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research newsletter

Capital Market Competitiveness

Introduction

This, the fifth edition of the ECGI Research Newsletter, focuses on Capital Market Competiveness.

There is a widely-held view in America, shared to some extent and with no little delight in Europe, that US capital markets might have become less competitive. If this is true, is it caused by the corporate governance reforms introduced in the USA after Enron, in particular by Sarbanes-Oxley? Is this surprising? One would expect capital markets with stronger corporate governance regulation to allow capital to be raised more easily and cheaply. Did this new US regulation however go too far and introduce counterproductive measures? Perhaps there are forces other than corporate governance regulation at work: technology; the governance of stock exchanges themselves or the trust investors place in financial institutions?

On the other hand, is there anything Europe can feel smug about when it comes to enforcement? The United States brings more enforcement cases, putting more people in prison and handing out more fines than all 27 EU states combined. Then again, does Europe really lag behind the U.S. on enforcement or does it have more efficient regulation that simply requires less enforcement? And is European enforcement itself more efficient, achieving more with less?

These and other questions are covered in six recent research working papers published by the ECGI which are précised in this newsletter. They were also addressed and debated at the recent Transatlantic Corporate Governance Dialogue Conference at the Securities and Exchange Commission in Washington DC. A short report on this conference completes this edition. For those who want more detailed coverage, transcripts and video recordings can be found at *www.ecgi.org/tcgd/2007/proceedings.php*

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The ECGI is extremely grateful to the Fédération des Experts Comptables Européens (FEE), the representative organisation for the accountancy profession in Europe, for kindly agreeing to sponsor this new initiative over the next three years in recognition of the valuable work they believe the ECGI is undertaking.

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Research digest

Six working papers on this topic have been published by the ECGI. The papers set out the authors' propositions in detail and supply the accompanying evidence. This digest pulls out some of the key strands from the papers which can be downloaded from the SSRN website via the ECGI website ***www.ecgi.org/wp***

Has New York become less competitive in global markets? Evaluating foreign listing choices over time.

Craig Doidge, Joseph L. Rotman School of Management, University of Toronto; G. Andrew Karolyi, Department of Finance, Ohio State University; René M. Stulz, Department of Finance, Ohio State University (ECGI Finance Series No 173/2007)

In 1998, the major New York exchanges, the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and NASDAQ, collectively attracted 31% of all the foreign listings in the world, the London Stock Exchange's (LSE) Main Market and Alternative Investment Market (AIM) had 16%, and no other exchange had more than 7%. In recent years, London's market share of foreign listings has increased while the market share of the US has fallen. This is regularly cited as proof that the US market became less competitive after the introduction of the SOX legislation because of the increased burden of cost and liability associated with it, particularly with s 404.

The paper finds that cross-listings have been falling on U.S. exchanges as well as on the London main exchange. This decline in cross-listings is explained by changes in firm characteristics rather than by changes in the benefits of cross-listings. The authors show that, controlling for firm characteristics, there is no cross-listing deficit on U.S. exchanges to be explained by Sarbanes-Oxley.

In earlier work, the authors showed that firms cross-listed on U.S. exchanges are worth more than comparable firms from the same country which are not cross-listed. They called the different in valuation the "cross-listing premium." To ascertain further whether the benefits and costs of listing on the US exchanges have changed over time, the authors conducted the most complete analysis of the relative valuation of US listed firms to date.

They used several distinct approaches to measure the cross-listing premium: cross-sectional regressions, Fama-MacBeth regressions, pooled regressions with firm fixed-effects, and event-time regressions. With each approach, they found that there is a listing premium for firms that list on US exchanges but that there is no listing premium for firms that list in London. The listing premium is robust: it exists every year and it is permanent in event time. They found no evidence that the listing premium falls after 2001, even for listed firms from countries with good investor protection.

The authors argue that the typical foreign firm has a controlling shareholder and comes from a country where controlling shareholders have more of an opportunity to make themselves better off at the expense of minority shareholders than is usual in the US. There is a governance benefit from cross-listing on a US exchange because listing reduces controlling shareholders' ability to extract private benefits from the corporations they control. Some controlling shareholders are willing to bear the cost of better governance because it enables them to raise capital on better terms to fund their firm's growth opportunities. It will always be the case that many firms will choose not to list in the US as long as, by not doing so, controlling shareholders have more freedom to run their corporations to benefit themselves at the expense of minority shareholders.

Another factor which should be borne in mind is the type of listing being undertaken. The authors point out that whilst it is undoubtedly true that, though the number of foreign listings in New York and on London's Main Market has fallen in recent years, the total number of foreign listings in London has increased but that is because of the increase in foreign listings on AIM. The number of listings on AIM has increased most dramatically in recent years: foreign listing counts increased from only two within one year of its launch in 1995 to 220 at the end of 2005. Although the success of AIM is impressive, it is critical to understand that the typical firm that lists on AIM is a small firm that would not have been able to list on a US exchange, either in the 1990s or in more recent years. Consequently, it is simply wrong to interpret the success of AIM and the resulting growth in market share of London as evidence of a decline in the attractiveness of US exchanges.

Is the US Capital Market losing its Competitive Edge?

Luigi Zingales, Professor of Finance, University of Chicago (ECGI Finance Series No 192/2007)

In this paper, the author analyses the competitiveness of the US capital market by studying the recent trend in their share of global IPOs i.e. IPOs of foreign companies that sell their shares outside their domestic market. These are the companies that are most sensitive to the cost and benefits of listing in different markets so are the best indicator of changes to competitiveness.

In the late 1990s the US capital market was attracting 48% of all the global IPOs. This dropped to 6% in 2005 and is estimated to be only 8% in 2006. There is no obvious single reason why this should have happened.

When it comes to an IPO, domestic equity markets are a natural magnet for companies. It is not surprising that Chinese companies choose to list in Hong Kong, or that Indian companies choose to list in Mumbai. That cannot be seen as an indicator of a lack of competitiveness in the US market. Looking at the total number of IPOs is equally misleading. IPOs come in waves associated with the fluctuating investment opportunities across sectors. In the early 1980s there was a flood of IPOs in oil and natural resources, in the late 1980s of biotech companies, and in the late 1990s of internet companies. That the US capital market is not experiencing a phase like that is not necessarily a bad sign and definitely not a sign of its loss of competitiveness.

The NYSE has always marketed itself as the most liquid market in the world and liquidity has always been indicated as one of the main reasons why foreign companies want to be listed in the US. There are no studies directly related to liquidity but Professor Zingales quotes a study which loos at the location of trade volume between the US and domestic markets for cross listed stocks over the period 1980 – 2001. In the early 80s there was a higher volume of trading in the US. By the end of the 90s that position had reversed, though not for developing markets interestingly enough.

This evidence is consistent with the hypothesis that in the last decade or so the U.S. equity market has become relatively less attractive vis-à-vis equity markets in developed countries.

This is not to say that the US market has become less competitive, but only that the markets in other developed countries have caught up. Electronic and globalised trading have helped to erode the unique advantage of trading in New York.

Several recent studies provide evidence that a US cross-listing increases the number of financial analysts following its stock and that this is associated with more accurate earnings forecasts and better valuations. For various reasons there has been a reduction in analyst coverage and it is possible that this reduction might have eroded the advantages of a US listing.

Then there is the bonding argument whereby companies coming from a market with less high standards of governance and disclosure than the US benefitted from the fact that they now complied with the higher standards set by the US with a lower cost of capital. A study in 2006 by Hail and Leuz showed that cross listing in a US exchange reduces the cost of capital by 70 to 110 basis points.

Unfortunately, it is less clear how these benefits have changed in the last several years. The introduction of tighter disclosure requirements under SOX has increased the bonding provided by a US listing but more bonding is not necessarily better. For a company from a developing country, for instance, which has to pay bribes to compete in the marketplace, a more complete disclosure can be too costly from a competitive point of view. But while the possibility that SOX created excessive bonding cannot be ruled out, that alone cannot explain all the data. The drop in US market share is very similar if IPOs from countries where some opacity might be useful in doing business are excluded.

Another factor which could contribute to a lack of competitiveness is concerned with listing costs. The NYSE has significantly higher listing costs than its competitors. A recent study conducted by the consulting firm Oxera for the LSE found that a typical £100M ($187M) company will pay £45,390 ($84,880) to list on the LSE (equal to 0.05% of its value) and £81,900 ($153,150) to list on the NYSE (equal to 0.08%). Annual fees are also more expensive: £19,110 ($35,735) in New York versus £4,029 ($7,534) in London. However, in the grander scheme of things these costs are trivial and it is difficult to imagine that they would play any significant role in the decision to list in London rather than New York, particularly if the reduction in the cost of capital is as great as suggested by Hail and Leuz.

When a foreign company sells securities to US retail investors it exposes itself to the possibility of class action suits, in particular to security class actions. This is probably the cost of a US listing that is most difficult to quantify. In a few (but highly visible) cases like Enron directors had to contribute to the settlement out of their own pockets (above and beyond what was covered by the director liability insurance). This generates an interesting agency problem. Even if cross listing in the United States increases shareholders' value, is it in the interest of a company's directors, who reap only a very tiny fraction of the shareholders gain, but face significant personal costs?

These conclusions are confirmed by a small survey done by Ernst & Young on the CEOs and CFOs of 20 of the 42 US companies that chose to list their stock on London's AIM. The most cited main driver of their choice (30% of the cases) was access to institutional investors. Only 20% cite SOX. In fact, 40% of these companies are either SOX compliant now or are working to become so in the near future. Another 15% cite cost and 5% cite better analysts following. No one single reason dominates but many factors together conspire in making the US capital market less attractive.

Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?

Valentina G Bruno, American University; Stijn Claessens, IMF and University of Amsterdam (ECGI Finance Series No 142/2007)

A lot of evidence has been produced over the past few years about the importance of corporate governance. Typically this empirical literature has investigated corporate governance from either a country or a company point of view. But it can be important to take country and company corporate governance aspects into account together. Take two similar companies implementing exactly the same governance practices but located in two different countries. In one country the corporate governance practice may be required by law, whereas in the other country corporations adopt the same practice voluntarily. These same corporate governance practices may consequently be valued differently by investors. Also, shareholders may consider some aspects of the legal regime in one country as substitutes for the same corporate governance practices used in another country. Or shareholders may prefer to invest in companies whose country of incorporation guarantees better protection in the eventuality of legal disputes, irrespective of the company's corporate governance practices.

In short, corporate governance practices and their effects on firm valuation are not independent of the legal regime and vice-versa. Both the strength of country protection as well as companies' corporate governance practices need to be considered when studying the impact of corporate governance.

To date these interactions between company and country corporate governance had not been studied much, but new data which has recently become available allows for such research. Specifically, the authors used the Institutional Shareholder Services (ISS) dataset which looks at 5300 US companies and 2400 non-US companies from 22 advanced economies for 2003 – 2005. ISS provides individual corporate governance practices for each company. It covers, inter alia, information on the composition and independence of boards and committees, the level of shareholders' involvement in the company's decisions, and relations with the auditors.

Using this data the authors found that across the 23 countries two corporate governance practices are positively and significantly associated with performance: the degree of board independence, and the existence and independence of board committees. Also, as a general rule, the absence of entrenched boards and higher investor protection at a country level are positively associated with performance. They also found evidence that strong corporate governance practices pay off less for small companies, possibly because those practices involve costs in terms of monitoring, time and resources which offset the benefits. But for companies that depend heavily on external financing, stricter corporate governance practices have a positive impact on the valuation.

Importantly, they found interaction effects between the strength of legal protection and the companies' corporate governance practices. Specifically, for companies with poor corporate governance practices, there is very little or no impact of better investor protection. And for companies with good corporate governance practices, there is a discount associated with stronger investor protection. This suggests that on one hand country legal protection cannot substitute for weak company corporate governance practices. And on the other hand, for corporations with strong corporate governance practices, excessive country regulation can harm valuation, consistent with a hypothesis that excessive regulation can reduce managerial initiatives and make the corporation less agile, leading in turn to lower returns on investment and depressed valuations.

These findings suggest that the optimal form of corporate governance is not necessarily a strong form of corporate governance. The authors point out that the data used for their analysis was only available for developed countries. In many emerging markets and developing countries where there are questions about issues such as public enforcement and the quality of the judicial system, enhancing country level governance is likely to have positive effects on value. There are also likely to be important interactions between company corporate governance practices and overall public governance, including the presence of corruption, that need to be considered when evaluating the effects of stronger corporate governance regimes.

Why do Firms go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations.

Christian Leuz, University of Chicago - Graduate School of Business; Alexander Triantis, University of Maryland - Robert H. Smith School of Business; Tracy Wang, University of Minnesota - Twin Cities - Carlson School of Management (ECGI Finance Series No 155/2007)

In 2003 and 2004, there was a sudden surge in deregistrations with approximately 300 US companies de-registering their stock for reasons other than a merger, acquisition, liquidation, registration withdrawal, or going-private transaction. The authors studied about 480 firms which de-registered from 1998 to 2004. Given the time period they were also able to study the effects of SOX and found that deregistrations in 2003 and 2004 were certainly much higher than in previous years. However, the increase is entirely attributable to firms' going dark, rather than to going private transactions.

A company with a class of securities registered under the Securities Exchange Act of 1934 may choose to terminate the registration of any such class of securities if the securities have fewer than 300 holders of record, or fewer than 500 holders of record if the company's total assets have not exceeded $10 million at the end of the company's three most recent fiscal years, and if the company satisfies some additional criteria. If a company deregisters all of its securities, its duty to file any reports under Section 13(a) of the 1934 Act is effectively suspended, and the company is no longer subject to SOX and the SEC rules promulgated thereunder. Going dark thus not only drastically diminishes the amount of financial information provided to outside shareholders, it also alters the protection available to these investors.

Typically the high cost of complying with SEC reporting requirements including SOX is given as the key motivation for going dark. But there is a downside. There is a large negative reaction from the market to firms going dark, roughly 10% on average. The authors posit two possible reasons for this. Firstly the fact that investors may assume that, in addition to the costs of reporting, deregistering may signal that the firm's future prospects have deteriorated and hence the market reaction also reflects these negative news.

A second theory is that outside or minority shareholders may view the decision to go dark as a mechanism to hide poor performance or to make it easier for managers and large owners to extract private benefits of control.

The authors' results suggest that for many firms going dark is a response to financial difficulties and deteriorating growth opportunities. Prior to deregistration, going dark firms are more distressed and exhibit increases in their short-term liabilities, decreases in trading volume and deteriorating operating performance, compared to firms that could deregister but continue to report. Moreover, firms with lower asset growth and more financial distress at deregistration tend to underperform in the months after going dark.

These findings are consistent with the cost savings explanation and the notion that the decision to go dark signals bad news about a firm's future prospects.

However, there is also evidence that agency problems and insiders' private benefits play into the decision to go dark and that, at least for some firms, cost savings are not the only reason. Firms with more extreme accruals and larger free cash flow are more likely to go dark. Moreover, these firms are even more likely to go dark when external monitoring and corporate governance are weak, and they experience more negative stock market reactions upon announcing the decision to go dark. Finally, and perhaps most importantly, the market reaction to going dark is significantly less negative when outside investors are better protected.

Companies that go private are often confused with companies that go dark because companies that go private also deregister their securities and are no longer required to file with the SEC. However, there are important distinctions. Going dark firms continue to trade in OTC markets. In contrast, going private transactions typically involve restructuring that concentrates ownership in the hands of management and private equity investors, and often significantly increases the level of debt. These transactions usually require the infusion of new capital and involve legal complexities. As a result, these transactions are worthwhile only if the company has significant potential that can be more fully realised under a highly incentivised management, and if the size of the firm can produce efficiency gains and tax benefits that outweigh the costs associated with the transaction. Consistent with the earlier literature on going-private transactions, the authors found that going-private firms have significantly higher free cash flow than do going-dark firms. Going dark companies in turn tend to have poorer accounting quality. Managers may decide to take the company dark in order to hide poor performance, rather than participating in a going private transaction to work towards improving performance, which may endanger their position in the company.

The authors' research also indicated that, while the higher cost associated with SOX may well push some firms to go dark as they claim, it appears that, for many firms, it was the implied stronger governance and scrutiny imposed by SOX which motivated the decision to go dark, suggesting that the provisions of SOX do "work".

US Securities in a World of Global Exchanges

Reena Aggarwal, Stallkamp Faculty Fellow & Professor of Finance, Georgetown University – Robert Emmett McDonough School of Business; Allen Ferrell, Harvard Law School and Jonathan Katz, former Secretary, US Securities and Exchange Commission (ECGI Finance Series No 146/2007)

Since 1993, when the Stockholm Stock Exchange became the first to demutualise, a wave of exchanges has converted to 'for profit' entities. Traditionally, exchanges have been Self-Regulating Organisations (SROs) that have regulatory responsibility for their members. This dual role as an SRO and a profit seeking body has caused concern that for-profit publicly traded exchanges will be lenient in regulating themselves and use their regulatory powers to gain unfair competitive advantage.

At the same time that exchanges have themselves become public companies, there have also been major changes in the disclosure and governance requirements of public companies, which may be influencing a company's decision on where and whether to go public. The new requirements have impacted the capital raising process globally and the choice of listing venue. These developments have in turn intensified competition among exchanges, and may lead to a wave of cross-border consolidations by exchanges and other trading platforms. The likely emergence of "global" exchanges as a product of these cross-border mergers raises the pressing question of how these global exchanges are going to be regulated.

Another factor affecting competitiveness are the advances in computing and telecommunications which have reduced the fixed costs associated with establishing a securities market and led to the rise of 'virtual' exchanges such as Electronic Communication Networks (ECN) or Alternative Trading Systems (ATS). In order to avoid the costs associated with registering as an exchange, ECNs registered as broker-dealers and formed strategic alliances with exchanges, combining the regulatory status of the exchange with the trading platforms of ECNs.

Companies also now have the ability to issue securities globally, so competition is no longer confined to a country's boundaries and this has diminished the traditional liquidity advantages of the US markets.

The new competitive environment has led to innovation and reduced costs. However, there are concerns that this has placed undue strains on the regulatory structure. These issues have included the concern that trading might move to markets with lower regulatory requirements, the existence of inconsistent rules across markets, and that exchanges may reduce the rigor of their regulatory oversight in order to gain market share.

One of the issues arising from de-mutualisation is that a for-profit organisation needs to maximise revenue and minimise costs and this model sits at odds with unprofitable regulatory responsibilities. In order to address this conflict, exchanges need to separate out market operations and regulatory functions. Governance and structural changes are a pre-requisite for becoming de-mutualised, focussing on the board and the committee structure to ensure that exchanges have the requisite number of independent directors and the appropriate committees

Exchanges are also required to limit ownership and voting by broker dealers. Historically exchanges were member-owned organisations but demutualisation has raised the concern that a member's self-interest could compromise the self-regulatory function if a member controls a significant stake in its regulator. An exchange might not diligently monitor a member's trading if the member is a controlling shareholder. Many exchanges around the world have ownership limits, often capping ownership by a single entity at 5%.

Cross-country mergers between exchanges are following close on the heels of the organisational transformation of exchanges. These cross-border mergers have several potential benefits: cost savings; increased liquidity; reducing the transaction costs of purchasing foreign securities; and diversification of the exchange's business into new product areas. However, globalisation of stock exchanges beyond the authority of a single national regulator creates a difficult regulatory problem. Should a regulator that has accepted the principle that a stock exchange may be a for-profit entity, restrict potentially advantageous acquisitions in another country merely because it lacks the authority to directly regulate the acquired component? Or must the regulator look to alternative creative approaches to fulfilling its regulatory duties?

The paper includes a study of what was, at the time of writing, the proposed merger of the NYSE and Euronext, which the authors felt was clearly structured to avoid provoking a premature and restrictive regulatory response to globalised markets.

Trusting the Stock Market

Luigi Guiso, Economics Department, European University Institute; Paola Sapienza, Department of Finance, Northwestern University; Luigi Zingales, University of Chicago (ECGI Finance Series No 170/2007)

Politicians and business commentators argued after recent corporate scandals that the reason investors were deserting the stock market was because of a lack if trust. This paper looks at the role of trust in explaining stock market participation and portfolio choices.

The decision to invest in stocks is made on the basis of an analysis of the risk-return trade-off given the available data. It also depends on the investor having trust that the data is correct. The authors define trust as being the subjective probability that individuals attribute to the possibility of being cheated. This subjective probability is partly dependent on objective external factors, such as the quality of investor protection, but it is also dependent on the subjective characteristics of the person trusting. Differences in educational background, history and religious upbringing have all been shown to create considerable differences in levels of trust across individuals, regions and countries.

The authors included some specific questions on trust and attitudes to risk in the 2003 annual Dutch National Bank (DNB) household survey which also includes detailed information on household's financial assets, income and demographics. The DNB survey went to a sample of 1943 Dutch households. They found that trusting individuals are significantly more likely to buy stocks and risky assets and, conditional on investing in stock, they invest a larger share of their wealth in it. This effect is economically very important: trusting others increases the probability of buying stock by 50% of the average sample probability and raises the amount invested in stock by 3.4 percentage points (15.5% of the sample mean).

The DNB survey provided a measure of generalised trust. Stock market participation can also be discouraged by specific mistrust of the institutions, brokerage house etc. To assess the role of this specific trust the authors used a customer survey conducted by a large Italian bank, where people were asked about their confidence towards the bank as a broker. Once again, trust had a major impact on both the decision to invest and the portion of assets that were invested.

That lack of trust - either generalised or personalised – reduces the demand for equity implies that companies will find it more difficult to float their stock in countries characterised by low levels of trust. Using cross-country differences in stock participation and ownership concentration, the authors found that trust has a positive and significant effect on the stock market participation and a negative effect on the dispersion of ownership. These effects are present even when controlled for law enforcement, legal protection, and legal origin. Cultural differences in trust appear to be a new additional explanation for cross-country differences in stock market development.

This trust based model provides a new way to interpret the growing evidence that familiarity breeds stock market investments. Empirically there is evidence to show that investors tend to invest in companies they are familiar with. Traditionally this has been interpreted as evidence of a model of investors with limited information put forward by Merton in 1987. The authors suggest an alternative interpretation; that there is a strong correlation between trust and local knowledge. Mistrust will therefore be less of an obstacle when investing in local stocks.

The effect of trust does not fade away with wealth. For those with above median financial assets, the effect of trust is of the same order of magnitude and actually somewhat larger than in the overall sample. This may explain why the rich may choose to keep themselves out of the stock market, even if they can afford to pay the fixed participation cost.

These working papers and others in the ECGI's Finance and Law Series can be downloaded free of charge from the SSRN's Financial and Legal Research Institutes Papers Series via the ECGI website at www.ecgi.org/wp

Transatlantic Corporate Governance Dialogue

Corporate Governance Standards and Capital Market Competitiveness

On 9th October 2007, the European Corporate Governance Institute (ECGI) and the American Law Institute (ALI) held the fourth in a series of meetings which seek to bring together European and American experiences and perspectives on corporate governance. This particular meeting, on the theme of "Corporate Governance Standards and Capital Market Competitiveness" was held in the offices of the Securities and Exchange Commission (SEC) in Washington DC.

There has been much talk about the competitiveness of the American capital markets and in particular whether or not America is now a less popular jurisdiction given the costly and onerous requirements of the Sarbanes-Oxley Act of 2002 on US listed companies. The meeting heard from distinguished speakers from both sides of the Atlantic, with very different views which made for a lively and thought provoking debate.

The move towards globalisation

Following a welcome and introduction from ECGI Chairman, **Antonio Borges** and **Lance Liebman**, Director of the American Law Institute, **Christopher Cox**, Chairman of the SEC gave the keynote speech which opened proceedings. He painted a broader canvas than European/American co-operation and considered co-operation between markets globally, which he argued was *"equally as important to building bridges and understanding among people and nations as all the diplomacy that foreign ministries and departments of state routinely conduct". He then went on to point out, "At the same time as our markets become increasingly interconnected, the regulatory friction from different national regulatory regimes becomes more significant. That friction is often produced by different conceptions, different assumptions, about corporate governance, that are challenging regulators and marketplace actors alike to think about what we can do, individually and together, to help realise the benefits of the global marketplace".*

"As regulators, we have to be aggressive in our role as market referees and protectors of investors' interests, and at the same time we have to be humble in recognising that regulation is not the fuel that drives our markets, thought it undoubtedly is the oil that greases the gears. Too little regulation, and investors demand a premium for their money to compensate them for the greater risk that they face in a lawless market. Too much regulation, and the costs outweigh the benefits, robbing investors of return, and making markets less efficient. When that happens, not just investors, but consumers and entire national economies pay the price. So it is always important that regulators strike a balance between under-regulation, which carries the risk of fraud, abuse, and loss of investor confidence, and over-regulation, which saps the economic vitality of otherwise vibrant markets."

Chairman Cox is clear that different markets can legitimately have different concerns depending on their particular structures. Even markets which look to be similar on the surface, such as the US and the UK, actually have very different characteristics (such as the widely held nature of shareholdings in the US compared to the high concentration of ownership, particularly among institutional shareholders, in the UK) which then have an impact on the form of regulation found in the different jurisdictions.

So, although regulatory objectives may be converging, that doesn't mean that all regulation should necessarily be the same. Regulation must reflect the particular characteristics of the individual market. *"Unless we keep in mind the reasons that legitimate differences can exist, and it's easy for us to forget that in our increasingly globalised world, then the job of mutual co-operation will be made needlessly more difficult. Just because capital now flows across borders more easily, and businesses routinely operate on a world-wide basis, doesn't mean that a one-size-fits-all approach to securities regulation is wise. We've got to respect our differences as we build on common ground."*

SEC Chairman Christopher Cox

And the ultimate bedrock of that common ground is to allow investors to have the choice of where to invest their money. But it's not enough to say 'let the market decide', it is the role of the regulator to make sure that investors are making their decisions on the basis of clear, comparable and factual information about the companies they are choosing whether or not to invest in.

"That's why ensuring that both retail and institutional investors are properly informed is so central to the transatlantic regulatory dialogue. Just as disclosure and transparency is a key element of good corporate governance everywhere, the cost of obtaining and processing information about the corporation presents a barrier to shareholders that makes for a systemic problem in corporate governance," said Chairman Cox.

One step in the right direction, he felt, is International Financial Reporting Standards (IFRS). These are designed to provide, a single, world-wide set of standards which would permit investors around the world to benefit from a high level of comparability and quality in financial reporting; eliminating the need to try to understand financial information that's prepared using different accounting standards in many different jurisdictions. However, Chairman Cox was also very keen to emphasise that in order to provide reliable information, it is important that IFRS are applied faithfully and consistently across national borders, if they are to provide the benefits they are designed to. The temptation to provide nationally tailored versions must be resisted.

Chairman Cox ended by saying, *"Where possible, we should work together to eliminate unnecessary and redundant regulation, to recognise how different regulatory approaches may achieve our shared objectives, and to learn from each other about what works and what doesn't when it comes to corporate governance. And we should learn together to trust the choices that investors make as we help to ensure that these choices are fully informed."*

Empirical Finance

Professor René Stulz, Everett D Reese Chair of Banking and Monetary Economics; Director of the Dice Centre for Research in Financial Economics, Ohio State University, took as his starting point the fact that cross listings on the New York Stock Exchange (NYSE) are taking place less frequently than they used to. He pointed out that a common argument is that the US regulatory environment has become less favourable, but that there are a lot of other potential reasons why the number of cross listings are down. Having learned from the example of the US markets, foreign markets have now improved their own position and are a more favourable option than they once were. Perhaps there are issues with the exchanges themselves? For example, the NYSE was slow to move to electronic trading which might have had an impact. Or the fall in cross listings might be explained simply by looking at business cycles?

Professor Stulz presented three hypotheses. First, what he called the 'anti-Sox' hypothesis which posits that there is too much regulation in the US market which makes a cross listing less attractive. This hypothesis would be particularly relevant for full listings as opposed to private placements under Rule 144(a) or Level One listings on the over-the-counter (OTC) market which do not attract the same level of disclosures and compliance. The second could be called the 'loss of trust' hypothesis. This assumes that the failures of Enron and WorldCom in 2001 and 2002 had an impact on the credibility of US institutions. The third hypothesis is simply that the characteristics of firms that are not cross-listed in the U.S. changed following the drop in stock values early this century and that this change in characteristics made a cross-listing less attractive.

The three hypotheses could explain a reduction in the number of listings and there certainly was a decrease in the number of full listings after 2002. However, Professor Stulz argues that the level of listings in all markets has declined since the early 2000s and that this fall is mostly driven by changes in the characteristics of firms that are not cross-listed. Further, firms for which a cross-listing was most advantageous were cross-listed by the early 2000s, so that it would have been unreasonable to expect the number of cross-listings in the U.S. to keep increasing as it did in the 1990s since the number of firms eligible for cross-listings is finite.


Professor René Stulz

He made a comparison between the US markets and the London market which is anecdotally considered to have experienced increased listing activity over the same period which has been attributed to the fact that London is a more attractive environment. However, the growth in activity has actually been driven by the Alternative Investment Market (AIM) and companies listing on AIM have significantly reduced obligations and would be unlikely to be eligible to list on the NYSE or NASDAQ in any event. When looking at full listings, there is no evidence of an advantage for London. .

Ultimately Professor Stulz produced two reasons why the US capital markets are not less competitive.

If the US markets really were less competitive, the characteristics of the firms that listed before 2002 might be expected to be different than those that listed afterwards, but what the evidence shows is that that is not the case, implying that there is no difference in the conditions of the market to make it less attractive now than it was prior to 2002.

Looking at the governance premium for the US between 1990 and 2005, although it slumped in 2001/2002 (supporting the loss of trust hypothesis), it did go back up after that. And looking at the difference between the average governance premium for companies with a full listing as opposed to a Level 1 listing, the premium was 85% higher for those with a full listing implying that companies do see an advantage in complying with the extra level of regulations required. One conclusion is that, far from the regulatory regime being less attractive, those firms that do cross list in the US benefit precisely because of the strict regulations and a strong SEC.

Professor Luigi Zingales, Robert C McCormack Professor of Entrepreneurship and Finance, University of Chicago Graduate School of Business; ECGI Fellow, took a different approach to the topic, arguing that there were two distinct issues and it was important to distinguish between them. Firstly, whether or not the US capital markets are becoming less competitive and then, if that is the case, whether it is increased regulation which has contributed to that decline.

He pointed to several indications that the US has become a less attractive place to raise capital. The numbers of domestic IPOs in the US are very low, much lower than would be expected given the business cycle, even IPOs backed by venture capitalists. On the other hand, the number of public companies which are going private is at an historical peak. In addition the US share of the global IPO market is shrinking and many important foreign companies are delisting from the NYSE.

Part of the reason for this decline could be a legacy from the technology boom. America was seen as the best place to list technology shares and during the 1990s a large number of high technology companies flocked to the US to list. When the boom was over, the bubble of US dominance burst. However, when the numbers of high tech, non-US IPO listings being marketed in the US are considered against the number of non-US IPOs being marketed internationally and the same sets of statistics are considered for non-high tech companies, it turns out that there is very little real difference between the two, so this does not really provide a satisfactory solution.

Perhaps the companies who are not listing on the US markets are ones which the US wouldn't want anyway, companies from emerging markets where corporate governance rules are not as well developed? "After all, regulation is designed to keep the bad people out, so if the boom is made out of dubious Russian and Chinese companies with bad corporate governance, the fact that they are listing in London and not in New York should be a compliment to the SEC and to the US regulations," said Professor Zingales. But this too does not seem to provide the answer because the share of global IPOs from developed countries with well established corporate governance is also in decline.


Professor Luigi Zingales

A third reason is liquidity. Liquidity in other markets has much improved and companies are finding that, whereas they needed to be listed in the US because a large percentage of trading took place there, that is no longer the issue and accordingly the low trading volume does not justify the high costs of listing in the US market anymore. Professor Zingales collected the reasons given for de-listings not associated with mergers and found that of the 44 companies concerned, 52% quoted the low trading volume as the main reason, with another 18% looking to reduce costs and 16% looking to reduce complexity.

Another possible reason, which has not so far been studied in great detail, is the issue of visibility. There is some evidence from the 1990s that when a stock cross listed, it attracted the interest of an increased number of analysts and it has been suggested that this of itself led to better earnings forecasts and consequently to higher prices. There is also evidence that for various reasons the number of analysts following a stock in the US has dropped dramatically. Although there is no research as such as to whether these two factors coming together have had any impact, it is certainly something which would be worth investigation.

Turning to regulation, and the Sarbanes-Oxley Act (SOX) in particular, Professor Zingales quoted a study by Litvak in 2006 which looked at the reactions by foreign companies cross listed in the US and similar companies which were not cross listed and drew the conclusion that although the difference in return was negative and significant it was not huge. As might be expected, the cross listed companies which experienced the most negative returns were from developed countries which already had established standards of governance and which therefore did not particularly benefit from stricter controls in the US.

Another reason which is regularly cited for the US market not being quite so competitive is an increased exposure to liability. The exposure has always been there but the perception of it is greater now, partly because the level of awards is bigger than it used to be (the total value of settlements has increased from $150 million in 1997 to $9.7 billion in 2005) and also because in some recent instances, directors have actually had to make payments out of their own personal funds which does have a tendency to concentrate the mind.

Finally, the political climate in the US does appear to have had an impact on the business sector. Particularly since 9/11, the US has been hostile to foreigners, especially Arabs; it is not easy to get an American Visa; there is a fear that funds held in the US may be liable to expropriation; and finally there is the fact that there can be a hidden cost of disclosure under SEC rules in the form of time consuming investigations from other government departments.

In conclusion, Professor Zingales feels that the US capital markets are suffering, but not because of draconian regulation, rather because of genuine competition from other markets which are becoming better at what they do. But he also believes that regulation is one thing which can and should be carefully monitored to ensure that it doesn't further hamper American competitiveness unnecessarily.

A changing landscape

Professor Eddy Wymeersch, Chairman of the Committee of European Securities Regulators (CESR) gave the second keynote speech looking at what stage the debate on governance has reached in Europe, and specifically at boards and shareholders.

There have been fundamental changes in both the nature of and activities of shareholders. Recent years have seen the rise of the activist shareholder who wants much more of a say in corporate control. In addition to the traditional professional investors, there is also a new set of investors now - hedge funds, specialised governance funds, sovereign wealth funds as well as an increase in the number of non-European shareholders from markets such as India, China and Russia. The role of the State has also changed, intervening increasingly actively in all kinds of control transactions and interfering more to

Professor Eddy Wymeersch

protect 'national champions' from foreign takeovers. There is always concern where the State is a major shareholder that its actions will be motivated not as an ordinary shareholder, from a primarily financial perspective, but that politics will also have an influence on the way it behaves.

The question of disclosure is of course key to good governance. BRITE (or Business Register Interoperability Throughout Europe) is a pan-European company register which will contain all companies' official documents throughout Europe. The Integrated Project to set it up officially started in March 2006 and it is expected that it will take three years to complete.

Professor Wymeersch also felt that there should be greater disclosure of share ownership. Companies should have the right to know exactly who owns all their shares, not just major shareholders with more than 5%. "Should we not be working and devising techniques to make sure that the companies are informed of the identity of the shareholders so that not only do they know who they are, but also so that they can get in contact with them."

Another step currently under development towards better disclosure focuses on the provisions of the Transparency Directive relating to the centralised storage and filing of regulated information currently held nationally in Officially Appointed Mechanisms or OAMs. As of yet, no decision has been made as to exactly how all this data should be centralised, whether there should be one single database, or some kind of linkage system between the individual OAMs or different websites at each of the issuers. The Commission is currently deliberating over the best way forward.

Professor Wymeersch then spent a little time on the one share, one vote issue which has been a topic much under discussion in Europe. A recent study by the ECGI and ISS concluded that there was no conclusive evidence of a causal link between deviations from the proportionality principle and either the economic performance of listed companies or their governance. However, it did find some evidence that investors perceive these mechanisms negatively and consider more transparency would be helpful in making investment decisions. Professor Wymeersch pointed out that, when asked in abstract about control enhancing mechanisms, institutional investors did tend to reply in the negative, but when it came to whether or not they would ever invest in a company which operated some such mechanism, the response was different. They would look at that on a case by case basis and if it looked to be a good investment, that fact would be more important than proportionality. He suggested that the issue which needs to be looked at instead of proportionality is that of private benefits, calling for the introduction of laws or rules against private benefits such as those already in force in some Member States such as the German Konzernrecht and comparable rules in France, Italy, the Netherlands and Belgium.

Professor Wymeersch ended by calling for a comparative study of the role of the shareholder vis à vis the board in the EU and in the US. Better understanding is needed to establish not only what the differences are but also the relevance of those differences and whether or not there is room for convergence. Increasingly governance issues are coming into the public policy forum and it would be a shame if the US and Europe went in different directions because of a lack of understanding. 'And then, the final question would be, perhaps, let us think a little bit if the regulators, the securities regulators, have any role to play in corporate governance. Up to now they haven't done so, but perhaps in the future it might be one of the enforcement mechanisms if nothing else helps,' he concluded.

Substitute Compliance

Professor Howell E Jackson, James S Reid Jr Professor of Law at Harvard Law School looked at the issues around foreign issuers who want to come into the US to raise capital. Currently they find themselves bound by US law, having to comply with it to a certain degree, in order to maintain access to US public markets. One way around this is substitute compliance, whereby one jurisdiction will accept that the regulatory regime in another jurisdiction, whilst not being identical, is sufficiently robust to provide the same safeguards as the original jurisdiction requires. For example, recently Portugal decided that compliance with SEC rules will be sufficient to list on the Portuguese Stock Exchange.

Professor Jackson referred to a new model set out by two senior SEC officials in a recent article (Tafara and Petersen - *A Blueprint for Cross-Border Access to US Investors: A New International Framework*, Harvard International Law Journal 48 HARV. INT'L L.J. 31)

Under this model the system of regulation could be modified to allow both broker dealers and foreign exchanges forms of entrance into the US without compliance with current US regulatory requirements provided that the other government's regulatory structure is acceptable to the SEC. This would require two levels of determination. At the first level, the SEC would have to be confident that oversight arrangements of the other government were robust, that there was reciprocity so that US entities could operate in a similar way in the other country and that an appropriate system of treaties and Memoranda of Understanding were in place. The second layer of determination would be undertaken at the firm level: each individual firm or exchange


Professor Howell E Jackson

that wanted to participate would have to be separately assessed. The US securities couldn't be brought back into the United States, so US issuers couldn't list overseas and then come back in by the back door as it were. There would be residual, anti-fraud jurisdiction by the SEC.

One of the interesting things about this proposal is that part of the analysis consists of whether the foreign jurisdiction has adequate oversight, which includes reviewing not just the formal rules, but also requirements for supervision and enforcement of or compliance with those rules. Basically, not only asking whether or not the domestic rules are acceptable in themselves, but also whether the non-US regulators are sufficiently intense at applying those rules in practice and enforcing the law for the US to accept substitute compliance.

But is it possible to measure how stringently law is enforced? One crude way, Professor Jackson suggests, is to look at the size of the budgets and the numbers of staff that the regulatory agencies in the various jurisdictions have. If they do not have sufficient resources available to them, can they be carrying out an effective enforcement programme? Work which Professor Jackson has recently undertaken indicates that there is a positive relationship between how large the budget is, taking into account the size of the country, and how large its capital markets are.

Another way of judging how intense the regulators are could be by measuring their outputs, looking at the number of enforcement actions a jurisdiction brings and the level of sanctions imposed. On most measures, the US has more enforcement actions per trillion dollars of market capitalisation than most other jurisdictions by a large margin and also leads the way on penalties.

Finally Professor Jackson suggested that one could look at various objective measures of market outcomes, for example the number of IPOs that are going to different jurisdictions, which markets institutional investors are investing in, econometric measures of the sort that Professors Stulz and Zingales were talking about, data on earnings manipulations etc. There are technical measures for many items which might inform the SEC about which countries to accept for substitute compliance.

But he went on to warn of complexities in making international comparisons. There are variations in national goals which can be reflected in financial regulation, for example, the US takes money laundering and anti-terrorism efforts more seriously than some jurisdictions so part of their regulatory budgets and enforcement actions are about goals that other countries may or may not share. It can be difficult to accurately calculate regulatory inputs if, for example, regulation is the remit of a central bank or, on the other hand, if it is diffuse in nature, involving more than one regulatory body.

Looking at regulatory outputs can also be difficult – if there are a large number of enforcement actions, does this mean that the regulator is cracking down hard on the few problem firms, or are there a disproportionate number of unlawful actions. There are also differences in regulatory philosophies. The US prides itself on the successful pursuit of enforcement actions whereas the UK approach is to try to resolve enforcement actions before they get to court, making direct comparison difficult.

Professor Jackson's own conclusion is that there's no single metric which captures everything about regulatory intensity in other jurisdictions but at a collection of these things does begin to give a reasonably good picture of what's important.

He would like to see more data collected about the actual pictures of enforcement intensity in a host of jurisdictions and then to look at US laws and regulations in addition to the exchange and broker deals which are currently on the table. "There are a wide variety of other regulatory structures where we could look at the question of substitute compliance and think about whether we should begin to accept foreign jurisdictions either fully or, for certain kinds of investors in the US, on a limited basis, or maybe with conditions, for example some US rules would apply, but not others, if there were places where we didn't think the substitute compliance was wholly adequate."

Professor John C Coffee Jr, Adolf A Berle Professor of Law, at Columbia Law School asked whether market competitiveness should be defined as "the ability of a capital market to attract foreign listings and foreign offers" or "the ability of a capital market to offer its users the lowest cost of capital - particularly equity capital - or a valuation premium". Both definitions are valid but each one has a different set of beneficiaries. The first mainly benefits market professionals - investment banks, exchanges, and other intermediaries - and ultimately that will create economic value and greater production. The main beneficiaries of the second definition are not only shareholders, but other citizens generally, because the lower cost to capital has macroeconomic impact and it implies a greater gross domestic product and lower unemployment, so there is a broader social wealth. Both approaches can create social wealth; the question Professor Coffee went on to pose was whether pursuing the goal of maximising foreign listings can erode the cost of equity capital?

Professor Coffee quoted research which showed that there had been a consistent pattern of a valuation premium from cross-listing in New York, but no valuation premium, and sometimes even a discount, from cross-listing in London. One possible reason is that, although the onerous requirements of the Sarbanes Oxley Act might be expensive to comply

Professor John C Coffee Jr

with, those requirements and the fact that the SEC has a reputation for stringent enforcement might give investors greater trust and confidence in the accuracy and reliability of financial results, and because they trust the results there is a correspondingly lower cost to capital.

The puzzle, if this is the case, is why don't more firms choose to cross list on the US market? One possible reason for this might lie in the structure of ownership. A foreign firm with a controlling shareholder may choose not to list because the cost of losing the private benefits of control means more to them than getting the advantage of a lower cost of capital.

Another possibility is that, although the US has traditionally been seen as having exemplary disclosure standards which have added to its listing premium, as there is increasing convergence towards common disclosure standards and international financial reporting standards, this listing premium may, arguably, have eroded in recent times.

But the key is enforcement intensity, and that is something that is not likely to change in the near future in the US. He looked at similar measurements of enforcement intensity as Professor Jackson had, looking at regulatory inputs and outputs and also the regulatory style, or the proportion of the regulatory budget which went on enforcement activities, comparing the UK and the US as well as the Australian and Canadian models. The SECs expenditure on enforcement as a percentage of its total budget averaged out over the three years from 2003 to 2006 was 39.5%. The Australia Securities and Investment Commission's expenditure over the same period was even higher at 46%, compared with a UK figure of 12.6%. Some of this might be explained by the fact that the US and Australian systems have more similarities than the UK system, but the Canadian model is very similar to the US system, and the research showed that over the 2002 – 2004 period, the SEC alone imposed 384 times the financial sanctions imposed by the Canadian Authorities and if you added in the sanctions imposed by all US governmental agencies, that figure jumped to 718.

Professor Coffee also looked at the numbers of private actions and criminal actions undertaken and presented statistics that show that on every level, enforcement actions in the US are much higher than those elsewhere and in the UK in particular. Between 1978 and 2004, 755 individuals and 40 firms were indicted in the US and 1,230 years of prison time were imposed, an average sentence of 4.2 years. In contrast, criminal enforcement is used very rarely in the UK. He also looked specifically at the actions and penalties imposed in cases of insider dealing. He was not suggesting that jurisdictions which might be termed "enforcement averse" did not regulate and monitor their markets merely that they did so with persuasion and guidance and he is not convinced that such an approach works for some kinds of misbehaviour, such as insider trading.

He finished by arguing that the definition of capital market competitiveness needs a little bit more focus because there are some conflicts of interest here. The interests of investors and market professionals may diverge, with market professionals preferring a regulation-light approach that attracts more listings, and investors preferring a stronger policy that minimises the cost to capital, gives them greater protection, and also benefits the overall economy by reducing the cost to capital. So where does all this leave substitute compliance? Basically, the SEC cannot assume that all jurisdictions operate under the same level of enforcement intensity and therefore should move very cautiously when looking at substitute compliance.

Eilís Ferran is Professor of Company and Securities Law at the University of Cambridge Law Faculty and Centre for Corporate and Commercial Law. She agreed with Professors Howell and Jackson that regulatory enforcement levels vary around the world but thought that instead of allowing that diversity to hold up practical progress and international corporate and securities regulation, energies should be concentrated on living with diversity and managing it. In order to do that it is necessary to have a detailed understanding of how compliance, supervision and oversight is organised and how it actually works in individual countries. Although the physical numbers of enforcement actions might be lower across Europe than they are in the US, she didn't accept that this was an indication of low enforcement. There are more measures of compliance than enforcement alone. To illustrate her points she needed to concentrate on one Member State as each Member State applies the rules within the context of their own system making pan-European analysis impossible, so she concentrated on the UK market.

Professor Ferran explained the role of the Financial

Professor Eilís Ferran

Reporting Review Panel (FRRP) which has oversight responsibilities in respect of the annual and periodic accounts of listed issuers, including some foreign companies, and it also has some formal enforcement powers. However, the FRRP has never brought a case to court and the number of reviews is very much fewer than the US model but similar to other European models, for example Germany and Denmark.

What these figures do not reveal is anything about the style of the different regulatory bodies. The FRRP regards itself as adopting a risk-based approach in selecting companies for review, and its style is consensual. Consistent with the principles-based, outcomes-focused approach, it seeks to improve standards of corporate governance by working with business rather than through the deterrent effect of catching wrongdoers. There have been some independent reviews of how the FRRP operates which indicate that, although the various sanctions it has at its disposal have never been used, they do have credibility and are felt to be effective. Professor Ferran also noted that both Germany and Ireland, in setting up their own review structures, modelled them on the UK's working model.

It is possible, of course, that confidence in the robustness of enforcement in the UK is misplaced, and it could all come to seem dangerously complacent should a major fraud come to light. But the alternative possibility cannot be discounted entirely. Maybe there is, in fact, enough enforcement in the system to act as a sufficient deterrent when seen in combination with auditing standards, active institutional investors, stronger shareholder powers, and a principles-based, outcomes-focused approach to public oversight and enforcement.

It's not for the regulators to monitor the quality of explanations. Such monitoring should be left to shareholders and to the market generally, since they can provide a more flexible and more graduated response to a range of disclosure shortcomings than any regulator can.

The European Corporate Governance Forum recently cautioned against public regulatory authorities playing a large role, because it is primarily for shareholders to make their own evaluation. That European wariness with regard to giving regulators strong powers in the area of corporate governance is based on concern that it could lead to rigidity, destroying the flexibility that is meant to be inherent in the comply-or-explain approach.

Understanding is a key and necessary preliminary step in providing a foundation for substitute compliance to become a reality. There is a need for empirical measurements to provide a framework within which the practical collaboration that's already taking place in a variety of fields - in auditing and accounting for example - can be placed, and can assist in the development of those efforts.

Professor Ferran finished by pointing out that Europe has made very significant progress in streamlining cross-border supervision and making it more effective whilst at the same time living with diverse institutional models and supervisory styles that persist at national level. It is possible to look at the European experience, and to extract from it some positive predictions as to the development of substitute compliance from an idea to a practical reality.

Making Corporate Governance Work Across the Atlantic

In the final session of the day **former US Senator Paul Sarbanes** started by remembering the context in which he and Senator Michael Oxley co-sponsored the Sarbanes-Oxley Act. SOX has come in for a lot of criticism but when it was introduced, it was in the context of real hardship. Trillions of dollars were lost on the market value of public companies, thousands of jobs were lost, retirement savings dried up, people who thought they'd provided adequately for their retirement were suddenly in dire circumstances. Enron, in the first quarter of 2001, reported a 20%


Former US Senator Paul Sarbanes

increase in earnings; the second quarter, reported another 20% in increase in earnings over the first quarter. By October, it restated its earnings. In November, it restated its earnings again. In the first week in December, it declared bankruptcy, the largest bankruptcy in US history up to that point, exceeded and eclipsed by Worldcom only six months later. *"This isn't just a few bad apples we're talking about here. This is a systemic breakdown. Money magazine said that there had been a total failure by everyone, a complete breakdown in the system, in all of the checks and balances. And I think there was obviously a real crisis in investor confidence with respect to the US markets," he said, and it was against that background that the legislation was drafted.*

He explained that consideration was given to whether severe punishment of those offenders who had been caught would be sufficient to deter others from acting in the same way but that it was felt that the only way to proceed was to try to impose a system in which such activities were stopped before they began. Of course there can never be a guarantee of success, and if someone is determined to defraud or cheat then they will, but by making it as difficult as possible for them to succeed it was hoped to deter as many as possible from trying.

Since SOX was introduced in 2002, investor confidence has recovered, there is greater corporate accountability, financial reporting is more reliable and transparent, auditor oversight is significantly improved. The introduction of the Public Company Accounts Oversight Board (PCAOB) was probably the single most important change made by this legislation, because the auditors had been self-regulating up to that point. There was peer review but no oversight from any outside body so the creation of the PCAOB led to the strengthening of auditor independence and of audit committee requirements.

However, there have been criticisms of SOX and in particular of s 404 which says that, if you are a public company, a) you have to have a series of internal financial controls and b) that those controls must be independently attested. It has been the level of costs associated with these activities which has been criticised but Senator Sarbanes argued that the problem is not in the legislation, it is in the implementation. The PCAOB has recently issued auditing guidelines which are intended to focus on material risk and get away from dotting every 'i', crossing every 't' and checking all the boxes. It is hoped that addressing the way the law is enforced will satisfy the critics and prevent the dilution of the investor protection inherent in s404 by changing the law to take more and more companies beyond its scope.

Another criticism is that the Act has had an effect on the competitiveness of the US capital markets by discouraging companies from wanting to list in the US. But Senator Sarbanes agreed with previous speakers who had pointed out that the world was changing, other markets were maturing and growing, providing the liquidity to support IPOs, something which had started long before SOX. If anything, SOX had helped to restore confidence in the US markets and without it things might be in a worse position. He pointed out that in an attempt to retain competitiveness, lowering of standards was not an option, particularly not with the increase in the number of retail, unsophisticated investors. He also commented on the fact that most of the growth in the UK listings had been on the AIM market which had a much lighter regulatory touch and that these companies would not necessarily be welcomed in the US markets.

Pierre Delsaux, Director, Free Movement of Capital, Company Law and Corporate Governance, DG, Internal Market and Services of the European Commission agreed with Commissioner Cox that there is a broader context than US and European markets alone. *"Markets are volatile and there is also growing competition between the different countries in the world, not only the US and Europe but also China, Japan, India, and others which are emerging. It is important to take into account the global dimension,"* he said.

He also stressed the benefits of diversity and the need to accept and embrace differences rather than seeing them as a weakness. Naturally there must be some common rules designed to protect investors, but there is no 'one-size fits all' solution. And just because one country does things in a different way, as long as they have the same ultimate objective, it does not mean that what they are doing is wrong, it's just a different way of getting to the same goal.

M. Delsaux then talked about enforcement levels. He asked, although he did say this was undoubtedly overly simplistic, what is more important - the number of sanctions, or the fact that the market are functioning efficiently, protecting investors and protecting issuers? He commented about one

Pierre Delsaux

monitoring body which found that, until they move to a risks based approach, the sheer volume of reports they received was sufficient to make their monitoring task practically impossible.

His fourth point was the importance of maintaining open lines of communication between the US and Europe if there is ever to be a level of convergence. "It's important, because, by the mere fact that we talk on a regular basis, that we meet every six months to discuss certain common issues, we create understanding, we build confidence in each other," he said.

Three things seemed to him to be key in moving forward towards convergence. First, to understand that all jurisdictions can learn things from each other if they are prepared to be open and receptive. Secondly that if convergence is to be reached it is important to define exactly what is meant by convergence and what steps are need to reach that. Finally he said that though convergence was still a long way off, if the US and Europe could develop a workable model it would be a great step forward and the next step would be to share it with, but not impose it on, others in the global markets.

Jaap Winter, partner with De Brauw Blackstone Westbroek and former Chairman of the EU High Level Group of Company Law Experts, summed up the two different approaches to governance which had been evident in the day's presentations. The US approach favours strict enforcement and compliance with clear guidelines. The European approach favours a less rigid, 'comply or explain' regime, giving shareholders sufficient (some may even think excessive) rights to call boards to account with the regulators rarely if ever using the enforcement powers that they do have. He described the two approaches as the US focussing on accountability


Jaap Winter

for compliance and Europe focussing on accountability for behaviour.

He then went on to argue that corporate governance goes beyond legal regulations and the financial and economic elements. It is also about the behaviour of the people involved and different cultures have different norms. This makes it even less desirable to try to impose one set of rules across borders which is why he thinks convergence will never happen, apart from in certain discreet technical areas such as accounting standards.

He moved on to consider mutual recognition equivalence and argued that this is broader than merely looking at the enforcement of the rules. For true convergence he felt there was a need to have a much broader and deeper understanding of where the different governance systems were really equivalent; to understand the underlying behaviours behind the actual rules and how they are enforced. He was concerned that the substitute compliance was discussed earlier in the day was in fact merely unilateral mutual recognition, whereby one jurisdiction had a set of rules and required another jurisdiction to explain how they conformed to those rules rather than accepting that the other jurisdiction may have a different way to reach the same end, a way which may in fact be just as effective as the first jurisdiction's rules.

One possible approach is to let the market sort it out for itself. Not to worry about the different governance regimes but instead to require full disclosure of how a company's governance structure differs from the market on which it is seeking to raise capital and let the investors decide whether they are prepared to accept that level of governance. Caveat Emptor (Let the buyer beware). One problem with that approach is that no-one is really certain how much investors really value good governance.

A better approach would be to have a combination of mutual recognition equivalence, recognising certain minimum levels of governance, together with extensive disclosure. Without understanding the hidden factors in a governance system, it is difficult to say whether it is a good or a bad system so it would be wrong to try to impose any particular system on another. In any event, as Dr Winter pointed out "US investors and EU investors alike, invest directly in outside markets, so it is simply not true for the EU, nor for the US, to say that you can only protect the investors in your jurisdiction by imposing your laws on whatever happens outside your jurisdiction. We should trust others to give appropriate investor protection in other jurisdictions." He also feels this approach would be a good way of opening doors to emerging markets.

The final speaker of the day was **Harvey Goldschmid**, Dwight Professor of Law at Columbia Law School and former SEC Commissioner. He started by setting out the two basic rules concerning the regulation of the financial markets and corporate governance. First there must be a regulatory framework that maintains and enhances investor faith and fairness and integrity of markets. There can be different approaches to this, but fairness, integrity, and investor faith are core. And then those frameworks must be kept effective and efficient.

The US financial markets are critical to the effective functioning of America - its allocation of capital, its new industry, its entrepreneurial spirit. These markets are vital in the most important way. But he is concerned when he hears arguments about the competitiveness of the markets being used to try to water down the regulations and methods of enforcement that do exist. He decries the groups that complain about the heavy regulatory burden in the US. "The problem with what we've had here in the US is that there's too much hyperbole coming from US representatives, from the business community, about how difficult things are." He referred back to the 15% premium which attaches to a US listing. "Though I'll ask this as a question, I don't have much question about what I'm asking, could it be that our aggressive, effective regulatory and enforcement system for securities actually creates a good part of this premium for cross listing, and, more importantly, from the US standpoint,


Professor Harvey Goldschmid

provides the confidence that has made our securities markets the gem of our economy?"

Professor Goldschmid became SEC Commissioner the day after SOX was signed into law in 2002 and he well remembers the turmoil that the US markets were in at that time.

"If SOX achieved nothing else, it helped to turn around the lack of confidence and trust in the US markets at that time," he said. But it has also done far more than that. Critical substantive changes have been made in US laws in terms of disclosure and in terms of governance. True 404's did attract cost, but that was more a product of the implementation rather than of the law itself. High enforcement figures have been mentioned but Professor Goldschmid pointed out that "In terms of enforcement in this wild litigation climate, the figures for 2006 are lower in terms of SEC litigation since 2002, and are lower in terms of private enforcement than any time in the last ten years."

*"Sarbanes-Oxley actually has had a small, if any, impact on the competitiveness of US capital markets. Where there was disagreement, it was about whether the US capital market has become more or less attractive," said ECGI Executive Director, **Professor Marco Becht** in summing up this most successful conference. "What we heard from Eddy Wymeersch and from Christopher Cox was another sign that as the leaders of these very important institutions, they were completely aware of the need for transatlantic coordination on certain aspects of their jobs" concluded **Lance Liebman,** Director of the American Law Institute.*

Earlier editions of the Newsletter

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VOLUME 1/SPRING 2006

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VOLUME 2/SUMMER 2006

Effective Boards
VOLUME 3/WINTER 2006

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