INTERNATIONAL IMPLICATIONS OF SARBANES-OXLEY: RAISING THE RENT ON US LAW

LARRY E RIBSTEIN*

The spectacular crashes and frauds of Enron and other US companies triggered a legislative response in the US in the form of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). This Act is likely to have unintended effects not only in the US, but also in international securities markets in which the US is a dominant player. Sarbanes-Oxley reflects a potential shift in the philosophy underlying the US securities laws from disclosure to substantive regulation of corporate governance. This shift could deter foreign firms from listing in the US, or otherwise becoming subject to US law. This is significant because some foreign firms in effect "rent" US law in order to overcome deficiencies in their home country law. By raising this rent, Sarbanes-Oxley may reduce the demand for US law, blocking non-US firms from moving toward more efficient governance, and impeding the internationalisation of securities markets and laws. Alternatively, the SEC and perhaps Congress may forestall such flight by subjecting foreign-based firms to a lower level of regulation. This may encourage the development of country-based choice of governance rules, and therefore a kind of jurisdictional choice regime. The adoption of separate regulatory regimes for foreign and US issuers may, in turn, cause US regulators to reduce regulation of US as well as of foreign firms. Thus, international effects ultimately may constrain US regulation, most likely by curtailing the move from disclosure to substantive regulation of governance.

The spectacular crashes and frauds of Enron, WorldCom, and other US companies triggered a re-evaluation of legal rules intended to curtail fraud. The frauds occurred because of monitoring failures at several levels, including directors, prominent accounting and law firms, institutional shareholders, debt rating agencies, and securities analysts, and apparently escaped detection by supposedly efficient securities markets. In response to arguments that government regulators needed to restore confidence in the securities markets,[1] Congress passed the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"),[2] "the most far-reaching

* Corman Professor, University of Illinois College of Law. Thanks for helpful research assistance by Wulf Kaal on German law and comments by Christian Kirchner, Paul Arlman, Michael A Perino, and an anonymous reviewer.

[1] See, eg WW Bratton, "Enron and the Dark Side of Shareholder Value" (2002) 77 *Tulane Law Review*, 1275.

[2] See Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, Pub L No 107-204 (codified as amended in scattered sections of 15, 18 USC). Title VII of the Act is the Corporate and Criminal Fraud Accountability Act of 2002. § 801, 116 Stat, 800. Title IX is White Collar Crime Penalty Enhancements Act of 2002 Section 901, 116 Stat, 804. Title XI is the Corporate Fraud and Accountability Act of 2002. § 1101, 116 Stat, 807–10.

reforms of American business practices since the time of Franklin Delano Roosevelt."[3]

As I have previously discussed, the Act is unlikely to have its intended effect in US securities markets because the changes it makes are only incremental, impose significant costs on US firms and markets, and because liquid and active securities markets are capable of responding adequately to fraud without regulation.[4] The present article reinforces these conclusions by analysing the perverse effects of Sarbanes-Oxley in international securities markets in which the US is a dominant player.

In general, Sarbanes-Oxley "punctuates" the evolution of securities laws, as often occurs in the wake of stock market crashes.[5] From an international perspective, Sarbanes-Oxley stands at the crossroads of three major developments, with three related effects on international corporate governance. First, Sarbanes-Oxley reflects a potential shift in the philosophy underlying the US securities laws from disclosure to substantive regulation of corporate governance. This shift significantly affects foreign firms' costs of complying with US law.

Secondly, the move from disclosure to substantive regulation could deter foreign firms from listing in the US, or otherwise becoming subject to US law. This is significant because foreign firms' use of US law potentially is a factor in causing functional or de facto international convergence toward dispersed ownership.[6] The US, in effect, "rents" its securities laws to firms based in countries with less developed securities laws and markets. The rent is in the form of the costs these firms pay to comply with US law. By raising the rent, Sarbanes-Oxley may reduce the demand for US law, thereby blocking non-US firms from moving toward dispersed ownership and, in turn, impeding the internationalisation of securities markets and laws.

Thirdly, foreign firms' potential flight from US markets itself could affect US securities regulation. On the one hand, the SEC and perhaps Congress might react, and to some extent has reacted,[7] to forestall such flight by exempting foreign-based firms or subjecting them to a lower level of regulation. This may encourage the development of country-based choice of governance rules, and therefore a kind of jurisdictional choice regime. Moreover, the adoption of

[3] President Bush described the Act as Press Release, President George W Bush, Signing Statement of George W Bush (30 July 2002), available at www.whitehouse.gov/news/releases/2002/07/200207030.html (last visited 14 Oct. 2002).

[4] See LE Ribstein, "Market vs Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002"(2002) 28 *Journal of Corporation Law*, 1.

[5] See JA Grundfest, "Punctuated Equilibria in the Evolution of United States Securities Regulation"(2002) 8 *Stanford Journal of Law, Business and Finance*, 1; LE Ribstein, "Bubble Laws" (2003) 40 *Houston Law Journal*, 77.

[6] See JC Coffee, Jr, "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications" (1999) 93 *Northwestern University Law Review*, 641.

[7] The SEC has proposed limited exemptions for foreign firms from the audit committee and attorney disclosure provisions in Sarbanes-Oxley. *See infra* text at n 61.

separate regulatory regimes for foreign and US issuers may cause US regulators to reduce regulation of US as well as of foreign firms. In particular, US regulators may have to scale back substantive regulation of governance under the securities laws, thereby turning full circle back to the regulation that triggered the international reaction.

This article proceeds as follows. Part I discusses the shift represented in Sarbanes-Oxley from disclosure to substantive regulation. Part II discusses the potential effect of this shift on foreign firms that are subject to US regulation because they list in the US. Compliance with Sarbanes-Oxley may be particularly costly for foreign firms that have non-US-style governance—especially those with co-determined boards in which labour participates in governance. Disclosure-oriented regulation does not present as serious a problem for such firms because it is more easily adapted to alternative governance styles. Part III discusses the potential effect of this shift in giving non-US-based firms an incentive not to list in the US, and thereby impeding functional convergence. Part IV discusses the implications of an alternative scenario of the SEC's exempting foreign-based firms from the law or qualifying the law's application to such firms. This, in turn, could have implications both for the applicable choice of law rule and for the content of US regulation even as applied to US firms.

I. The Shift from Disclosure to Substantive Regulation

Federal securities regulation in the US for 70 years has been explicitly based on the fundamental principle that the law regulates what issuers must say about their companies and not the types of firms or securities that may be sold. According to William O. Douglas, Securities and Exchange Commission chairman and participant in the drafting of the securities laws, and later Supreme Court Justice, "[a]ll the Act pretends to do is to require the 'truth about securities' at the time of issue, and to impose a penalty for failure to tell the truth". Once it is told, the matter is left to the investor.[8] Thus, the federal securities laws have been interpreted as not supporting direct regulation of corporate governance.[9]

The focus on disclosure is consistent with the strongest justifications for the federal securities laws. Federal fraud law reduces firms' costs of signaling the quality of their information.[10] Mandatory disclosure regulation arguably reduces the costs

[8] WO Douglas & GE Bates, "The Federal Securities Act of 1933" (1933) 43 *Yale Law Journal* 171, 171.

[9] See *Bus Roundtable v SEC*, 905 F 2d 406 (DC Cir 1990) (holding the SEC exceeded its statutory authority in promulgating a rule banning national security exchanges and associations from listing stock of corporations that restrict per share voting rights of common shareholders); *Santa Fe Indus. v Green*, 430 US 462 (1977) (holding that Congress, by enacting section 10(b) of the Securities Exchange Act of 1934, did not seek to regulate transactions that constitute no more than internal corporate mismanagement).

[10] See FH Easterbrook & DR Fischel, *The Economic Structure Of Corporate Law* (Cambridge, Mass, Harvard University Press, 1991) 287–88.

of producing and disseminating firm-related information. The federal securities laws address the over-production of information that might result if each investor gathered his own information, as well as the under-production of information that may result because market participants cannot fully capture the benefits of producing information about firms by trading on it or selling it before it is swiftly impounded in market price.[11] Though firms have incentives to disclose information without being required to do so in order to increase its value,[12] they may lack adequate incentives to disclose comparative-type information that would help investors choose among firms and industries.[13] Also, even if firms have incentives to disclose, their agents may not.[14]

There are, of course, arguments against mandatory disclosure. Exchanges and states can internalise the costs and benefits of information because the more investors trust exchange-listed or state registered stocks the more they will trade those stocks, and the higher prices the exchanges and states can charge for listing and registration.[15] Indeed, there is evidence that the securities laws did not increase disclosure.[16]

The important point for present purposes, however, is that, whatever the case for federal regulation of disclosure, the arguments for federal regulation of substantive corporate governance are even weaker, particularly once mandatory disclosure rules are in place. Once the market is informed about firms' internal governance, it can efficiently price different governance structures, and capital can flow to the most efficient structures. Not only would there be little benefit in substantively regulating corporate governance under federal law, but there would be a significant cost because different governance forms suit different firms. The disclosure focus enables federal regulation to transcend differences among state corporation laws.

The disclosure/governance distinction, however, has always been unstable. Reformers long have distrusted state regulation of governance of large corporations, and particularly the international dominance of the tiny state of Delaware. Almost 30 years ago William Cary published his manifesto for federal regulation

[11] See *id* at 283–86.

[12] See *id* at 288–90. Indeed, this is the basis of the bonding theory of cross-listing discussed in *infra* subpart III(C).

[13] See *id* at 290–92.

[14] See JC Coffee, Jr, "Market Failure And The Economic Case For A Mandatory Disclosure System"(1984) 70 *Virginia Law Review*, 717.

[15] See Easterbrook & Fischel, *supra*, n 10, 290–96.

[16] See CJ Simon, "The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues" (1989) 79 *American Economic Review*, 295; GA Jarrell, "The Economic Effects of Federal Regulation of the Market for New Security Issues" (1981) 24 *Journal of Law and Economics*, 613; GJ Benston, "The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements", in HG Manne (ed), *Economic Policy And The Regulation Of Corporate Securities* (Washington, American Enterprise Institute for Public Policy Research, 1969), 23; GJ Stigler, "Public Regulation of the Securities Markets" (1964) 37 *Journal of Business*, 117.

based on the supposed failings of Delaware law,[17] and the scholarly arguments against Delaware have continued in various forms through the present.[18]

The federal securities laws have, indeed, been expanded to embrace substantive regulation of corporate governance.[19] In 1968 Congress responded to threats to the tenure of incumbent managers by adding the Williams Act, which regulates both disclosures connected with takeover bids and the terms of tender offers.[20] In 1978, Congress added the Foreign Corrupt Practices Act,[21] which added significant bookkeeping duties as a way of tracking corporate bribes. A firm's affirmative duty to disclose detailed information is not easily separated from a substantive duty to *have* that information. As under state law, these duties are imposed on executives. Even before Sarbanes-Oxley, chief executives and chief financial officers had to sign the annual 10-K and the latter had to sign the quarterly 10-Q, and could be held liable if they knew the statements were false.[22] Moreover, the SEC and the courts have expanded Section 10(b) and Rule 10b-5 to cover insider trading, which is a kind of substantive regulation of insider conduct.[23]

Calls for expanding federal securities regulation beyond its disclosure focus intensified after the recent collapse of the securities markets and disclosures of massive accounting frauds at major US corporations. Like the 1929 crash, the 2002 crash was laid at the door of poor corporate governance and inadequate state oversight. The difference this time was that federal law's disclosure-only approach seemed to have failed. Sarbanes-Oxley accordingly included several provisions that can be seen as a significant move toward federal regulation of governance:

1. Section 102 provides that only firms registered with the new Public Company Accounting Oversight Board may provide the audit that is required for firms publicly trading in the US. This brings into play the substantial new oversight of auditors under the Act,[24] regulation of auditing

[17] See W Cary, "Federalism and Corporate Law: Reflections upon Delaware" (1974) 83 *Yale Law Journal*, 663.
[18] See, eg LA Bebchuk "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law" (1992) 105 *Harvard Law Review*, 1435.
[19] See generally, Coffee, *supra*, n 6, 683–92 (discussing several "substantive" requirements in the federal securities laws, including tender offer regulation and the Foreign Corrupt Practices Act); RB Thompson & H Sale, "Securities Fraud as Corporate Governance: Reflections Upon Federalism" (2003) 56 *Vanderbilt Law Review*, 859.
[20] See Securities and Exchange Act of 1934, ss 13(d) and 14(d)–(e).
[21] See Securities and Exchange Act, s 13(b)(2).
[22] See *Howard v Everex Corp*, 228 F3d 1057, 1061–64 (9th Cir 2000).
[23] See LE Ribstein, "Federalism and Insider Trading" (1998) 6 *Supreme Court Economic Review*, 123.
[24] See 15 USCA. S 7213 (providing for auditing, quality control, and independence standards and rules, including seven-year retention of work papers, peer review of audits, disclosure of auditors' testing of issuers' internal controls, monitoring of ethics and independence, consultation within auditing firms, supervision, hiring, acceptance of engagements, and internal inspection); *id.* S 7214 (providing for inspections of auditing firms annually for firms doing more than 100 audits per year and every three years for other firms, including inspection of selected engagements and the firm's quality control system.); *id.* S 7215 (providing for investigations, including requiring testimony and

standards,[25] and restrictions of auditing practices that might create conflicts of interest.[26]

2. Section 301 of the Sarbanes-Oxley Act directs securities exchanges and securities associations to prohibit the listing of any security of an issuer that does not have an audit committee responsible for hiring and oversight of auditors and that is wholly independent.[27]
3. Section 302 requires reporting firms' principal executive and financial officers to certify in 1934 Act annual or quarterly report detailed facts concerning the report's accuracy, that the officers are responsible for establishing and maintaining internal controls and have designed such to ensure that material information is reported to them, and that the officers have disclosed to the issuer's auditors and the audit committee significant deficiencies in the design or operation of internal controls and fraud by employees who have a significant role in the issuer's internal controls.[28] This section imposes significant new federal monitoring duties on corporate executives comparable to those imposed under state law.[29]
4. Section 304 requires an issuer's chief executive officer and senior financial officer to reimburse any incentive or equity-based compensation or profits from stock sales during a year following the issuance of a financial document that had to be restated due to "the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws."[30] This is, in effect, strict liability that can be imposed even if the compensation amount was unrelated to the misconduct, executives were not involved in the misconduct, and the executives were unaware of the misconduct at the time of receiving the compensation and exercised reasonable care in monitoring and instituting controls.
5. Section 307[31] and recent rules promulgated under this provision,[32] impose significant new duties on lawyers, including a duty to report "evidence of a

documents, suspension and revocation of registrations of firms or their associated persons who do not cooperate, and sanctions for firm and individual violations and for failures to supervise).

[25] *Ibid.* S 7218 (requiring as a condition of SEC recognition of accounting standards as "generally accepted" that these standards be promulgated by an organisation funded as set forth in section 109 and a majority of whose members have not been associated with an accounting firm for two years).

[26] See 1934 Act, Ss 10Ai(i), (j), (k) and (l) (requiring preapproval by the issuer's audit committee of both audit and permitted nonaudit services, client rotation of audit and reviewing partners, detailed reports by audit firms to issuers' audit committees and prohibiting audit services to an issuer whose chief executive officer or senior accounting officers were employed by the auditing firm and participated in an audit of the issuer during the preceding year).

[27] *Ibid.* S 78j–1(m).

[28] 15 USCA s 7241.

[29] For an example of a state law monitoring rule, see *In re Caremark International Inc. Derivative Litigation*, 698 A 2d 959 (Del Ch 1996) (discussing directors' duty to supervise and institute internal control systems).

[30] *Ibid.* S 7243.

[31] *Ibid.* S 7245.

[32] See 17 CFR ss 205.1–205.7.

material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" to the chief legal counsel or chief executive officer, and to independent directors if the legal counsel or officer do not appropriately respond. This provision effectively restructures the relationship between corporate counsel and their clients. Moreover, the SEC's rules allow an issuer to establish a "qualified legal compliance committee" as a procedure for reporting evidence of a material violation. Although issuers are not required to have such committees, the practical problems involved in lawyers' internal reporting responsibilities effectively will compel many firms to establish this new governance structure.

6. Section 402[33] prohibits issuer loans to executive officers or directors. This provision reaches into the details of the firm's compensation practices.
7. Section 404 requires annual report disclosures stating management's responsibilities for establishing and maintaining an adequate internal control structure and procedures for financial reporting and an assessment of the effectiveness of the structure.[34] This obviously gives managers and their firms a strong incentive to have such a control structure and procedures.
8. Section 406 provides for SEC rules regarding disclosure of the issuer's code of ethics for senior financial officers or an explanation of why the issuer does not have one and immediate disclosure of changes or waivers.[35] Again, this gives firms an incentive to have such a code of ethics in order to avoid a potentially embarrassing explanation of why they do not.
9. Section 407 requires disclosure concerning whether the audit committee has a "financial expert" as defined in the Act and SEC rules, and if not, why not.[36] This constrains firms' ability to determine the membership of their boards by defining the qualifications of the holder of at least one board position.
10. Section 806 prohibits a reporting company or its employees or agents from taking adverse employment actions against employees who lawfully provide information or assist in a federal or in-house investigation or securities law case regarding conduct the employee reasonably believes constitutes a securities law violation.[37] This provision potentially adds a new category of substantive employment law constraining firms' termination of employees.

[33] 15 USC Section 78m(k).
[34] *Ibid.* s 7262.
[35] *Ibid.* s 7264.
[36] *Ibid.* s 7265. *See infra* n 60 and at text.
[37] 18 USC s 1514A.

II. Effect on Non-US-based Firms

Nearly a sixth of the listings on the New York Stock Exchange are foreign-based issuers.[38] As detailed below, these firms are subject to regulation under the US securities laws. Indeed, as discussed in Part III, the application of these laws may explain why at least some of the companies list here.

That the internal structure of non-US firms may differ significantly from that of US-based firms was not a significant problem for application of the US securities laws as long as these laws required only that the structure be disclosed, not that it conform to US standards. To be sure, securities exchanges have imposed governance requirements such as audit committees, but the exchanges have exempted foreign-based issuers from these rules.[39] Also, the pre-Sarbanes-Oxley substantive duties discussed in Part I were at least not inconsistent with the internal structure imposed by foreign law. Notably, foreign issuers that become subject to US law are exempt from provisions that might have caused the most problem for them, including proxy regulation under Section 14 of the 1934 Act and insider reporting and regulation under Section 16.[40] The SEC has tried to limit the burdens imposed by disclosure regulation by moving toward application of international standards.[41]

Sarbanes-Oxley creates new problems for foreign-based firms listed in the US because it imposes new substantive requirements that may conflict with foreign firms' home-country law and contains no exemption for such firms. Most importantly, Section 301 requires exchanges to bar listing securities of an issuer that does not have a wholly independent audit committee that is responsible for hiring and oversight of auditors.[42] This requirement presents a general problem for the vast majority of firms based in countries other than the US that are controlled by one or a few large shareholders.[43] The audit committee must be staffed by wholly

[38] For recent data, see JC Coffee, Jr, "Racing Towards The Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance" (2002), 102 *Columbia Law Review*, 1757.

[39] See Special Study Group of the Committee on Federal Regulation of Securities, American Bar Association, Section of Business Law, "Special Study on Market Structure, Listing Standards and Corporate Governance" (2002) 57 *Business Lawyer* 1487, 1514–15.

[40] See 17 CFR s 240.3a12–3(b).

[41] See *International Disclosure Standards*, Securities Act Release No 7745 (28 Sept 1999); *Concept Release: International Accounting Standards*, Securities Act Release No 7801 (16 Feb 2000).

[42] 15 USC s 78j–1(l). *See* Coffee, *supra*, n 38 at 1825–26 (noting that the audit committee requirements of the Sarbanes-Oxley Act are "particularly threatening to many European firms").

[43] See M Faccio, and LHP Lang, "The Ultimate Ownership of Western European Corporations" (2002), 65 *Journal of Financial Economics*, 365 (showing data indicating that in 13 Western European countries an average of 37% of corporations do not have a shareholder controlling at least 20% of the vote, with only the UK and Ireland above 40%); R La Porta, F Lopez-de-Silanes, and A Shleifer, "Corporate Ownership around the World" (1999) 54 *Journal of Finance*, 471 (showing data indicating that 80% of large publicly traded US do not have a shareholder controlling at least 20% of the vote).

independent members, excluding any "affiliated person" of the issuer[44] subject to limited exceptions by SEC rule.[45] Pursuant to SEC rules, an "affiliated person" is one who "controls, or is controlled by, or is under common control with, such issuer."[46] "Control" "means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[47] There is a safe harbour for beneficial owners of 10% or less of any class of equity securities of the issuer who are not also executive officers or directors,[48] and in a foreign issuer one member may represent majority shareholders as an observer.[49] But the Act otherwise excludes significant shareholders who otherwise might insist on more of a voice in this powerful committee.

Moreover, even apart from the exclusion of major shareholders, the audit committee may involve unnecessary expense for firms with controlling shareholders. In such firms the main governance problem is controlling shareholders' oppression of minority shareholders rather than managerial agency costs. An independent audit committee is most valuable in helping shareholders judge management by ensuring the quality of the firm's auditing. Marginal differences in the quality of auditing are unlikely to be effective against shareholder opportunism. Accordingly, the additional decision-making costs entailed by audit committees are unlikely to be outweighed by benefits in non-US firms.

Special problems arise in meshing Sarbanes-Oxley audit committee rules with German laws requiring two-level boards—that is, a "managing board" composed of corporate insiders, and a "supervisory" board, which has the duty to monitor management,[50] composed half of labour and lower-level managers and half of shareholder representatives.[51] These problems fall into at least three categories.[52]

First, German law establishes a procedure for ensuring auditor independence that conflicts with, or at least makes unnecessary, the audit committee provisions in Sarbanes-Oxley. In German companies with two-level boards, the auditor is

[44] 15 USC s 78j–1(m)(3).
[45] See *infra* text at n 61.
[46] See 17 CFR s 240.10A-3(e)(1)(i).
[47] *Ibid.* S 240.10A-3(e)(3).
[48] *Ibid.* S 240.10A-3(e)(1)(i).
[49] *Ibid.* S 240.10A-3(b)(1)(iv)(D).
[50] See s 111 I AktG.
[51] See generally KJ Hopt, "Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron", ECGI-Law Working Paper No 5/2002, available at http://papers.ssrn.com/paper.taf?abstract_id=356102 (November 2002). See also TJ Andre, Jr, "Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany" (1998) 73 *Tulane Law Review* 69 (discussing the analogous problems of applying an earlier CalPers proposal on director independence to German firms).
[52] Problems of this sort led to criticism of the audit committee rule in the German press. See Hopt, *supra* n 43, n 62 (referring to a "heated discussion" on incompatibility of independence requirements with German co-determination). This provoked objections by 24 major German corporations, which wrote the SEC requesting an exemption. See Petition for Rulemaking submitted by the Organization for International Investment, File No. 4-462 (19 Aug. 2002).

appointed at the shareholders' annual general meeting (AGM) upon nomination and determination of the auditor's independence by the supervisory board.[53] Establishing an audit committee that complies with Sarbanes-Oxley appears illegally to usurp the appointment powers already assigned to the shareholders.

Secondly, the German board structure complicates staffing the audit committee consistently with Sarbanes-Oxley. Sarbanes-Oxley Section 301 makes ineligible anyone who receives "any consulting, advisory or other compensatory fee from the issuer" or is "an affiliated person" of the issuer.[54] This excludes all of the members of the managing board of a large German corporation.[55] With respect to the supervisory board, section 301 seems to exclude at least most of the labour members, representatives of a controlling shareholder, and shareholders or their representatives who have commercial or professional relationships with the firm. Indeed, it might be applied to exclude *all* supervisory board members because these members are eligible for compensation[56] and generally are paid. Although labour members of the supervisory board cease being day-to-day employees, they probably still would be considered employees with new supervision and monitoring jobs. These problems cannot be resolved by excluding employee representatives from audit committees because such exclusion might improperly evade the power-sharing arrangement under the Codetermination Act (MitbestG),[57] which requires supervisory boards to include representatives of shareholders and employees.[58]

Thirdly, even if an audit committee staffed as required by Sarbanes-Oxley is permitted under German law, Sarbanes-Oxley may disrupt the power balance effectively established for large German companies by tipping power toward the group from which the committee members are selected. This is obviously the case if the members are drawn from either shareholders or labour. Since the labour members are *former* employees, their interests might be aligned with those of the shareholders.[59] Also, Sarbanes-Oxley requires at least one member of the committee to meet the demanding (though unclear) definition of "financial expert."[60]

[53] AktG s 119 I Nr. 5; HGB §318 I.

[54] 17 CFR s 78j–1(m)(3).

[55] S 87 I 1 AktG (providing for compensation of management by the supervisory board).

[56] S 113 I 1 AktG.

[57] A German corporation is usually subject to the Codetermination Act if it employs more than 2000 employees. S I 1 Nr 2 MitbestG. This would include most large German corporations that would be most likely to be subject to US law.

[58] S 96 I AktG. See G Halbach *et al*, *Labour Law in Germany: An Overview* (Bonn, Federal Ministry for Labour and Social Affairs, 5th rev and extended edn, 1994), 458 (noting that "[l]iterature generally assumes that committees that do not have at least one employees' representative are legally inadmissible").

[59] See Hopt, *supra* n 51 at 16.

[60] See Sarbanes-Oxley Act, s 407 (requiring board audit committee to have at least one "financial expert", defined as one having education or experience including an understanding of accounting principles, experience in preparing financial statements, internal accounting controls and conveying an understanding of audit committee functions).

Because of the importance of financial expertise to the operation of the audit committee, the "financial expert" may have significant clout. This may tilt power toward either the shareholders or labour, depending on whether the financial expert represents the shareholders or is a trade union official.

The SEC has issued a rule that ameliorates the above problems.[61] The rule permits non-executive employees in foreign-based issuers to serve as audit committee members,[62] permits observer representatives of large shareholders,[63] and permits foreign firms to substitute for the audit committee "a board of auditors (or similar body), or . . . statutory auditors, separate from the board of directors."[64] Specifically, this board or body must not be elected by management, home country legal or listing provisions must set forth standards for the body's independence from the issuer or its management, and the body must be directly responsible pursuant to home country legal or listing provisions for overseeing, appointing and retaining the issuer's public accounting firm.[65] In its release accompanying the rule, the SEC said that in foreign private issuers with two-tier boards, "the term "board of directors" means the supervisory or non-management board. As such, the supervisory or non-management board could either form a separate audit committee or, if the entire supervisory or non-management board was independent within the provisions and exceptions of the proposed rule, the entire board could be designated as the audit committee."[66]

This rule does not, however, fully resolve the tensions between German law and the audit committee provisions of Sarbanes-Oxley. First, while the proposed rule permits vesting of the Sarbanes-Oxley audit committee functions in a single body, German law summarised above divides the function of appointing the auditors, which is subject to shareholder approval, and the function of supervising the auditors, which is in the supervisory board. It is not clear how these two functions must be meshed under the rule.

Secondly, even if a co-determined firm can form an audit committee that technically complies with both its governing country law and Sarbanes-Oxley, the committee is unlikely to be able to function as the Act contemplates. Co-determined firms may have to vest audit committee functions in the entire supervisory board in order to maintain the appropriate labour-shareholder balance of power. This will result in a large body of labour and shareholder members lacking sufficient cohesiveness, incentives and expertise to render close supervision. Thus, to accommodate audit committees, German law may have to change to permit board committees that do not reflect the power balance of the entire board. Moreover, because the members of the supervisory board must be drawn from a

[61] See 17 CFR s 240.10A-3.
[62] *Ibid.* S 240.10A-3(b)(1)(iv)(C).
[63] *Ibid.* S 240.10A-3(b)(1)(iv)(D).
[64] *Ibid.* S 240.10A-3(c)(2)(i).
[65] *Ibid.*
[66] Securities and Exchange Commission, Proposed Rule: Standards Relating To Listed Company Audit Committees, Release No. 33-8173 at note 86.

small pool of politically acceptable individuals,[67] each is likely to have several board positions and therefore not to be able to effectively supervise the firm's auditors. This appears to have undermined board supervision of the auditors of the Dutch co-determined firm Ahold, leading to significant accounting irregularities in that firm.[68]

The audit committee and other requirements of Sarbanes-Oxley raise even broader problems for the governance of co-determined firms. For example, the Act's provisions requiring reimbursement of compensation received while earnings were misstated[69] and prohibiting officer loans[70] may be particularly inappropriate for non-US-based firms. Because co-determined firms have strong shareholder monitoring and labour representation, manager-shareholder agency problems in such firms may differ significantly from those in US-style firms. US rules assume separation of ownership and control, and therefore may be redundant where shareholders are actively monitoring. Moreover, co-determination may increase the need to give managers incentives to maximise profits in order to discourage collusion with labour members and divert managers' attention from job security. Although the need for job security is mitigated by the absence in Europe of a strong takeover market,[71] the absence of this market further reduces managers' incentives to maximise shareholder wealth. Thus, shareholders may want to use other devices, such as encouraging share ownership through low-cost stock-purchase loans, to align managers' and shareholders' incentives. Sarbanes-Oxley not only precludes this particular device, but partially nullifies other compensation incentives by taking compensation away when an earnings misstatement is uncovered. The Act also saps the managers' already weak incentives to take risk by threatening managers with significant personal liability if financial information or monitoring devices they certified turn out to be wrong or inadequate. Sarbanes-Oxley therefore arguably imposes higher costs on non-US firms than on US firms with lower benefits.

III. Implications of Sarbanes-Oxley for Functional Convergence

This Part shows that Sarbanes-Oxley's move toward substantive regulation of corporate governance has potentially significant, and negative, implications for international corporate governance by impeding foreign firms' convergence toward US-type dispersed ownership. Subpart A briefly places the convergence issue in

[67] See Andre, *supra* n 51 at 155–56.

[68] See D Ball *et al*, "Directors Face Fire in Wake of Ahold", *Wall Street Journal*, 27 February 2003 at A6.

[69] See *supra* text at n 30.

[70] See *supra* text at n 33.

[71] See generally, C Kirchner & RW Painter, "Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform" (2002) 50 *American Journal of Comparative Law* 451.

the general context of the current debate on comparative corporate governance. This subpart shows that there is strong evidence favouring the efficiency of the dispersed-ownership model of corporate governance that prevails in the US. However, Subpart B shows that non-US firms and countries are impeded in various ways from adopting this form of governance. Subpart C discusses a main hope of convergence —that is, "functional" convergence through foreign firms' effectively "renting" US regulation by cross-listing in the US. Subpart D discusses Sarbanes-Oxley's potential interference with this form of convergence.

A. The Comparative Corporate Governance Debate

The recent comparative corporate governance debate focuses on the dialectic between "dispersed-owner" and "concentrated-owner" models. The "dispersed-owner" model is essentially the "Berle-Means" corporation prevalent in the US,[72] in which a large numbers of shareholders have ownership stakes that are too small to make active monitoring economically feasible. Berle and Means saw the dispersed-owner model as a problem because it left managers free to run firms in their own interests. It did not pay for owners holding small stakes to devote much attention to what their managers were doing because they would have to share the benefits of monitoring with other small shareholders. In the Berle-Means view, the result was rampant managerial agency costs and the stock market crash of 1929. The cure was more disclosure under the US securities laws of the 1930s, which hopefully would curb insider misconduct by forcing it into the open.

By contrast, the "concentrated-owner" model prevalent in much of the rest of the world, particularly including continental Europe, is characterised by higher concentrations of shareholding by families, banks, or other institutions.[73] In such firms, the shareholders' stakes are large enough to enable them to internalise the costs of information-gathering and monitoring managers.

Beginning in the mid-1960s, law and economics scholars in the US showed how market and contractual devices such as takeovers, markets for managers, executive compensation and other devices could ameliorate the agency costs that would otherwise flow from the free rider problem in the Berle-Means corporation.[74] Given these constraints, dispersed ownership could be seen as a blessing rather than a curse.

Most importantly, dispersed ownership facilitates efficient securities markets, which impound information rapidly into share prices. Efficient securities markets

[72] See generally, A Berle & G Means, *The Modern Corporation And Private Property* (New York, Macmillan, 1932).

[73] See *supra* n 43.

[74] See generally Easterbrook & Fischel, *supra* n 10; HN Butler & LE Ribstein, "Opting Out of the Corporate Contract: A Response to the Anti-Contractarians" (1990) 65 *Washington Law Review* 1; HG Manne, "The 'Higher Criticism' of the Modern Corporation"(1962) 62 *Columbia Law Review* 399.

provide several important benefits. First, they measure agents' performance and facilitate hostile takeovers to replace poorly performing agents.[75] Secondly, efficient markets provide an alternative to banks and institutions for financing new or existing ventures. In particular, efficient markets provide an exit for first-stage venture capitalists and reduce outside investors' risk-bearing costs by enabling them to hold diversified portfolios.[76] Thirdly, the ready availability of new ideas helps markets adapt quickly to changing business conditions. Fourthly, efficient markets can provide a medium for international competition, thereby constraining economic nationalism.[77]

These advantages of efficient securities markets do not mean that dispersed ownership is optimal for every firm. Powerful controlling shareholders are an alternative way of constraining agency costs where other agency-cost-control devices are too costly or ineffective. Firms' governance structures can be seen as contracts, which respond to various business conditions.[78] An important work by Demsetz & Lehn tested this proposition, showing that the extent of ownership concentration in US firms varied with business conditions, including firm size, the potential payoffs to owners from monitoring and other factors.[79]

However, beginning in the early 1990s there was a backlash against the initial law and economics defence of the dispersed owner model. The backlash coincided with the end of the takeover boom, and concerns about worker security and the dislocations caused by the takeovers of the 1980s. These problems indicated that the stability of concentrated ownership and labour participation in management may after all have some advantages over dispersed ownership and the constant threat of dislocation. In particular, Mark Roe suggested that the modern American corporation was not necessarily the best of all possible worlds, but rather at least partly attributable to political and historical conditions in the US, including populist distrust of large financial institutions.[80] Thus, US laws, among other things, hobbled banks' and pension funds' role in corporate governance, restricted

[75] See generally, HG Manne, "Mergers and the Market for Corporate Control" (1965) 73 *Journal of Political Economy*, 110.

[76] See R La Porta, F Lopez-de-Silanes, A Shleifer, and RW Vishny (2000) "Investor Protection and Corporate Governance" 58 *Journal of Financial Economics*, 3.

[77] See JN Gordon, *An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990–2000*, ECGI—Law Working Paper No. 06/2003 (January 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=374620.

[78] See generally, RN Coase, "The Nature of the Firm" (1937) 4 *Economica*, 386 (introducing concept of firm as a nexus of contracts); M Jensen & W Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Analysis*, 305, 311 (stating that "[t]he private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships . . .").

[79] H Demsetz & K Lehn, "The Structure of Corporate Ownership: Causes and Consequences" (1985) 93 *Journal of Political Economy*, 1155.

[80] MJ Roe, *Strong Managers, Weak Owners: The Political Roots Of American Corporate Finance* (Princeton, NJ, Princeton University Press, 1994); MJ Roe, "Chaos and Evolution in Law and Economics" (1996) 109 *Harvard Law Review*, 641.

large stock ownership of insurance companies, and fragmented share ownership by mutual funds.

The long stock market boom of the 1990s apparently restored both public and academic faith in dispersed ownership. A leading intellectual influence on this revival was the "law matters" literature.[81] Scholars showed that legal systems based on the common law and, to a lesser extent, Scandinavian-type civil law correlated both with rules that more strongly protected non-controlling shareholders and with lower degrees of ownership concentration than in other types of legal systems.[82] Firms can raise significant capital from minority shareholders only by assuring them that controlling shareholders will not selfishly divert cash flows.[83] It follows that countries with legal systems offering more shareholder protection have more widely held firms and broader capital markets.[84] There is also evidence that more legal protection makes firms and their investors better off.[85]

[81] This term was coined in JC Coffee, Jr, "Privatization and Corporate Governance: The Lessons from Securities Market Failure" (1999) 25 *Journal of Corporate Law*, 1, 1. For a useful and recent summary, see SJ Choi, "Law, Finance, and Path Dependence: Developing Strong Securities Markets" (2002) 80 *Texas Law Review*, 1657.

[82] See R La Porta, F Lopez-de-Silanes, A Shleifer, and RW Vishny (LLS&V), "Law and Finance" (1998) 106 *Journal of Political Economy*, 1113. Along similar lines, growth may be correlated with basic protection of contract and property rights in common law as compared with civil law countries. *See* PG Mahoney, "The Common Law and Economic Growth: Hayek Might be Right" (2001) 30 *Journal of Legal Studies*, 503.

[83] See H Hansmann & R Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal*, 439, 442.

[84] See LLS&V, Legal Determinants of External Finance" (1997) 52 *Journal of Finance* 1131 (showing that countries with poorer investor protection have smaller and narrower capital markets and fewer widely held firms); IJA Dyck & L Zingales, "Private Benefits of Control: An International Comparison", NBER Working Paper 8711 (2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=297337 (showing that higher private benefits of control, less developed capital markets, more concentrated ownership, and fewer privatisations as public offerings are correlated with stronger statutory protection of minority shareholders as well as non-legal factors including more diffusion of the press, tax compliance, and product market competition).

[85] See A Dittmar, J Mahrt-Smith, and H Servaes, "Corporate Liquidity", Working Paper (July, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=297337 (firms in countries with strong legal protection are less likely to maintain excess cash balances, for reasons other than problems relating to difficulty of raising needed external capital); FA Gul and HQiu, "Legal Protection, Corporate Governance and Information Asymmetry in Emerging Financial Markets", Working Paper, City University of Hong Kong (2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=298169 (greater legal protection is associated with lower levels of information asymmetry, defined as the relative importance of current earnings, and therefore with less serious agency problems in emerging market countries); LLSV, "Investor Protection and Corporate Valuation" (2002) 57 *Journal of Finance*, 1147 (showing that firms in countries with better investor protection have higher Tobin's Q ratios); LLSV, "Investor Protection and Corporate Governance" (2000) 58 *Journal of Financial Economics*, 3 ("LLSV 2000") (showing that firms in common law countries where investor protection is stronger make higher dividend payouts when firm reinvestment opportunities are poor than do firms in countries with weak legal protection); LLSV, "Agency Problems and Dividend Policies Around the World" (2000) 55 *Journal of Finance*, 1 (survey of 33 countries showing a correlation between minority shareholder protection and high dividend payout).

An implication of this work is that only certain countries and certain legal systems, notably including the US, are safe for dispersed ownership and efficient capital markets. Accordingly, while US firms operating under the umbrella of strong legal protection for shareholders can afford to adopt the ownership structures that best suit their needs, whether concentrated or dispersed, firms in countries with weaker protection are locked into concentrated ownership and thin markets in order to constrain agency costs.[86] Thus, legal protection increases the efficiency of governance by letting individual firms balance the agency-cost benefits and risk-bearing costs of high ownership concentration.

B. The Rocky Road to Dispersed Markets

The coexistence of concentrated and dispersed owner models of governance would seem to be an unstable equilibrium. Firms compete in global capital and product markets, and firms operating under local constraints would tend to lose in such competition. Moreover, better performing firms would at least provide a lesson in governance that less efficient firms could emulate.[87] Thus, if firms in countries with weak legal protection of shareholders, thin markets and concentrated ownership are at a global disadvantage, they would have economic incentives to throw off the shackles of their history and legal system and adopt laws that facilitate strong securities markets. Even if legal changes are difficult, private intermediaries such as stock exchanges could fill the gap.[88] At the same time, markets in open systems such as in the US and the UK ultimately could trump politics and force changes in laws.[89] The common law and its accompanying respect for property rights and limited government,[90] and the decentralised US federal

[86] See DK Denis & JJ McConnell, "International Corporate Governance" Working Paper, January, 2003, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=320121 (reviewing literature); KV Lins, "Equity Ownership and Firm Value in Emerging Markets" (5 August 2002) forthcoming *Journal of Financial and Quantitative Analysis* available at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID214909_code000302304.pdf?abstractid=214909 (firm values are lower when management group's control rights exceed its cash flow rights and higher with greater non-management control rights blockholdings, and both effects correlate with low shareholder protection, indicating that non-management blockholding can substitute for legal rights); A Durnev & EH Kim, "The Effects of Growth Opportunities and External Financing on Corporate Governance: Theory and Evidence", Working Paper, University of Michigan (2002) (relations between governance quality scores and Tobin's Q are stronger in countries that are less investor friendly).

[87] See Hansmann & Kraakman, *supra* n 83.

[88] See BR Cheffins, "Does Law Matter? The Separation of Ownership and Control in the United Kingdom" (2001) 30 *Journal of Legal Studies*, 459 (showing how dispersed ownership arose in the UK without legal changes); JC Coffee, Jr, "The Rise Of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control" (2001) 111 *Yale Law Journal*, 1.

[89] See F Easterbrook, "International Corporate Differences: Markets or Law?" (1997) 9 *Journal of Applied Corporate Finance* no 4 at 23; LE Ribstein, "Politics, Adaptation and Change" (1998) 8 *Australian Journal of Corporate Law*, 246; R Romano, "A Cautionary Note On Drawing Lessons From Comparative Corporate Law" (1993) 102 *Yale Law Journal*, 2021.

[90] See Coffee, *supra* no 88; Mahoney, *supra* n 82.

system,[91] lend themselves to change. Indeed, there is evidence of convergence between the two systems.[92]

The problem with convergence is that the level of shareholder protection in particular countries may be deeply embedded and resistant to change, particularly in the large part of the world in which concentrated shareholding dominates. This is supported by Khanna, Kogan, and Palepu,[93] who show that, although there is *legal* convergence among pairs of economically interdependent countries, there is no *de facto* convergence of the governance of specific firms in these countries.

Commentators have identified various forces that could lock firms into the concentrated-owner model even in the face of competition by firms that have adopted more cost-effective governance systems.[94] First, closed systems may have mandatory rules such as co-determinism that can be changed only when the advocates of change amass enough political capital to oust entrenched interest groups such as employees or labour leaders. The losers from change may have significant stakes in the existing system, while the beneficiaries of change are less cohesive political forces or firms that are yet to be formed or to become strong competitors. Also, endowment effects might exaggerate the effect of the stakes of the winners under the current system as compared with those of winners under a substitute system. Thus, legal reforms may require fundamental market changes that strengthen supporters of change, particularly including legal, accounting and securities professionals.

Secondly, firms' economic incentives to change may be weaker than the pro-convergence theorists suggest. Governance may not be an important enough ingredient in corporate success to put firms with inferior systems at a significant disadvantage in global product and capital markets. Firms compete mostly with firms in the same country, and pay the costs of country-wide bad governance only to the extent that they must access the capital markets. Thus, even if the dispersed

[91] See Ribstein, *supra* n 89; BR Weingast, "The Economic Role of Political Institutions: Market Preserving Federalism and Economic Development" (1995) 11 *Journal of Law, Economics and Organization*, 1.

[92] See Hansmann & Kraakman, *supra* n 83 (discussing broad worldwide convergence on governance practices, board structure, disclosure and takeover rules in Germany, Japan and the US, failure of alternative manager-oriented, labour-oriented, and state-oriented models of corporate law, and interest group and competitive pressures favouring convergence); A Shleifer, and RW Vishny, "A Survey of Corporate Governance" (1997) 52 *Journal of Finance*, 737; D Wojcik, "Change in the German Model of Corporate Governance: Evidence from Blockholdings 1997–2001", Working Paper (15 December 2001) available at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID294459_code011219500.pdf?abstractid=294459 (level of ownership concentration for German firms fell significantly, cross-holdings started to dissolve, and financial sector institutions declined in importance between 1997 and 2001, although variation among firms persisted).

[93] K Palepu, T Khanna & J Kogan, "Globalization and Similarities in Corporate Governance: A Cross-Country Analysis" Harvard Negotiation, Organization and Markets Working Paper No 02-31 (August 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=323621.

[94] The following arguments are discussed in LA Bebchuk & MJ Roe, "A Theory Of Path Dependence In Corporate Ownership And Governance" (1999) 52 *Stanford Law Review*, 127. See also, MJ Roe, "Corporate Law's Limits" (2002) 31 *Journal of Legal Studies*, 233.

owner model is economically superior, markets may be slow to weed out the concentrated owner firms.

Thirdly, the political impediments to and uncertain benefits of switching to the new system are exacerbated by the high costs of making the necessary changes. Significant laws may have to be in place before dispersed owners are sufficiently protected to permit a move to dispersed ownership.[95] This includes the specific legal voting and other shareholder rights highlighted by the law matters theorists,[96] and strong disclosure laws.[97] Commentators also have argued that common law is more conducive to dispersed ownership than civil law.[98] Moreover, the concentrated owner system may be maintained by an elaborate adaptive structure, so that any change would require changing the entire system. When considered in light of this adaptive structure, the concentrated owner model, even if worse than the dispersed owner model, may not be enough worse for the former type of firm to be at a significant disadvantage. Also, it may be difficult to determine how to change the current system to get desired results. In particular, changes to the system that would seem to foster dispersed ownership, because they work in dispersed-ownership systems, may have perverse results in block-holder systems.[99]

Fourthly, there may be significant cultural or background elements that lock in a concentrated-owner system and thereby prevent a move to dispersed ownership. For example, increased emphasis on government social security reduces the stock market's role in retirement savings. Less directly, Mark Roe argues that the law does not reach the main problem under dispersed ownership of managerial mistake, as distinguished from self dealing.[100] This needs to be addressed by devices that impound product market effects into executive action, particularly including incentive compensation and hostile takeovers. Yet in many concentrated-owner countries culture frowns on strong incentives, potentially disruptive takeovers and the Schumpeterian "creative destruction" that drives successful capitalism. Along similar lines, Amir Licht theorises that there are basic cultural and cognitive differences that matter to corporate governance.[101] For example, the level of

[95] See Shleifer & Vishny, *supra* n 92 (concluding that significant legal protection is necessary to support market-based system).

[96] See LLSV, *supra* n 85.

[97] See BS Black, "The Legal and Industrial Preconditions for Strong Securities Markets" (2001) 48 *UCLA Law Review*, 781 (concluding that the essential requirements for strong securities markets are laws and institutions that protect the ability of minority shareholders' to obtain information and develop confidence in company insiders); BS Black, "The Core Institutions that Support Strong Securities Markets" (2000) 55 *Business Lawyer*, 1565; Coffee, *supra* n 88; LLSV, *supra* n 76.

[98] See LLSV, *supra* n 82; Mahoney, *supra* n 82.

[99] See WW Bratton & JA McCahery, "Incomplete Contracts Theories of the Firm and Comparative Corporate Governance" (2001) 2 *Theoretical Inquiries in Law*, 745.

[100] See Roe, *supra* n 94.

[101] See AN Licht, "The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems" (2001) 26 *Delaware Journal of Corporate Law*, 147; AN Licht, C Goldschmidt, & SH Schwartz, "The Foundations of the Rule of Law and Other Norms of Corporate Governance" Working Paper (24 June 2002).

executive compensation may depend on whether a culture rewards entrepreneurship or prefers to maintain hierarchies,[102] and disclosure standards may depend on whether the culture values "uncertainty avoidance" and therefore may "may prefer to suppress transparency so as to avoid conflict and competition and to preserve security."[103] Finally, differences across countries in basic levels of trust and civil norms may increase economic growth[104] and may facilitate the development of larger firms.[105]

Fifthly, there is residual uncertainty about whether the dispersed ownership model really is superior to concentrated ownership when all costs and benefits are taken into account.[106] The overall effects of trading off social and economic stability for constructive adaptation and change cannot precisely be measured in terms of Tobin's Q. These arguments are likely to become stronger in the wake of the collapse of the bull market and the corporate frauds in the US.[107] Moreover, where there are basic cultural impediments to adopting the legal rules that would protect minority holders, as discussed in the preceding paragraph, the costs of a leap toward dispersed ownership probably would exceed the benefits.

In summary, although dispersed ownership probably leads to greater corporate efficiency than concentrated ownership, it is not clear how or whether countries can move from the latter to the former. The effect of changes in law may depend on deeply embedded legal, political, and cultural factors that, in turn, determine underlying market structure. Thus, dispersed owner systems may arise from a country's fundamental attributes.

C. Functional Convergence and "Renting" of US Law

The foregoing analysis helps describe a role for a particular method of causing concentrated owner systems to move toward the dispersed owner model despite the impediments discussed in subpart B. This has been referred to as "functional" convergence.[108] Even without a change in local law or culture, firms can "bond" the quality of their governance and disclosure by "cross-listing" their shares on exchanges in countries, particularly including the US, that strongly protect

[102] See Licht, *supra* n 101 at 196.

[103] *Ibid.* at 198.

[104] See S Knack & P Keefer, "Does Social Capital Have An Economic Payoff? A Cross-Country Investigation" (1997) 112 *Quarterly Journal of Economics*, 1251; R La Porta *et al*, "Trust in Large Organizations" (1997) 87 *American Economic Review*, 333.

[105] See *id* (showing that in societies where there is more trust big firms have larger shares of the economy).

[106] See Bratton & McCahery, *supra* n 99 at 755.

[107] See Gordon, *supra* n 77.

[108] See Coffee, *supra* n 6. For data on the increasing importance of cross-listing, see Coffee, *supra* n 38; WA Reese, Jr and MS Weisbach, "Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings" NBER Working Paper 8164, available at www.nber.org/papers/w8164 (March 2001) (noting that 496 firms cross-listed between 1984–93, and three times more, 1435, during the shorter period 1994–1998).

investor and shareholder interests.[109] In particular, it has been said that cross-listing in the US gives firms the advantages of increased legal enforcement by the SEC and in US courts through class actions and derivative suits, committing to more stringent disclosure requirements, scrutiny by reputational intermediaries including US underwriters, auditing firms, debt rating agencies, and securities analysts, and the listing requirements of US exchanges.[110] Cross-listing therefore enables foreign firms to give their shareholders a level of transparency that is not available under these firms' local law, discouraging majority shareholder opportunism by forcing it into the open. Equipped with such transparency, concentrated-owner firms can sell shares to minority shareholders and move toward dispersed ownership.

Functional convergence can be viewed as a way of bootstrapping change in concentrated-owner systems, or bypassing legal, cultural and political barriers to convergence. Under this approach, concentrated owner firms that are at a disadvantage in competing for capital in world markets can adopt at least some of the legal protection available in dispersed ownership countries without having to create such a system from scratch in their own countries. The existence of dispersed-owner companies may, in turn, provoke political change. These companies' competitors will have to lower their cost of capital as well. Investors and securities professionals in the new markets will form a political constituency favouring rules in their home country resembling those of the bonding jurisdiction.

Functional convergence may not be just a short-cut, but also may be preferable to convergence at a more basic policy level because it does not require an ex ante answer to the difficult question of which system is "better." Functional convergence permits a kind of market testing of both systems. The test will determine whether dispersed ownership really does work better for some formerly concentrated-owner firms, and which firms in a country can benefit from the change. Functional convergence can occur without changing the rules applicable to all firms in a country until the cost-benefit evidence is in. Nor is it necessary to make an ex ante theoretical determination of the feasibility of convergence, since the proof will be in what firms actually do. Thus, the greater the scepticism about the role and effect of de jure changes in a country's regulatory system, the greater the potential role for functional convergence.

The bonding story suggests that law, and specifically US law, is a significant factor in generating a worldwide move to dispersed ownership. It follows that the nature and quality of US law may have international implications, and that the costs and benefits of US law even within the US depend partly on this law's role in attracting foreign-based firms.

[109] For discussions of the role of bonding through cross-listing see Coffee, *supra* n 38; Coffee, *supra* n 6; Hansmann & Kraakman, *supra* n 83; LLSV 2000, *supra* n 85. Functional convergence also can be achieved by firms relocating or reincorporating in jurisdictions with stronger law. See *infra* text at n 133. The statement that US laws "strongly protect" shareholders is not intended to suggest that US law necessarily is stronger or better than non-US law.

[110] See Coffee, *supra* n 38 at 1780–82.

Supporting the bonding story requires eliminating other explanations of US cross-listings, including increasing liquidity and reducing market segmentation by enabling access to investors outside firms' home countries.[111] This would appear intuitively to be supported by the fact that firms can access investors in US markets without subjecting themselves to US affirmative disclosure requirements by selling without listing in the US.[112] However, this does not conclusively establish the bonding story, since firms can broaden the range of potential buyers by listing on exchanges. Moreover, firms selling here without listing are still subject to the anti-fraud laws,[113] which would suggest the possibility of bonding without listing.

There is, however, direct evidence of the bonding story. The value of cross-listed firms is higher than that of non-cross-listed firms from the same country, and this differential is negatively correlated with the level of investor protection in the home country, suggesting that firms from countries offering weak protection derive greater benefits from cross-listing.[114] Also, firms' equity issues increase following their cross-listings and the increase in post-listing equity offerings is primarily in countries with weak fiduciary duty protection.[115] This isolates a specific objective of bonding through cross-listing—that is, using the "bond" to sell additional equity following the cross-listing. Cross-listing firms are not simply trying to access US markets, but are, in effect, renting US law to facilitate access to non-US markets. Cross-listing's objective of increasing protection of minority shareholders and thereby decreasing the private benefits of control is demonstrated by a study showing that firms with dual-class stock that cross-list in the US reduce the price differential between low-vote and high-vote stock, with the largest decrease being in firms based in countries with the weakest protection of minority rights.[116] Finally, the significant increase in cross-listings during the mid-1990s[117]

[111] For summaries of these alternative theories and evidence, see Coffee, *supra* n 38 at 1779–1800; AN Licht, 'Cross-Listing And Corporate Governance: Bonding Or Avoiding?" (2003) 4 *Chicago Journal of International Law*, 141.

[112] Non-listed firms that are owned primarily by non-US investors and located outside the US are exempt from registration and reporting under the 1934 Act if they furnish disclosure documents filed under their home country law, and classes of such firms' securities are completely exempt if held by fewer than 300 US residents at the end of the firm's fiscal year. See 17 CFR s 240.12g3-2.

[113] See, eg *Bersch v Drexel Firestone, Inc*, 519 F 2d 974 (2d Cir), cert denied, 423 US 1018 (1975).

[114] See Craig Doidge, G Andrew Karolyi and René M Stulz, "Why Are Foreign Firms Listed In The US Worth More?" NBER Working Paper W8538 (1 October 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=285337.

[115] See Reese & Weisbach, *supra* n 108. Reese & Weisbach show that the size of the post-listing sales is not correlated with the selling firm's location in a weak country. This may be because other bonding alternatives are available for larger equity offerings.

[116] See CA Doidge, "U.S. Cross-Listings and the Private Benefits of Control: Evidence from Dual Class Shares" University of Toronto Working Paper (January, 2003) http://papers.ssrn.com/paper.taf?abstract_id=373740. The effect of the listing, as distinguished from firms' self-selection, is indicated by the fact such firms did not have lower voting premiums than comparable firms before they cross-listed.

[117] See sources cited in *supra* n 108.

is more consistent with a bonding explanation than an access-to-capital explanation given that the increase coincided with falling barriers to international investment.[118] In short, US law appears to be driving an international movement toward dispersed markets even without changes in background laws in other countries.

There may be, however, a darker side to cross-listing. Licht is sceptical that cross-listing can effectively bridge significant cultural and cognitive divides between different regimes.[119] According to Licht, cross-listing firms may be exploiting fundamental information asymmetries between home and cross-listing countries—that is, using the cross-listing to access investors who are less informed than those trading the same stock in the home country.[120] Licht cites work showing, among other things, that cross-listing is associated with more informed trading, insider misconduct,[121] post-listing disclosure of negative results, higher return volatility and trading volume in the home market, all suggesting that cross-listing is a bad rather than a good sign.[122] Although cross-listing firms may choose to list where the standards for domestic companies are high, as in the US, foreign firms are not subject to these standards.[123] Also, US regulators' appear to lack the ability and willingness to enforce US laws against foreign issuers.[124] Reese & Weisbach's evidence that cross-listing firms sell equity outside the US accordingly may reflect US investors' justifiable scepticism of such firms.[125]

The Licht story suggests that US regulators should be wary of cross-listing firms, perhaps subjecting them to disclosure regulation that is at least as stringent as that which applies to US domestic firms. Discouraging cross-listing would not, then, be a significant cost of Sarbanes-Oxley. For the remainder of this article I will assume that bonding is a significant factor in cross-listing. However, it is worth noting that Licht's story does not *support* Sarbanes-Oxley. Imposing more stringent *monitoring* standards on non-US firms discourages cross-listing without any gain in disclosure or restriction on the sort of insider misconduct such as insider trading that Licht fears. Indeed, given the limited reach of US regulation, Sarbanes-Oxley may trigger an adverse selection problem, where the worst foreign firms cross-list here to increase their insiders' access to unwary US investors, while the most credible

[118] See Doidge *et al*, *supra* n 114.

[119] See Licht, *supra* n 111.

[120] See *id* at 159 (citing evidence that cross-listing enables informed domestic traders to take advantage of less informed liquidity traders in other countries).

[121] Another study along these lines is JI Siegel, "Can Foreign Firms Bond Themselves Effectively by Renting US Securities Laws?", AFA 2003 Washington, DC Meetings (5 July 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=308481 (showing that Mexican firms had increased self-dealing following cross-listing in the US).

[122] See Licht, *supra* n 111.

[123] See *infra* text at n 138.

[124] See Siegel, *supra* n 121.

[125] See Licht, *supra* n 111 at 161. One problem with this reasoning is that it leaves unclear why foreign firms would increase equity issues outside the US after the cross-listing, as Reese & Weisbach, *supra* n 108, show. In other words, why would not non-US investors be equally sceptical?

international firms, which are most exposed to US-based litigation and enforcement, avoid US markets.

D. Effect of Sarbanes-Oxley on Convergence

For present purposes, the most important question concerning the convergence phenomenon described above is the effect of changes in US law, particularly including Sarbanes-Oxley. There is strong reason to suspect that such changes, along with other factors, may shrink the "rental market" for US law.[126] Controlling shareholders in firms from weak-protection countries have strong incentives to hold onto their control rather than bonding their disclosures under US law.[127] It follows that these firms will not cross-list if the price of bonding with US law exceeds the benefits from additional equity sales.

The marginal character of the bonding explanation is indicated by Doidge *et al*, who find that foreign companies listed in the US have significantly greater Tobin's Q ratios than do firms from the same countries that are not listed in the US.[128] The authors theorise that only companies whose shareholders gain the most from the growth opportunities provided by additional capital will sacrifice the benefits of control to cross-list in the US. This is indicated by the fact that these firms' stock prices increase *before* the listing, when the firms' growth opportunities, and the controlling shareholders' willingness to share these opportunities with minority shareholders, become apparent. It follows that the lower the benefit controlling shareholders realise from listing their firms in the US, the less they are likely to do it, other things being equal. This implies that the collapse of the bull market should sharply reduce cross-listing by reducing what firms can gain by cashing in on their growth opportunities.[129]

More importantly for present purposes, it follows that if the benefits of cross-listing remain constant, cross-listing should decline if the costs increase. Thus, if Sarbanes-Oxley increases what managers and controlling shareholders have to "pay" for cross-listing in the US, this is likely to exacerbate any decline of cross-listings from the collapse of the bull market. In other words, although strong US securities laws may drive the bonding theory of convergence, it does not follow that more regulation will encourage more cross-listing in the US.

[126] For a different conclusion, see Michael A Perino, "American Corporate Reform Abroad: Sarbanes-Oxley and the Foreign Private Issuer" (ms. 2003) (arguing that Sarbanes-Oxley will not deter foreign firms from listing in the US because cross-listing firms can bear the additional costs the Act imposes and these firms derive substantial benefits from cross-listing). On the other hand, there is an indication that cross-listing in the US has declined following Sarbanes-Oxley, although the reasons are unclear. See C Karmin, "Foreign Firms Lose the Urge To Sell Stock in US Market", *Wall Street Journal*, 24 July 2003 at C1.

[127] See *id*; Reese and Weisbach *supra* n 108.

[128] See Doidge *et al*, *supra* n 114 (showing that, at the end of 1997, foreign companies listed in the US have a Tobin's q ratio that significantly exceeds that of firms from the same country that are not listed in the US even after controlling for firm and country characteristics).

[129] See *id*.

This point is reinforced by the fact that the precise features of US law that effectuate bonding are not well understood. Significantly, it has been argued that the benefits of cross-listing in the US are primarily reputational rather than from the characteristics of the law itself.[130] The SEC can at most punish nondisclosure rather than the insider misconduct itself. Moreover, even enforcing disclosure regulations against foreign firms is difficult because of problems of gathering evidence, particularly given US pleading and discovery burdens.[131] These weaknesses in US enforcement against foreign firms raise a question of how cross-listing in the US can bond foreign firms. If enforcement is minimal, perhaps even significant strengthening in US regulation of foreign cross-listed firms will have little effect on such listings. On the other hand, if low-level enforcement is all that firms want or need to reinforce reputational effects, even a small increase in the cost of cross-listing may sharply reduce such activity.

Even if strengthening enforcement of investor protection under US law would increase the value of the cross-listing bond, it is unlikely that this would be the effect of the particular type of strengthening involved in Sarbanes-Oxley. The problem is that the increased substantive protection in the Act is aimed at shareholder-manager agency costs such as those involved in inadequate audit committee supervision, executive loans and the like, rather than at shareholder opportunism.[132] Cross-listing firms are unlikely to be seeking new forms of substantive governance, which they can always adopt in their home countries. Moreover, US firms differ from the non-US firms that are subject to Sarbanes-Oxley in that the managers and controlling shareholders of the latter firms have *chosen* to subject themselves to US law. Those in control of cross-listing firms therefore presumably have incentives to adopt governance devices for which benefits to outside investors outweigh the costs. This is particularly so if the devices, such as audit committees, do not significantly threaten insiders' control.

More generally, US lawmakers lack information as to what laws are appropriate to protect shareholders in non-US firms. Designing such law involves a complex balancing process. Minority shareholders need enough protection from abuse of control to warrant investing in a firm, but too much protection may leave shareholders with inadequate incentives to acquire control or to monitor managers.[133] Such monitoring may be particularly important in firms operating in countries that lack strong legal protections against manager-shareholder agency costs.

Finally, Sarbanes-Oxley potentially discourages an even stronger form of functional convergence than that accomplished through cross-listing—that is,

[130] See Siegel, *supra* n 121.

[131] The SEC must rely on, and often does not receive, foreign co-operation. See *id* at n 18. On this point, see AN Licht, "Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions" 2000 *Columbia Business Law Review*, 51.

[132] See *supra* text at n 110.

[133] See Bratton & McCahery, *supra* n 99.

foreign-based firms actually becoming full-fledged US firms by incorporating in Delaware or some other US state. Edward Rock discusses Israeli venture capital firms' use of this device to present themselves as American firms rather than as foreign private issuers.[134] One potential advantage of this device for foreign firms is that it assures application to minority shareholders of fiduciary duties under US state law. This may be more helpful to concentrated-ownership foreign firms than application of devices under Sarbanes-Oxley intended to address shareholder-manager problems of US-type firms. Yet Sarbanes-Oxley may discourage foreign-based firms from reincorporating in the US by imposing the costs discussed above.

In short, in addition to its unsuitability for US firms, Sarbanes-Oxley imposes additional costs on foreign firms attempting to use US law, and thereby may discourage efficient convergence of US and foreign law. To the extent that firms use US listings to raise capital throughout the world,[135] raising the rent could not only reduce the depth of US markets, but also raise the worldwide cost of capital.

IV. Indirect Implications of Avoidance by Non-US-based Firms

Part III suggests that Sarbanes-Oxley and other pro-regulatory moves in the US may discourage firms from cross-listing in the US. These firms may forego the benefits of cross-listing or some other country may fill the regulatory vacuum and offer the bonding formerly offered by the US. In either event, the shrinking of the cross-listing market may have negative effects in the US. Avoidance by non-US firms of the US market may reduce US investors' ability to diversify their portfolios. Perhaps more importantly, this avoidance may reduce the revenues of US securities firms, thereby provoking these firms to lobby for reducing the regulatory burden on cross-listing firms.

This Part discusses two possible alternative outcomes that turn on the potential effect of Sarbanes-Oxley on cross-listings by non-US firms. First, as discussed in subpart A, this may spur adoption of a real-seat-type jurisdictional choice system for securities regulation. Secondly, subpart B shows that such jurisdictional choice may have a kind of feedback effect in weakening regulation for US-based issuers.

A. Jurisdictional Choice

[134] See EB Rock, "Coming to America? Venture Capital, Corporate id.entity and US Securities Law" University of Pennsylvania Law School, Institute for Law and Economics, Res. Paper No 02-07 (April 2002), forthcoming in CJ Milhaupt (ed) *Global Markets, Domestic Institutions: Corporate Law and Governance In A New Era Of Cross-Border Deals* (New York, Columbia University Press, 2003) available at http://ssrn.com/abstract id.=313419. This device is fully effective only if the firm can prevent application of home state law under the "real seat" rule. Rock shows how startup firms exiting the private phase into public markets can adjust the factors that determine the "seat."

[135] See *supra* text at n 108.

The jurisdictional choice scenario is suggested by what in fact happened in the wake of Sarbanes-Oxley. In response to a backlash among European executives, including a widely publicised complaint about application of Sarbanes-Oxley to large German firms,[136] the SEC issued a rule mitigating the Act's application to firms with two-tier boards.[137]

This response was predictable from a public choice standpoint. The SEC has an incentive to, in effect, engage in regulatory "price discrimination" by imposing more stringent regulation on US-based firms that cannot easily avoid the regulation than on foreign-based firms that can choose whether to be subject to US law.[138] The Sarbanes-Oxley exemptions serve the same purpose as other differential application of the securities laws to foreign-based firms, including those under proxy rules, section 16 of the 1934 Act, 10Q filings, foreign firm registration of securities offerings in the US Regulation S, SEC rules on cross-border tender offers, business combinations, and rights offerings, and scheduling and confidentiality of filings.[139]

This price discrimination may, in turn, increase acceptance of the application of the US securities laws to issuers based on their home country law—that is, a kind of real seat rule—rather than based solely on whether they sell securities in the US.[140] In general, the higher the regulatory costs of US law for foreign firms, the more likely a home country-based rule will arise. Such a rule makes economic sense to the extent that the regulatory costs imposed on foreign firms depend on the substantive nature of the regulation. As US securities laws move from pure disclosure to substantive regulation, they mostly affect the quality of foreign firms' governance as distinguished from efficient market pricing of these firms' securities. The governance effect will be felt mostly in the firms' home countries rather than by investors in foreign markets. If the home country internalises the costs and benefits of regulation, it follows that that country ought to determine the extent of regulation.[141]

[136] Twenty-four German corporations, including DaimlerChrysler, Bayer, and Deutsche Telekom wrote the SEC to request an exemption from the Act, and Porsche decided not to list on the NYSE. See Mark Landler, *Porsche Is Balking at US Auditing Rule*, NY Times, 21 Aug. 2002, at W1.

[137] See *supra* text at n 61. Similarly, the SEC's rule under s 307 of the Act on lawyers' duties exempted foreign attorneys not admitted in the United States, and who do not advise clients regarding US law. See *supra* text at n 32.

[138] See F Tung, "From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation" (2002) 2002 *Wisconsin Law Review* 1363.

[139] *Id* at 1402–3. *See also*, JA Fanto, "The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance" (1996) 17 *Northwestern Journal of International Law and Business*, 119 (discussing lower disclosure standards for foreign issuers under Form 20-F); MB Fox, "Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities" (2001) 41 *Virginia Journal of International Law*, 653 (discussing exemption of foreign firms from Regulation FD).

[140] This parallels the effect of physical exit in promoting jurisdictional choice within the US federal system. *See* LE Ribstein, "From Efficiency to Politics in Contractual Choice of Law" (2003) 37 *Georgia Law Review*, 363.

[141] See Fox, *supra* n 138.

The jurisdictional choice provoked by stricter US regulation is unlikely, however, to lead to a rule under which firms can elect to be governed by the law of any state or country regardless of where they are based. Such choice would not be favoured by any powerful interest group. Investor groups may or may not seek more regulation, but they probably would not actively seek deregulation through jurisdictional choice. Business interest groups, including issuing firms, the securities industry, and securities professionals, would not want to destabilise regulation to this extent since this could reduce the value of investments they have made in the status quo.[142] Enforcement of the choice of incorporating state theoretically could arise as a way to prevent firms from physically exiting non-enforcing states. But as noted immediately above, a real-seat approach to securities regulation offers a compromise under which political jurisdictions can enforce their law against firms that have high costs of exit.

B. Weakening Regulation of US-based Firms

A possible alternative to jurisdictional choice is weakening the substantive regulation. Regulatory price discrimination through jurisdictional choice is an unstable equilibrium because of the way US-based firms may react to differential regulation of foreign-based and US-based firms. Exempting non-US-based firms may increase US firms' political opposition to regulation by both increasing the costs of the regulation for such firms and weakening the public interest argument for mandatory rules. Accordingly, stronger US regulation may lead to pressure against increasing substantive regulation under the US securities laws, or at least to making this regulation optional for US firms.

This point arguably follows from Coffee's arguments *against* jurisdictional choice once the SEC has discriminated between US and non-US firms. Coffee asserts that differential standards may impede inter-firm comparisons;[143] domestic firms might be "stigmatized" because of investors' inability to distinguish such firms from foreign firms in which insider trading is allowed to occur;[144] US firms will have to disclose proprietary information that their foreign rivals can hide;[145] and that trust in the securities markets may decline if foreign firms trading in the US can tolerate opportunism by controlling shareholders.[146] Moreover, permitting foreign issuers to comply with foreign standards concedes that regulation is unnecessary.[147] It arguably follows from this analysis that *if* US regulators do permit jurisdictional choice by non-US issuers, this weakens both normative arguments for applying stricter mandatory rules to US-based issuers and regulators' political ability to do so.

[142] *Ibid.*
[143] See Coffee, *supra*, n 6 at 694 (characterising this as a "network externalities" argument).
[144] *Ibid.* at 694.
[145] *Ibid.* at 695.
[146] *Ibid.* at 696.
[147] *Ibid.* at 697.

The problem of squaring jurisdictional choice with the objectives of mandatory regulation has led to an uneasy balancing process. The SEC itself does not want to facilitate evasion of its regulation by US-based firms.[148] Thus, as the SEC noted in its Comment proposing audit committee rules:

> "With the growing globalization of the capital markets, the importance of maintaining effective oversight over the financial reporting process is relevant for listed securities of any issuer, regardless of its domicile."[149]

The SEC therefore has sought to balance the benefits of accommodating foreign issuers against the costs of weakening the protection of investors buying foreign-based securities in the US. This balancing led to the unwieldy compromise in the SEC's proposed audit committee rules. These rules sought to facilitate compliance by two-tiered boards, but in a way that raises questions about the form the compliance must take, and that leaves firms with two-tiered boards in an awkward position under Sarbanes-Oxley.[150] These problems inevitably result from trying to balance the conflicting objectives of permitting price discrimination through jurisdictional choice and maintaining mandatory regulation of US securities markets.

In short, foreign firms' use of US cross-listing as a bonding device has countervailing effects on US regulation. On the one hand, such cross-listing may increase the potential costs of excessive regulation both directly by reducing cross-listings and indirectly by impeding efficient convergence toward dispersed ownership. On the other hand, this response by non-US-firms may itself either deter overregulation or spur broader jurisdictional choice. These effects are particularly likely if increased regulation takes the form of extending US securities laws into regulation of internal governance, as has occurred in the Sarbanes-Oxley Act. Such regulation may be particularly costly for non-US firms whose governance fundamentally differs from that of US firms because of its orientation toward concentrated ownership and non-shareholder constituencies.

V. Conclusion and Implications

The Sarbanes-Oxley Act was a watershed in US securities regulation whose effects have not fully been realised or analysed. This Article has focused on international implications of the Act. Sarbanes-Oxley causes real problems not just for US-based firms but for foreign based firms that become subject to US law, particularly through cross-listing in the US. These effects arise primarily because of the Act's foray beyond the traditional disclosure preserve of US federal law into substantive

[148] See JC Coates, IV, "Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis" (2001) 41 *Virginia Journal of International Law*, 531.
[149] See SEC Release, *supra* n 66 at note 82.
[150] See *supra* text at n 67.

regulation of governance. Such regulation, which focuses on manager-shareholder agency costs, has low benefits for firms whose share ownership is concentrated. It also has potentially high costs for co-determined firms, where increasing board power could upset the delicate balance of power between labour, management and owners.

This Article shows that Sarbanes-Oxley could have some unintended effects when evaluated from an international perspective. To the extent that the Act does deter cross-listing, it could entail the indirect cost of impeding efficient convergence between concentrated-owner and dispersed-owner systems. At the same time, this potential effect on cross-listing raises the political stakes for US regulators. These regulators may respond, and indeed to some extent have responded, by, in effect, price discriminating—that is, partially exempting foreign issuers from some of the Act's requirements.

The price discrimination response may, in turn, lead in one or both of two directions. On the one hand, it may lay the groundwork for broader enforcement of jurisdictional choice, at least to the extent of recognising a real seat rule for disclosure regulation. On the other hand, jurisdictional choice may prove less attractive to US regulators than simply retrenching into a strictly disclosure regime. Under this scenario, the spectre of jurisdiction choice and competition serves to constrain excessive regulation.

This analysis of the international implications of Sarbanes-Oxley illustrates the extent to which international securities markets force regulators to think beyond national boundaries. Non-US regulators need to keep an eye out for their local firms' tendency to "rent" US law in response to the weakness of home country law. At the same time, cross-listing adds an international dimension to any cost-benefit analysis of US law.

More fundamentally, this Article has shown that regulation in the context of international markets is inevitably a dynamic process rather than a static result. The mobility of capital means that any regulation is subject to being tested as firms reject bad or unsuitable laws and seek to be subject to good ones. This gives regulators both valuable information about which laws work, and incentives to meet market demand.