://www.cfo.com/article.cfm/8127167. The data are also available in the SEC's Performance and Accountability Reports, all available on the agency's website. The SEC figures total all of the civil and administrative proceedings (excluding mere investigations) initiated during the calendar year indicated along the *x*-axis. In 2006, 218 civil actions and 356 administrative proceedings were brought; in 2005, the two components amounted to, respectively, 335 and 294; in 2004, the numbers were 375 and 264, respectively; in 2003, 271 and 365, respectively; in 2002, 270 and 280, respectively. *See* SEC, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 8 (2006) [hereinafter SEC, 2006 REPORT], *available at* http://sec.gov/about/secpar/secpar2006.pdf; SEC, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 7 (2005) [hereinafter SEC, 2005 REPORT], *available at* http://sec.gov/about/secpar/secpar2005.pdf; SEC, 2004 PERFORMANCE AND ACCOUNTABILITY REPORT 25 (2005), *available at* http://sec.gov/about/secpar/secpar04.pdf; SEC, ANNUAL REPORT 2003, at 17 tbl. (2003), *available at* http://sec.gov/pdf/annrep03/ar03full.pdf; SEC, ANNUAL REPORT 2002, at 2 tbl. (2002), *available at* http://sec.gov/pdf/annrep02/ar02full.pdf.

The sources for the FSA data are the FSA's annual reports, all available on its website. *See* FSA, ANNUAL REPORT: 2005/06 app. 9, at 141 tbl. [hereinafter FSA, 2005–2006 ANNUAL REPORT], *available at* http://www.fsa.gov.uk/pubs/annual/ar05_06/ar05_06.pdf; FSA, ANNUAL REPORT: 2004/05 app. 9, at 140 tbl., *available at* http://www.fsa.gov.uk/pubs/annual/ar04_05/ar04_05.pdf; FSA, *supra* note 82, app. 9, at 140 tbl.; FSA, ANNUAL REPORT: 2002/03 app. 9, at 213 tbl., *available at* http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02_03.pdf. FSA numbers refer to all cases *opened* during the period April 1–March 31 of the respective year (as opposed to cases already open or closed during that time). Categories of cases include pensions and endowments, investment management, unauthorized activities, systems and controls, noncompliance with ombudsman, market protection, listing rule breaches, money laundering controls and financial fraud, and fitness and propriety issues or threshold conditions (by far the most numerous category in the last three years).

Finally, for the purpose of this chart, the terms "initiated" and "opened," when describing proceedings, are assumed to have equivalent meanings.

Although the SEC brought more actions in each year than the FSA, the difference might be explained, at least partially, by the larger market capitalization in the United States. The problems with this explanation are twofold: (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 brought by the U.S. self-regulators (e.g., the NYSE and the NASD) and by the various states are not included in the above chart, even though they have traditionally brought more enforcement actions than the SEC (although generally in less serious cases). Further, it is not clear that all "enforcement actions" are equivalent units; the SEC typically pursues multiple individuals in each enforcement action.[106]

Thus, the best measure of the disparity between the SEC and the FSA is more likely a comparison of the aggregate annual financial penalties imposed by each. The next chart sets forth the aggregate financial penalties imposed by the FSA and SEC for the years 2003 to 2006.[107]

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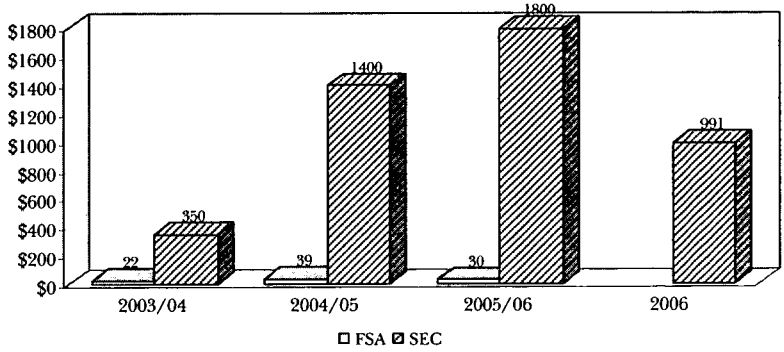
[106] As a note of historical interest, we should point out that in previous years, FSA numbers were substantially higher (666 cases in 1999–2000; 763 in 2000–2001). *See* FSA, ANNUAL REPORT: 2000/01, at 39, *available at* http://www.fsa.gov.uk/pubs/annual/ar00_01.pdf; FSA, ANNUAL REPORT: 1999/2000, at 37, *available at* http://www.fsa.gov.uk/pubs/annual/ar1999_00.pdf. 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 program, 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 of 2000, a statute that is usually viewed as prescribing more rigorous and selective discipline of the enforcement process. *See* Financial Services and Markets Act, 2000, c.8 (Eng.); FSA, DECISION MAKING MANUAL app. (2001), *available at* http://www.fsa.gov.uk/pubs/policy/psreg_annexj.pdf.

[107] The FSA data are from the 2005–2006 FSA annual report. *See* FSA, 2005–2006 ANNUAL REPORT, *supra* note 105, app. 9, at 142 fig. Penalties imposed in the various areas of FSA activities, *see supra* note 105, were added up to obtain yearly totals. These numbers were then converted from pounds to dollars at the rate in force on March 31, 2006 (£1 = $1.73980), the date on which the report closed. Historical currency exchange rates are available at OANDA.com, FXHistory—Historical Currency Exchange Rates, http://www.oanda.com/convert/fxhistory (last visited Dec. 1, 2007). The SEC data are from the SEC's 2006 annual report. *See* SEC, 2006 REPORT, *supra* note 105, at 54 exhibit 2.20.

In the case of the SEC, the amounts reflect the penalties actually collected, except in the case of 2003–2004 where the figure represents the amount ordered. Even greater amounts were ordered in the other years, but have not yet been collected. 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 declined to 82%. *Id.*

Figure 6: Financial Penalties Collected Annually: SEC Compared to FSA (in millions of dollars)



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.[108] Next, these data are adjusted to reflect the difference in market capitalization between the United States and the United Kingdom:[109]

In the case of the FSA, the amounts were "concentrated" in a relatively low number of individual penalties (22 in 2003–2004, 31 in 2004–2005, and 17 in 2005–2006).

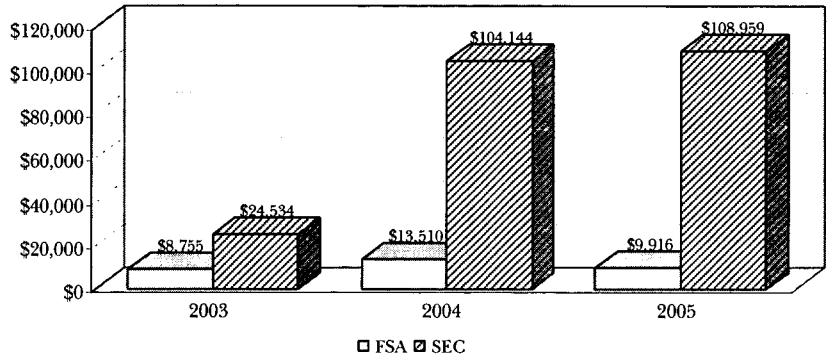
For an explanation of the different definitions of "year" in the respective annual reports, see *supra* note 105.

[108] *See* SEC, 2006 REPORT, *supra* note 105, at 8. This $3.3 billion was "ordered" in 2006, but may never be fully recovered.

[109] Market capitalization data are available from the World Federation of Exchanges. *See* World Fed'n of Exchs., Domestic Market Capitalization, http://www.world-exchanges.org/publications/Ts2%20Market%20cap..pdf (last visited Dec. 1, 2007). The London Stock Exchange capitalization (in billions) amounted to $2460 in 2003, $2865 in 2004, and $3058 in 2005. *Id.* For the purposes of this chart we considered U.S. market capitalization to be the sum of AMEX, NASDAQ, and NYSE capitalizations for each year. Thus calculated, U.S. market capitalization (in billions) amounted to $14,266 in 2003; $16,324 in 2004; and $17,438 in 2005. *Id.* Data for 2006 were not available at the time of this writing.

It should be noted that there is not a perfect correspondence between the duration of the year in which the penalties were imposed (e.g., April 1, 2003 to March 31, 2004) and the duration of the year during which market capitalization was assessed (e.g., January 1, 2003 to December 31, 2003). It seems unlikely that this has any significant effect.

Figure 7: Financial Penalties Collected Annually (in U.S. dollars per billion dollars market capitalization)



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 by the states (whose penalties can exceed those of the SEC).[110] Even on this adjusted and incomplete basis, however, it is apparent that the SEC imposed financial penalties that exceeded 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, as described above, staffing and budgetary levels for the FSA and SEC do seem roughly similar after adjusting for the relative size of their markets), their outputs are markedly different. By style and temperament, the United States punishes more severely.

This same pattern is at least as evident when one turns from the United Kingdom to Canada. Canada's system of securities negotiation closely resembles that of the United States, except for the fact that Canada is unique in lacking a national securities regulator. However, if one aggregates the expenditures of all the provincial regulators in Canada, and then adjusts for relative market size, staff size, and budgets devoted to securities regulation, the two countries appear roughly comparable.[111] But all similarities end when we turn from inputs to

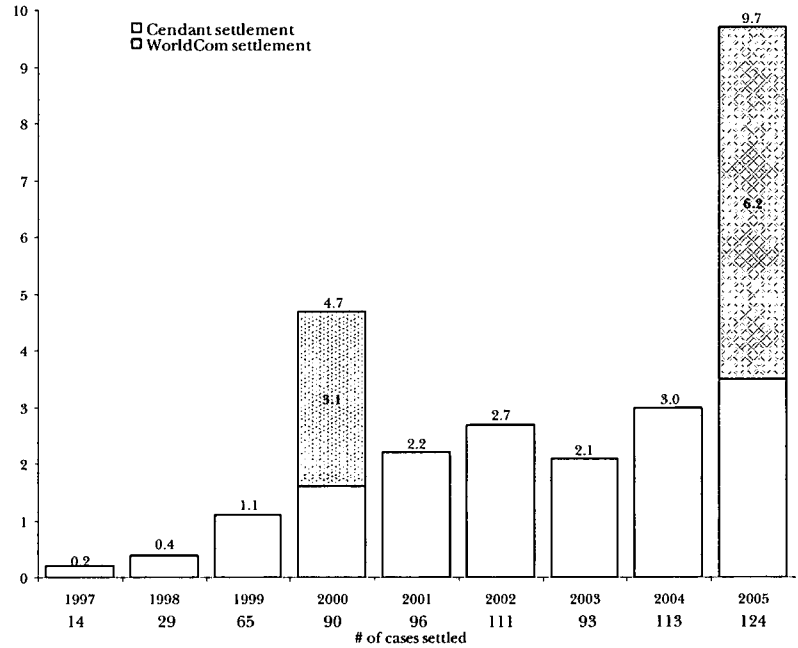
[110] In fact, from 2000 to 2002, the aggregate penalties imposed by the states exceeded the SEC's penalties according to Jackson's study. *See supra* Table 2.

[111] Howell E. Jackson, *Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches*, *in* THE TASK FORCE TO MODERNIZE SECURITIES LEGISLATION IN CANADA, CANADA STEPS UP: RESEARCH STUDIES: STRENGTHENING MARKET CREDIBILITY AND INTEGRITY 75, 98 (2006), *available at* http://

outputs. Howell Jackson found that over the period from 2002 to 2004, "[t]he 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."[112]

Although public enforcement in the United States (as measured by SEC sanctions) has become increasingly punitive over recent years, this shift is overshadowed by even greater increases in the amounts collected by private enforcement in the United States. Set forth below is a chart showing the aggregate values of securities class action settlements over this period.[113]

Figure 8: Annual Securities Class Action Settlement Amounts (in billions of dollars)



Although the Cendant settlement in 2000 and the WorldCom settlement in 2005 produce some discontinuity in the figures, a relatively

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www.tfmsl.ca/docs/V6(2)%20Jackson.pdf. Before making these adjustments, 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." *Id.* at 94.

[112] *Id.* at 116.

[113] This chart is taken from BLOOMBERG & SCHUMER, *supra* note 1, at 75 exhibit 19.

steady increase is evident 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 and 2006.[114] Nothing remotely comparable occurred in Europe or Asia, where the class action and the contingent fee remain virtually unknown.

Aggregating private and public civil enforcement, we find that, in 2005, the total monetary sanctions imposed in the United States 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).[115] Even the lower $5.3 billion number is more than double the 2003 figure (when class action settlements came to $2.1 billion and SEC penalties to $350 million, for a total of $2.45 billion).

G. *Criminal Enforcement*

Finally, the prospect of criminal enforcement radically distinguishes securities enforcement in the United States from that of 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).[116] In addition, it "barred four WorldCom executives from serving as officers or directors of publicly held companies" and suspended others "from appearing or practicing before the [SEC] as accountants."[117] The Department of Justice fined WorldCom another $27 million and criminally prosecuted its CEO (Bernard Ebbers), its CFO (Scott Sullivan), and four others, ultimately resulting in "combined sentences of 32.4 years in jail and $49.2 million in restitution."[118] A parallel private class ac-

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[114] Todd Foster et al., NERA Econ. Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar* 1, 5 (2007), http://www.nera.com/image/BRO_Recent_Trends_SEC1288_FINAL_0307.pdf.

[115] SEC penalties in 2005 were $1.8 billion and class action settlements were either $3.5 billion or $9.7 billion (depending on the treatment of the *WorldCom* settlement). *See supra* Figures 6 and 8.

[116] This summary is taken from Jonathan M. Karpoff et al., The Legal Penalties for Financial Misrepresentation 1 (May 1, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=933333.

[117] *Id.*

[118] *Id.*

tion settled in 2005 for over $6.2 billion, which was mainly paid by banks and financial institutions that worked with WorldCom.[119]

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.[120] Moreover, WorldCom is representative of the tendency for public and private penalties to be imposed on a cumulative and overlapping basis. Karpoff et al. have computed the public and private penalties imposed for "financial misrepresentation"[121]—a narrow category that essentially involves corporate financial fraud, and not insider trading, broker-dealer misconduct, or other frequently prosecuted securities violations. Thus, this is the bull's 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.[122] In about half (323) of these cases, the SEC enforcement action was accompanied by a private class action.[123] These 697 enforcement actions produced a total of 4469 sanctions against individuals and 719 against firms.[124] Some 987 administrative sanctions—i.e., cease and desist orders, censures, and suspensions from practice—were imposed, and courts entered some 2262 permanent injunctions against individuals and some 321 against firms.[125] Five hundred seventy-four executives "were barred from serving as officers and directors of public corporations," and 415 were barred from work as financial professionals.[126] 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, which happened in only 69 cases).[127] The median penalty for individuals was $280,000.[128]

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[119] The exact settlement amount was $6,133,000,000 plus interest. *See In re* WorldCom, Inc. Sec. Litig., 388 F. Supp. 2d 319, 322-35 (S.D.N.Y. 2005).

[120] Karpoff et al. point to such recent examples as Qwest Communications ($250 million), Bristol-Myers Squibb ($100 million), and Royal Dutch/Shell ($100 million). Karpoff et al., *supra* note 116, at 2.

[121] *Id.* at 1.

[122] *Id.* at 4.

[123] *Id.* at 8.

[124] *Id.* at 8-9.

[125] *Id.*

[126] *Id.* at 9.

[127] *Id.* at 10.

[128] *Id.*

Finally, some 755 individuals and 40 firms were indicted; 543 of the individuals pleaded or were found guilty while only 10 were acquitted.[129] A total of 1230.7 years of incarceration and 397.5 years of probation were imposed (with the average sentence being 4.2 years).[130] More recently, the pace has increased. Since the Department of Justice's Corporate Fraud Task Force was formed in 2002 in the wake of Enron, it has charged over 1300 defendants and obtained over 1000 guilty pleas and convictions.[131] In short, financial fraud by issuers, their agents, and their 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.[132]

H. *Enforcement Styles*

Regulators behave very differently, even accounting for disparities in 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 doing business. In this regard, the FSA and the SEC appear to be located at opposite ends of the continuum. Indeed, both agencies publicly proclaim as much. In 2006, the FSA's then-chairman said that his agency was "emphatically not an enforcement-led regulator."[133] In contrast, it is a virtual truism to por-

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[129] *Id.* at 9. The figure for acquittals is current as of December 31, 2005. At that time, some 232 individuals were awaiting trial. *Id.*

[130] *Id.*

[131] Press Release, U.S. Dep't of Justice, Fact Sheet: Corporate Fraud Task Force (Aug. 9, 2006), *available at* http://www.usdoj.gov/opa/pr/2006/August/06_odag_521.html.

[132] For recent evidence and analysis of the sharply higher sentences being imposed on white collar offenders, see Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 55 (2007); J. Scott Dutcher, Comment, *From the Boardroom to the Cellblock: The Justifications for Harsher Punishment of White-Collar and Corporate Crime*, 37 ARIZ. ST. L.J. 1295, 1302-03 (2005); Jamie L. Gustafson, Note, *Cracking Down on White-Collar Crime: An Analysis of the Recent Trend of Severe Sentences for Corporate Officers*, 40 SUFFOLK U. L. REV. 685, 700 (2007).

[133] *See* John Tiner, Chief Executive, FSA, Keynote Address at the Enforcement Law Conference (June 16, 2006) (transcript available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0616_jt.shtml). The FSA has recently come under some criticism in the United Kingdom for its failure to combat financial crime effectively. *See, e.g.*, Alistair MacDonald, *Judging a U.K. Watchdog*, WALL ST. J., July 23,

tray the SEC as primarily an enforcement agency.[134] Yet ironically, the FSA has considerably more formal authority over the London Stock Exchange than the SEC has over U.S. exchanges; indeed, the FSA even possesses authority to determine the listing rules of the London Stock Exchange,[135] while the SEC faces severe constraints on its ability to amend stock exchange rules.[136] Although the FSA has more than ample legal authority, it is reluctant to use it and strives to employ other means of influence in preference to enforcement actions.[137] Again, this illustrates that formal legal powers mean less than regulatory style and philosophy.

But how does one measure regulatory style? Probably the best measure is to focus on the percentage of a regulator's budget that goes to enforcement activity. Doing so highlights the very different approaches to enforcement of the securities regulators in the United Kingdom, the United States, Germany, and Australia. Collectively, they show that the common law countries may diverge more than they agree.

Set forth below is the FSA's enforcement budget as a percentage of its total budget for the years 2004 to 2007.[138]

2007, at C1 (reporting on recent skepticism in the United Kingdom as to whether the FSA truly protects investors). Thus, public statements that disparage or deemphasize enforcement, such as Mr. Tiner's, may become less common.

[134] *See, e.g.*, Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 319 (1985) ("The notion that the SEC behaves as if one of its principal duties is to police a cartel of exchanges and brokers is consistent with the modern economic theory of regulation.").

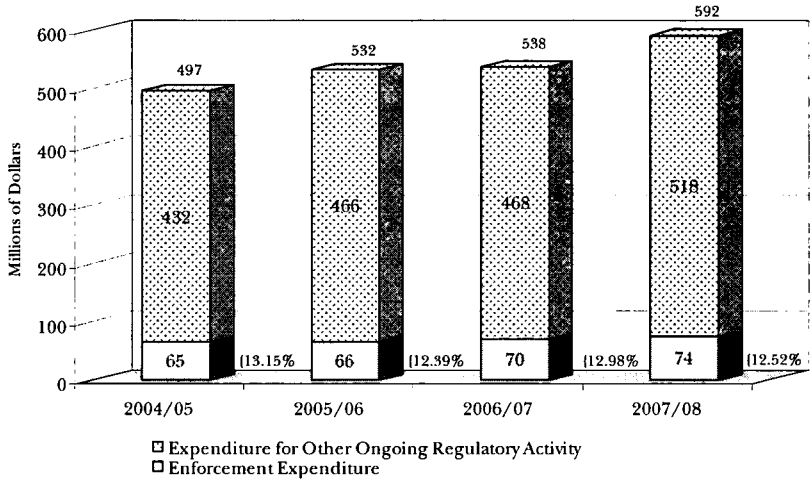
[135] Jackson & Gkantinis, *supra* note 64, at 47.

[136] *See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406, 416-17 (D.C. Cir. 1990) (invalidating an SEC rule seeking to regulate shareholder voting through listing standards).

[137] In July 2007, possibly in response to public criticism, the FSA issued a *Market Watch* newsletter, which expressed its concerns about the high rate of suspicious trading on takeovers, and stated, characteristically, that the FSA was "committed to working in partnership with the industry to reduce the incidence of market abuse." *Market Division: Newsletter on Market Conduct and Transaction Reporting Issues*, MARKET WATCH (FSA, London, U.K.), July 2007, at 1, *available at* http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter21.pdf. Much of the newsletter focused on advice to companies on how to control properly the dissemination of material, nonpublic information. Will this have any meaningful effect? This author doubts that it will.

[138] The data are found in FSA, Business Plan 2007/08, at 39 tbl.4.3 (2007) [hereinafter FSA, 2007–2008 Business Plan], *available at* http://www.fsa.gov.uk/pubs/plan/pb2007_08.pdf, and FSA, Business Plan 2006/07, at 42 tbl.4.2 (2006), *available at* http://www.fsa.gov.uk/pubs/plan/pb2006_07.pdf. While the figures for early years are actual, the amount for 2006–2007 is an estimate and the amount for 2007–2008 is a budgetary allocation. The amounts, originally stated in British pounds sterling, were

Figure 9: FSA Enforcement Activity as a Percentage of the FSA's Total Budget, 2004–2007



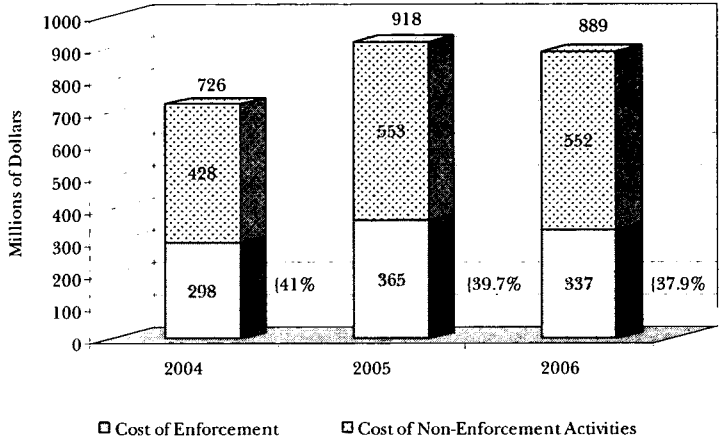
As this chart shows, enforcement expenditures at the FSA ranged between 12.4% and 13.2% of its total budget over this period.

In contrast, as the next chart shows, enforcement expenditures at the SEC have ranged between 37.9% and 41.0% of its total budget.[139]

converted at the going rate as of February 26, 2007 (£1 = $1.96390). *See* OANDA.com, *supra* note 105.

[139] The cost-of-enforcement data are taken from the SEC's 2005 and 2006 annual reports. *See* SEC, 2006 REPORT, *supra* note 105, at 61 tbl.; SEC, 2005 REPORT, *supra* note 105, at 53 tbl. The figures are as of September 30 of each year.

Figure 10: SEC Enforcement Activity as a Percentage of the SEC's Total Budget, 2004–2006



Both agencies then were stable and consistent in their behavior, but the SEC devoted a percentage of its budget to enforcement that was roughly three times that devoted to enforcement by the FSA. If anything, the foregoing comparison may understate the disparity. In 2007, the United Kingdom's National Audit Office, which plays a role comparable to the Government Accountability Office (GAO) in the United States, estimated that only 8% "of the FSA's total budget goes to the Enforcement Division."[140] Gently chiding the FSA, the National Audit Office concluded that "[c]ombating financial crime has tended to receive less attention than other elements of the FSA's responsibilities."[141]

Next, let's consider the case of the German financial regulator, BaFin.[142] Like the FSA, it has a broad jurisdiction covering banking, securities, and insurance.[143] Over the period from 2005 to 2007, its budgets show the following:[144]

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[140] NAT'L AUDIT OFFICE, THE FINANCIAL SERVICES AUTHORITY: A REVIEW UNDER SECTION 12 OF THE FINANCIAL SERVICES AND MARKETS ACT 2000, at 47 (2007), *available at* http://www.nao.org.uk/publications/nao_reports/06-07/0607500.pdf.

[141] *Id.* at 7.

[142] "BaFin" is the shorthand acronym for German words that translate into "Federal Financial Supervisory Authority."

[143] *See supra* note 77.

[144] *See* Bundesanstalt für Finanzdienstleistungsaufsicht, Haushaltsplan: 2007, at 17 (2006), *available at* http://www.bafin.de/haushalt/2007_hh.pdf (showing budgets for

Table 3: Amount Spent on Enforcement by BaFin

Year	Total Budget (€ MM)	Amount Spent on Enforcement (€ MM)	Percentage
2005	109.71	3.40	3.1%
2006	126.82	6.51	5.1%
2007	120.15	7.81	6.5%

Although BaFin's budget is considerably smaller than the FSA's, the percentage spent on enforcement (4.9% on average) is less than half the 12.5% spent on enforcement by the FSA.[145] Thus, one can legitimately ask: is the FSA more like the SEC or more like BaFin? Despite their different legal origins, the FSA and BaFin seem to share a common aversion to enforcement.

But the full story is more complex. BaFin does investigate and refer insider trading cases, which are then prosecuted by German criminal prosecutors. In 2005, BaFin opened 54 new insider trading investigations, filed complaints against 95 persons, and referred 23 cases to prosecutors.[146] While the prosecutors had mixed success, 9 convictions were obtained for insider trading.[147] In 2006, 51 investigations were started and 11 convictions were obtained for insider trading.[148] Even if most insider trading referrals could not be successfully prosecuted, those convictions that did result still dwarf the British experience, where criminal prosecutions are unknown and civil cases are few.[149]

In fairness, enforcement in Germany does not typically take the form of litigation. Rather, BaFin relies more on auditing, conducting

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2005, 2006, and 2007); Bundesanstalt für Finanzdienstleistungsaufsicht, Haushaltsplan: 2007 (Enforcement) 8 (2006), *available at* http://www.bafin.de/haushalt/2007_hh_enforce.pdf (showing expenditures on enforcement for 2005 and 2006, and estimated expenditures for 2007).

[145] *See supra* Figure 9.

[146] *See* BUNDESANSTALT FÜR FINANZDIENSTLEISTUNGSAUFSICHT, 2005 ANNUAL REPORT 159 [hereinafter BAFIN, 2005 ANNUAL REPORT], *available at* http://www.bafin.de/jahresbericht/2005/kapitel_VI_en.pdf.

[147] *Id.* at 160.

[148] BUNDESANSTALT FÜR FINANZDIENSTLEISTUNGSAUFSICHT JAHRESBERICHT 2006, at 166 tbls.22 & 23 (2006), *available at* http://www.bafin.de/jahresbericht/2006/kapitel_VII.pdf.

[149] *See supra* notes 94-97 and accompanying text.

its own audits of an issuer's financial statements on both "spot check" and extraordinary bases, with BaFin "seek[ing] to perform around 120 spot checks every year."[150]

In this light, the SEC, with its very different emphasis on litigation, deterrence, and high penalties, appears to stand apart, employing a very different approach to enforcement than either the FSA or BaFin. Still, it does not stand alone. At least one securities regulator does appear to rival and perhaps outdo the SEC at enforcement: Australia. Although Australia has substantive corporate and securities laws closely resembling those of the United Kingdom, 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 Investments Commission (ASIC), Australia's securities regulator, exceeded that of the SEC.[151]

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[150] See BAFIN, 2005 ANNUAL REPORT, *supra* note 146, at 182.

[151] The data on ASIC's enforcement expenditures relative to its total budget, as illustrated in Table 4, were provided to the author by Professor Ian Ramsay of the University of Melbourne and are available in ASIC's annual reports. *See* ASIC, ASIC ANNUAL REPORT 2005–06, at 14 tbl., 15 tbl. [hereinafter ASIC, 2005–2006 REPORT], *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_Annual_Report_2006.pdf/$file/ASIC_Annual_Report_2006.pdf; ASIC, ASIC ANNUAL REPORT 2004–05, at 12 tbl. [hereinafter ASIC, 2004–2005 REPORT], *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_AR_05.pdf/$file/ASIC_AR_05.pdf; ASIC, ASIC ANNUAL REPORT 2003–04, at 10 tbl. [hereinafter ASIC, 2003–2004 REPORT], *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_AR_04_complete.pdf/$file/ASIC_AR_04_complete.pdf. In terms of dedicated staff, ASIC had 373 enforcement personnel out of a total staff of 1394 (or 26.8%) in 2005–2006, 420 enforcement personnel out of a total staff of 1497 (or 28.1%) in 2004–2005, and 385 out of a total staff of 1466 (or 26.3%) in 2003–2004. ASIC, 2005–2006 REPORT, *supra*, at 17, 15; ASIC, 2004–2005 REPORT, *supra*, at 14-15; ASIC, 2003–2004 REPORT, *supra*, 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. ASIC, 2005–2006 REPORT, *supra*, at 17 tbl. Hence, the percentage may be even higher.

Table 4: Amount Spent on Enforcement by ASIC

Year	Total Budget (AUS $)	Amount Spent on Enforcement (AUS $)	Percentage
2003-04	$196 million	$84 million	42.9%
2004-05	$208 million	$97 million	46.6%
2005-06	$218 million	$102 million	46.8%

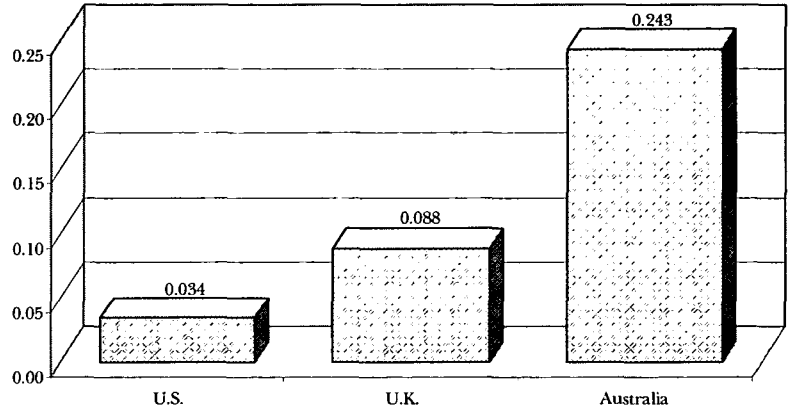
This translates into an average percentage of 45.4%—almost four times that of the United Kingdom.

The level of ASIC's enforcement effort also appears to exceed that of both the United States and the United Kingdom, once adjustment is made for the smaller size of the Australian market. From 2005 to 2006, ASIC commenced 195 criminal, civil, and administrative actions against some 391 defendants,[152] and, after adjustment for relative market capitalization, Australia leads both the United Kingdom and the United States.[153]

[152] ASIC 2005–2006 REPORT, *supra* note 151, at 18. In the same period, 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. *Id.*

[153] The adjustments for relative market size were based on market capitalization figures taken from the website of the World Federation of Exchanges. World Fed'n of Exchs., Domestic Market Capitalization (2005), http://www.world-exchanges.org/publications/EQUITY105.pdf. For more information on the method used to calculate market capitalization, see note 109, *supra*. The data on the number of enforcement cases brought by the SEC and FSA were taken from the agencies' annual reports. *See* SEC, 2006 REPORT, *supra* note 105, at 8; FSA, 2005–2006 ANNUAL REPORT, *supra* note 105, app. 9, at 141 tbl. Although the United States comes in last on this market-adjusted chart, it must be remembered both that (1) the SEC's jurisdiction is limited to securities regulation, while the other two share a broader jurisdiction, and (2) this chart excludes the cases brought by self-regulatory organizations and the states in the United States, which efforts may equal or exceed that at the SEC.

Figure 11: Number of Enforcement Cases in 2005 (per billion dollars of market capitalization): Comparison of United States, United Kingdom, and Australia



Australia has also used criminal sanctions aggressively,[154] although more recently it has placed a greater emphasis on civil litigation.

The differences among these three agencies go even deeper than their budget numbers reveal. In its 2007–2008 business plan, the FSA explains that it outsources enforcement, hiring outside attorneys and accountants because it is not economical for it to retain full-time enforcement personnel.[155] In contrast, the SEC and ASIC rarely outsource enforcement matters to private law firms. In fact, for the SEC, with an over 1200-person enforcement staff, enforcement is the core mission.[156]

To sum up, the United Kingdom outsources enforcement, while Germany principally relies on auditing. In contrast, in the United States and Australia, litigation is the preferred weapon; Australia, like

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[154] *See* Helen Bird et al., *Strategic Regulation and ASIC Enforcement Patterns: Results of an Empirical Study*, 5 J. CORP. L. STUD. 191, 246 (2005) (finding that the ASIC made "predominant" use of criminal penalties between 1997 and 1999). More recently, Australia has made increasing use of civil penalties to punish selective disclosure and insider trading offenses. *See* Michelle Welsh, *Eleven Years On—An Examination of ASIC's Use of an Expanding Civil Penalty Regime*, 17 AUSTL. J. CORP. L. 175, 176 (2004).

[155] *See* FSA, 2007–2008 Business Plan, *supra* note 138, at 39 ("The unpredictable size, timing and complexity of enforcement cases means that it is not economical to retain permanent staff to handle all cases.").

[156] Arguably, a permanent and substantial enforcement staff could create an incentive to bring enforcement actions so as 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.

the United States, even has some private securities litigation. Prior comparative research on securities regulation has focused on budgets and staff size, but the critical variable may instead be the percentage of the regulator's budget devoted to enforcement. Once we focus on this variable, the supposed dichotomy between "common law" and "civil law" jurisdictions seems to break down.

III. THE BONDING HYPOTHESIS

Theories about the motives underlying cross-listing and its impact on the cost of capital date back several decades. Generally, the early theories stressed investment barriers and segmented markets. By cross-listing, the corporation leaped over these barriers and obtained access to a lower cost of capital.[157] 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.[158] Using a broad sample of cross-listing announcements, a 1999 study by Darius Miller found a positive 1.2% average abnormal return upon the announcement of a U.S. cross-listing by a foreign issuer.[159] Even more interestingly, the stock market reaction was greater for emerging market firms (1.5%) and for firms listing on the major U.S. exchanges (2.6%).[160] Given the general decline of investment barriers and market segmentation during the 1990s, it seemed puzzling both that (1) the number of firms seeking to cross-list rose exponentially in the 1990s when investment barriers were falling, and (2) the vast 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. Paradoxically, however, the race to cross-list intensified in the 1990s, just as market barriers fell. Moreover, in the face of a high positive stock market reaction to

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[157] For reviews of these traditional theories, see Doidge et al., *supra* note 11, at 207-210, and G. Andrew Karolyi, *The World of Cross-Listings and Cross-Listings of the World: Challenging Conventional Wisdom*, 10 REV. FIN. 99, 101-05 (2006).

[158] Two 1999 studies were especially noteworthy: Stephen R. Foerster & G. Andrew 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, 983 (1999), which observed that cross-listed shares experienced unusually significant positive price changes, and Darius Miller, *The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts*, 51 J. FIN. ECON. 103, 103 (1999), which found the market reaction to cross-listing to be significantly more positive than had been previously observed.

[159] Miller, *supra* note 158, at 114 tbl.4.

[160] *Id.*

cross-listing in the United States, 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. Contemporaneously, U.S. firms were sharply reducing their own cross-listings abroad.[161] 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:[162] managers "bonded" themselves not to accumulate excessive private benefits by deliberately subjecting themselves to a stricter regulatory regime (i.e., that of the United States) 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. generally accepted accounting principles (GAAP). At once, 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); (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).

Empiricists quickly found additional evidence of bonding. In particular, William Reese and Michael Weisbach showed that firms cross-listing into the United States behaved very differently than non-cross-listing firms, with the former typically making equity offerings in both the United States and abroad after they had cross-listed in the United States.[163] Still, doubts persisted that these findings were robust enough to make the bonding hypothesis stronger than other rival explanations. Then, more recently, studies found a disparity reaching as high as 30% or more between the Tobin's q of firms that cross-listed on a

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[161] *See* Pagano et al., *supra* note 15, at 2661, 2664 (noting that the number of American companies cross-listed in Europe fell from 284 to 184 between 1986 and 1997 as European exchanges became less attractive).

[162] Coffee, *The Future as History*, *supra* note 13, at 691-92.

[163] Reese & Weisbach, *supra* note 13, at 91; *see also* Evangelos Benos & Michael S. Weisbach, *Private Benefits and Cross-Listings in the United States*, 5 EMERGING MARKETS REV. 217, 237-38 (2004) (finding that positive stock price reactions following cross-listing announcements were indicative of bonding).

major exchange and that of similar firms that did not cross-list.[164] This evidence compelled a greater acceptance of the bonding hypothesis.[165]

Even more recently, researchers found that there has consistently been a valuation premium associated with a U.S. listing, but none with a listing on the London Stock Exchange.[166] At this point, the inadequacy of the traditional explanations seems apparent, because they cannot explain the unique premium for cross-listing on a U.S. exchange. An even more 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 "fewer than one in 10 large public companies from outside the United States choose to cross-list their shares on U.S. markets."[167] 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.

Other evidence also corroborates this explanation that controlling shareholders may find bonding to be too costly and so forego a U.S. cross-listing. Empirical studies have found that firms cross-listing in the United States make better financial disclosures[168] and rank higher on indexes measuring the quality of their corporate governance.[169] Even more telling is the fact that firms with controlling shareholders, particularly controlling shareholders enjoying high private benefits of control, are less likely to cross-list. One recent study finds that the probability that a firm will cross-list on a U.S. exchange is inversely related to both (1) the level of the control rights held by the control group and (2) the margin by which these control rights exceed the

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[164] *See* studies discussed *supra* notes 11, 15. Tobin's *q* is calculated as the market value of a company divided by the replacement value of its assets. A ratio above 1 shows that management has caused the firm's market value to exceed its asset value. Thus, a high ratio suggests a strong management that is maximizing shareholder value.

[165] For this conclusion, see CLARK & WÒJCIK, *supra* note 19, at 139.

[166] *See supra* note 15 and accompanying text.

[167] Doidge et al., *supra* note 11, at 206.

[168] *See* Khanna et al., *supra* note 19, at 499-50 (concluding that cross-listing firms have better disclosure practices because of either listing regulations or self-selection by firms that elect to cross-list).

[169] CLARK & WÒJCIK, *supra* note 19, at 151-52.

controlling shareholders' cash flow rights.[170] Because the controlling shareholder whose control rights exceed its entitlement to dividends probably designed the governance structure of its corporation precisely to allow it to receive private benefits, it is hardly surprising that such a shareholder 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,[171] which allows them to sell their shares to sophisticated institutional investors, but not to retail investors. This "private" entry into the United States means that these foreign issuers need not register under either the Securities Act of 1933 or the Securities Exchange Act of 1934.[172] As a result, such issuers do not become subject 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 United States is much smaller than those incident to entry onto a major exchange (and sometimes it may even be negative).[173] Why then make such a limited entry? The most

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[170] Craig Doidge et al., *Private Benefits of Control, Ownership, and the Cross-Listing Decision* 18 (Charles A. Dice Ctr. for Research in Fin. Econ., Working Paper No. 2005-2, 2005), *available at* http://www.cob.ohio-state.edu/fin/dice/papers/2005/2005-2.pdf.

[171] *See* Private Resales of Securities to Institutions, 17 C.F.R. § 230.144A (2007). Rule 144A was principally designed to give foreign issuers access to 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. *Id.* § 144A(d)(3)(i).

[172] Rule 144A offerings are not considered to be public offerings of securities, and are thus exempted from registration by section 4(2) of the Securities Act of 1933. *See* 15 U.S.C. § 77d(2) (2000) (exempting "transactions by an issuer not involving any public offering"). So long as fewer than 300 holders resident in the United States 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* Exemptions for American Depositary Receipts and Certain Foreign Securities, 17 C.F.R. § 240.12g3-2(a) (2007).

[173] It has long been known that the stock price reaction was insignificant to a foreign firm's entry into the U.S. markets by means of a private placement under Rule 144A (as opposed to a listing on a U.S. exchange). *See* Coffee, *Racing Towards the Top*, *supra* note 13, at 1784-85; Miller, *supra* note 158, at 114-15. More recent work by Doidge et al. has found that the Tobin's *q* valuation ratio is significantly higher for foreign firms cross-listing onto a U.S. exchange in comparison to foreign firms listing over the counter or making a Rule 144A offering. *See* Doidge et al., *supra* note 3, at 18-19. Nonlisted foreign firms that enter the United States by these other means "have low sales growth, low Tobin's *q* ratios, and higher insider ownership compared to U.S. exchange-listed firms or even compared to other listed firms." *Id.* at 19. Another recent study finds that cross-listings in the over-the-counter market are associated only with "less pronounced" reductions in the firms' cost of capital and that Rule 144A private placements even have adverse effects. *See* Hail & Leuz, *supra* note 12, at 28, 15.

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 cross-listing by Israeli firms (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.[174] Although this study concludes that "law does not matter" (at least for Israeli companies),[175] it does recognize that Israeli courts are "very slow" in processing corporate cases and, because of their heavy case loads, are "unable to develop expertise or robust precedence in matters pertaining to securities law."[176] 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" but ignoring the greater prospect of enforcement—both public and private—in the United States.

A related objection has been that U.S. enforcement—both private and public—seldom focuses on foreign issuers.[177] Because the deterrent threat incident to cross-listing is thus asserted to be illusory, it might follow, if this premise were accurate, that the bonding premium was based on a false premise. In truth, the data here are 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 is overstated. 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" of all time, ranked by their settlement values. Its 2006 report shows that three out of these top ten involved foreign de-

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[174] *See* Ariel Yehezkel, *Foreign Corporations Listing in the United States: Does Law Matter? Testing the Israeli Phenomenon*, 2 N.Y.U. J.L. & BUS. 351, 393 (2006) (arguing that there is no significant difference between Israeli and U.S. securities laws because Israeli securities laws adopt the "supervisory structure and the regulatory philosophy" underpinning the U.S. laws).

[175] *Id.* at 397.

[176] *Id.* at 392.

[177] *See* Jordan Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting U.S. Securities Laws?*, 75 J. FIN. ECON. 319, 335, 342-43, 346-49 (2005) (asserting that the SEC rarely took enforcement actions against cross-listed foreign firms between 1934 and 2002).

fendants, and all three such cases were resolved in 2006.[178] Similarly, in 2006, the SEC brought and settled significant enforcement actions against both TV Azteca, a major Mexican broadcasting company,[179] and European former officers and directors of Spiegel, Inc.[180] In 2005, it sued nine officers of Royal Ahold,[181] and in 2006, the Department of Justice extradited three British investment bankers to stand trial in connection with the Enron criminal prosecution (despite an angry national protest in Great Britain).[182] 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 United States 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

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[178] *See* Foster et al., *supra* note 114, at 5 tbl. Two of these three cases involved Nortel Networks, a Canadian issuer, which settled separate securities class actions covering different time periods for $1.143 billion and $1.074 billion, respectively. The other foreign defendant was Royal Ahold, NV, a Dutch company, which settled for $1.1 billion. These settlements rank fifth, seventh, and sixth, respectively, on the list of the ten largest class action settlements. *Id.* Another major securities class action was recently brought against Royal Dutch Shell, a British-Dutch corporation with ADRs listed on NYSE, and survived at least an initial challenge to class certification. *See In re* Royal Dutch/Shell Transp. Sec. Litig., 380 F. Supp. 2d 509, 548, 551 (D.N.J. 2005) (affirming jurisdiction over nonresident foreign defendants and the claims of foreign class members), *amended by* 404 F. Supp. 2d 605 (D.N.J. 2005).

[179] *See In re* TV Azteca, S.A., Exchange Act Release No. 54,445, 2006 SEC LEXIS 2041 (SEC Sept. 14, 2006) (admin. proceeding) (finding that TV Azteca failed to comply with section 13(a) of the Exchange Act by failing to file an annual report). Pursuant to this settlement, TV Azteca's registration under the Securities Exchange Act was revoked, *id.*, and certain of its senior officers were barred from serving as officers or directors of a public company. SEC v. TV Azteca, S.A. de C.V., et al., Defendants Agree To Settle SEC Charges, Litigation Release No. 19,833 (Sept. 14, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19833.htm.

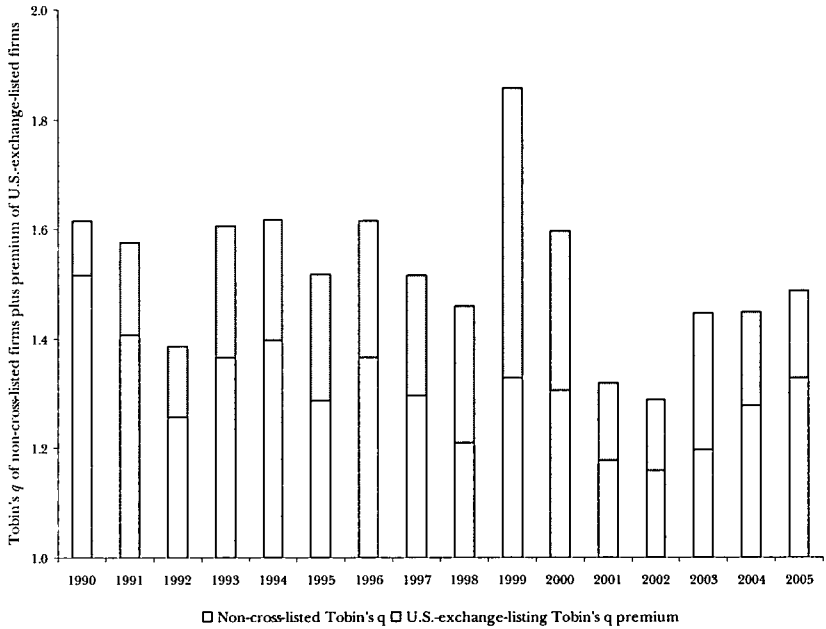
[180] *See* Judith Burns, *Spiegel Ex-Officers Settle SEC Charges in Accounting Case*, WALL ST. J., Nov. 3, 2006, at B4 (reporting that the former officers and directors of Spiegel, which had been acquired by a European corporation that allegedly caused it to conceal its deteriorating financial performance, had consented to penalties ranging from $100,000 to $170,000 each).

[181] *See* Ron Scherer, *Enron Effect: The Changed Corner Office*, CHRISTIAN SCI. MONITOR, Jan. 18, 2005, at 1.

[182] *See* Kate Murphy, *3 Britons in Enron Case Are Told To Remain in U.S.*, N.Y. TIMES, July 22, 2006, at C3 (describing extradition of three British investment bankers who were indicted on fraud charges in the Enron prosecution).

consequence of Sarbanes-Oxley and U.S. overregulation.[183] In truth, there has been a recent decline, but most of it occurred prior to the passage of Sarbanes-Oxley in 2002. Subsequent to the Act's passage, the listing premium rose significantly in 2003, and has remained relatively stable thereafter. The following chart shows the cross-listing premium for the years 1997 to 2005.[184]

Figure 12: The U.S. Cross-Listing Premium, 1990–2005



What caused the decline between 2000 and 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 restatements in the United States shook investor confidence and de-

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[183] PAULSON REPORT, *supra* note 1, at 47-48.

[184] Doidge et al., *supra* note 3, at 49 fig.2. This figure shows the average Tobin's *q* of non-cross-listed firms each year, as well as the premium (in the darker tone) for firms cross-listing on U.S. exchanges. For another examination of the cross-listing premium over an overlapping period, see Litvak, *The Cross-Listing Premium*, *supra* note 18. Litvak 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 the costs of Sarbanes-Oxley to outweigh its benefits. *Id.* at 1898, 1896, 1871. Professor Litvak does not discuss the period after 2002.

pressed the equity market.[185] In particular, the initial public offering (IPO) market in the United States dried up for both domestic and foreign IPOs. This is important because studies have shown that a principal motive for cross-listing by a foreign issuer is to conduct an IPO.[186] Thus, the most plausible inference is that, as of 2000 and 2001, when the average listing premium fell dramatically, both U.S. and foreign investors postponed contemplated IPOs and therefore had little reason to enter into this now scandal-ridden market. But then, after 2002, as the IPO market slowly strengthened, issuers again saw increased value in a cross-listing. Such a pattern does not prove that Sarbanes-Oxley strengthened U.S. corporate governance, but it is at least consistent with such an interpretation of investors' perceptions.

If most objections to the bonding hypothesis can be dismissed as requiring no more than modest qualifications, one significant problem remains, which starts from a seeming paradox. Considerable evidence shows that the bonding premium is greatest for companies incorporated in jurisdictions with the weakest investor protections.[187] But other studies find that corporations from such countries are the least likely to cross-list.[188] Both tendencies make sense. Investors receive greater protection from cross-listing when the home jurisdiction's law is the weakest, and it is precisely in those cases that 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 desire to finance them by conducting an IPO soon after cross-listing.[189] These firms cross-list to obtain a lower cost of capital. But, if it is predominantly firms with superior investment projects that 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

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[185] For a concise discussion of the wave of financial restatements that began to accelerate in 1997 and has continued through 2005, see PAULSON REPORT, *supra* note 1, at 119-21. As it notes, the U.S. GAO has found that the annual frequency of restatements rose seven-fold over this period, from 0.9% in 1997 to 6.8% in 2005. *Id.* at 120 fig.V.1.

[186] *See* Reese & Weisbach, *supra* note 13, at 86 tbl.3.

[187] *See* Hail & Leuz, *supra* note 12, at 7-8 (discussing studies that have reached this conclusion).

[188] *E.g.*, Doidge et al., *supra* note 170, at 18, 23.

[189] *See* Reese & Weisbach, *supra* note 13, at 101-02.

that believes it possesses superior investment opportunities wants to convince the market of its claim, it might cross-list in the United States to signal to investors not that it has adopted superior protections for minority shareholders, but that its investment projects are superior. The market's reaction might in effect be, "You would not do anything as dangerous as listing in the United States, unless you were very certain of your investment opportunities"—essentially, one bonds in order to signal. The relative contributions of the two—bonding and signaling—to the valuation premium seem indeterminate.

Clearly, self-selection plays a large role. Few firms cross-list simply to obtain a valuation premium; rather they seem to have capital-raising or acquisition plans, which cross-listing allows them to pursue at a lower cost. 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 United States 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. Clark and Wójcik shed some light on the issue, finding that foreign firms that cross-list in the United States increase the disparity between their higher governance ratings and the lower ratings of non-cross-listing firms *subsequent* to the time that they cross-list.[190] 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 represent a relatively small proportion of the firms that are potentially 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?

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

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[190] CLARK & WÓJCIK, *supra* note 19, at 148-49.

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

Second, a political theory can be advanced to the effect that various corporate constituencies—labor in particular—have agreed to acquiesce to the receipt of private control benefits by controlling shareholders in return for the controlling shareholders' tacit agreement to subordinate shareholder wealth maximization to the interests of other constituencies. This implicit social contract argument is similar to theories that Mark Roe has repeatedly advanced.[191]

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. Under this view, once a nation achieves dispersed ownership, those individual owners become a potent political force. Following scandals, they demand reforms and retribution. In 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

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[191] *See, e.g.*, MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 35-37 (2003) [hereinafter ROE, POLITICAL DETERMINANTS]; Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460, 496-98 (2006) [hereinafter Roe, *Legal Origins*]; Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 602-03 (2000); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065, 2068-70 (2001). Professor Roe's essential thesis is that in labor-friendly political regimes (a description that characterized Europe during much of the twentieth century), dispersed shareholders could not effectively resist labor's claims on the corporation, but controlling shareholders could (at least to a greater degree). Concentrated shareholders could strike an implicit bargain with labor under which the controlling shareholders' right to private benefits of control was recognized in return for their guarantee of high employment and wages to labor. Such a bargain was easy for labor to accept because its cost largely fell on minority shareholders, not labor.

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 show 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.[192] The United States and the United Kingdom are characterized by dispersed shareholder ownership, while civil law jurisdictions (and most of the world) are 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, minority shareholders must instead fear exploitation by controlling shareholders.

This is not to claim 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. As noted earlier, civil law jurisdictions seem to adopt a more intrusive and regulatory stance toward securities regulation, but place less emphasis on enforcement. Arguably, one may substitute for the other. To illustrate, when a controlling shareholder proposes a squeeze-out merger or a self-dealing transaction, it will typically be an open and visible matter, and minority shareholders may complain to the regulator. The regulator might then take a variety of actions (e.g., warnings, refusal to approve or to issue other required clearances) that do not involve an enforcement proceeding and do not levy any financial penalty, but could force the modification or cancellation of the transaction. In this context, it is at

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[192] This follows from the very different characteristic structure of shareholder ownership in the two types of jurisdictions. For the argument that the structure of ownership determines the prevalent type of fraud, see John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S.A. and Europe Differ*, 21 OXFORD REV. ECON. POL'Y 198, 198 (2005).

least arguable that ex ante review is more efficient than ex post enforcement.

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 facing managerial misbehavior must rely more heavily on enforcement actions.

Controlling shareholders are also more likely to be repeat players than are managers; hence, they may have a greater interest in preserving their reputational capital. To be sure, both managers and controlling shareholders can face "final periods" in which the possibility of enormous gains overcomes their desire to protect their reputational capital. 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 sell only in privately negotiated sales of control blocks at values above the market price). The recent shift to equity compensation in the United States may have exacerbated the agency costs relating to managerial conduct because stock options are a high-octane fuel that can create perverse incentives.

In summary, 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 the regulators will not permit it 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 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 that there is at least 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 United States de-

clined relative to a sample of non-cross-listed, but otherwise similar, firms from the same jurisdictions.[193] Given the tendency of foreign firms to have controlling shareholders who consumed substantial private benefits of control, one might have predicted that minority shareholders in such controlled firms would have benefited from Sarbanes-Oxley's increased rigor. But apparently, the public shareholders in these firms instead perceived the enhanced enforcement as involving more costs than benefits for them. This apparent distaste for increased regulation may suggest 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 United Kingdom. In the United Kingdom, 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 United States.[194] If the United Kingdom has superior corporate governance, it arguably might feel 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 London Stock Exchange, 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 could better resist the power of

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[193] *See* Litvak, *The Effect of Sarbanes-Oxley*, *supra* note 18, at 213-15.

[194] For an overview, see Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2002-05 (1994).

labor than could dispersed owners.[195] Where labor is powerful (as it is 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 and related constituencies a stronger claim on the firm's cash flow than they could negotiate in dispersed ownership systems, but in turn ask labor to accept the controlling shareholders' diversion of the private benefits of control to themselves. Labor, in turn, has little reason to object because these benefits do not come out of its own pocket, but those of the minority shareholders. Stated approvingly, this thesis sees a social contract. Viewed skeptically, however, this thesis essentially describes a coalition of the rich and the poor against the middle class.

This hypothesis 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 try, 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 preexisting legal rules enabled strong capital markets to develop. The countertheory is that where dispersed ownership systems of corporate governance did develop, their rise in turn created a political demand for investor protection.[196] Once ordinary citizens entered the equity securities markets and invested their life savings in stocks, they demanded legal protections against fraud and fiduciary abuse. In short, legal rules followed, rather than preceded, market developments.

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[195] *See* ROE, POLITICAL DETERMINANTS, *supra* note 191, at 14; Roe, *Legal Origins*, *supra* note 191, at 497.

[196] *See* Coffee, *supra* note 6, at 65-66, 80-81 (asserting that strong markets create a demand for stronger legal rules).

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 found that British securities markets developed prior to the enactment of any strong comprehensive system of investor protection.[197] Indeed, these authors doubt that Britain had a strong system of investor protection, comparable to that of the United States, prior to 1980.[198] 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.[199]

This hypothesis that the law follows, rather than leads, economic developments makes it easier to understand 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 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 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, which, even if defrauded, hesitate before demanding new laws, stronger regulation, and more enforcement (which could some day be applied against them). Even the enforcement disparity between the United States and the United Kingdom can be explained on this basis: although the United Kingdom has dispersed ownership, shareholders in the United States are more "re-

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[197] *See* Julian Franks et al., *Ownership: Evolution and Regulation* 37-38 (European Corporate Governance Inst., Fin. Working Paper No. 009/2003, 2006), *available at* http://ssrn.com/abstract=354381 ("[D]ispersed ownership developed on the basis of informal relations of trust rather than formal systems of regulation.").

[198] *See id.* at 15, 58 tbl.A3 (noting that the Companies Act first granted U.K. investors preemption rights in 1980).

[199] For such an assessment, see Zhong Zhang, Legal Deterrence: The Foundation of Corporate Deterrence—Evidence from China 56-57 (June 14, 2007) (background paper, Initiative for Policy Dialogue conference) *available at* http://www0.gsb.columbia.edu/ipd/pub/Zhong_Zhang_Legal_Deterrence.pdf.

tail" in character, while the United Kingdom's market is dominated by institutions. Hence, there is a greater political demand in the United States 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.[200] 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 United States 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 competition among them); and (4) the U.S. public's apparent preference for retributive punishment in securities cases.[201]

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 deemed more persuasive, these differences should persist. But if dispersed

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[200] *See* sources cited *supra* note 191.

[201] The political preference of U.S. voters for strong enforcement and exemplary punishment is shown not just by the Sarbanes-Oxley Act, which vastly elevated penalty levels, but by earlier legislation as well. In 1988, Congress elevated the penalties for insider trading in response to popular demand in the Insider Trading and Securities Fraud Enforcement Act of 1988, which also added section 20A to the Securities Exchange Act of 1934 to authorize private litigation against insider trading. Pub. L. No. 100-704, secs. 3-5, 102 Stat. 4677 (codified as amended at 15 U.S.C. §§ 78u-1, 78ff(a), 78t-1 (2000)). Congress also moved to a sentencing guideline system in 1991, in part to increase actual penalty levels for white-collar crime. The United States Sentencing Commission repeatedly enhanced the then-mandatory sentencing guidelines through the 1990s. *See* Cindy R. Alexander et al., *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, 42 J.L. & ECON. 393, 418 (1999) (finding that fines and penalties imposed on public corporations had increased since the implementation of the guidelines). 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.

ownership is the driving force, the disparity in enforcement levels between the United States and Europe may decrease as retail participation in the stock market continues to grow across Europe.

V. THE POLICY TRADEOFFS

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 United States, while decreasing the barrier to firms with controlling shareholders intent on enjoying the private benefits of control. A more counterproductive policy would be hard to imagine.

But one cannot simply stop at this point. The next question must be faced: Should the United States further increase its unique emphasis on enforcement? Or has it already hit the point of diminishing returns such that some relaxation would not increase its cost of capital? If the latter is true, a relaxation might arguably attract some listings by firms that today face significant costs in conforming their governance to U.S. standards. Kate Litvak's data show that foreign firms cross-listed in the United States declined in value as Sarbanes-Oxley's approaching application to foreign issuers became clear.[202] If these already cross-listed firms constituted a representative sample of firms that were, on average, seeking to bond themselves, then their shareholders logically 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 show that the U.S. listing premium began to rise again the year after Sarbanes-Oxley.[203] How can these opposing trends be reconciled?

A. *Should the United States Relax Enforcement?*

The premise of the recent debate has been that foreign firms are fleeing the United States because of overregulation. That premise

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[202] Litvak, *The Effect of Sarbanes-Oxley*, *supra* note 18, at 195.

[203] *See* Doidge et al., *supra* note 3, at 49 fig.2.

appears to be highly questionable, but it was also always true that only a limited number of foreign firms were ever attracted to the U.S. markets. This suggests in turn that relaxing U.S. enforcement efforts, which never viewed the foreign issuer as a priority enforcement target to begin with, would have a modest (and possibly counterproductive) impact.

How can we reconcile the inconsistent evidence that (1) the stock prices of cross-listed foreign firms went down as Sarbanes-Oxley advanced through Congress (at least in comparison to similar non-cross-listed firms), and (2) the listing premium has increased since 2003? The simplest explanation is that investors in cross-listed foreign firms did indeed perceive 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 had little beneficial impact where a controlling shareholder would still elect the board.[204]

The subsequent apparent increase in the listing premium is a more speculative matter. If we assume that cross-listing firms come to the United States to raise equity or make 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).[205] This implies that a primary purpose underlying the decision of foreign firms to cross-list was no longer attainable, at least in the short run. It is no surprise then that these firms' premium over non-

[204] At the time, the implications of section 404 of Sarbanes-Oxley were not understood because its statutory language is not demanding. It was not until the PCAOB's adoption of Auditing Standard No. 2 a year later that its high costs came into view. *See supra* notes 24, 25, and accompanying text.

[205] According to Thomson Financial, U.S. IPOs declined after 2000, reaching bottom in 2003. They have more recently risen, but not back to their pre-2000 level:

Year	Number	Value
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	225	$42 billion

Back of the Envelope, N.Y. TIMES, Dec. 22, 2006, at C5. The data for 2006 were as of December 2006; the data for 2007 were projections.

cross-listed firms decreased. But by the same token, as the IPO market reawakened in subsequent years, that premium began to increase modestly again. This analysis at least furnishes a testable prediction, under which a rise in IPOs should produce an increased listing premium.

If the U.S. IPO market is awakening, one would expect some increased migration of foreign firms to the United States. This does not mean that the NYSE or NASDAQ will outcompete the London markets 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 does suggest that the recent 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 general relaxation of enforcement makes little sense, more selective relaxation may. Although LLS&V hypothesized that private enforcement outperformed public enforcement in encouraging the growth of securities markets,[206] the latest evidence shows the reverse, that "public enforcement typically dominates private enforcement."[207] Moreover, even if private enforcement is thought to generate desirable general deterrence, some aspects of our current system of private enforcement are particularly likely to discourage the foreign issuer from entering the U.S. market. Today, if the foreign issuer stays offshore and does not cross-list, it is unlikely to become subject to a securities class action, because class actions are not generally recognized outside the United States and U.S. courts would be unlikely to certify a wholly extraterritorial class of foreign investors who did not purchase on the U.S. market. But if the foreign issuer does cross-list in the United States, it now faces the prospect that, even though it lists few shares in the United States, a global class action might be certified covering investors around the world.[208] Indeed, in the recent *Royal*

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[206] *See* La Porta et al., *supra* note 31, at 20 ("Public enforcement plays a modest role at best in the development of stock markets.").

[207] Jackson & Roe, *supra* note 103, at 37.

[208] *See, e.g.*, *In re* Royal Ahold N.V. Sec. & ERISA Litig., 437 F. Supp. 2d 467, 469 (D. Md. 2006) (approving a class action settlement where the vast majority of the class members were non-U.S. residents); *In re* Royal Dutch/Shell Transp. Sec. Litig., 380 F. Supp. 2d 509, 548 (D.N.J. 2005) (denying the defendants' motion to dismiss the claims of foreign investors), *amended by* 404 F. Supp. 2d 605 (D.N.J. 2005).

Ahold class action, the $1.1 billion settlement was paid by a foreign corporation incorporated in the Netherlands, even though an estimated 80% of the class resided outside the United States.[209] Any rational foreign issuer is likely to regard this disparity between a small issuance of shares in the United States and a potentially much larger global liability to all investors worldwide—because of the worldwide reach of 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 United States and will require that some conduct occur in the United States,[210] this requirement has been easily satisfied in a number of cases, either because the cross-listed firm had some U.S. operations or because its management communicated with securities analysts in the United States.

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 nonresident investors who did not purchase in the U.S. market to be included within the class

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[209] The *Royal Ahold* litigation, which is the largest securities settlement to date involving a European corporation, *see supra* note 178, is the subject of multiple reported decisions. For the decision preliminarily certifying the settlement, see *In re* Royal Ahold N.V. Sec. & ERISA Litig., No. 03-MD-01539, 2006 WL 132080, at *4 (D. Md. Jan. 9, 2006); for the decision approving the settlement, see 437 F. Supp. 2d at 469. The defendants estimated that 80% of the class consisted of foreign investors. 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 at 12, *In re* Royal Ahold N.V. Sec. & ERISA Litig., 437 F. Supp. 2d 467 (D. Md. 2006) (No. 03-MD-01539).

[210] This "conduct test" was initially formulated by Second Circuit Judge Henry Friendly. *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 986-87 (2d Cir. 1975) (holding that for the Securities Exchange Act to apply to transnational frauds, conduct occurring in the United States needs to be more than "merely preparatory" to the fraud); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1334 (2d Cir. 1972) (noting that the Securities Exchange Act does not apply "[w]hen no fraud has been practiced in this country and the purchase or sale has not been made here"). Its premise is that Congress would not have "intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when [they] are peddled only to foreigners." IIT v. Vencap, Ltd., 519 F.2d 1001, 1017 (2d Cir. 1975). Absent significant conduct by the defendant in the United States that extends beyond "merely preparatory" efforts, the class action is likely to be dismissed. *See, e.g., In re* Nat'l Austl. Bank Sec. Litig., No. 03-6537, 2006 WL 3844465, at *5-7 (S.D.N.Y. Oct. 25, 2006) (dismissing such a proposed class action where "a significant, if not predominant, amount of the material conduct . . . occurred a half-world away"), *amended by* 2006 WL 3844463 (S.D.N.Y. Nov. 8, 2006).

not only forces U.S. courts to serve as "policemen to the world," but also dissuades foreign issuers from cross-listing. As important as it may be to a foreign issuer to reduce its cost of capital, it is not worth risking potential liability in the billions.

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.[211] To illustrate, imagine that a hypothetical pension fund owns a portfolio of companies of which, over a period of time, 100 become defendants in securities class actions. In 50 of these cases, the pension fund is in the plaintiff class and shares in the recovery; in the other 50, it is not in the plaintiff class and thus bears some of the recovery. The payments would thus balance out, except for the fact that the recovery received in the 50 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 increased liability insurance premiums). 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,[212] but almost certainly not imminent. In the interim, it must be recognized that private enforcement of the securities laws in the United States is working imperfectly, achieving little, if any, compensation and only limited deterrence because its costs fall largely on innocent shareholders rather than the culpable corporate officers actually responsible for "cooking the books" and other misdeeds.[213]

Thus, if in the United States 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 pre-

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[211] For a fuller statement of this critique (and supporting evidence), see John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1556-61 (2006).

[212] For specific proposals, see *id.* at 1572-84.

[213] Because of a variety of factors, corporate officers almost never contribute funds from their own pockets to settle securities class actions. *Id.* at 1550-51.

scription 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. Borak*[214] 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 professionals are rarely sued and corporate officers often 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.[215]

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.[216] 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 Commission will not impose significant financial penalties on corporate issuers unless "the issuer's violation has provided an improper benefit to the shareholders."[217] 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.[218]

The SEC's premise here is that large penalties imposed on the corporation fall on innocent shareholders and so should be used only

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[214] *See* 377 U.S. 426, 432 (1964) ("Private enforcement of the proxy rules provides a necessary supplement to Commission action.").

[215] Most importantly, it would be necessary to overturn *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994), which exempts those who "aid and abet" a securities law violation from civil liability under Rule 10b-5.

[216] The number of enforcement actions fell from 629 in 2005 to 574 in 2006, and the total penalties collected fell from roughly $1.8 billion to $991 million. *See supra* Figures 5 and 6.

[217] Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

[218] *See* Brooke Masters & Jeremy Grant, *SEC Near to a Formula for Options Fines*, FIN. TIMES (London), Feb. 7, 2007, at 24 (reporting the SEC's movement toward creating a formula for punishing companies that takes into account the financial benefit the company received from backdating).

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.[219] 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.[220] If so, the obvious policy prescription is to move from a system of enterprise liability (under which penalties are principally imposed on the corporation and, ultimately, its shareholders) 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 plaintiff's bar because it alone has authority to sue and sanction aiders and abetters.[221]

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 United States.

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[219] For a fuller version of this argument, see Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 727-30.

[220] *Id.* at 726, 731.

[221] *See* Securities Exchange Act of 1934 § 20(e), 15 U.S.C. § 78t(e) (2000) (authorizing the SEC, but not private plaintiffs, to sue any person who "knowingly provides substantial assistance to another person" in connection with a securities law violation).

D. *Cross-Border Securities Regulation*

Currently, the SEC is considering whether to permit foreign brokers to access U.S. investors through websites and other means and solicit them to buy the securities of foreign issuers that do not comply with U.S. disclosure requirements.[222] 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 officials have termed "substituted compliance."[223] 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. Logically, this should reduce the incentive for foreign issuers to cross-list on U.S. exchanges if they can access U.S. capital by other means. In response, some have suggested that the SEC should also permit U.S. exchanges to list foreign issuers that do not comply with U.S. disclosure or governance standards.[224] But if this were done, the ability of foreign issuers to "bond" by opting into higher disclosure and governance standards might be impaired. Even with unfettered access through foreign brokers to foreign stocks that did not comply with U.S. disclosure standards, U.S. investors could still understand that an 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

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[222] Floyd Norris, *Should U.S. Markets Be Wide Open?*, N.Y. TIMES, Feb. 9, 2007, at C1.

[223] *See* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31, 32 (2007) (proposing a framework that permits exemption from SEC registration based on compliance with foreign securities regulations and laws substantively similar to the SEC's).

[224] *See* Edward F. Greene, *Beyond Borders: Time To Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85, 95-96 (2007). Others preceded Greene in making this suggestion. *See, e.g.*, Franklin R. Edwards, *Listing of Foreign Securities on U.S. Exchanges*, J. APPLIED CORP. FIN., Winter 1993, at 28, 32-36 (suggesting that a loosening of SEC reporting requirements for foreign issuers would carry little danger); Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696, 731 (1998) (explaining the superiority of a disclosure regime that is determined by the nationality of the issuer rather than investor residency or transaction location).

that do not comply with U.S. standards subjects at least undiversified retail investors to a risk from which accurate share pricing does not protect them.[225]

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 typically underfunded 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 fall well below what the SEC would have done. More work remains to be done here before the SEC's trial balloon is ready for adoption.[226]

CONCLUSION

This Article began by asking whether the U.S. capital markets are losing their competitiveness. The answer may depend on what we mean by "competitiveness." At least two definitions are possible: (1) the ability to attract foreign listings and offerings, and (2) the ability to minimize the cost of capital. Although these goals are not contradictory, they can frequently be in tension, because relaxed regulation may facilitate the former while retarding the latter. Different constituencies also benefit, with market professionals gaining when offerings and listings are attracted, while the public (including noninvestors) benefits from a reduced cost of capital.

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[225] That the market may be efficient and that share prices may be 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 not all retail investors are diversified, and many will be predictably injured by such variance. Thus, the stock price can be accurate, but retail investors can still suffer injury.

[226] 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" for U.S. public enforcement than foreign public enforcement is.

Against this backdrop, enforcement intensity may advance the latter goal, while potentially chilling the former. Clearly, the United States pursues securities law violations through both public and private enforcement with an intensity unmatched elsewhere in the world. This intensity probably contributes to the United States' lower cost of equity capital, but may also explain the unwillingness of many foreign firms to enter the U.S. market. Possibly, this pattern of higher enforcement intensity in the United States may extend beyond securities and financial regulation and characterize other fields as well,[227] but this Article will not attempt to cover that broader waterfront. Nor has this Article contended that the United States' enforcement policy is always wise or just or that the United States has found the optimal level of enforcement intensity. Rather, the principal point has been that the United States occupies a polar position on the enforcement continuum and this affects the character of its capital markets.

But what explains the unique level of enforcement intensity in the United States? Here, the differences between common law and civil law jurisdictions, while they exist, do not provide much explanatory power, because once one focuses on enforcement outputs, the United Kingdom appears in some respects to more closely resemble Germany than the United States. The better hypothesis appears to be 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. Probably the most striking contrast among securities regulators is the difference between their inputs and their 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 largely inhabit a world 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,[228] it seems more committed than other regulators

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[227] Political scientists have, for example, noticed sharp contrasts in the "regulatory style" of environmental regulation between the United States and Japan. *See* ROBERT A. KAGAN, ADVERSARIAL LEGALISM: THE AMERICAN WAY OF LAW 194-95 (2001) (characterizing U.S. enforcement as harsher and more adversarial, and describing the pitfalls of this style).

[228] The SEC certainly uses ex ante controls, such as no-action letters, advance review and approval of registration statements, and prior clearance of certain transac-

to a policy of general deterrence through substantial penalties. Other nations may also prefer informal negotiations and dispute resolution. Whether non-U.S. regulators can achieve functionally similar results through such "lighter" forms of regulation remains uncertain. Arguably, the FSA's evident preference for gentle guidance over tough enforcement may work adequately with law-compliant public corporations and investment banks, but such an approach seems futile in the case of more predatory misbehavior, such as insider trading, and it is the latter that may most affect the cost of capital.

Conversely, the possibility that the United States overdeters also cannot be dismissed. In particular, the United States also outdistances the rest of the world in its commitment to private enforcement. But private enforcement seems to have had little, if any, impact on clearly criminal behavior such as insider trading. In this light, the social utility of public and private enforcement should not be equated. In theory, both can deter, but in practice, private enforcement visits most of its penalties on the shareholders who are to be protected, while the culpable largely escape sanctions. Because of the circularity of the securities class action, with diversified shareholders essentially suing diversified shareholders, the more we rely on private enforcement, the more we encourage pocket-shifting wealth transfers, with each such transfer among shareholders being heavily taxed by the legal system.[229]

These disparities between the United States and the rest of the world in the intensity of both public and private enforcement may suggest that the United States has a problem—or, alternatively, that the rest of the world does. This Article will not attempt to pass final judgment. It has not been this Article's claim that the United States employs the optimal level of enforcement. Rather, its real claim is that enforcement intensity affects the cost of capital. If this hypothesis is accepted, then it has dramatic implications for securities regulators: their mission should not be simply to protect investors, but to reduce the cost of capital and thereby enhance gross domestic product. The literature on securities regulation has long underplayed this public-regarding role, but noninvestors as well as investors depend on the efficiency of securities regulation, as the costs of underenforcement fall on the economy as a whole.

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tions, in effect to regulate entry into its capital markets. But these controls are not employed by the Division of Enforcement, which is committed to ex post enforcement.

[229] *See* Coffee, *supra* note 211, at 1556-61.

To state this hypothesis is not to claim that it has been fully proven. 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 of the participants regarding enforcement. Today, they are not even speaking the same regulatory language.

Within the United States, this hypothesis that enforcement policy can affect the cost of capital also suggests that a basic conflict may exist between the interests of the public and those of the professionals and intermediaries active in the securities markets. For the professionals, relaxing enforcement may imply more transactions, more listings, and a higher volume of business. Possibly, this explains the FSA's relative distaste for enforcement. Yet, although attracting a higher volume of business is desirable, it has low visibility costs to society to the extent that the cost of capital is thereby raised. Professionals win, but investors and the public may lose from such a policy.

For all these reasons, much as Clemenceau said about war and the generals, enforcement policy is too important to be left to the discretion of the enforcers.