# Capital Markets Competitiveness: A Survey of Recent Reports

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*This Article considers various factors affecting the competitiveness of U.S. capital markets in comparison to foreign markets as offered in recent reports by the Committee on Capital Markets Regulation, McKinsey & Co. (commissioned by the City of New York), and the U.S. Chamber of Commerce. We then consider the recommendations offered by these groups to improve the competitiveness of U.S. securities markets.*

## I. INTRODUCTION

Today's global economy provides companies seeking to raise capital with many options. In recent months, the costs and risks that can accompany listing in the U.S. have motivated debate whether the U.S. markets are losing a competitive edge in attracting both foreign issuers as well as smaller U.S. issuers who may be considering listing on A foreign exchange.

In response to concerns that the U.S. is becoming less competitive as a venue for capital formation, several groups have recently produced or commissioned white papers offering solutions to help the U.S. maintain or improve its position. Perhaps the most significant of these efforts is that of the Committee on Capital Markets Regulation, otherwise known as the Paulson Committee because of its public support by U.S. Treasury Secretary Henry Paulson.[1] This 17-member panel was formed in September 2006 to examine the extent to which U.S. capital markets are losing competitive ground to foreign and private competitors, the reasons for such a possible loss, and the potential impact of a loss of competitiveness on the financial industry and the overall economy.[2] The Paulson Committee's "Interim Report of the Committee on Capital Markets Regulation" (the "Interim Report"), produced in November 2006, offers a

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[1] Deborah Solomon, *Paulson Pulls for U.S. Markets*, WALL ST.J., Oct. 23, 2006, at C1.

[2] Alan Murray, *Panel's Mission: Easing Capital-Market Rules*, WALL ST.J., Sept. 12, 2006, at A2.

number of ways to approach competitiveness concerns.[3] Not surprisingly, the Interim Report advocates for changes in the implementation of Section 404—the section of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act") which sets out new, and costly, internal controls requirements. However, the Interim Report stops short of pushing for any wholesale statutory changes, instead suggesting, among other things, improved guidance from the Securities and Exchange Commission ("SEC" or the "Commission") and revisions of the materiality standards under Section 404 to ensure that internal control reviews focus on the most significant risks.[4] Another suggestion is to exempt foreign issuers with equivalent home country requirements from Section 404, and to relax the section's application to small companies by, among other things, potentially eliminating the auditor attestation requirement.

Besides addressing Section 404, the report also proposes measures to improve corporate governance and the current U.S. litigation and regulatory climate. To help curb the effects of private securities litigation, the report suggests a cap on auditor liability, a potential safe harbor for certain audit practices, and limits on damage awards. To reduce the regulatory burden, the report suggests limiting how and when state regulators can pursue cases by requiring state authorities to notify the SEC of their actions and permit the SEC to have the final say on settlements of potentially national importance.[5] The report also suggests strengthening shareholder rights by requiring boards of directors to obtain shareholder approval before enacting poison pills, unless the situation involves a hostile takeover.[6]

The report has received its fair share of criticism. Detractors of the report have suggested that the real motivation behind the report is to protect underwriters and reduce regulation.[7] Along these lines, many have questioned the makeup of the committee, as well as its sources of funding.[8] While the committee includes academics, the CEOs of two of the "big four" accounting firms, and executives from the financial services industry, no former government regulators were asked to serve.[9] Furthermore, the committee was reportedly financed with a $500,000 contribution from a nonprofit organization founded by former American International Group

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[3] COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT (2007), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf [hereinafter INTERIM REPORT].

[4] R. Glenn Hubbard & John L. Thornton, *Action Plan for Capital Markets*, WALL ST.J., Nov. 30, 2006, at A16.

[5] Kara Scannell & Deborah Solomon, *Financial Rule Overhaul Hits a Nerve*, WALL ST.J., Dec. 1, 2006, at C3.

[6] Hubbard & Thornton, *supra* note 4.

[7] Jenny Anderson, *Sharply Divided Reactions to Report on U.S. Markets*, N.Y.TIMES, Dec. 1, 2006, at C8.

[8] *Id.*

[9] *Id.*

Inc. Chairman Maurice Greenberg, as well as a $500,000 contribution made by Kenneth Griffin, the head of hedge fund Citadel Investment Group LLC, and Wilbur Ross, a private investor.[10]

Critics also have taken issue with the report's reference to a decrease in U.S. IPO activity and an increase in private equity buyouts as evidence of a drop in U.S. competitiveness.[11] According to New York Governor-Elect Eliot Spitzer, who has referred to some of the report's recommendations as "absurd," the rise in private equity activity is in reality attributable to poor management by public companies.[12] Furthermore, while the report assigns much of the blame for the decrease in IPO activity on U.S. private litigation and regulatory enforcement, critics have pointed to improving foreign markets as a reason for the loss in IPO activity.[13] Whether decision-makers ultimately will heed many of the report's recommendations remains to be seen.[14] However, critics' reception of the report has been much more succinct. "It is very elegant whining," said former Securities and Exchange Commission Chairman Richard Breeden.[15]

In addition to the Paulson Committee, politicians also have voiced concerns regarding the competitiveness issue. President Bush and Vice-President Cheney have made public comments suggesting that they are not satisfied with the regulatory costs imposed by Sarbanes-Oxley. Mr. Bush suggested that he would like to see fine-tuning of Sarbanes-Oxley, while Mr. Cheney has said that Sarbanes-Oxley may have gone "too far."[16] New York City Mayor Michael Bloomberg and New York Senator Charles E. Schumer recently co-authored an opinion piece in the *Wall Street Journal* on November 1, 2006 titled *To Save New York, Learn From London*, in which they squarely addressed the competitiveness concern.[17] In addition to his co-authorship of the column, Mayor Bloomberg retained consulting firm McKinsey & Co. on behalf of New York City to investigate the causes of foreign issuers' decisions to raise capital outside of the U.S. (the McKinsey Report),[18] with a particular focus on the retention of New York's status as the global financial services leader.

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[10] Scannell & Solomon, *supra* note 5.
[11] Anderson, *supra* note 7.
[12] *Id.*
[13] *Id.*
[14] As discussed in Part IV, *infra*, the SEC has implemented some of the proposals recommended by the Paulson Committee, although some proposals may have already been under consideration prior to the issuance of the INTERIM REPORT.
[15] Anderson, *supra* note 7.
[16] *Cheney Echoes Recent Concerns on Sarbanes-Oxley*, WALL ST.J., Oct. 31, 2006, at C6.
[17] Charles E. Schumer & Michael R. Bloomberg, Op-Ed, *To Save New York, Learn From London*, WALL ST. J., Nov. 1, 2006, at A18.
[18] Aaron Lucchetti & Carrick Mollenkamp, *New York to Study Lack of IPOs*, WALL ST.J., Sept. 27, 2006, at C3.

Finally, the Commission on the Regulation of U.S. Capital Markets in the 21st Century (the "Chamber of Commerce Committee"), convened by the U.S. Chamber of Commerce, has also recently released recommendations on improving capital markets competitiveness (the "Chamber of Commerce Report"). Like the Paulson Committee, the Chamber of Commerce Committee was composed of a number of influential academics, former politicians, lawyers, accountants and businesspeople.[19] Although the Chamber of Commerce Report focuses on a number of the same issues as the McKinsey Report and the Interim Report, it notes that "[g]enerally, this Commission sought to add to the discussion rather than revisit the ground covered by others."[20] Among other suggestions, the Chamber of Commerce Report recommends that: public companies stop issuing earnings guidance or, alternatively, move away from quarterly guidance with one earnings-per-share (EPS) number to annual guidance with a range of EPS numbers; the government act to increase retirement savings plans by connecting all employers of twenty-one or more employees without any retirement plan to a financial institution that will offer a retirement arrangement to those employees; and that the government encourage employers to sponsor retirement plans and enhance the portability of retirement accounts through the introduction of a simpler, consolidated 401(k)-type program.[21]

While a detailed review of these reports is not possible in so few pages, this paper does attempt to outline a number of the causes of, and solutions to, the perceived waning of U.S. markets' competitiveness. While the reports are all quite comprehensive, broad-reaching, and not significantly redundant in their coverage and recommendations, we focus on three areas that figure most prominently and repeatedly in these and other discussions of decreasing U.S. competitiveness: regulatory burdens, underwriting and listing costs, and litigation risk.

This paper proceeds as follows: Part II considers the impact of underwriting fees, listing fees and trading costs on capital markets competitiveness. Part III discusses the impact of regulatory costs that factor into an issuer's decision to list in the U.S., focusing primarily on the impact of the Sarbanes-Oxley Act. Part IV looks at the risks of private securities litigation and examines the current trend towards a U.S. class action culture in Europe. We conclude in Part V.

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[19] COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, U.S. CHAMBER OF COMMERCE, REPORT AND RECOMMENDATIONS, App. 1: Commissioner Biographies,147-61 (Mar. 2007), *available at* http://www.capitalmarketscommission.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5weu6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf [hereinafter *Chamber of Commerce Report*].

[20] *Id.* at 5.

[21] *Id.* at 167-69.

## II. INITIAL LISTING COSTS

### A. *Underwriting Fees*

A commonly heard argument[22] is that the U.S. is disadvantaged because its investment banks charge more than their overseas competitors. A June 2006 Oxera Ltd. study commissioned on behalf of the London Stock Exchange entitled "The Cost of Capital: An International Comparison"[23] ("Cost of Capital Study") points to this pricing differential as a significant factor in foreign firms' decisions to forego listing in the U.S. However, a closer look at underwriting fees in the U.S. and abroad shows a more complex situation.

U.S. underwriters charge a fee for new IPOs at a rate of around 6.5-7% of total IPO receipts.[24] In comparison, underwriters in Europe charge around 3-4% of gross IPO receipts.[25] According to the Cost of Capital Study, this difference in fees cannot be explained by differences in the quality of underwriting services.[26] Furthermore, the study points to the fact that the same investment banks oftentimes charge higher fees for transactions on U.S. exchanges as opposed to transactions on European exchanges.[27]

However, upon closer inspection, several factors can be seen to mitigate the higher costs charged by U.S. investment banks. First, the Cost of Capital Study notes that American underwriters tend to use the more expensive "bookbuilding technique" in pricing IPOs, while European underwriters oftentimes use a variety of lower-priced techniques including auctions or fixed-price offers.[28] This can somewhat justify the higher U.S. underwriting fees because fixed-price offerings have fallen out of favor in recent years due to evidence that they may lead to a high level of under-pricing.[29] Furthermore, a study has suggested that U.S. underwriters are more willing to revise their offer price upwards if there is strong demand.[30] In addition to differences in underwriting techniques, IPO expert Jay Ritter,

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[22] INTERIM REPORT, *supra* note 3 at 6.
[23] *See* LEONIE BELL, LOUIS CORREIA DA SILVA & AGRIS PREIMANIS, THE COST OF CAPITAL, AN INTERNATIONAL COMPARISON 40, *available at* www.londonstockexchange.com/NR/rdonlyres/B032122B-B1DA-4E4A-B1C8-42D2FAE8EB01/0/Costofcapital_full.pdf.
[24] *Id.* at 4.
[25] *Id.*
[26] *Id.* at 40.
[27] *Id.* at 19.
[28] *Id.*
[29] Jay R. Ritter, *Differences between European and American IPO Markets,* 9 EUROPEAN FINANCIAL MANAGEMENT, 421, 426 (2003).
[30] *Id.* at 428 (citing Alexander Ljungqvist and William Wilhelm, *IPO Pricing in the Dot-Com Bubble,* 58 J. OF FIN. (2003) at 723-752).

a Professor of Finance at the University of Florida, suggests that U.S. underwriters compete on non-price terms like analyst coverage, market share and reputation.[31] Professor Ritter highlights the issue of analyst coverage in a survey of the differences between American and European IPO markets, suggesting that issuers place such great importance on analyst coverage that they may be willing to pay higher prices for U.S. underwriters with "top ranked analysts."[32] A report by TheStreet.com echoed similar sentiments regarding reputation and its potential ability to allow U.S. underwriters to charge higher fees, suggesting that IPO clients place such importance on underwriter reputation that they "tend not to be price sensitive."[33] Finally, some have suggested that the higher prices charged by U.S. underwriters are explained in part by the greater securities litigation risks and regulatory costs that underwriters face in the U.S.[34] The flip side of the concern over costs and risks incurred by gatekeepers such as underwriters (under Section 11 of the Securities Act, for example), however, is the possibility that investors may find these regulations comforting, and pay, in return, a premium for shares offered in the U.S. that offsets the higher fees charged by American underwriters.

Although the significantly higher underwriting fees charged in the U.S. may seem to suggest that the fees may play a prominent role in issuers' decisions to forego listing in the U.S., underwriting fees may have little influence. Different pricing and underwriting techniques used by U.S. banks, the positive analyst coverage that may accompany the use of a U.S. underwriter, and an enhanced gatekeeper role imposed by litigation risk in the U.S., all may justify the higher cost of U.S. underwriters. Interestingly, one article suggests that not much attention was given by issuers to the higher underwriting fees charged by U.S. underwriters.[35] Given that foreign IPO data have shown a decrease in foreign listings in the U.S. since around 2000,[36] it is arguable that the issue would have surfaced much sooner if underwriting fees played a more significant role in issuers' listing decisions. Alternatively, however, underwriting fees may play a more significant role in listing decisions when the differences in the legal framework, governance and other quality standards on exchanges diminish.

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[31] Laurie Kulikowski, *US IPOs Fork It Over*, THESTREET.COM, Sept. 29, 2006, http://www.thestreet.com/newsanalysis/wallstreet/10311932.html.
[32] Ritter, *supra* note 29, at 428.
[33] Kulikowski, *supra* note 31, quoting analyst Brad Hintz of Sanford Bernstein.
[34] Rob Garver, *The Big Get Bigger*, CFO MAGAZINE, Oct. 1, 2006, at 90, *available at* http://www.cfo.com/article.cfm/7960737.
[35] Daniel *Gross. Adios, IPOs: Don't blame America's declining IPO business on Sarbanes-Oxley*, SLATE, Aug. 2, 2006, http://www.slate.com/id/2147063.
[36] Luigi Zingales, *Is the U.S. Capital Market Losing Its Competitive Edge?* (The Initiative on Global Financial Markets, Working Paper No. 1, Nov. 2006), *available at* http://research.chicagogsb.edu/gfm/research/papers/1LZingalescompetitiveness.pdf.

B. *Underpricing, Listing Fees, and Trading Costs*

Although there is not extensive data on their significance, a number of other factors also appear to impact the listing decision. Among these factors are IPO discounting, initial and ongoing listing fees, and trading costs.

Along with the higher underwriting fees discussed above, another concern with the predominant U.S. method of bookbuilding underwriting is that the underwriter often causes the issuer to "leave money on the table" (although in reality, the money is not left on the table, but goes into the pot of the initial purchasers). IPO underpricing or discounting is seen when an issue is priced at a modest initial offering amount, but then sees a significant increase in the price of the security in secondary trading. This suggests that the issuer could have sold the issue for more than the bankers priced the shares, and some percentage of the total possible gain has been taken by the initial purchasers at the expense of the issuer. Several explanations are routinely offered for IPO underpricing, from the relatively benign (adverse selection theories, which suggest that because of information asymmetry the only way to appeal to less informed investors in the IPO market is to offer the shares at a discount relative to the after-market price) to the sinister (underwriters seek to reward favored investors through underpricing in the hope that the investors will hire the underwriters for other services). Whatever the reason, significant differences in IPO discounting across jurisdictions will affect the relative attractiveness of capital raising in those jurisdictions.

As part of its analysis of underwriting differences, Oxera looked at the underpricing in the U.S. and European markets, finding that there is significant variation across companies with respect to underpricing. Discounting seems to be most prevalent on the AIM (11.2%), followed by Nasdaq (6.6%).[37] The London Stock Exchange's Main Market IPOs have an average discount of 4.4%, which is slightly lower than the discount for NYSE IPOs (5.1%).[38] The smallest discounts were seen on the Deutsche Boerse (2.6%) and the Euronext exchange (0.8%).[39] Notably, however, the Cost of Capital Study did not see a significant relationship between underpricing and underwriting fees. Some researchers have suggested that "prestigious underwriters that charge higher fees may use their reputation capital to certify the value of the company and thereby reduce investor uncertainty about the value of the issue. This could lower the level of the discount and justify the higher fees paid to the underwriter."[40] However,

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[37] BELL, ET. AL., *supra* note 23, at 21.
[38] *Id.*
[39] *Id.*
[40] *Id* at 22.

the study did not find a systematic relationship between the level of underwriting fees and the initial IPO discount: "For example, the majority of US IPOs were charged underwriting fees of between 6% and 7% and had average discounts of 6.89%. This compares with average discounts of between 3.13% and 7.1% for European IPOs that all had underwriting fees in the 2–4% range."[41]

The United States is at a comparative (although perhaps inconsequential) disadvantage with regard to listing fees. U.S. issuers will often pay both higher fees at the initial listing stage as well as higher ongoing fees. Oxera reports that the costs of listing a £100,000,000 company (roughly a $200,000,000 company in U.S. dollars) are lower on the LSE (£43,390) than either the NYSE (£81,900) or the Nasdaq Global Market (£54,600). The costs of listing on the AIM are much lower (£4,180). Note also that the Nasdaq's small cap market, the Nasdaq Capital Market (£51,870), is also not competitive with the AIM on initial listing fees.[42]

Ongoing listing fees are also higher in the U.S. Again using a £100,000,000 company for comparison, costs for the LSE (£4,029) drops quite significantly, the AIM remains at the same cost as the listing fee (£4,180), while the U.S. exchanges remain relatively higher: NYSE, £19,110; Nasdaq Global Market, £16,653; and Nasdaq Capital Market, £11,466.[43] Given the small overall costs involved, however, the Interim Report responds that "it is difficult to imagine that [listing costs] would play a significant role in the decision to list in New York versus London."[44]

Of perhaps more concern is the liquidity and level of execution on the exchange. Trading costs are relevant to the listing decision because empirical evidence has demonstrated that the trading costs incurred by investors in secondary markets will impact a company's share price and its cost of capital. According to the Cost of Capital Study, the NYSE continues to enjoy a cost-of-trades advantage over the UK and other European markets. Nasdaq, perhaps surprisingly, does not.

In the Cost of Capital Study, Oxera analyzed both direct costs ("broker commissions and exchange and other fees"[45]) and indirect costs (effective spreads—"i.e., the difference between the price of a trade and the midpoint of the best-quoted bid and ask prices, just prior to the trade"[46]). The study does not distinguish between LSE Main Market and AIM trades. The study reports that the total direct costs were lowest on the NYSE (16.1 basis points (bps)), versus 18.8bps on Nasdaq and 40.1bps on the LSE. However, Oxera argues that the result is skewed by the impact of stamp

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[41] *Id.*
[42] *Id.* at 24.
[43] Bell, et. al., *supra* note 23, at 25.
[44] INTERIM REPORT, *supra* note 3, at 49.
[45] Bell, et. al., *supra* note 23, at 28.
[46] *Id.*

duty on LSE trades: "Stamp duty is a transaction tax that applies to dealing in UK equities. The charge applies at a 0.5% rate on all purchases of UK equities unless a specific exemption applies—e.g., intermediaries such as market-makers are exempt from stamp duty."[47] However, "overseas issuers are subject to stamp duty only if they have a register in the UK. In other words, stamp duty payment is associated with the geographic location of registration, rather than the location of listing and raising capital."[48] When stamp duty costs are excluded, "the direct trading costs were between 0.7bps and 3.4bps lower on the LSE than on the other exchanges examined in this study."[49] With respect to indirect costs, however, which effectively measure liquidity, the NYSE leads significantly: 7.4bps versus 10.1 on the LSE and 11.9 on Nasdaq. Because of this liquidity advantage, the NYSE still offers the best performance in terms of trading costs, even excluding stamp duty, with total trading costs of 23.5bp, followed by the LSE (25.5bps excluding stamp duty) and Nasdaq (30.8bps).[50] Interestingly, the study finds that Nasdaq also ranks significantly behind both Germany and France in total trading costs (27.1bps and 27.0bps, respectively).[51]

## III. ONGOING REGULATORY COSTS OF THE LISTING JURISDICTION

### A. *The Sarbanes-Oxley Act of 2002*

In deciding whether to list in the United States, companies of all sizes must consider the potential regulatory costs imposed by public company life. However, because these regulatory costs generally impose a disproportionate burden on smaller companies, the effect of the regulatory burden plays a concomitantly higher role for many start-up companies deciding where to list. The passage of Sarbanes-Oxley in the U.S. in July 2002 added new regulatory costs for public companies. These costs have come to the forefront of a heated public debate regarding the recent trend of foreign issuers foregoing listing on U.S. exchanges. While the regulatory costs added by Sarbanes-Oxley have undoubtedly had an impact on listing decisions, critics have arguably exaggerated the linkage between Sarbanes-Oxley's regulatory costs and the drop in foreign listings, although Sarbanes-Oxley has undoubtedly affected capital formation for smaller U.S. companies.[52]

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[47] *Id.*
[48] *Id.* at 29.
[49] *Id.*
[50] Bell, et. al., *supra* note 23, at 29.
[51] *Id.*
[52] *See, e.g.*, Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post-Sarbanes-Oxley*, 41 WILLAMETTE L. REV. 707 (2005).

Some commentators have suggested that Sarbanes-Oxley's passage has increased corporate accountability, financial transparency and investor confidence, while lowering the cost of capital.[53] However, detractors of Sarbanes-Oxley have said that the Act is unnecessarily burdensome crisis legislation, the regulatory costs of which outweigh its benefits.

### 1. Components of Sarbanes-Oxley

The Sarbanes-Oxley Act contains a number of provisions that can potentially affect an issuer's decision of whether or not to go public or to list in the U.S. These provisions can be broken down into two categories that appear in the Act itself: enhanced financial disclosures and corporate responsibility provisions.

Sarbanes-Oxley's inclusion of provisions regarding enhanced financial disclosure fits with the expressed goal of the Act to "protect investors by improving the accuracy and reliability of corporate disclosures."[54] Section 404 requires the company to provide annual reports containing an internal controls report, which requires management to establish and maintain adequate internal control structures and procedures for financial reporting.[55] Furthermore, the section requires an auditor to attest to, and report on, the internal controls assessment made by the issuer.[56]

Among the corporate responsibility provisions of Sarbanes-Oxley are provisions that are in essence substantive corporate governance regulations, a stretch from the U.S. tradition of disclosure-based regulation. For example, Section 301 directs national securities exchanges to prohibit the listing of securities of issuers who do not have an audit committee composed solely of independent directors.[57] The committee must also have the power to appoint, compensate, and maintain oversight over the firm's auditor.[58] Section 302 requires senior executive officers to certify in periodic reports that the executives have reviewed the reports, that the reports contain no omissions or misstatements of material fact, and that the report fairly represents the financial condition of the issuer.[59] Furthermore, the executives must certify that they are responsible for establishing and

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[53] Ernst & Young LLP, *Emerging Trends in Internal Controls,* May 10, 2006, SEC and PCAOB Roundtable, at 9, *available at* http://www.Sarbanes-Oxley.be/AABS_Emerging_Trends_May2006.pdf.

[54] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Preamble, 116 Stat. 745 (codified in various sections of titles 15, 18 and 28 U.S.C.)

[55] *See* 15 U.S.C. § 7262 (2006).

[56] *Id.*

[57] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Section 301 (codified at 15 U.S.C. § 78j-1)(2006).

[58] *Id.*

[59] *Id.* Section 302 (codified at 15 U.S.C. § 7241).

maintaining internal controls, have examined and evaluated the effectiveness of internal controls, and disclosed to the auditor and audit committee all significant deficiencies in the internal controls or any fraud that involves management.[60]

### 2. The Regulatory Costs of Sarbanes-Oxley

As highlighted earlier, opponents of Sarbanes-Oxley have become increasingly outspoken about the Act's regulatory costs. A look at some of the cost statistics can help explain why. One study found that audit fees for S&P 500 companies have risen 63% in the 2 year period since the passage of Sarbanes-Oxley, from $2.5 billion to $4 billion.[61] Another study estimated a loss of total market value of firms attributable to the passage of Sarbanes-Oxley at $1.4 trillion.[62] Studies have shown an increase in audit costs in the post-Sarbanes-Oxley era, inversely related to a company's annual revenue.[63] One survey has indicated that the costs of being public have more than doubled since Sarbanes-Oxley, "rising on average from $900,000 to $1.95 million, with the increase attributed primarily to higher audit, insurance, and outside director fees."[64] Lastly, a Foley and Lardner LLP study conducted in 2003 cited increases in directors' and officers' insurance, accounting and legal fees, and board compensation as the biggest components of the increases in compliance costs.[65]

While many different provisions of Sarbanes-Oxley have been blamed for the increase in regulatory costs, the provision that has generated the most criticism has been Section 404. The provision's requirement of an annual assessment of the effectiveness of an issuer's internal controls has been widely regarded as the most controversial section of Sarbanes-Oxley.[66] Opponents of Section 404 suggest that in practice the section has been interpreted far too broadly, costing millions of dollars in expenses and executive time. One complaint is that companies' executives are forced to document matters that oftentimes have little to do with the integrity of

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[60] *Id.*

[61] Kara Scannell & Deborah Solomon, *Business Wins Its Battle to Ease A Costly Sarbanes-Oxley Rule,* WALL ST.J., Nov. 10, 2006, at A1.

[62] Larry E. Ribstein, *Sarbanes-Oxley after Three Years*, 15 (U Illinois Law & Economics Research Paper No. LE05-016), *available at* http://ssrn.com/abstract=746884.

[63] Gregory Carl Leon, *Stigmata: The Stain of Sarbanes Oxley on U.S. Capital Markets* 24-25 (GWU Law School Public Law Research Paper No. 224), *available at* http://ssrn.com/abstract=921394.

[64] Roberta Romano, The *Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1588 (2005).

[65] Michael A. Perino, *American Corporate Reform Abroad: Sarbanes-Oxley and the Foreign Private Issuer*, 4 EUR. BUS. ORG. L.REV. 213, 231 (2003).

[66] *Id.*

financial statements.[67] Another common complaint is that auditors have become too conservative in performing their Section 404 work due to fear of SEC or private action if client fraud is discovered. As a result, the firms' auditor attestations often identify so many essential internal controls that they become extremely expensive to implement.[68] One survey found that companies on average spent $3.8 million to comply with Section 404 in 2005.[69]

Accounting firms have argued that although Sarbanes-Oxley compliance entails high start-up costs, these costs sharply decrease within the first few years following Sarbanes-Oxley implementation. This reduction is said to occur because of the fact that the greatest compliance costs are incurred during the first year, when the issuer undertakes the largest and most expensive efforts to overhaul its systems. After the first year, compliance costs drop as the issuer's systems are largely in place and need substantially fewer adjustments. A May 2006 survey by Ernst and Young LLP found that issuers' total Section 404 compliance costs "fell nearly 44 percent for larger companies . . . and nearly 31 percent for smaller companies."[70] However, a study prepared by *Financial Executives International* found that, on average, companies' Section 404 compliance costs fell 16% from 2004 to 2005, in contrast to a projected drop of 26%.[71] Cost drops aside, the fact remains that Sarbanes-Oxley compliance costs will likely never return to pre-Sarbanes-Oxley levels due to added expenses resulting from the increased role of auditors in the reporting process.[72]

Sarbanes-Oxley critics have also pointed to the fact that compliance costs for small public companies appear to be disproportionately affected by the Act.[73] Recent studies have shown that Sarbanes-Oxley 404 compliance costs for smaller companies as a proportion of revenue are larger than those of larger companies, in a magnitude of .009 compared with .0006.[74] This is because the costs of complying with securities laws and Sarbanes-Oxley have an element of fixed cost that does not vary proportionally with firm size.[75] Arguably, these fixed costs post-Sarbanes-Oxley have increased because successful compliance requires significant assistance from outside attorneys, consultants, and accountants. Besides the need to look outside the firm for help, many companies have protested that

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[67] Scannell & Solomon, *supra* note 61.
[68] *Id.*
[69] *Id.*
[70] ERNST AND YOUNG, LLP, EMERGING TRENDS IN INTERNAL CONTROLS: MAY 10, 2006 SEC AND PCAOB ROUNDTABLE 3 (2006).
[71] Scannell & Solomon, *supra* note 61.
[72] Leon, *supra* note 63, at 27.
[73] Rose, *supra* note 52.
[74] Romano, *supra* note 64, at 1588.
[75] William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J 141, 151.

Sarbanes-Oxley compliance creates the need to spend millions of dollars to hire employees, install new computer systems, and hire auditors to verify work.[76] One study estimated costs of $1,037,100 for software start-up alone.[77]

In addition to out of pocket start-up costs and professional fees, Section 404 can affect smaller issuers in more subtle ways as well. For example, one effect of Section 404 has been to require the separation of certain executive functions. The effect of this separation arguably can disproportionately increase costs at smaller companies, where employees may be more likely to serve multiple roles.[78] The division of roles among more employees may often require hiring additional help, which adds to costs.

Further supporting the assertion that Sarbanes-Oxley has affected smaller companies disproportionately is the increasing number of firms that have decided to go private to avoid the costs of being public companies.[79] One study specifically examined the companies that decided to "go private" in 2004. The study found that, of those companies who in their filings specifically mentioned federal securities law compliance as one of the reasons for their decision, the aggregate securities regulation compliance costs were $12.2 million, a number representing nearly 51% of total profits.[80] With figures like these, the decision to go private may seem like a foregone conclusion. The results of the increases in going-private transactions can be epitomized by the comments of Steve Schwarzman, CEO of private equity firm The Blackstone Group L.P., who has said Sarbanes-Oxley "is probably the best thing that's happened to our business and one of the worst things that has happened to America."[81]

Critics of Sarbanes-Oxley have also pointed to the recent emergence of London's Alternative Investment Market ("AIM") as further evidence that compliance with the current U.S. regulatory climate is too burdensome for smaller issuers. In 2005, the AIM market accounted for 52% of all European IPOs.[82] Among the aspects of the AIM that add to its appeal are its limited listing requirements: "no minimum-market capitalization, stockholder's equity, trading volume, or share price for

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[76] Scannell & Solomon, *supra* note 61.
[77] Carney, *supra* note 75, at 148.
[78] *Id.* at 147.
[79] Romano, *supra* note 64, at 193.
[80] Carney, *supra* note 75, at 150.
[81] Andy Serwer, *Stop Whining about SarbOX*!, FORTUNE MAGAZINE, Aug. 1, 2006, *available at* http:/money.cnn.com/magazines/fortune/archive/2006/08/07/8382589/index.htm.
[82] Bell, et. al., *supra* note 23, at 55.

listing purposes."[83] In addition, the process is relatively bureaucrat-free as the U.K. listing authority does not review or approve AIM listing documents. This job is left in the hands of "Nominated Advisors," or "Nomads" for short, which act as reputational intermediaries and ensure rule compliance. Nomads are typically investment banks or law firms that charge a fee for their role.

Many Sarbanes-Oxley critics have lumped the success of the AIM together with the success of the London Stock Exchange ("LSE") when comparing the success of London to the NYSE's recent performance in attracting foreign listings. However, the AIM's status as a small company market necessarily reduces its importance in the debate on the competitiveness of larger exchanges, since AIM companies would fail to meet the minimum market capitalization requirements of the LSE and NYSE, and in some cases even Nasdaq's Capital Market. Furthermore, any U.S. company attempting to avoid American securities regulations by listing on AIM will find itself subject to the requirements of the Securities Exchange Act if it has more than 500 shareholders.[84] Consequently, the AIM's success cannot be regarded as derogative of the competitiveness of the NYSE, the Nasdaq Global Market and perhaps even the Nasdaq Capital Market. What the success of the AIM market does suggest, however, is that there is a gap in U.S. regulations that has created a difficult situation for small companies to find good sources of capital. These companies have increasingly turned to the AIM.

Some commentators have proposed a repeal of Sarbanes-Oxley as a solution to the various problems presented by the Act.[85] However, a repeal of the Act appears very unlikely. In addition to the fact that Democrats have taken control of both the House of Representatives and the Senate, even the Republican-led Congress did not indicate a willingness to repeal Sarbanes-Oxley, despite early signals of its heavy costs. More importantly, as this paper seeks to suggest, Sarbanes-Oxley is only a part of the overall competitiveness problem of U.S. markets. Repealing Sarbanes-Oxley by no means guarantees a return of foreign listings to U.S. markets, as many other significant factors will continue to impact listing decisions.

Of the three major U.S. reports to address capital markets competitiveness, the Interim Report provides the most significant discussion and recommendations with respect to Sarbanes-Oxley. The drafters of the Interim Report raise (but do not necessarily endorse)

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[83] Arthur S. Berner, Bryce D. Linsenmayer & Francesca Cinotti, *The Alternative Investment Market of the London Stock Exchange*, 10 WALL ST. LAW. (June 2006), http://www.realcorporatelawyer.com/wsl/wsl0606.html.

[84] *Id.*

[85] Larry E. Ribstein & Henry N. Butler, *The Sarbanes-Oxley Debacle: What We've Learned; How to Fix It* (Abstract from book published by AEI Press (2006), Illinois Law & Economics Working Paper No. LE06-017), *available at* http://ssrn.com/abstract=911277.

arguments that Section 404 of Sarbanes-Oxley has positively changed the "'tone at the top' among public companies when it comes to financial reporting, with a higher level of engagement from audit committees, CEOs, and CFOs on accounting issues."[86] The report also refers to observations that "many of the control weaknesses uncovered in the early years of Section 404 implementation have led to significant improvements in the control environment."[87] However, the Interim Report also discusses a number of sensible (but perhaps not novel) adjustments to the implementation of Section 404.

First, because a central feature of the analysis required under Section 404 is the detection of "material weaknesses" in internal controls, the scope of the definition of "material weakness" directly impacts that regulatory burden of the statute. Accordingly, the Interim Report suggests that the Public Company Accounting Oversight Board ("PCAOB") reduce the scope and materiality standards in Auditing Standard No. 2 ("AS2") "to ensure that reviews are truly risk-based and focus on significant control weaknesses."[88] Specifically, the Interim Report recommends that the definition of materiality in AS2 be revised to say that "a material weakness exists if it is reasonably possible [as opposed to the existing standard of "more than a remote likelihood"] that a misstatement, which would be material to the annual financial statements, will not be prevented or detected."[89] The Interim Report also "recommends . . . that the SEC revise its guidance on materiality for financial reporting so that materiality is generally defined, as it was traditionally, in terms of a five percent pre-tax income threshold."[90] Ironically, the Interim Report is suggesting a move from a more flexible principle—issuers should consider whether qualitative factors may make a quantitatively small deviation material—to a rigid but more predictable rule—a five percent threshold for materiality. This recommendation would move the SEC away from its position in Staff Accounting Bulletin No. 99 ("SAB 99"), in which the SEC alerted issuers that quantitatively small errors (e.g., below a five percent pre-tax income threshold) may nonetheless be material if qualitative factors are at issue. For example, the SEC notes that such a small discrepancy may be material if it masks a trend in earnings, or allows a company to hit an earnings target.[91] Because SAB 99 gives the SEC an effective means to help police

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[86] INTERIM REPORT, *supra* note 3, at 115.
[87] *Id.* at 115-116.
[88] *Id.* at 19 (noting that that the SEC and the PCAOB have already "embraced" this path).
[89] *Id.* at 131.
[90] *Id.*
[91] SEC Staff Accounting Bulletin No. 99 at § 1: "Assessing Materiality," http://sec.gov/interps/account/sab99.htm.

such deceptive practices, it seems unlikely that the SEC would move away from its current standard.

Second, the Interim Report also recommends that the PCAOB and the SEC provide additional guidance to auditors and issuers through

- clarifying and permitting greater judgment as to the auditor's role in understanding and evaluating management's assessment process;
- confirming that auditors, in attesting to management's assessment, are not required to perform similar assessments to those needed in issuing their own opinions;
- reinforcing the appropriateness of the auditor's use of judgment throughout the audit of internal controls over financial reporting, including in the evaluation of strong indicators of material weakness;
- clarifying that the auditor attestation does not require the auditor to report separately on management's own internal control assessment process ; and
- incorporating the frequently-asked questions guidance into the text of AS2.[92]

Third, the Interim Report also recommends that the SEC and PCAOB should allow "multi-year rotational testing" for "lower-risk components of financial processes and other areas, such as certain elements of the information technology environment" (rather than a complete review each calendar year of each aspect of internal controls), as part of an annual attestation, although the Interim Report notes that "[c]ritical components of financial processes and higher risk areas such as procedures for preparing the annual financial statements and related disclosures should be tested each year."[93]

Fourth, as a reflection of a more "principles-based" focus, the Interim Report recommends that the SEC and PCAOB should allow auditors to "increase reliance on the work of others and give guidance to both management and auditors regarding the auditor's maximum reliance on inputs from existing sources (for example, internal auditors and management) in performing their control work."[94] This, the drafters believe, will result in a more efficient "risk-based" assessment.[95]

Fifth, the Interim Report suggests scaling of Section 404 by continuing to defer application of Section 404 to non-accelerated filers (companies with less than $75 million of market capitalization) should continue to be deferred until its proposed changes in materiality, enhanced guidance, and multi-year rotational testing take effect. At that point, the Interim Report recommends that the SEC should "reassess the costs and

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[92] INTERIM REPORT, *supra* note 3, at 132.
[93] *Id.*
[94] *Id.* at 132-33.
[95] *Id.* at 133.

benefits of extending Section 404 to small companies."[96] To the extent that the SEC finds that, even with the proposed reforms, the costs are still too high relative to the benefits, the Interim Report recommends that the SEC "ask Congress to consider exempting small companies from the auditor attestation requirement of Section 404 while at the same changing the management certification requirement to one requiring reasonable belief in the adequacy of internal controls."[97] However, the Interim Report does not recommend that smaller companies be required to merely meet a "design-only" standard, "under which outside auditors would generally assess the overall adequacy of the design of controls and only test effectiveness in limited areas,"[98] because the drafters believe that "a reliable judgment about design cannot be made without testing effectiveness."[99] The Interim Report comments that "to maintain otherwise risks seriously misleading investors,"[100] a debatable proposition given that disclosure requirements could make investors aware of the differences in the level of testing, the risks of which would presumably be priced into the company's securities.

Finally, the Interim Report recommends that the SEC "not apply Section 404 to foreign firms that could demonstrate that they were subject to equivalent home country internal control regulation,"[101] a view echoed by members of the SEC staff,[102] and calls for "more data collection and ongoing monitoring"[103] of the impact of Section 404.

Generally, the Sarbanes-Oxley recommendations offered in the Interim Report are measured and politically feasible, although many critics of Sarbanes-Oxley might argue that the recommendations only alleviate symptoms rather than cure the disease. Of other, stronger remedies, Yale law professor Roberta Romano has advanced a promising potential solution that would ease the effects that Sarbanes-Oxley places on smaller companies and foreign issuers: a "SOX-by-box" regime. Under SOX-by-box the controversial corporate governance provisions of the Act would become default rules that can be opted out of by a shareholder vote.[104] Smaller companies could use such a process to free themselves of the burdens of Sarbanes-Oxley 404. Note, however, that this solution requires cooperation from the SEC in the form of the Commission using its exemptive powers under Section 36 of the Exchange Act. As the Chamber

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[96] *Id.*
[97] INTERIM REPORT, *supra* note 3, at 133.
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] 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, 61 (2007).
[103] INTERIM REPORT, *supra* note 3, at 133.
[104] *See generally* Romano, *supra* note 64, at 1594-95.

of Commerce Report notes, there is some uncertainty whether the SEC's exemptive authority under the Exchange Act would cover such an exemption for Section 404, which is not part of the Exchange Act.[105] Hence, the Chamber of Commerce recommends adopting 404 as part of the Exchange Act in order to provide a clear path for exemptive relief.

In response to the many concerns expressed over implementation of Section 404, the SEC has recently reaffirmed its willingness to provide relief as appropriate. On April 4, 2007, the Commissioners endorsed recommendations of the Staff to "eliminate waste and duplication in the Sarbanes-Oxley compliance exercise, in a move that will particularly benefit smaller companies."[106] The SEC has already provided some guidance to management on Section 404 compliance,[107] and has asked the PCAOB to align its new auditing standards (AS-5) with the SEC's guidance, "particularly with regard to prescriptive requirements, definitions and terms."[108] As evidence of at least some shift to more principles-based rules (the wisdom of which is discussed below), the Commissioners also asked the staff to focus on "scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies, encouraging auditors to use professional judgment in the 404 process, particularly in risk assessment; and following a principles-based approach to determining when and to what extent the auditor can use the work of others."[109] Whether this course of action was arrived at independently or as a result of the recommendations of the Interim Report, the SEC's efforts should address many of the concerns of the Paulsen Committee.

### 3. The SEC's Accommodation of Foreign Issuers

A foreign issuer's decision to list in the U.S. may also be affected by the current perception that Sarbanes-Oxley has deviated from a previous tradition of the SEC of making accommodations to foreign issuers. These accommodations have included the SEC not subjecting foreign issuer reporting companies to proxy statement requirements and short-swing profit rules. Following the passage of Sarbanes-Oxley, the SEC has not been nearly as accommodating. This shift has been said to be in part because the

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[105] CHAMBER OF COMMERCE REPORT, *supra* note 19, at 122.

[106] Press Release 2007-62, Securities and Exchange Commission, SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation to Ease Smaller Company Burdens, Focusing Effort on 'What Truly Matters' (April 4, 2007), *available at* http://sec.gov/news/press/2007/2007-62.htm.

[107] Securities & Exchange Commission, *Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions*, *available at* http://www.sec.gov/info/accountants/controlfaq0604.htm.

[108] Press Release, Securities and Exchange Commission,, *supra* note 106.

[109] *Id.*

Act unambiguously applies to all issuers that file periodic reports under U.S. securities laws, regardless of where the companies are domiciled.[110] Furthermore, the Act does not contain a single reference to foreign issuers, suggesting that they are not to be afforded special treatment.[111] Lastly, some commentators have suggested that the political climate surrounding the passage of Sarbanes-Oxley precluded the SEC from using its powers to exempt foreign issuers from certain Sarbanes-Oxley requirements.[112]

Despite this recent trend against accommodation by the SEC, some of the latest events suggest that the tide may be turning once again. As stated in a Price Waterhouse Coopers Securities Litigation study, "the U.S. spent 2005 extending 'olive branches' to foreign private issuers."[113] During 2005, the SEC also extended the deadline for Section 404 compliance by foreign issuers to July 15, 2007, made a one-time accommodation allowing foreign private issuers to file less detailed financial data,[114] and proposed new rules making it easier for foreign private issuers listed on U.S. exchanges to de-list.[115] The hope is that this proposed regulation will attract more foreign private issuers to the U.S. by easing foreign issuers' concerns regarding the currently onerous de-listing process.[116]

Empirical studies that examine the extent to which increasing regulatory costs have influenced listing decisions of foreign issuers have been somewhat inconclusive. What has become increasingly clear is that in recent years the U.S. has attracted a decreasing amount of foreign IPOs. In 2005, 24 out of 25 of the top 25 IPOs were issued on exchanges outside of the U.S.[117] This figure stands in sharp contrast to the year 2000, when 9 out of 10 of the world's largest non-U.S. IPOs listed in New York.[118] Furthermore, only 3 of the top 20 IPOs of 2006 were listed in the U.S.[119] This declining foreign IPO data suggests that increasing regulatory costs have tipped the scale towards issuers listing outside of the U.S. However, it is worth noting that many of the top overseas listings from 2005 involved

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[110] 15 USC § 7201(7) (2006).
[111] Perino, *supra* note 65, at 214.
[112] *Id.* at 226.
[113] PRICEWATERHOUSECOOPERS LLP, 2005 SECURITIES LITIGATION STUDY 53 (2006), *available at* http://www.pwc.com/extweb/pwcpublications.nsf/docid/7999A70324592B738525715C0059A94.
[114] *Id.* at 54.
[115] *Id.*
[116] *Id.*
[117] Allan Murray, *Fees May be Costing Wall Street its Edge in Global IPO Market*, WALL ST.J., Aug. 2, 2006, at A2.
[118] Corey Boles, *London Remains an IPO Draw, U.S. Changes Notwithstanding*, WALL ST.J., Aug. 8, 2006, at C4.
[119] Scannell & Solomon, *supra* note 61, at A1.

privatizations of formerly state owned companies like China Construction Bank, Electricité de France, and Gaz de France that predictably listed in their respective home markets.[120] The decisions to list formerly state owned companies at home can just as easily be explained as an issue of national pride, not one of the competitiveness of capital markets.

However popular it may be to blame Sarbanes-Oxley for decreasing IPO activity, it can also be argued that the decrease in IPOs is unlikely to last long. One of the major justifications for foreign issuers to list on U.S. exchanges is to gain access to more liquid capital markets than are available in their home countries. To the extent that foreign markets have become deeper and more efficient, U.S. listings may suffer. However, issuers choose to list in the U.S for reasons beyond pure liquidity. Oftentimes bonding or signaling is a significant reason for listing in the U.S. By voluntarily submitting to the U.S. disclosure regime with its heavy costs of regulatory compliance, an issuer from a country with weak securities regulation signals a credible commitment that it "will not extract private benefits of control."[121] Consequently, if this bonding effect is in fact the issuer's primary motivation for listing in the U.S., Sarbanes-Oxley will not be a factor. This is because as the regulatory burdens of submitting to the U.S. regime have increased, the signal that bonding conveys may become stronger and more valuable.[122]

The bonding effect will be tested in the coming months, as the SEC recently proposed rules that allow foreign private issuers to exit the Exchange Act reporting regime. Under the current rules, a foreign private issuer may terminate its registration of a class of securities only if its subject securities were held of record by less than 300 residents in the United States. The SEC seeks to amend these rules "out of concern that, due to the increased globalization of securities markets in recent decades as well as other trends, it has become difficult for a foreign private issuer to exit the Exchange Act reporting system even when there is relatively little U.S. investor interest in its U.S.-registered securities."[123] The SEC also noted that "because of the burdens and uncertainties associated with terminating registration and reporting under the Exchange Act, the current

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[120] Murray, *supra* note 117, at A2.

[121] Perino, *supra* note 65, at 215.

[122] Kate Litvak's research on cross-listing premia (the increases in price generally thought to be attributable to the bonding effect provided by listing in a jurisdiction with higher regulatory standards) suggests, however, that investors expected Sarbanes-Oxley "to have greater costs than benefits for cross-listed firms on average, especially for smaller firms and already well-governed firms." Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L.REV. 1857, 1857 (2007).

[123] Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-55540, 17 C.F.R. Parts 200, 232, 240 & 249 (Mar. 27, 2007).

exit process may serve as a disincentive to foreign private issuers accessing the U.S. public capital markets."[124]

Rather than relying on the number of U.S. securityholders, the new rules allow eligible foreign registrants to use a benchmark for deregistration based on U.S. average daily trading volume ("ADTV") relative to worldwide ADTV. Under the proposed rules, a foreign registrant may deregister if, during the 12-month period ending 60 days before filing for deregistration, its U.S. ADTV was 5% or less of its worldwide ADTV, regardless of the total number of U.S. residents holding its securities.

In a comment that seems representative of practitioners advising foreign firms, a Clifford Chance partner noted:

> One of the SEC commissioners has been quoted as predicting that there would be no "rush to the exits." I wish I were as sanguine. I believe that we are about to see many European companies deregistering their securities, with a consequent decrease in the access of US investors to the securities of many fine companies.
>
> Sarbanes-Oxley may not be the only factor that has made the US less competitive in attracting international capital-raising, but it has clearly played a significant role.[125]

On the potential exodus of foreign issuers, an academic commentator offers this appraisal:

> Most if not all of these issuers will cite Sarbanes-Oxley to justify the termination of their listing. But don't always believe it. These issuers originally listed in the United States for a variety of reasons, and for many a delisting will simply mean the reasons no longer exist (and probably haven't for a long time). For example, many a foreign high-tech company listed on the Nasdaq during the tech bubble seeking the extraordinary high equity premium accorded Nasdaq-listed tech stocks. Post-crash, many of these foreign companies still exist but are much smaller or have remained locally-based and a foreign listing is no longer appropriate for them.[126]

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[124] *Id.*

[125] Sara Hanks, Letter to the Editor, *Sarbox's Role in Lowering US Ability to Attract Capital*, FIN. TIMES, Mar. 28, 2007.

[126] Stephen M. Davidoff, *The Coming Delisting Wave*, M&A Law Prof Blog (May 30, 2007), *available at* http://lawprofessors.typepad.com/mergers/2007/05/the_coming_deli.html.

B. *A Move to "Principles-Based" Corporate Governance?*

Critics of Sarbanes-Oxley have argued that the rigid strictures of Sarbanes-Oxley epitomize the inflexibility of U.S. securities regulation.[127] In response to these concerns, the Paulson Committee recommended a move to more "principles-based" regulation by the SEC and the exchanges, as exemplified by the "comply-or-explain" approach taken by the UK's Financial Services Authority (FSA), under which a company is required to either adhere to a set of government-mandated governance principles or explain why it has not. As a definitional matter, a comply-or-explain regime seems inapposite as a reflection of "principles-based" governance: does making a rule optional thereby transform it into a standard or principle? What is suggested by the call for principles-based regulation is not (or perhaps not merely) the adoption of a comply-or-explain approach by the SEC and SROs, however, but a more fundamental change in the nature of the regulation, so that regulation is more "risk-based,"[128] and "based on outcomes or results rather than prescribed processes and inputs."[129]

Interestingly, a "comply-or-explain" approach was already adopted by the SEC in its implementation of the Sarbanes-Oxley Act with respect to disclosure of the registrant's code of ethics and whether the audit committee includes at least one member who is a "financial expert".[130] However, Sarbanes-Oxley generally has been perceived to have increased a rules-based tendency of U.S. regulation, [131] perhaps most significantly because it and related exchange regulations set out specific director independence qualifications.[132] Arguably, this indicates not just a move to a more rules-based approach, but a related shift in philosophy of U.S. securities regulation from a disclosure regime to a regime of substantive regulation which implicates not just securities regulation but corporate law. Within the realm of the mandatory disclosure regime, "the [U.S.] federal securities laws have been interpreted as not supporting direct regulation of corporate governance."[133] However, the director independence rules and certain other provisions (such as the prohibition on loans to officers) of Sarbanes-Oxley can be interpreted as a departure from this tradition in that

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[127] Sridhar R. Arcot & Valentina G. Bruno, *One Size Does Not Fit All, After All: Evidence from Corporate Governance*, 3, *available at* http://ssrn.com/abstract=887947.
[128] INTERIM REPORT, *supra* note 3 at 64.
[129] *Id.*
[130] *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 33-8177, 79 SEC Docket 1077 (Jan. 23, 2003).
[131] *See, e.g.*, Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties,* 30 WM. MITCHELL L. REV. 1149, 1195 (2004).
[132] *Id.* at 1212.
[133] Larry E. Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on U.S. Law*, 3 J. CORP. L. STUD. 299, 301 (2003).

they directly prescribe substantive corporate governance regulations. The substantive corporate governance provisions in Sarbanes-Oxley that trump state law have led some to believe that Sarbanes-Oxley is the spearhead of a future federalization of corporate law.

A potential federalization of U.S. corporate law may impact listing decisions because it represents a potential decrease in flexibility of the U.S. corporate legal regime, which until now has largely been a creature of state authority. Professor Romano has argued that leaving corporate law in the province of the individual states has established a system of regulatory competition in the U.S.[134] As this argument holds, American state corporate law regimes have evolved in a manner that is both flexible and contractarian. State corporate laws are flexible in that they are essentially default rules; parties can contract around provisions of the state corporate codes as they see fit.

Sarbanes-Oxley's requirement of certain governance structures, rather than governance choices, has led to an increased perception that U.S. law is inflexible, which has arguably impacted foreign listings. Indeed, some European commentators have already seized the opportunity to condemn U.S. corporate law as rigid in light of the development of Sarbanes-Oxley and its substantive corporate governance provisions. These commentators argue that the flexibility that issuers seek can be found abroad, and that the U.S. "has an essentially mandatory system of corporate governance, epitomized by Sarbanes Oxley."[135]

1. Comply or Explain: The UK Approach

Differences between the U.S. regime and the increasingly popular "comply-or-explain" approach to corporate governance may also affect an issuer's decision to list in the U.S. The difference between the two approaches to corporate governance has been brought to the forefront by the current surge in foreign IPO activity on the London Stock Exchange coupled with the concurrent drop in activity on the NYSE. European proponents of the London Stock Exchange have suggested that part of the explanation for the decrease in listings is a result of the comply-or-explain approach to corporate governance.

The comply-or-explain approach was introduced in the U.K. following several corporate scandals in the 1980s. The U.K. established the approach by introducing a system in which the government introduced a "Code of Best Practice" which sets out various guidelines of corporate governance. The approach is rather simple: in yearly reports, companies

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[134] *See* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 Yale J. on Reg. 209, 210-11 (2006).
[135] Arcot & Bruno *supra* note 127, at 3.

must report whether they comply with the Code, and if a company fails to comply, it must provide reasons for the deviation. Proponents of the comply-or-explain system argue that it is preferable to the U.S. system because it is a "concept of principles, as opposed to strict regulation,"[136] supporting the view that foreigners consider the U.S. regime as inflexible. Overall, the system is said to possess greater flexibility than the U.S. regime because companies are free to tailor their corporate governance policies to their particular needs. Compliance with the Code is not mandatory, and the company is free not to comply as long as an explanation is provided. It is worth noting that the comply-or-explain approach has picked up a large following internationally, with similar Codes having been adopted in Australia, Austria, Belgium, Canada, China, Germany, Hong Kong, Indonesia, Ireland, Italy, Korea, Malaysia, Mexico, Poland, Portugal, Singapore, Spain, and Sweden.[137]

The recent popularity of the comply-or-explain type regime, coupled with the success of the LSE, may point towards a U.S. adoption of comply-or-explain type corporate governance provisions as a solution to decreasing U.S. market competitiveness. In a recent speech in New York, U.S. Secretary of the Treasury Henry Paulson extolled the virtues of a regulatory structure that is based on compliance with principles as opposed to prescriptive regulations, saying that principles- based regulations offer the flexibility to work on compliance with the spirit, not just the letter, of rules.[138] "Principles-based regulation" is a hallmark description of the comply-or-explain system. Mr. Paulson's comments can therefore be interpreted as an endorsement of the kind of principles-based system embodied by the comply-or-explain approach.

As attractive as a change of U.S. regulations from a prescriptive regime to a principles-based system may seem, however, other considerations remain in play. First, the adoption of a federal comply-or-explain system could divide the ranks of those arguing for "principles-based" regulation, since a move to a comply-or-explain type regime would also mean an expansion of federal oversight of corporate governance. If this is the case, a move towards comply-or-explain could arguably run into resistance from entrenched supporters of the current corporate law regime.

Second, it is not clear whether a comply-or-explain approach would, in practice, provide the advertised flexibility. The approach embodied by recent "comply-or-explain" type provisions of Sarbanes-Oxley suggests that any comply-or-explain provisions in the U.S. may take on more of a mandatory element than in the U.K. As noted above, Sarbanes-Oxley Section 406, which requires issuers to disclose whether

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[136] *Id.* at 6.
[137] *Id.* at 6.
[138] Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets at The Economic Club of New York on November 20, 2006, at heading "Regulatory Structure," http://www.ustreas.gov/press/speeches.html.

they have adopted a Code of Ethics for senior financial officers,[139] and Section 407, which mandates disclosure of whether the company has a financial expert on the audit committee,[140] effectively operate as mandatory rules by shaming the registrant into compliance. Similarly, the UK's comply-or-explain approach is not without its critics. European detractors have argued that the comply-or-explain regime of the U.K. is not as flexible in practice as in theory, with the Combined Code operating as a rather rigid set of rules.[141] This result stems from the fact that for the comply-or-explain regime to remain flexible, companies who deviate from the Code by providing an explanation must not be penalized by investors and rating agencies for doing so. Investors may merely check for compliance without reading the explanations, thus reducing the effectiveness of the approach.[142]

A move away from the prescriptive corporate governance provisions of Sarbanes-Oxley and other U.S. securities regulations towards a principles-based regime may offer a partial solution to the U.S. competitiveness problem. The potential for increased flexibility, lower costs, and added focus on compliance with the spirit of regulations is appealing. However, this approach may prove unwise. It is not assured that the U.S. will be able to transplant these kinds of regulations into the U.S. regulatory apparatus with ease. Such a system may not operate as effectively unless coordinated with a centralized governance system, and transplanting such a system into the U.S.'s current regime could result in a radical and costly federalization of corporate law.

## IV. PRIVATE SECURITIES LITIGATION AND ITS POTENTIAL EFFECTS ON LISTING DECISIONS

Although Sarbanes-Oxley Section 404 has been the primary target for critics seeking to assign blame for the recent foreign IPO decrease, the risk of private securities litigation in the U.S. may ultimately be the most significant factor causing foreign companies to forego listing in the U.S. While receiving more scrutiny as of late, private securities litigation arguably has not received the attention it deserves when it comes to the competitiveness issue. Nevertheless, the role of private litigation has been

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[139] 15 U.S.C. § 7264 (2006).

[140] 15 U.S.C. § 7265 (2006).

[141] Financial Reporting Council, *Review of the 2003 Combined Code: The Findings of the Review*, at 1, *available at* www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20review%20main%20findings%2018%20January%202006.pdf.

[142] Arcot and Bruno's paper analyzing the stock prices of British companies has suggested that the U.K. markets have incorporated into prices the effects of complying with the Code but have not similarly incorporated explanations. Arcot & Bruno *supra* note 127, at 24.

brought to the forefront in the Chamber of Commerce Report, Interim Report and by Secretary Paulson's recent remarks that "the broken tort system is an Achilles heel for our economy."[143]

A look at U.S. securities class action statistics can support Secretary Paulson's characterization of the American tort system as a significant drag on public companies in the U.S. While 2005 saw securities litigation filings drop for the first time in 11 years, statistics from the previous year show securities class action filings at an all time high. Evaluating the statistics from 2004 and 2005 in the context of overall securities litigation in the U.S. over the past several years can help provide a clearer picture of the future litigation risks facing U.S listed issuers.

A Price Waterhouse Coopers Litigation Study from 2004 reveals a flood of private securities litigation against issuers listed in the U.S., with 29 foreign companies sued in U.S. private securities class actions.[144] This number of filings was the highest ever in one year, and represented a 90% increase over 2003, and a more than 107% increase from the average number of filings during the seven year period from ranging from 1996 through 2003.[145] Furthermore, settlement values were extremely hefty. The average settlement value during 2004 was $27.6 million, a figure representing an 18% increase over the year previous.[146] Total settlement value in 2004 was $5.4 billion, "the highest amount on record" according to the study.[147] The number of high dollar settlements (amounts of $100 million and up) during 2004 increased 66% from the year before. Finally, SEC enforcement actions leading to criminal and money penalties reached all time highs.[148]

While the 2004 statistics paint a grim picture of the securities class action landscape in the U.S., the PricewaterhouseCoopers 2005 securities class action litigation study shows an unexpected drop in securities litigation. During 2005 the number of class actions filings fell 17% from the previous year and 11% below the ten-year average.[149] Furthermore, the number of private securities class actions filed against foreign companies fell 34%, and SEC enforcement actions against foreign issuers fell as well.[150] However, despite these positive signs, the average value of settlements during 2005 increased 156% from $27.8 million to $71.1

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[143] Deborah Solomon, *Treasury's Paulson Warns of Overlap,* WALL ST.J., Nov. 21, 2006, at A2.
[144] PRICEWATERHOUSECOOPERS LLP, 2004 SECURITIES LITIGATION STUDY 2 (2005), *available at* www.pwc.com/gx/eng/cfr/gecs/pwc_2004_seclit_study.pdf.
[145] *Id.* at 4.
[146] *Id.* at 7.
[147] *Id.*
[148] *Id.* at 12.
[149] PRICEWATERHOUSECOOPERSLLP, *supra* note 113, at 5.
[150] *Id.* at 56.

million.[151] The increase in both average and total settlement values, as well as the fact that 2004 was a record year for private securities litigation, led the survey to conclude that the 2005 drop in both private and public securities litigation is likely to be temporary.

A study released by NERA Economic Consulting presents similar figures regarding filings in 2005, but comes to different conclusions.[152] The study points out that it is too early to suggest a future downward trend in filings because the 2005 decrease was not evenly distributed across the U.S.; most of the decrease came from a drop in filings in the Ninth Circuit.[153] More significantly, the study predicted that average settlement values might actually begin to fall, in part because the outcomes of the majority of the biggest cases associated with the crash of the stock market bubble have been determined.[154]

Mixed trends continued in 2006. Cornerstone Research reports that only 110 securities class action lawsuits were filed in 2006, compared to 178 in 2005 and an average of 193 for the years 1996-2005.[155] When options backdating cases are removed, only 90 claims were filed in 2006.[156] However, the amount paid in settlements continued to rise.[157] In the years 1996-2005, securities class action settlements averaged $22.6 million.[158] Even excluding the $6.6 billion partial settlement in the Enron case, the average settlement in 2006 was $105 million.[159] The medians between the time periods differ little—$6.7 million from 1996-2005 versus $7.0 million in 2006—indicating an increase in the number of "mega settlements."[160] In 2004 and 2005, for example, seven and nine cases respectively were settled for $100 million or more, while 2006 saw 14 such cases.[161]

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[151] *Id.* at 17.
[152] *See* Ronald L. Miller, Todd Foster, & Elaine Buckberg, *Recent Trends in Shareholder Class Action: Litigation: Beyond the Mega Settlements, Is Stabilization Ahead?* NERA Economic Consulting Study, (2006). *Available at* www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf.
[153] *Id.* at 2.
[154] *Id.* at 6.
[155] CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS: 2006: A YEAR IN REVIEW 1, available at http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf.
[156] *Id.* at 1.
[157] CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2006 REVIEW AND ANALYSIS 2, available at http://securities.stanford.edu/Settlements/REVIEW_1995-2006/Settlements_Through_12_2006.pdf.
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] *Id.* at 3.

While there is positive news in the most recent securities litigation surveys, the statistics unquestionably show that there is a significant amount of private securities litigation risk for firms listed in the U.S., both foreign and domestic, and this risk in the U.S. undoubtedly remains a significant factor in listing decisions. Further, even if the risk of securities litigation has diminished, perception may lag reality.

Highlighting the concerns with securities litigation in the U.S. is only the initial step in the overall inquiry into private litigation risks. How significantly a foreign issuer weights U.S. private securities litigation risk will also ultimately depend on how the U.S. litigation climate compares with the climate of the issuer's home country. In the U.S., the main procedural method used to vindicate private securities litigation is the class action lawsuit. However, securities class actions, and class actions generally, do not exist in most of Europe,[162] and procedural mechanisms for securities cases vary worldwide. This fact can make it difficult to compare American securities litigation to that of other nations. However, examining some of the mechanisms that have led to the current U.S. litigation climate and noting their presence or absence in other countries can assist one in drawing conclusions regarding the possibility of a U.S. style litigation culture emerging abroad.

In the U.S., most private securities litigation is carried out through the mechanism of a class action lawsuit, where "individuals with common interests enforce their rights in a single suit."[163] The class action mechanism is particularly appropriate for securities litigation because there are likely to be dispersed shareowners with individual damages too small to merit any one individual's recovery effort. By aggregating the interests of dispersed shareholders, recovery can be obtained for all. As such, a class action lawsuit represents the riskiest type of litigation that a company may be faced with, because of the potential for a massive damages award.

In practice, the U.S. class action system has seen its share of critics. Among the strongest criticisms advanced is that the system provides distorted incentives to class action attorneys, creating an agency problem where an attorney may negotiate a settlement with a defendant for a smaller judgment and a large legal fee.[164] In addition, attorneys may also be tempted to bring nuisance value "strike" suits because of the fact that defendants often choose to settle rather than face high legal costs, ominous document requests, and negative publicity.

In the U.S., a general sentiment that unrestrained private securities litigation was harming American business led to the passage of the Private

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[162] Michael Freedman, *Can You Say Tort,* FORBES, Dec. 27, 2004, at 124, *available at* http://www.forbes.com/global/2004/1220/022.html.

[163] Edward F. Sherman, *American Class Actions: Significant Features and Developing Alternatives in Foreign Legal Systems*, 215 F.R.D. 130, 132.

[164] Linda A. Willett, *U.S.-Style Class Actions in Europe: A Growing Threat?* 5 (2005), available at www.nlcpi.org/books/pdf/BRIEFLY_Jun05.pdf.

Securities Litigation Reform Act of 1995[165] ("PSLRA"), which consists of Section 27 of the Securities Act of 1933 and 21D of the Exchange Act of 1934. The PSLRA contains a number of substantive provisions that affect a plaintiff's ability to bring frivolous federal securities class action lawsuits. Among the most significant provisions are ones that require the appointment of a lead plaintiff who has suffered the largest losses, disclosure of repeat lead plaintiffs, a stay on discovery until the claim passes a motion to dismiss, attorney sanctions, disclosure of settlement terms to class members, and restriction on attorney's fees on the basis of reasonableness.[166]

As evidenced by the most recent securities class action litigation statistics, despite the passage of the PSLRA in 1995, private securities litigation in the U.S. has continued to present a major threat to U.S. listed companies. In the decade since the passage of the PSLRA, many critics have commented that the statute has not produced its intended results, as the number of securities class actions suits filed has steadily risen. In addition, the PSLRA rules have been circumvented and in some cases even blatantly broken, as evidenced by the recent indictment of prominent New York securities class action firm Milberg Weiss for allegedly paying illegal kickbacks to lead plaintiffs. When coupled with increasing settlement values and a steady rise in filings, stories like Milberg Weiss' arguably show that the PSLRA has at best only produced modest changes in the highly litigious climate in the U.S.

Having examined some of the perceived flaws in the American class action compensation system, it is instructive to consider the procedural mechanisms that drive a litigation regime towards U.S. style class action litigation, and their presence or absence in regimes abroad.

Two relevant procedural mechanisms have greatly contributed to the class action culture of the U.S.: the contingency fee and the "opt-out" provisions of the Federal Rule of Civil Procedure 23, and the allowance of punitive damages. The contingency fee, where a plaintiff's payment of fees is conditioned on the attorney's victory, has been described as "one of the drivers of class action litigation" [167] because of the incentives that it creates. In addition, Federal Rule of Civil Procedure 23's opting-out provision greatly increases the incentives to bring class action litigation as well. The provision requires that a member of a potential class action opt-out of the class or be bound to the outcome of the litigation.[168] In practice, very few potential plaintiffs opt-out, giving the class action significantly more power.

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[165] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as additions to 15 U.S.C. §§ 77 & 78).
[166] Securities Act of 1933 § 27(a)(6), 15 U.S.C.§ 78u-4 (2006).
[167] Willett, *supra* note 164, at 9-10.
[168] Fed. R. Civ. P. 23.

While the abovementioned three procedural mechanisms have promoted the development of a class action culture in the U.S., several unique characteristics of European litigation procedure have prevented such a culture from forming in that region.[169] Among these characteristics is the fact that in Europe, the use of contingency fees has been restricted and civil trials generally are not brought before a jury, in sharp contrast to the wide use of juries in civil trials in the U.S. In addition, European Union members do not allow broad pre-trial discovery as in the United States. This lack of broad discovery reduces the costs of defending lawsuits for European defendants and puts another hurdle in front of potential plaintiffs. However, this factor may be mitigated to some extent by the fact that the PSLRA significantly restricts discovery. Lastly, most European Union countries have followed the "loser pays" rule, which can also operate to discourage litigation by plaintiffs.

A. *Class Action Rules Abroad*

The recent cases of fraud at Parmalat and Ahold, among others, have motivated consideration of securities class actions and have likely contributed to a current trend of European countries taking steps towards adopting American style class actions. In this regard, France, Germany, Italy, Sweden, and the Netherlands "have either adopted or are considering [adopting] limited forms of class-action [law]suits."[170] This trend notwithstanding, the concept of American style class actions remains largely undeveloped in Europe. A country-by-country look at class action rules of the U.S.' primary competitors further illustrates the uniqueness of the American private litigation class action culture.

In the U.K, English common law provides for "representative proceedings." Each member of a class must be identified, and opting-out is not permitted. Contingent fees are nonexistent (although UK law allows "conditional fees" where the lawyer receives a bonus if the case is successful),[171] and the loser pays rule applies, leading many plaintiffs to take on insurance policies to cover the costs of a failed case.[172] Limited

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[169] Adele Nicholas, *Class Action Litigation Makes Headway In Europe,* INSIDE COUNSEL, Dec. 1, 2005, *available at* http://www.insidecounsel.com/issues/insidecounsel/15_169/global_views/238-1.html.

[170] Mary Jacoby, *Courting Abroad: For the Tort Bar, A New Client Base: European Investors*, WALL ST.J., Sept. 2, 2005, at A1.

[171] Winand Emons & Nuno Garoupa, *The Economics of US-style Contingent Fees and UK-style Conditional Fees,* (Bern University Discussion Paper Series 04-07, 2004) available at http://130.92.195.20/publikationen/download/dp0407.pdf.

[172] Freedman, *supra* note 162.

pre-trial discovery is allowed, although England is the only EU member state to permit discovery.[173]

In 2005, Germany passed a law that allows for a "model case procedure" to handle mass capital market proceedings.[174] This is different from American class actions in that claims can only be brought by known persons; thus opting-out is not permitted. In addition, although the plaintiffs can share the costs of the model case ruling, the loser pays rule applies.[175]

While Asian markets are beginning to emerge as a major competitor for IPO listings, private securities litigation risks are much less significant in Asia than in the U.S. This has been due to factors which include a lack of political support (as evidenced by China where securities class action defendants are often proxies for the central government),[176] a lack of procedural mechanisms, and a prevalence of the concentrated shareholder model which in turn discourages minority shareholder protections.

In Taiwan, for example, group litigation is "difficult and unusual."[177] Until the early 1990s, group litigation was suppressed due to political factors. However, political agendas aside, Taiwanese securities class actions are not much of a threat to issuers because of high coordination costs, information costs, court costs, and a lack of procedural laws. Plaintiffs must "opt-in" to collective litigation, limiting litigation to specific, known parties resulting in high coordination costs. There is no civil discovery procedure in Taiwan, adding to information seeking costs. Exorbitantly high court fees further discourage Taiwanese securities litigation, in that plaintiffs must advance court fees of up to 1% of the claim at the district court and appellate levels, and 1.5% at the highest level of appeal.[178] Although Taiwan does not have a "loser pays" rule, the losing party is required to cover her own attorney's fees and court fees.[179] With such high court fees, it is easy to see how plaintiffs may be discouraged from bringing group litigation.

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[173] Mark Wegener, Peter Fitzpatrick & Gregor Kleinknecht, *Is European Dispute Resolution Being Americanized*, HOWREY LLP LITIGATION INTELLIGENCE EUROPE 2 (2005), *available at* www.howrey.com/docs/Lit_Intelligence.pdf.

[174] German Ministry of Justice, *The German "Capital Markets Model Case Act,"* available at www.bmj.bund.de/media/archive/1056.pdf.

[175] *Id.*

[176] Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System?*, 24 U. PA. J. INT'L ECON. L. 599, 638-39 (2003).

[177] Lawrence S. Liu, *Simulating Securities Class Actions: The Case in Taiwan* 4 (Working Paper Series, 2000), available at http://ssrn.com/abstract=251224.

[178] *Id.* at 5.

[179] *Id.*

South Korea's litigation regime is interesting to consider because South Korea adopted a securities class action law in January 2004 that to some extent emulates U.S. class actions.[180] The Act recently had a minimum asset size requirement of $1.67 billion that in effect exposed only those Korean companies with the largest market capitalization to liability.[181] However, this asset cap expired on January 1, 2007, so that smaller companies now also face class actions.[182] The small market capitalization landscape of South Korea makes widespread class action litigation unlikely because there are fewer potential securities class action targets in South Korea than are available in the U.S. For example, after Samsung Electronics, a company that possesses a market capitalization that represents 20% of the market capitalization of all listed companies in South Korea, there is a sharp dropoff in companies with large market capitalization. Lastly, the country also lacks a well developed securities plaintiffs' bar, large institutional investors, and a business-experienced judiciary.

Private securities litigation in China is literally in its infancy, largely because of the state dominated ownership of many companies in China. Although the new 2006 Chinese Company law provides a broad private right of action for private shareholders to bring suits, class actions and contingency fees are not permitted in China.[183] A 2002 Supreme People's Court of China decree lifted a temporary ban on private shareholder litigation but also imposed several significant limitations. One such limitation is a requirement that an administrative actor sitting as a trial level judge issue an "administrative penalty decision" before the courts can hear a case, leaving the courts' function as simply deciding whether damages are warranted, and at what amount.[184] Furthermore, cases are heard in the domicile of the defendant corporation, meaning that in practice the local government ends up being a defendant in a court whose judges it has appointed.

### B. *Recommendations for Modifying Private Securities Litigation*

The committees' recommendations include some proposals with respect to Rule 10b-5 which some in the press characterized as an attack on Rule 10b-5. The New York Times, for example, reported that "an adviser to the Paulson Committee [John Coffee]. . . recommended that the SEC adopt the exception to Rule 10b-5 so that only the commission could bring

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[180] Stephen J. Choi, *The Evidence on Securities Class Actions* 50 (UC Berkeley Public Law Research Paper No. 528145, 2004), available at http://ssrn.com/abstract=528145.
[181] *Id.* at 67.
[182] *Id.*
[183] Hutchens, *supra* note 176, at 601.
[184] *Id.* at 635.

such lawsuits against corporations."[185] However, in a response to this and similar reports, the same adviser responded that the proposal was actually much more modest.[186] Rather than remove the possibility of private litigation, the committee reports recommend repairing the "dysfunctional" class action system.[187]

The reports raise procedural and substantive concerns with private securities litigation and Rule 10b-5. The procedural concerns all reflect a concern that securities litigation unfairly punishes companies while inadequately compensating victims. One manifestation of this problem is the circularity of securities class actions. In the words of Coffee, "Fundamentally, shareholders are suing shareholders. As a result, diversified shareholders wind up making pocket-shifting wealth transfers to themselves."[188] Coffee notes that the actual culprits of the fraud—typically management—do not usually contribute to the settlement. Instead, these costs are borne by the issuer and its current shareholders and the directors' and officers' liability (D&O) insurer. Further, the less sophisticated, undiversified "buy and hold" investors will seldom fall within a class period, nor will they be able to even out their litigation losses (if such "evening out" is possible given the 20-30% contingency fee collected by the plaintiffs' attorneys) with recoveries from other claims from trades in a class period. To counteract these problems, Coffee suggests that "[t]he basic goal should be to move, at least marginally, from a system of entity liability to a system of managerial and agent liability that placed the costs instead on the culpable."[189] One way to accomplish this would be for "the SEC to adopt an exemptive rule under §36 of the Securities Exchange Act of 1934 that would shield a non-trading public corporation from liability for monetary damages under Rule 10b-5,"[190] which would leave 10b-5 as it currently operates in most cases, but for other cases (including the most catastrophic cases like Enron and WorldCom, in which the issuer was bankrupt) "would force the plaintiff's bar to sue and settle with corporate officers and agents—i.e., auditors, underwriters, and law firms—instead of treating the corporate entity as the deep pocket that paid everything."[191]

Although Coffee envisions increased recovery from culpable individuals and entities, it is important to note that neither Coffee nor the Interim Report suggests facilitating 10b-5 actions against professional

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[185] Stephen Labaton, *Businesses Seek New Protection on Legal Front*, N.Y.TIMES, Oct. 29, 2006, at 1.
[186] John C. Coffee, Jr. *Capital Market Competitiveness and Securities Litigation*, NEW YORK LAW JOURNAL, Nov. 16 2006, at 5.
[187] *Id.*
[188] *Id.*
[189] *Id.*
[190] *Id.*
[191] *Id.*

service firms such as lawyers, underwriters and accountants by allowing 10b-5 suits based on "scheme liability." Under this liability theory, recently offered by the SEC, a plaintiff could recover against firms that "engage with the corporation in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation's stock."[192] Note that such a test does not require that the firm's own conduct demonstrate a deceptive purpose and effect.

The Chamber of Commerce Report calls attention to scheme liability, supporting the Eighth Circuit's *Charter Communications* holding that:

> any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5. . . . To impose [scheme] liability . . . would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.[193]

While the Chamber of Commerce suggests that the SEC move away from its support of scheme liability, the point is perhaps now moot because the Supreme Court recently granted cert to a case, *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, raising questions about aider and abettor liability under Section 10(b). Specifically, the question presented was:

> Whether this Court's decision in Central Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164 (1994), forecloses claims for deceptive conduct under 10(b) of the Securities Exchange Act of 1934 where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning these transactions.[194]

Securities litigation may also unfairly punish companies because under Sarbanes-Oxley Section 308—"Fair Funds for Investors"—the SEC is granted the authority to order that civil penalties obtained from a defendant be added to a fund used to compensate victims of the securities fraud.[195] However, the Interim Report points out that "there are no limitations on recoveries in concurrent, private lawsuits even after the SEC

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[192] Brief of the Securities & Exchange Commission, Amicus Curiae in Simpson v. Homestore.com, Inc., 9th Cir., No. 04-55665 (October 22, 2004).

[193] *In re* Charter Communications, Inc. Securities Litigation, 443 F.3d 987, 992 (8th Cir. 2006).

[194] Quotation of Questions Presented available at http://www.supremecourtus.gov/qp/06-00043qp.pdf (internal citations omitted).

[195] 15 U.S.C. § 7246 (2006).

has made a Fair Funds distribution, raising the possibility of a wasteful double-recovery by shareholders that would undermine the original purpose of Section 308 by permitting overcompensation and, likewise, over-deterrence."[196]

Finally, the Interim Report suggests that the SEC prohibit "pay-to-play" practices among plaintiffs' firms. Prior to the passage of the PSLRA, many suits were brought by professional plaintiffs who owned only a few shares of many different companies. These plaintiffs worked in a symbiotic relationship with plaintiffs' firms—the firms had a plaintiff already at hand, and the plaintiff was compensated by the firm for their willing participation in the suits. The PSLRA works to counteract this possibility by creating a presumption that the potential plaintiff with the largest amount of damages should be the lead plaintiff in the action. However, since public pension funds are often the presumptive plaintiff, a new practice has developed, whereby plaintiffs' firms will make contributions to the campaigns or parties of the state officials who select the law firm. Then, "[p]ossibly in return, the elected official picks the law firm as the pension fund's class counsel when the fund elects to serve as lead plaintiff."[197] Without naming names, the Interim Report cites an example of "a leading plaintiffs' law firm [that] contributed $100,000 to a state comptroller's campaign, and senior partners at the firm made additional contributions. Shortly after winning re-election, the comptroller appointed the contributing law firm to represent the state's public-employee pension fund in a shareholder class action lawsuit."[198]

The Interim Report suggests a remedy similar to a rule used in the regulation of municipal bonds: Rule G-37 of the Municipal Securities Rulemaking Board mandates that an investment bank making a political contribution to any elected official may not underwrite the municipal bonds of the political subdivision of such official.[199] Similarly, the Interim Report recommends that "[w]hen political contributions are made by lawyers to individuals in charge of a state or municipal pension fund, the attorneys should not be permitted to represent the fund as a lead plaintiff in a securities class action."[200]

The committees also raise substantive concerns with 10b-5 litigation, focusing on the lack of predictability of the rule. The Interim Report notes that "considerable uncertainty exists about many of the elements of Rule 10b-5 liability as a result of conflicting interpretations by

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[196] INTERIM REPORT, *supra* note 3 at 82.
[197] *Id.* at 83.
[198] *Id.*
[199] MSRB Rule G-37, http://www.msrb.org/msrb1/rules/ruleg37.htm.
[200] INTERIM REPORT, *supra* note 3, at 84.

courts."[201] The Interim Report recommends that the SEC provide guidance in three areas: materiality, scienter and reliance.[202]

As the Interim Report notes, there is conflict between the Ninth and Third Circuit Courts on whether a disclosed misrepresentation is "immaterial" as a matter of law if it does not produce any effects on the market, with the Ninth Circuit answering in the negative and the Third in the affirmative.[203] There is also a split between the Second and Ninth Circuits on scienter, with the Second Circuit requiring plaintiffs to establish a strong inference of fraudulent intent on the part of the defendant, as required by the Second Circuit, or merely "deliberate recklessness," as required by the Ninth Circuit.[204] Finally, the Interim Report recommends that "the SEC . . . clarify use of the fraud-on-the-market theory by defining more sharply the circumstances under which a plaintiff is excused from proving reliance on the defendant's alleged material misstatement or omission."[205]

While these recommendations will certainly provide a more predictable litigation environment in the U.S., it does not seem certain that the SEC would give guidance on substantive 10b-5 interpretations, despite having itself promulgated the Rule. Although the SEC has occasionally given guidance into a similar area—when it clarified the scope of the misappropriation theory of insider trading through Rule 10b5-2—it is not clear that the SEC would step into an area which, in contrast to the misappropriation theory, is relatively rich in case law. The SEC may be less willing to step between two circuit courts in an area of law that seems disposed to Supreme Court review than it would be to set out interpretations of a new rule. Substantive changes are perhaps more likely to come from the Supreme Court, Congress, or both, than from the SEC, although the SEC could certainly play a role as *amicus curiae* and an advocate to Congress with respect to these issues.

With respect to the procedural changes that would limit or eliminate suits against a non-trading company, prohibit pay-to-play practices, and limit the amount of damages recoverable through class actions when the SEC provides victim compensation with funds obtained through a Fair Funds remedy, all of these likely would, if not as a matter of statutory construction than as a matter of political expediency, require Congressional action, rather than SEC action as suggested by the Interim Report. Because 10b-5 is an SEC rule, a limitation imposed by the SEC on

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[201] *Id.* at 80.
[202] *Id.*
[203] Compare No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 934 (9th Cir. 2003) with Oran v. Stafford, 226 F.3d 275, 282 (3d Cir. 2000).
[204] Compare Novak v. Kasaks, 216 F.3d 300, 307 (2d Cir.), cert. denied, 531 U.S. 102 (2000) with *In re* Silicon Graphics, Inc. Sec. Lit., 183 F.3d 970, 977 (9th Cir. 1999).
[205] INTERIM REPORT, *supra* note 3, at 81.

suits against the issuer would fall within the SEC's exemptive authority.[206] But such a significant change by the SEC, however worthwhile, seems unlikely. Following an undoubtedly acrimonious public review and comment period, the SEC would certainly find itself in court defending a rule that would be presented by the claimants as a betrayal of the SEC's investor protection mandate. As a general observation regarding the committees' procedural recommendations, while producing procedural rules through the SEC framework would almost certainly be easier than trying to get similar rules through Congress (as amendments to the Private Securities Litigation Reform Act, for example), the political significance of Rule 10b-5 and the class action mechanism practically compels Congressional action.

C. *Auditor Liability Caps*

Both the Interim Report and the Chamber of Commerce Report suggest protection of auditors from "catastrophic" judgments. A frequently-heard solution (from the committees and other sources) to this danger is to adopt legislation that places a cap on auditor liability to civil damages. According to the Wall Street Journal, this kind of auditor protection is being "championed" by the Paulson Committee.[207] Under such legislation, auditor liability to damages in a civil suit would be capped in much the same way as some states place a cap on physician malpractice liability. In recent statements made at the Economic Club of New York, Secretary Paulson suggested that the Bush Administration was sympathetic to proposals protecting auditors from civil and criminal liability.[208]

The argument for auditor liability caps has been advanced by the "Big Four" public accounting firms in the U.S., who argue that it is merely a matter of time before one of the firms is put out of business by way of a large damages award.[209] The auditing firms argue that they are unable to obtain sufficient insurance to cover the risk of a damages award, in part because "in a worst case scenario," damages could potentially climb as high as "the total stock market value of the companies they audit."[210]

However, critics have argued that auditor liability caps are unnecessary, pointing to the fact that the number of class action lawsuits naming auditors as defendants has steadily decreased between 2002 and

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[206] *See* John Coffee, *Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation*, 106 COLUM. L. REV 1534, 1582-83 (2006).
[207] David Reilly, *Booming Audit Firms Seek Shield From Suits*, WALL ST.J., Nov. 1, 2006, at C1.
[208] Stephen Labaton, *Treasury Chief Urges Balance in Regulation of U.S. Companies*, N.Y.TIMES, Nov. 21, 2006, at C1.
[209] Reilly, *supra* note 207.
[210] *Id.*

2005, from fourteen suits to five.[211] Furthermore, critics allude to the fact that during the wave of accounting scandals and lawsuits of the early 2000s, no auditors suffered a deathblow by way of civil damages. Arthur Anderson LLP, the only national auditing firm to fall, met its end at the hands of a criminal obstruction of justice conviction.[212]

Despite the predictable rhetoric on both sides of the issue, the potential effectiveness of auditor liability caps in reducing litigation risk lies somewhere between the lines. Auditor liability caps can likely be helpful in reducing litigation risk against auditors, and to this extent they may be a partial solution to the overall litigation climate in the U.S. However, auditor liability caps alone cannot solve the problem. While auditor caps may help lower the number of auditors listed in securities class action lawsuits, no one has yet suggested that liability caps will lower the total number of class action suits filed. Even if caps are instituted, it is arguable that auditors will continue to be listed in securities class actions for the simple fact that they may be the only deep pockets available for a plaintiff to pursue when a fraudulent issuer goes bankrupt. So while potentially a step in the right direction, auditor liability caps alone cannot solve the problem.

In sum, U.S. litigation risk has been, and likely will continue to be, an immensely significant factor in foreign listing decisions. Consideration of the above-mentioned American securities class action data sheds light on the significant possibility that litigation risk in the U.S. may frighten away foreign issuers. Although data suggests that foreign firms are not subject to litigation at higher rates than their American counterparts, this fact is of little solace to foreign issuers due to the great amount of securities litigation present in the U.S. While it remains to be seen whether the 2005 drop-off in securities class action filings leads to long-term decline in U.S. securities litigation, the fact remains that securities class action activity has risen steadily in ten out of eleven of the years since the enactment of the PSLRA. Furthermore, average settlement values have skyrocketed.

While the fact that European countries have been moving towards a U.S. style class action litigation system is interesting, in the short term it is also unlikely to have any significant impact on how foreign issuers balance litigation risks at home versus the risks of listing in the U.S. Though foreign countries have shown a willingness to adopt various parts of the U.S. class action system, at the present time no country has adopted the kinds of procedural and structural mechanisms that have led to the development of the class action culture in the U.S., including a dedicated plaintiffs' bar. As U.S. class action lawyer Michael Hausfield notes with respect to the UK, "there's no such thing as a claimant lawyer as opposed to a defendant lawyer. Most firms in the UK will take both or either, unlike

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[211] *Id.*
[212] *Id.*

the US, where it clearly has a plaintiff bar and a defence bar."[213] Thus, any convergence with the American securities class action culture will likely be gradual.

Given the fact that private securities litigation risk in the U.S. likely plays such a significant role in foreign listings decisions, plans for so called "tort reform" or the passage of more limited measures like auditor liability caps may be where a potential solution lies. However, whether the currently Democratic legislature has the political will to pass such legislation remains to be seen. For now, private securities litigation looks to continue to pose an ongoing threat to foreign IPO activity in the U.S.

## V. CONCLUSION

Despite the current atmosphere of heated rhetoric surrounding Sarbanes-Oxley, it is clear that the U.S. competitiveness problem runs much deeper than the passage of the Act. As others have noted, we see litigation risk as the problem most likely to affect a listing decision for foreign companies. The higher burdens imposed through Sarbanes-Oxley have a greater impact on the listing decision for smaller U.S. issuers, although the SEC is already working to alleviate some of the difficulties created by Section 404. As we witness the anxiety caused by the capital flight to other markets (both private and foreign) and the numerous recommendations for reform, we note two reminders that an informed, measured approach to the concerns of capital markets competitiveness may be in order. The first may be seen with the 1980s consternation regarding the Japanese Keiretsu system. The perceived superiority of the Japanese "big bank" finance capitalism system led to a call for the adoption of a similar system in the U.S.; ultimately these proposals were silenced by a booming American economy of the 1990s while Japan's economy struggled.[214]

The second is a recent pair of reports in the Financial Times. In one, the paper notes that the Financial Services Authority (FSA), the UK's primary financial services regulator, "gave the first official recognition of intensifying City concern about the impact some overseas listings are having on the standards and reputation of London."[215] The FSA is

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[213] Jon Robins, *Michael Hausfield brings class actions to the UK*, The Lawyer.com (Oct. 24, 2005), http://www.thelawyer.com/cgi-bin/item.cgi?id=117237&d=122&h=24&f=46.

[214] William J. Carney, *Will Choice of Corporate Law Become Trivial?*, BALANCING OF INTERESTS: LIBER AMICORUM PETER HAY ZUM 70. GEBURTSTAG. 78 (Hans-Eric Rasmussen-Bonne, Richard Freer, Wolfgang Lüke, Wolfgang Weitnauer, eds., 2005), available at http://ssrn.com/abstract=870496.

[215] James Mackintosh, *FSA to Act on Foreign IPO Concerns*, FINANCIAL TIMES, Apr. 5, 2007, at 1.

concerned that investors are not being adequately informed of certain companies' choice of "light-touch listing methods, which can offer investors less protection."[216] The FSA also announced that "it was calling for a formal debate about the balance between attracting new flotations and maintaining quality."[217] In a related article, the Financial Times online edition also reported that "a storm of protest from shareholders, politicians, consumer groups and investment trusts has prompted the Financial Services Authority to scrap a new light-touch regulatory regime designed to attract hedge funds to list in London."[218] While the US wonders if the pendulum has swung too far in favor of regulation designed to protect investors, the UK wonders if its light-touch regime will fail to protect investors by encouraging a market for lemons.

Recent times have seen steps towards a convergence in corporate law, class action litigation procedures, and accounting standards. World capital markets are merging, and it appears that international barriers to capital flow are destined to fall. As the world's economic landscape changes, our regulatory systems must change as well. Nevertheless, regulatory changes should only be made after slow and thoughtful consideration. If anything, the passage of Sarbanes-Oxley has shown that we cannot merely regulate our way to happiness.

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[216] James Mackintosh, *FSA Scraps Light-Touch Listing Regime*, FINANCIAL TIMES ONLINE, Apr. 4, 2007, http://www.ft.com/home/us (enter article title in search box).
[217] *Id.*
[218] James Mackintosh, FSA scraps light-touch listing regime, Financial Times, April 4, 2007, http://www.ft.com/cms/s/12f08f42-e2f7-11db-a1c9-000b5df10621.html.