CROSS-LISTING AND REGULATORY COMPETITION

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ABSTRACT

Firms can "rent" the securities laws in other countries by listing or selling securities there while remaining subject to local law. Firms thereby can reduce their cost of capital despite political and other impediments to strong securities laws in their home countries. The cross-listing market has implications for both cross-listing jurisdictions and the home jurisdictions of cross-listing firms. From the standpoint of home countries, firms' flight to other markets may result in political pressure to adopt laws similar to those in the cross-listing countries. However, this pressure is unlikely to cause convergence of international corporate laws. To the extent divergence persists, cross-listing firms' costs of complying with the internal governance law of cross-listing jurisdictions may exceed the benefits of cross-listing. In order to avoid reducing cross-listings, cross-listing jurisdictions have an incentive to exempt foreign firms from their internal governance law or to avoid regulating internal governance. This has important implications for expanding US federal regulation of internal governance: Just as the federal government is Delaware's competition, so the international market for cross-listings is Washington's competition.

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Over the last 20 years many firms have chosen to "cross-list," or trade their shares in markets other than in their home countries, although this usually subjects them to tougher laws. For example, ten percent of registrants with the US Securities and Exchange Commission (SEC) are foreign, based in 60 countries (Cunningham). For the last decade, 5-15% of all listed issuers on world exchanges have been from outside the listing country (Licht, 2003). Seventeen percent of New York Stock Exchange listed companies are foreign firms (Table 1). There were approximately 1200 foreign firms reporting with the SEC as of December 31, 2003.[1] Commentators have noted the acceleration since 1984 (Reese and Weisbach; Karolyi; Perino).

This phenomenon has been subjected to extensive theoretical and empirical examination, particularly over the last five years. The potential importance of cross-listing is highlighted by the "law and finance" literature on the role of law in developing strong securities markets (e.g., LLSV 1998). Capital markets are important because they create wealth by funding ideas and development of resources. However, transitional and emerging economies may not have the basic legal and social framework necessary for strong securities markets (Roe). Even in sophisticated industrialized countries the preconditions for strong securities markets conflict with deep-seated political, social and cultural institutions. Accordingly, nations with weak securities markets may not want to copy the securities laws of countries that have strong securities markets, and may accomplish little if they do.

This is where cross-listing enters the picture. Although political systems and legislation are relatively intransigent, capital is highly mobile. Firms can use that mobility to seek the optimal regulation. Specifically, by subjecting themselves to regulation in countries that have strong securities markets, firms can, in effect, "rent" that country's securities law and enforcement, thereby leapfrogging local impediments to adopting such law. In other words, regulation can be selected on the "micro" level of the firm as well as the "macro" level of the country or other political entity.

Cross-listing as a solution to the problem of creating strong securities markets intersects with the general law and theory of regulatory competition.[2] Much of the theory regarding regulatory competition, including in the specific context of securities regulation (e.g., Romano; Choi & Guzman, Fox), focuses on opting *out* of strict regulatory regimes. Opt-out requires the firm's home jurisdiction to consent not to use its jurisdictional power over the moving firm to impose its own regulation. There is precedent for this in the US "internal affairs" rule for corporate governance and contractual choice of law for commercial contracts (Ribstein 2003). But securities laws still apply on a territorial basis, according to the location of firms and transactions. Cross-listing involves a different type of securities regulation competition: opting *into* an alternative, perhaps stricter, regime

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[1] *See* www.sec.gov/divisions/corpfin/internatl/alphabetical.htm.

[2] I refer to "regulatory" rather than "jurisdictional" competition to focus on competition among legal regimes rather than other characteristics of the cross-listing and domestic markets.

from that in which the firm is based, but without exit from the issuer's home country law (Coffee 2002).

Cross-listing has implications not only for cross-listing *firms* but also for *jurisdictions* in which these firms are based. These countries have an incentive to develop local securities laws in order to keep firms trading at home. Also, cross-listing firms might demand changes in home country law in order to better coordinate with the law of the cross-listed (target) jurisdiction. Coffee (2002) suggests that this may lead to "convergence" in corporate law. More generally, this paper, like my other work on jurisdictional competition (e.g., Ribstein 2003), shows how the mobility of firms, people and money across borders, transmitted through interest groups to political decision-makers, can produce long-run legal changes.

There is, however, a limit to cross-listing's ability to effect legal change in the *home countries* of cross-listing firms. At the same time, the market for foreign listings may affect the law of *cross-listing* countries. If these jurisdictions attempt to impose laws on cross-listing firms that conflict with the law of their home countries, this could reduce cross-listing, and therefore the benefits foreign firms bring to cross-listing jurisdictions. These jurisdictions may respond by exempting foreign-based firms or otherwise tailoring their laws to meet these firms' needs. In particular, the cross-listing market may constrain recent US efforts to extend its federal securities laws from the regulation of disclosure to regulation of internal corporate governance. Thus, while the US federal government may be Delaware's real competition (Roe 2003), Washington's competition may be the international market for cross-listings.

This paper proceeds as follows. Part I discusses the importance of law in creating strong capital markets. Part II discusses the demand for cross-listing by firms seeking greater access to world capital markets. Part III discusses the effect of cross-listing on the home jurisdictions of cross-listing firms. Part IV discusses the effect of the cross-listing market on target jurisdictions. Part V provides concluding remarks.

I. THE ROLE OF LAW IN STRONG CAPITAL MARKETS

Cross-listing firms are seeking stronger law and enforcement than are available in their home countries. Accordingly, in order to understand the market for cross-listing, it is first necessary to discuss how law affects the development of capital markets.

A. LAW AND FINANCE

The "law and finance" or "law matters" literature, beginning principally with La Porta, et. al (LLSV) (1998), rejected the standard law and economics assumption that private contracts are critical to investor protection. Instead, they showed that legal protection mattered to protection of investors, and that the requisite legal protection is found only in certain legal systems – more in common law than in civil law regimes. The "law and finance" literature thus divides the world into two broad camps. In civil law countries, corporations are mostly controlled by shareholders who own a significant fraction of the stock. In common law countries, corporations typically are owned by dispersed shareholders, with no one shareholder holding enough shares to wield significant control.

There arguably are advantages to both types of control depending on the nature of the business and its environment (Demsetz & Lehn). For example, large shareholders generally make long-term commitments to the company, and have incentives to monitor managers closely. On the other hand, making a large enough investment in a firm to be able to exercise control reduces the investor's opportunity to hold a diversified portfolio. There may be only a limited number of investors who are willing to make such large bets. By contrast, risk diversification helps promote entrepreneurial activity. Moreover, dispersed ownership leads to more trading, which discounts information more rapidly into share prices. This facilitates monitoring of managers and controlling shareholders by minority shareholders, creditors and potential purchasers of control.

Thick capital markets with dispersed shareholders, however, can exist only when supported by an appropriate legal framework. Investors who passively hold diversified portfolios of shares effectively place control of their money in the hands of corporate managers. Delegation of control entails agency costs. Dispersed ownership potentially increases these costs. Diversified investors with small stakes have little incentive to monitor each firm in their portfolios because they cannot capture the benefits of monitoring. This creates a need for laws and institutions that protect minority shareholders by giving them a say in control transactions, remedies for fiduciary breach, and enough information and accounting transparency to let them accurately track managers' performance (Black 2001, 2002; LLSV 2000; Coffee 2001). Specifically, LLSV (1998) focus on such shareholder rights as the linking of pro rata cash flow and voting rights, proxy and cumulative voting for directors, the rights to subscribe to new stock issues, sue insiders for expropriation, and call extraordinary shareholders' meetings. There is evidence that firms in countries with such laws and institutions have a lower cost of capital than firms elsewhere (Hail & Leuz). Conversely, firms whose managers can expropriate investors' capital have been shown to attract less US equity investment than firms with stronger governance (Lins & Warnock).

Establishing the appropriate legal structure is important not simply to "protect investors," but to encourage investment, thereby fostering capital accumulation and encouraging productivity (Beck, et al). Potential investors can simply refuse to turn over their money to firms, and instead invest in government securities or put their money in mattresses. Investors will do this, for example, rather than investing in firms with opaque accounting and weak governance. Investors also can take their money to other markets where they are better protected. Although managers can promise to voluntarily disclose information, investors may not rely on such promises, particularly if they do not know when disclosures are complete or whether managers are lying, or if they know that disclosure is costly (Grossman 1981; Zingales).

The role of legal protection in encouraging investment, as distinguished from protecting investors who have already made the investment decision, is significant to opt-in theories of regulatory competition. The fact that strong legal rules enhance the market for a firm's shares, and thereby its ability to fund its business, gives firms an incentive to seek out regulatory environments that are stricter than the firm's home regulation.

Although legal protection appears to be important in encouraging dispersed owner markets, it is not clear that the rights LLSV (1998) identify are the ones that matter. Kraakman, et al, discuss a variety of alternative strategies for dealing with agency problems. They note, in particular, that protection of minority shareholders correlates with ownership structure but not with particular governance rules (id at 61). It nevertheless might be the case that common law regimes are particularly hospitable to dispersed ownership, though not because of the specific rights LLSV emphasize. As discussed below in subpart IV.E., this question has important implications for the extent to which the cross-listing country's law should be applied to cross-listing firms.

B. IMPEDIMENTS TO MACRO-LEVEL CHANGES

Before analyzing individual firms' opting into regulation, it is necessary to consider why firms' cannot simply rely on macro-level changes in their home country laws to accommodate dispersed ownership structures even without cross-listing. Competition for capital in global markets would tend to divert capital, and therefore growth opportunities, from firms with weaker governance, giving firms an incentive to demand stronger investor protection laws (Hansmann & Kraakman). Stock exchanges would also lobby to improve the legal environment, or attempt on their own to fill the gap (Cheffins).

The problem with this scenario is that there are powerful political, cultural and legal impediments to change (Bebchuk & Roe; Roe 2002). First, existing forms of governance are supported by entrenched interest groups (Rajan & Zingales). For example, investors would want assurances that managers are loyal to their interests, not those of stakeholders such as labor. This would mean, for example, dismantling entrenched labor representation on the boards of large German corporations. Also, greater rights for minority shareholders obviously threaten the interests of powerful controlling shareholders. Conversely, firms' incentives to lobby for change may be weakened by the fact that they compete for capital mostly with firms in the same country. Demand for change may be limited primarily to large, international firms.

Second, effective change may require a country to adopt a large securities regulation framework (LLSV; Shleifer & Vishny). This framework begins with legal rules, including a strong mandatory disclosure system (Black 2000, 2001; Coffee 2001). Shareholder protection depends not only on formal rules, but also on norms and supporting market and legal institutions (Paredes). This is illustrated by the recent Parmalat fraud, a large scale theft that was not caught by auditors. Italy had fairly strong laws on governance and auditing (Melis), but apparently inadequate enforcement.[3] This may be at least partly attributable to the weakness of Italian courts in fashioning shareholder remedies (Enriques 2003a). More fundamentally, shareholder protection may be imbedded in a country's common law system, in which sophisticated judges can fill blanks that necessarily arise in governance contracts (LLSV 1998; Mahoney) and which evolved historically to protect private property. And elements of a system adapt to each other. For example, the strong legal enforcement mechanism in the US may be, in part, an adaptation to weak monitoring by dispersed shareholders (Kraakman, et al). For these and other reasons, the costs of a move to a wholly different system may exceed the benefits. A partial move that does not make all of the necessary changes in the system might be worse than no move at all (Bratton & McCahery).

Third, a move to shareholder protection might require changes not only in corporate and securities laws, but in the basic culture and political structure. Diversified investors would want their managers to take reasonable risks even if this raises the potential for failure because they know some firms in their portfolios will succeed. A supporting political system would accommodate this interest by ensuring effective market discipline of managers, including incentive compensation and hostile takeovers. By contrast, social democratic countries frown on such elements of Schumpeterian "creative destruction" (Roe). In these cultures, laws help ensure the survival of individual firms in

[3] Melis asserts that the failures in this case were comparable to those in the US Enron situation. But while Enron involved novel business techniques that the market was unable to understand, Parmalat involved fairly straightforward, if large-scale, tunneling by a controlling shareholder.

order to minimize dislocation costs of labor and other stakeholders. Concentrated-shareholder governance may be deeply embedded in cultural preferences for hierarchy over entrepreneurship, "uncertainty avoidance" over risk, and security over competition (Hogfeldt; Licht 2001; Licht, Goldschmidt & Schwartz). Thus, labor-controlled firms invest less, take fewer risks, have slower growth, have more free cash and exhibit lower productivity than capital-controlled firms (Faleye, Mehrotra & Morck). Accordingly, in concentrated-shareholder countries there may be substantial public opposition to laws that encourage shareholder wealth-maximization at the expense of dislocation. For example, mandatory disclosure might shed an unwanted light on managerial acts designed to favor stakeholders over shareholders (Cunningham; Licht 2001). Finally, governance of specific firms depends on the level of trust in a society, and not just on the stringency of its laws (Knack and Keefer; LLSV 1997).

Fourth, it may not be clear that dispersed ownership really is superior to concentrated ownership when all costs and benefits are taken into account (Bratton & McCahery). This depends on preferences for risk or stability that are not reflected in existing measures of corporate wealth. These doubts have become more plausible in the wake of the corporate frauds and stock price collapse in the US (Gordon).[4]

In summary, even if there are significant benefits from dispersed ownership, it may be unclear whether a nation can or should move from concentrated to dispersed ownership. Even if the laws move, the supporting culture and institutions may not. Thus, there is evidence that even where countries converge toward shareholder protection, the governance of specific firms does not (Khanna, Kogan, and Palepu). This dims the prospects for immediate macro-level change in legal structures to those supporting dispersed ownership. Accordingly, individual firms need to be able to opt-into such laws on a micro level. The following three parts discuss the demand for and supply of such opportunities.

II. FIRMS' DEMAND FOR CROSS-LISTING

Part I suggests that cross-listing may be an important mechanism enabling firms to bypass impediments to capital formation that exist under their home country's laws and culture. This has important implications for regulatory competition. As discussed below in Part III, cross-listing might give dispersed-owner countries an incentive to tighten their laws to retain listing business. Part IV shows that countries such as the US with strong corporate and securities laws may have an incentive to design their own laws to gain global securities business by attracting cross-listing firms.

Before discussing the implications of cross-listing for regulatory competition, however, it is important to consider the extent to which cross-listing depends on the *law* of the cross-listing country. Under the bonding explanation, cross-listing is a form of regulatory competition in which cross-listing firms are seeking stronger laws. Although bonding seems to be the dominant explanation for cross-listing, there are other possible explanations for cross-listing that do not depend on the quality of the law of the cross-listing country and that are not precluded by the data (Coffee 2002 at 1779-1800; Licht 2002). For example, the home country may impose barriers to capital flow, trading in the cross-listing market may provide more liquidity, or such trading may make the firm more visible to investors or consumers. Under these explanations, cross-listing firms may not

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[4] More recently scandals such as Parmalat and Ahold raise questions about whether problems are focused in the US.

care about the law of the cross-listing jurisdiction.

As discussed in subpart A, significant evidence supports the bonding theory. Subpart B discusses an alternative to the bonding explanation – that cross-listing firms are "signaling" their prospects or plans, or those of its insiders. Cross-listing therefore conveys information that could not be communicated as cheaply or effectively in any other way. But even assuming that cross-listing efficiently reduces information asymmetry, the choice between signaling and bonding explanations may not have clear implications for firms' behavior because the information the signal conveys may depend on the level of law and enforcement in the cross-listing jurisdiction. Thus, in both cases, the cross-listing company is seeking stronger law. Under the bonding theory the company is seeking to bond its promises to non-controlling shareholders, while under the signaling theory the fact that the firm is willing to incur the costs of submitting to stronger law communicates information about the firm. The remaining subparts discuss theories of cross-listing that clearly do not turn on the quality of the law of the cross-listing country.

A. BONDING

Cross-listing enables firms' owners and managers to bond their promises to protect minority shareholder rights and provide disclosure.[5] More specifically, firms list in a country with strong investor protection to convince investors of their commitment to forego distributing the firm's assets to themselves (Benos & Weisbach at 13). This commitment may reduce the discount outside investors apply to the firm's shares, increasing the value of the shares enough to compensate the managers for the foregone private benefits. The potential for increased returns depends on what the firm can do with the money – that is, its opportunities for growth.

The insiders' bond consists of the risk of penalties for noncompliance imposed under the law of the cross-listing jurisdiction (Coffee 2002; Hansmann & Kraakman; LLSV 2000).[6] The risk of penalties depends on the extent to which the cross-listing country's law applies to foreign issuers. In the US, foreign issuers trade through American Depository Receipts (ADRs). "Level I" trading of ADRs, over the counter without listing on a national securities exchange, NASDAQ, or the Over-the-Counter Bulletin Board (OTC-BB), is subject to the exemption from issuer registration under Rule 12g3-2.[7] Under this rule, issuers need only give the SEC the same information they are

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[5] Firms may also want to bond promises of transparency to others besides investors, including customers and suppliers. See Khanna, et al (showing correlation between interaction in these markets and the quality of disclosure).

[6] According to Coffee, bonding mechanisms also include submitting to reputational intermediaries in the target jurisdiction, such as securities analysts, investment bankers, auditors and exchanges. However, the existence of such intermediaries does not directly turn on the law of the cross-listing country. Rather, these institutions can be seen partly as having been created by the target country's law, and partly as enhancing the effect of that law by monitoring for law violations.

[7] 17 C.F.R. § 240.12g3-2(b) (2003). Under this rule, 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 Section 240.12g3-2. In April 1998 firms trading on OTC-BB had to meet the same reporting requirements as firms trading on the NYSE and NASDAQ. In 1999, the SEC approved NASD Marketplace

otherwise required to file in their home country, with their home stock exchange, or otherwise. By contrast, Level II and III ADRs trade on a securities exchange, NASDAQ, or OTC-BB. They must register under Section 12 of the Exchange Act, and therefore must make annual disclosures on Form 20-F and reconcile home country financials to US GAAP. Level III issuers make public offerings in the US and therefore are subject to the more stringent regulation of the Securities Act of 1933, including strict liability for misrepresentations under §11 of that Act. Level IV ADRs trade on an exchange called "PORTAL" but are exempt from US reporting standards under SEC Rule 144A because they are traded solely among Qualified Institutional Buyers (QIBs).[8] Listing also triggers the requirements of US exchanges (Coffee 2002 at 1780-82).

The bonding theory of cross-listing generates several testable hypotheses, which depend on the alternatives available to foreign issuers in trading in the US and other target countries (Karolyi 1998). These tests attempt to distinguish bonding explanations for cross-listing from other explanations discussed below in this Part. Thus, to establish bonding it is not enough to show merely that cross-listing increases the firm's value or assists it in obtaining capital, but also that the stronger law of the target country is what produces this increase. There is, in fact, substantial evidence supporting the bonding theory:

- Doidge, Karolyi and Stultz found that foreign companies listed in the US have significantly greater Tobin's Q ratios, a measure of growth opportunities, than do firms from the same countries that are not listed in the US, and that this difference is larger for firms from countries with lower investor protection. This combined evidence suggests that the companies whose insiders have the most to gain from reducing the cost of capital seek bonding by cross-listing.

- Reese & Weisbach show that cross-listing firms tend to be from French civil law countries, where the "law and finance" literature suggests that investor protection is weakest. They also show that cross-listing firms increase their equity offerings *outside* the cross-listing country after their cross-listings. These data indicate that cross-listing firms leave their home countries for bonding purposes rather than simply to access investors in the cross-listing country.

- Benos & Weisbach observe that the rise of US cross-listings by European firms, which already trade in integrated securities markets, indicates that cross-listing is occurring for some reason other than just liquidity.[9]

- Fuerst shows that firms tend to cross-list in countries with stricter regulation than in their home country. He also shows that US firms, which do not have a comparable need for bonding, gain less of a price boost from listing abroad than non-US firms cross-listing in the US.

Rule 6530, which requires a company to register under section 12(g) of the Exchange Act to be eligible to have its securities quoted in the OTC-BB.

[8] 17 C.F.R. § 230.144A (2003). A QIB must own and invest at least $100 million in securities of unaffiliated issuers.

[9] Pagano notes that in 1986 there were more than five times as many American firms listed on European exchanges than European firms listed in the US, but after a decade more European companies listed in the US than vice versa.

- The value of cross-listed firms is higher than that of non-cross-listed firms from the same country (Foerster and Karolyi; Karolyi), particularly where investor protection in the home country is weak (Doidge, Karolyi and Stulz). The correlation with weakness of home country regulation indicates that it is the stronger law of the target country that produces the value differential.

- Hail & Leuz (2004) show that cross-listing reduces firms' cost of capital as distinguished from their analyst-projected cash flow. This indicates that increased returns from cross-listing announcements are attributable to market expectations of reduced appropriation from insiders rather than to market expectations that the firm will have more growth opportunities. This is more pronounced for cross-listing firms from weak-regulating countries, and for firms that list rather than trade over the counter (and therefore subject themselves to a higher level of regulation). These differences are consistent with a bonding explanation.

- In firms with dual-class stock that cross-list in the US, the cross-listing reduces the price differential between low-vote and high-vote stock, especially for firms based in countries with the weak protection of minority rights (Doidge). This indicates a market judgment that cross-listing reduces controlling shareholders' ability to divert corporate wealth from non-controlling holders.

- Lang, Raedy & Yetman show that cross-listed firms have stronger earnings and manage earnings less than non-cross-listed firms. Firms that are already well-governed have lower marginal costs of cross-listing in stricter regimes than firms that have poor governance, and therefore are more likely to bond their performance through cross-listing, holding other factors constant. This data does not, however, preclude the possibility that the firms are seeking non-bonding benefits from cross-listing.

- Home-country rivals of cross-listing firms lose value at the time of the cross-listing, particularly in emerging market countries (Melvin & Valero-Tonone). Similarly, Lee shows that shareholder wealth increases on cross-listing and decreases for non-cross-listing firms from the same country, particularly if they have high agency costs. This indicates the market's unfavorable assessment of the governance of firms that do not cross-list after cross-listing by other firms from the same country shows that this is an option.

- Pagano, Roell and Zechner show that European firms listing elsewhere in Europe tend to increase their borrowing after the cross-listing, while those listing in the US, which has stronger investor protection regulation than in Europe, are seeking new equity for expansion. Bonding assists the latter objective but not the former.

A possible problem with the bonding theory concerns its assumption that the law of the cross-listing regime actually will be enforced against the cross-listing firm. Courts in the cross-listing country may not be able to reach key people and assets in the cross-listing firm. Siegel (2002) documents that US regulators and private lawyers appear to lack the ability and willingness to enforce US laws against foreign issuers. The US Securities and Exchange Commission (SEC) lacks the authority to punish insider misconduct other than that which violates US disclosure laws. It faces difficulties in enforcing disclosure regulations against foreign firms because of problems of gathering evidence, particularly given US pleading and discovery burdens. Accordingly, it must rely on foreign cooperation (Licht 2000).

Benos and Weisbach argue that it is "plausible" to expect that regulations on the books will be enforced and that it matters mainly whether investors and managers "perceive" that cross-listing is important. These perceptions may be heightened when they are advised by lawyers who seek to increase the demand for their services (Coffee 2002). While investors may misperceive the likelihood or effectiveness of enforcement, information about the quality of laws and of enforcement would seem to be readily available and therefore accurately discounted into stock prices. It follows that firms could not significantly reduce their cost of capital by submitting to a mere mirage of enforcement.

Licht (2003) is skeptical of the bonding theory, and argues that cross-listing is actually a race to the bottom. His suspicion is based partly on the fact that it is insiders who make listing decisions, heightened by survey data that they are deterred from cross-listing in countries with high standards (Fanto and Karmel; Biddle and Saudagaran (1989) and Saudagaran and Biddle (1992)).[10] However, cross-listing is not a true race to the bottom because cross-listing firms cannot avoid their home country's law. It is not surprising that insiders take the costs and benefits of complying with the law of the cross-listing country into account in deciding whether to cross-list. This is consistent with the evidence reported above that cross-listing is done mainly by higher-quality firms, which are already doing what more stringent laws require, and by firms with higher growth opportunities, which derive more benefit from the lower cost of capital produced by cross-listing. Licht also concludes from Reese & Weisbach's evidence that cross-listing firms sell outside the US that US investors are skeptical of these firms. But it is not clear why investors in the home market would not also be skeptical.

Apart from the enforcement issue, the data does not establish that bonding works perfectly. Insiders in cross-listing firms may in fact continue to engage in misconduct after the cross-listing (Licht 2003). There is also evidence of bad accounting by cross-listing firms (Lang). For present purposes, however, it is not necessary to show that cross-listing is fully effective, but only that the quality of the law and enforcement regime of cross-listing countries matters in the competition for cross-listings. If so, cross-listing may trigger the effects on lawmaking discussed below in Parts III and IV.

B. SIGNALING

Firms can signal to assure investors of their high quality. A signaling strategy involves subjecting the firm to constraints that are more costly for low quality than for high quality firms. Prominent examples in the literature include borrowing that increases the risk of bankruptcy (Ross) and legal restrictions on contracts (Aghion and Hermalin). Under these general theories, cross-listing may communicate information that is not otherwise cheaply available. However, in analyzing signaling theories, it is important to distinguish signaling behavior from conduct that is more amenable to bonding or liquidity explanations.

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[10] Although interviews with business people and lawyers may be less reliable than regressions based on the observable characteristics of all firms in the market and the actions they take. For example, business people may not express the actual reasons for their decisions, as where they are simply mimicking other firms. Interviews accordingly may be more helpful in assisting in the selection of independent variables than in determining the influence of particular variables.

First, the cross-lister may be signaling that it has significant growth prospects (Fuerst). The signal depends on the intuition that such opportunities are necessary to justify the costs to insiders of the cross-listing and complying with the other country's more stringent law.

Second, the cross-listing firm may signal that it intends to behave according to the standards of the US or other cross-listing jurisdiction. This is similar to bonding, except that it does not directly depend on the quality of the cross-listing country's law or enforcement. Rather, the clarity of the signal again turns on the assumption that the cross-listing firm incurs greater law-compliance costs and risks, particularly including the risk of liability, if it is a low-quality firm than if it is a high quality firm. This may be the case, for example, if the firm is exposing itself to a high (even socially excessive) risk of litigation in the event of price declines (Iacobucci). Also, the firm may incur higher compliance costs such as hiring lawyers and gathering information if it is a low quality, than if it is a high-quality, firm.

Third, cross-listing may indicate that the firm already has better governance than non-cross-listing firms even prior to listing (Lang et al; Melvin & Valero-Tonone). Such firms incur lower costs by cross-listing than firms that have to make more significant governance changes in order to comply with the law of the cross-listing jurisdiction. Conversely, firms that do not cross-list even after other firms in their country do so signal that they have weaker governance. Firms that choose to list under weaker standards, such as the Rule 144A private equity market in the US, send a similar signal of weak governance (Hail & Leuz 2004).

Fourth, cross-listing may signal that the cross-listing firm's insiders do not have significant opportunities for extracting private benefits from the firm (Barzuza; Bebchuk (2002)). This reasonably assumes that the insiders of such firms incur lower costs of cross-listing than those of firms with greater opportunities to extract private benefits. Conversely, insiders of non-cross listing firms signal that they *can* extract high private benefits, thereby making their shares valuable to purchasers of control. This differs from the previous explanation in that the insider's appropriation opportunities may depend on private information rather than the more public information concerning the type of governance the firm has adopted. However, some information about the private benefits of control may be readily available. Studies have shown that the value of control can be computed from the prices of control and non-control shares in dual-class issuers (Doidge). This suggests that these firms need not send a costly signal regarding insiders' potential to realize private benefits. On the other hand, insiders probably have some information concerning private benefits that the market does not have, particularly in the many firms where the controlling shareholder exercises control through a single class of stock (Benos & Weisbach).

Are signaling and bonding theories of cross-listing distinguishable? The signal may depend on the firm's incurring costs by exposing itself to enforcement of cross-listing country's law (Fuerst), which is the key to a bonding explanation. Accordingly, much of the evidence of bonding would also support a signaling explanation. But there may also be differences between signaling and bonding theories. First, bonding theories generally assume that the cross-listing firm is choosing a higher-quality law. However, a firm can signal its quality by choosing a law that would be *inefficient* in a world of complete information because, for example, they create a risk of excessive litigation (Iacobucci). Accordingly, the nature of the legal regime selected by cross-listing firms may make more sense from a signaling than from a bonding perspective.

Second, although bonding theories depend on legal enforcement, signaling theories may not. For example, the cross-listing involves costs and fees of making the filing even if the firm has no intention of complying with cross-listing country law, or incurs no detriment of doing so. Thus, Blass & Yafeh observe that Israeli firms go public in the US although they conclude that US law and enforcement are no stricter than Israeli law. These firms incur costs that are unrelated to enforcement of stricter laws, particularly including the under-pricing that occurs with initial public offerings in the US but not in Israel. As discussed below in this Part, there also might be a liquidity explanation, or the firms may be forming under US state corporation law and thereby undertaking to comply with internal governance in addition to disclosure standards.

C. LIQUIDITY-BASED EXPLANATIONS

Firms may cross-list not to subject themselves to stricter law, but in order to bring themselves to the attention of more investors. It is important to distinguish these explanations of cross-listing from a bonding explanation. Only the latter explanation involves a direct choice of the listing country's law as distinguished from the characteristics of its market, though the law may be relevant under the "Law and Finance" in helping to create the market.

First, cross-listing may be an attempt to overcome barriers to cross-border capital flow that encourage market "segmentation," or different prices in different markets. Segmentation could occur if investors in Country A incur extra costs of trading shares that are listed only in Country B, as where laws restrict or tax such transactions. By overcoming segmentation and reaching more investors, a firm can lower its cost of capital because risks are shared among more shareholders. Miller (1999) provides some evidence supporting this theory by showing that firms that cross-list on major US exchanges have higher abnormal returns than those that list on less liquid exchanges such as PORTAL. He also shows that Chilean firms, which face home barriers to capital flows, have large abnormal returns from cross-listing.

However, these effects could be attributable to differences in disclosure regimes faced by the different categories of cross-listing firms. Thus, Miller shows that cross-listing firms are hurt by private sales but helped by more regulated public sales. Also, the evidence cited above correlating cross-listing with the type of law in the domestic or cross-listing market, or the location or nature of the cross-listing companies' financing activities after cross-listing, is largely inconsistent with a market segmentation explanation. Moreover, there is evidence that the prevalence of cross-listing by firms in a market does not depend on the market's degree of integration (Doidge, Karolyi & Stultz; Lee).

Second, cross-listing may bring the cross-listing company to the attention of more investors under Merton's (1987) "awareness hypothesis." A related explanation is that cross-listing may lead to more analyst and media attention (Baker, Nofsinger and Weaver). Foerster and Karolyi (1999) show that the prices of cross-listing companies increase depending on how much they increase their shareholder base. Also, Phylaktis & Korczak show that trading in the US contributes to price discovery in the shares of cross-listed firms. This may explain some cross-listing between countries with comparable regulation and integrated markets, such as that by Israeli firms (Blass & Yafeh), and the greater amount of cross-listing in the US than in London (Baker, Nofsinger & Weaver).

In general, the data over the last five years discussed above establishes bonding as a dominant explanation for cross-listing. This supports viewing cross-listing as *regulatory* rather than just *market* competition.

D. ALTERNATIVES TO CROSS-LISTING

Assuming that cross-listing firms seek to bond their investor protection by cross-listing, there is a further question why they obtain this bonding by cross-listing rather than in other ways. As discussed below in this Part, there are other feasible methods by which firms can bond their behavior. However, these methods may involve higher costs or lower benefits than cross-listing.

1. Reputational bonding

Companies may reassure investors through a reputation for fair dealing gained by refraining from unfair conduct (Klein and Leffler). The market trusts the firm because it knows that the firm will forfeit the bond if it cheats. The reputational bonding theory is consistent with evidence that bonding occurs even without an expectation of legal enforcement (Siegel). Siegel suggests that firms might be achieving reputational bonding by cross-listing in the US. King & Segal (2004) test for this by finding a proxy for reputational bonding – the relative extent of trading in the US and in the home country following cross-listing. King & Segal find that Canadian shares cross-listed in the US are valued more highly than non-cross-listed Canadian firms only if the cross-listed firms trade predominantly in the US. Such trading suggests that the firm has successfully posted a reputational bond with US investors.

It is not clear how cross-listing interacts with reputational bonding. Firms might just stay home and trade on their enhanced reputations, or capitalize on their reputations by trading in more liquid markets, without getting an additional boost from the law of the cross-listing country. On the other hand, cross-listing might interact in various ways with legal enforcement. First, the legal remedies provided for through cross-listing provide incentives for trial lawyers and others to spot violations, thereby enhancing the value of the reputational bond (Ribstein 2004a).

Second, firms might cross-list if they already have reputations for fairness to minority investors even in the absence of legal constraints in their home countries, but are seeking to further reduce their cost of capital through bonding. This is consistent with evidence discussed above that the highest-quality firms are the most likely to cross-list.

Third, cross-listing might be viewed as the first stage in a reputational bonding process. In the second stage the firm shows that it can operate without its insiders appropriating gains from minority investors. This, in turn, bonds future good behavior. Under this explanation, cross-listing provides initial bonding for firms when they first enter public markets, but would be less valuable for firms that already have established reputations. This may not show up in the data on which firms tend to cross-list (Lang, et al; Doidge, et al) because high-quality firms have lower costs of complying with cross-listing law, or gain signaling as well as bonding benefits.

2. Certification

Firms could bond or signal good behavior through certification (Lerner & Tirole). This is distinguishable from a "licensing" type regime in which firms are required to comply with certain rules in order to trade. Under certification, the firm contracts to be bound by certain rules, subject to a contractual penalty such as damages or expulsion from the certifying organization, but is legally permitted to trade even without listing.[11] The willingness to submit to damages for breach of performance can be considered either a bond against poor performance or a signal that the firm is high-quality and therefore faces a relatively low risk that the penalty will be assessed.

An advantage of certification over regulation is that it lets firms choose their preferred tradeoff between the costs of obtaining a tougher certification and the benefits of offering a higher level of assurance to investors (Lerner & Tirole). Firms could certify their securities in several ways. First, they could hire outside agencies such as Standard & Poor's and Moody's to, in effect, stand in for regulators in the US or other cross-listing countries. For example, Standard & Poor's certification has been said to be an instrument of financial reform in Russia (Judge & Naumova). Firms might get an effect similar to that of certification by purchasing "financial statement insurance" (Cunningham 2004; Ronen). The insurer would agree to hire the auditor and pay investors in case of fraud.

Second, firms can certify their integrity by listing on securities exchanges. In the US, exchange listing automatically triggers application of the securities laws. Exchanges also impose listing requirements and monitor for violations. Firms theoretically could bond their promises to shareholders by listing without subjecting themselves to the law of the listing country (Mahoney 1997). Huddart, Hughes, Brunnermeier present a model in which exchanges compete for traders, and insiders have the incentive to give up profits by listing on a high-disclosure exchange because they know that liquidity traders will avoid low-disclosure exchanges. Coffee (2002) discusses exchanges' role in providing the bonding benefit of cross-listing, stressing the New York Stock Exchange's strong reputation as a reason for the US's advantage in the cross-listing market. Because of the role of exchange listing in triggering legal regulation in the US it is difficult to separate the effect of listing from that of subjecting the firm to US law. More generally, the LLSV (1998) data on securities regulation around the world does not track exchange regulation.

Certification, including regulation by exchanges alone, as in the UK (Black & Coffee), might provide a lower level of bonding than subjecting the firm to the risk of legal liability, given the exchange's limited investigatory resources and inability to levy criminal penalties. Indeed, the data on bonding discussed above in Section II.A focuses on differentiating among the levels of regulation to which foreign issuers submit in the US. Thus, firms may bond through a *combination* of certification and cross-listing.

3. Sale without listing

If, as suggested immediately above, legal enforcement is what matters, firms can bond their protection of investors by selling in the US or other foreign country even without listing there because merely selling in the other market exposes the firm to fraud litigation.[12] In the US this would include litigation under the general anti-fraud provisions of the Securities and Exchange Act of 1934.

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[11] By this definition, cross-listing might be viewed as a type of certification in that the firm voluntarily subjects itself to the law of the cross-listing country in the sense that it could trade in its home country without cross-listing. However, certification is used here to refer to obligations imposed by law as a condition of engaging in a particular activity – in this case, trading in the US.

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

A problem with bonding through unlisted sales is that this triggers only limited regulation. Most importantly, foreign firms are not subject to mandatory disclosure, or to the monitoring obligations that accompany such mandatory disclosure. For example, firms may have no duty under fraud law to disclose "soft," or evaluative, information. This reduces the value of any bond associated with trading in the other market. Coupling listing with legal regulation in the US complicates the determination of whether the bonding is produced by the exchange listing alone, or by the regulation that accompanies the listing. Thus, an unlisted firm may signal that it is of lower quality than a firm that is willing to submit to the higher legal costs and risks of full-fledged mandatory disclosure regulation.

4. Local incorporation

Firms could choose not only to comply with the securities law of another country, but also to incorporate under the law of that country. For example, Israeli venture capital firms have locally incorporated to present themselves as American firms rather than as foreign private issuers (Rock). This would seem to create a stronger bond because it subjects the firm to regulation not only of its disclosures, but of matters that federal disclosure laws do not reach, including shareholder governance powers to elect directors and vote on corporate transactions, fiduciary duties and remedies dealing with abuse of managerial power, and protection of minority shareholders in control transactions.

More importantly, local incorporation gives the cross-listing firm the benefit of adjudication by the courts of the incorporating jurisdiction. This could allow firms to bypass corruption or lack of business sophistication in the courts of their home country. In fact, the quality of the Delaware's courts has been at least as responsible as the quality of its law in maintaining Delaware's dominance in US corporate law (Romano). Even if Delaware law inefficiently favors litigation, Delaware incorporation benefit the firm by sending a signal that the firm is high-quality and therefore presents a relatively low risk of litigation compared to other firms (Iacobucci). Although firms could try to obtain Delaware adjudication without choice of Delaware law through a choice of forum clause in their incorporating document, a Delaware court is likely to decline to hear such a case on *forum non conveniens* grounds.

The problem with local incorporation as a bonding device is that it subjects the firm whose operations and headquarters remain in a foreign country to possibly conflicting regulations under both home country and foreign law where home country law applies a "real seat" choice of law rule. Some of these rules may conflict with those in countries that provide for bifurcated boards with labor representation and that force shareholders to share power with other stakeholders.

Accordingly, non-US firms would be likely to incorporate in the US only if they physically move their operations and headquarters to the US, their home jurisdictions, like Israel, apply the law of the incorporating state or their law is compatible with that of the cross-listing jurisdiction. Moving to the US negates an important advantage of cross-listing of facilitating the flow of capital to countries that have not yet developed the conditions for strong capital markets. The state-of-incorporation rule is not yet widespread outside of the US, though *Centros*[13] and *Inspire Art*[14] may signal its

[13] Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459 (1999), 2 C.M.L.R 551 (1999).

introduction into Europe. Finally, the compatibility condition would limit the benefits of cross-listing to the firms that least need to outsource law.

E. SUMMARY AND IMPLICATIONS

The above analysis has several broad implications for regulatory competition. First, it suggests that most cross-listing firms are choosing the mandatory disclosure *law* of the cross-listing country and not simply its *market.* Thus, countries can compete for cross-listing business by offering law and enforcement regimes that are attractive to cross-listing firms. The remainder of this article builds on this assumption.

Second, cross-listing firms may be seeking a range of legal regimes in which to cross-list varying in legal strictness. This follows from the differences among cross-listing firms regarding their benefits and costs of bonding through cross-listing and the tradeoffs inherent in alternative certification strategies.

Third, cross-listing firms generally can be assumed not to be seeking full regulation of internal affairs in the cross-listing country. This follows from the fact that they likely will remain subject to laws in their home countries that differ materially from those in the cross-listing country. This suggests that cross-listing countries should apply only disclosure rules to foreign firms that can be meshed with a variety of different governance regimes (see subpart IV.C, below).

III. EFFECT ON HOME COUNTRY LAW

An obvious effect of cross-listing is that the law of the cross-listing country will be applied to a significant number of firms based elsewhere. The above analysis suggests that this enables firms to bypass impediments to adoption of rules supporting strong capital markets at the "macro" or political level. This Part considers cross-listing's effects in the home countries of cross-listing firms. Subpart A considers how cross-listing might produce political effects in these home countries. Subpart B discusses the consequences of potential incompatibility between the laws applied to firms through cross-listing and these firms' home-country law or culture.

A. POLITICAL CONSEQUENCES OF CROSS-LISTING

Cross-listing may affect not only the cross-listing firms but, less directly, the laws of their home country. First, firms that cross-list and therefore become subject to the stronger shareholder protection rules of the US or other cross-listing jurisdiction may demand changes in local laws that will make these rules mesh better with those of the cross-listing jurisdiction. Notably in this regard, the first firms to cross-list from a particular jurisdiction may be the largest and most influential, because they have the lowest costs of complying with strict laws, and stand to gain the most from increased access to capital.

Second, local securities, legal and accounting professionals may have an interest in promoting changes in local law to help maintain local trading. These groups' incentives are sharpened by the fact that cross-listing has been shown to reduce the value

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[14] Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd, September 30, 2003), 2003 E.C.R. __ (2003) (requiring member state to show an "overriding reason relating to the public interest" in order to block application of incorporating state law).

of the same country's non-cross-listing firms (see section II.A, above). This gives the remaining firms a strong incentive to cross-list.[15] Cross-listing therefore may shrink securities professionals' local clientele.

These groups' efforts may cause home country governance to "converge" with US norms. For example, Coffee (2002) discusses how the Mexican securities industry promoted stronger rules in Mexico in the wake of Mexican firms cross-listing in the US. Wojcik (2004) finds remarkable convergence in Europe on disclosure and board structure between 2000 and 2003, a period that follows significant increases in cross-listing.

Even if cross-listing firms and securities professionals lobby for change in their home countries, it is not clear they will be successful. First, a move to laws that favor dispersed owners might be contrary to the interests of local banks and others that cater to controlling shareholders. A dispersed owner market lets entrepreneurs take their ideas directly to individual investors, making them less dependent on market intermediaries. These institutions may have enough clout to block significant change. They may also be able to push for regulation restricting cross-listing of local firms, and thereby alleviating the pressure to make local changes.

Second, to the extent that cross-listing causes a move to US-style shareholder wealth maximization it may hurt stakeholder groups such as labor or consumers who have power in firms under the more communitarian governance that prevails outside the US (Cunningham). In this view, prior to widespread cross-listing, stakeholders aligned with controlling shareholders were powerful enough to maintain a political equilibrium that efficiently took stakeholders' interests into account. However, cross-listing upsets this equilibrium by permitting stakeholder-controlled firms to take advantage of laws favoring dispersed ownership. Just as outsourcing in India puts pressure on worker welfare in the US, "outsourcing" to US law can put pressure on stakeholders in non-US firms. To be sure, shareholder groups and securities industry professionals may welcome the pressure cross-listing puts on stakeholder governance. The point here is simply that the outcome of this interest group competition may be indeterminate.

Third, there may not be a unity of interests between home country securities industry professionals who lose business from cross-listing, and local capitalists and others who gain from cross-listing. Local business people welcome reductions local firms' cost of capital regardless of how these reductions occur, including through cross-listing. Even local securities professionals who have specialized knowledge of local firms may gain business from increased trading of local firms in foreign markets. Moreover, securities professionals may gain from an increase in *local* trading that flows back from the cross-listing to the home market (see subpart IV.B). In other words, those who lose from cross-listing not only face opposition from stakeholder groups, but also may get little help from business interests.

Fourth, local business interests might prefer the cross-listing alternative to changes in local law that may have their own regulatory costs and unpredictable effects (Coates). Alternatively, they may be sufficiently indifferent between the two alternatives that they are unwilling to incur the costs of lobbying for change.

Fifth, cross-listing may even defeat convergence to the extent that it offers a way to obtain the benefits of stronger law without costly political change. In other words,

[15] However, the firms whose insiders have the most to lose from cross-listing may resist (Barzuza).

cross-listing be viewed as a safety valve that reduces the political pressure for strong corporate laws.

B. THE INCOMPLETE TRANSPLANT PROBLEM

As discussed above, cross-listing's main advantage is that it is supposed to give firms the benefits of strong legal protections for minority shareholders without the fundamental changes in their local law and culture that otherwise would be necessary. But this raises the question whether the cross-listing law can effectively bridge the gap – that is, whether legal concepts can be successfully transplanted from one system to another (e.g., Berkowitz, et al; Kanda & Milhaupt; Licht (2004)). For example, Licht (2003) discusses how cultures differ on such important governance concepts as accountability, independence and self-dealing. Cunningham argues that application of US law would impose US shareholder primacy and profit-maximization "spokes" on foreign "hubs" that emphasize the growth and survival of the corporate entity. Similarly, Roe concludes that concentrated ownership is an outgrowth of social democratic values and obedience to stakeholder interests. Paredes and Ahdieh elaborate on the specific institutions that exist in the US but not elsewhere that make dispersed ownership work. Stout argues that US-style fiduciary duties are unlikely to work in cultures that do not share similar attitudes on altruism.

As discussed below in subpart IV.E., these considerations point to exempting foreign firms from the cross-listing country's internal governance law. On the other hand, applying this country's disclosure law might make the cross-listed shares more palatable to minority investors than they would be without cross-listing, even if US-style governance cannot completely take hold.

In general, this Part suggests that complete convergence of corporate laws is not an inevitable, or even strongly likely, result of cross-listing. If governance systems resist change, this may put pressure on cross-listing countries to mitigate the application of their laws to foreign-based firms. This focuses attention on the political dynamic in the cross-listing country discussed in the next Part.

IV. EFFECTS IN CROSS-LISTING COUNTRY

This Part discusses the effect of cross-listing on the law of cross-listing jurisdictions. At first glance it might seem that cross-listing firms have no political clout to protect themselves from increasing regulatory costs in the cross-listing country. However, while they may not have a direct political *voice* in the cross-listing country, they have a greater power than local firms to force regulators to take their interests account because of the threat of *exit* from the cross-listing country. While local firms would have to physically relocate their business and shareholders to avoid the reach of their home country's securities laws, cross-listing firms can simply stay home and not list in jurisdictions that make their laws too burdensome. Thus, law changes in the cross-listing country can affect cross-listing firms' demand for that country's law.

This scenario depends on local interest groups in the cross-listing country being affected by the cross-listing market. Subpart A discusses potential adverse effects of applying the law of the cross-listing country to foreign firms. Although the theory of cross-listing discussed in Part II suggests that these firms likely are seeking to have this law applied to them, the costs of some legal provisions are likely to outweigh the benefits for cross-listing firms. It follows that changes in the cross-listing country's law may affect the number of cross-listings.

Subpart B discusses the political effects of the market for cross-listings, with particular application to the US. It shows that the potential for reducing lucrative trading in cross-listed firms may induce political action to exempt such firms or modify how regulation applies to them. Subpart C discusses the Sarbanes-Oxley Act of 2002 and its aftermath as an illustration of the potential effect of the cross-listing market on the cross-listed law. Subpart D discusses the policy aspects of exempting foreign firms from cross-listing country law in order to minimize the negative impact of that law on the volume of cross-listing. Subpart E presents an approach to exempting cross-listing firms – that is, exempting foreign firms from governance but not disclosure rules of the cross-listing jurisdiction.

Subpart F discusses implications of a strategy of exempting foreign firms from federal regulation of corporate governance. In general, it shows that, just as expanding federal law may constrain Delaware, federal law is, in turn, constrained by an international regulatory competition fueled by cross-listing.

A. LAW AND THE MARKET FOR CROSS-LISTINGS

Firms will not cross-list if the cost of doing so exceeds the benefit of reducing their cost of capital. Thus, if the benefits of cross-listing remain constant, cross-listing should decline if the costs increase. To the extent that cross-listing firms seek bonding under the law of the cross-listing jurisdiction rather than simply access to the cross-listed market, they would want some provisions of the cross-listing country's law to apply to them. However, it does not necessarily follow that stricter laws encourage more cross-listing. At some point the costs of bonding may exceed the benefits to cross-listing firms in terms of reducing their capital costs.

The details of determining which cross-listing country laws should be applied to cross-listing firms are discussed below in subpart IV.D. For present purposes it is sufficient to identify the inherent problem – the fact that cross-listing firms are subject to a very different legal and political structure in their home countries. Thus, while the law of the cross-listing country may be well-designed for dispersed-owner markets, it may not work for a firm based in a concentrated-owner market country that remains subject to the law and corporate governance structure of that country. As discussed in subpart I.B, the differences may be deep-seated. Indeed, it is the depth of these differences that makes macro-level change so difficult, and therefore compels firms to seek micro-level (firm-specific) change through cross-listing.

If the law of the cross-listing country is value reducing for cross-listing firms – that is, imposes legal costs in excess of bonding or signaling benefits – this may immediately cause a decline in cross-listings. The reason is that the market for cross-listings is likely to become increasingly competitive so that economic rents to the main players will dissipate. First, to the extent that cross-listing may viewed as a bridge from concentrated-ownership to dispersed-ownership markets, the overall market for cross-listing can be expected to shrink over time as more markets make the transition, through cross-listing or otherwise, to the legal framework necessary to support dispersed ownership. In other words, the market for cross-listing may be self-eliminating in the long run.

Second, as world securities markets develop, leading cross-listing jurisdictions such as the US are subject to more competition from other strong capital markets for the decreasing pool of customers. This means that they lose their ability to charge monopoly "rents" in the form of over-regulation. Cross-listing firms will be able to choose the jurisdiction that provides just the right level of bonding or that sends the right signal rather than having to choose between too much regulation and none at all.

B. POLITICS AND THE MARKET FOR CROSS-LISTINGS

Subpart A suggests that enacting some types of corporate law in the cross-listing country may reduce the number of cross-listings in that country. If that is the case, there is a further question whether this can have a feedback effect on the law of the cross-listing country. In other words, can the cross-listing market constrain the law of a country that attracts a large number of cross-listing firms?

The answer turns partly on whether any change in the number of cross-listings will be translated into political action in the cross-listing country. This depends on how cross-listing affects influential interest groups in those countries. These groups can be broadly divided into securities firms, on the one hand, who sell foreign securities, and legal and accounting experts who render professional services to foreign firms. With respect to the first group, any increase in the volume of securities transactions over US-based exchanges directly benefits the exchanges themselves, specialists on the exchanges and market makers who manage trading of the cross-listed shares. Securities brokers and dealers will have new products to sell, and therefore possibly increased commissions and profits for their firms. Thus, the securities industry would favor legal rules that encourage cross-listing. The benefit to exchanges and securities professionals is subject to "flow-back" of cross-listed securities to other countries, where the trading is handled by local exchanges and securities dealers. Indeed, this flow-back is important evidence of the bonding theory of cross-listing as distinguished from the search for additional liquidity in the target country.

The political effects of cross-listing differ somewhat for lawyers and accountants who benefit by advising cross-listing firms on host country legal and accounting standards, prepare disclosure documents and handle litigation. Like securities industry professionals, advisers would gain from increasing the number of new listings. On the other hand, lawyers and accountants could gain from laws that increase the advice and other services required for each listing even if foreign firms traded mostly in foreign markets or law changes deterred or reduced cross-listings. Moreover, lawyers and accountants as a whole may gain from increasing the complexity or rigor of the disclosure system even if the specialists in foreign securities lose business.

On balance, an increase in regulatory costs for cross-listing firms is likely to have a political effect in the cross-listing market. As discussed below, the size of the effect depends on the nature of the law changes – specifically, whether they raise a significant problem of meshing the law of the cross-listing country with that of cross-listing firms' home jurisdictions.

C. THE US EXPERIENCE

This subpart focuses on the US as a prime example of the impact of cross-listing on the law of the cross-listing jurisdiction. Section 1 discusses the general context in the US of the debate concerning the appropriate spheres of federal and state law. Section 2 discusses the impact of the Sarbanes-Oxley Act of 2002 on the cross-listing market. The adoption of that law, with its stricter regulation of internal governance and application to foreign firms, provided an opportunity for a sort of natural experiment of the interaction between the cross-listing market and the law of the cross-listed country.

1. The federal/state divide in US corporate law

Corporate law in the US traditionally has been divided between *state* law, which regulates internal governance of corporate law, and *federal* securities regulation, which is explicitly based on the principle that the law regulates only what issuers say about themselves. The effect of that division is that firms are left essentially free to decide how to govern themselves by choosing the applicable state corporation law. US law assumes that, if the market is adequately informed about firms' internal governance, it can efficiently price different governance structures, and capital can flow to the most efficient structures.

Some scholars, notably including Bebchuk and Cary, have argued for federal regulation of substantive corporate governance. Moreover, the governance/disclosure bifurcation never has been complete. The Securities and Exchange Act of 1934 always has regulated internal corporate governance through the proxy provisions in Section 14, which require extensive disclosures in connection with shareholder meetings and voting. Although the Act still emphasizes disclosure, the disclosure/substantive distinction may be subtle. For example, the shareholder proposal rule[16] requires managers to disclose in the proxy statement sent to shareholders proposals that individual shareholders plan to make at the shareholders' meeting. This effectively requires corporate managers to present certain subjects for debate. While the rule is formally subject to state law rules regarding what issues shareholders can raise, these rules are flexible enough not to impose much of a constraint. Thus, even if shareholders are not supposed to be able to propose specific management actions, they can propose precatory resolutions or charter amendments that amount to the same thing.[17] Moreover, the board may not be able to act under state law to limit effect of the rule by blocking shareholder proposals that the rule otherwise would allow.[18] Thus, the rule supersedes state law to some extent in defining board and the shareholder roles in corporate governance. The SEC recently demonstrated how far it could penetrate into regulating corporate governance by proposing to mandate shareholder nomination of directors in some situations.[19]

The SEC also has attempted to regulate corporate governance through the stock exchanges. The stock exchanges long have regulated the governance of listed firms (Thompson 2003). As long as this regulation can be enforced only by the threat of delisting, exchanges are constrained from over-regulating by the fact that firms can decide to list elsewhere. However, the situation is complicated in the US by the SEC's power to regulate the exchanges. Thus, when the New York Stock Exchange dropped its prohibition on dual-class shares after NASDAQ adopted a more liberal rule, the SEC adopted Rule 19c-4,[20] which restricted exchange authorization of dual-class shares. A

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[16] 17 CFR 240.14a-8.

[17] See, e.g., Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), vacated, 404 U.S. 403 (1972).

[18] SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947), cert. denied, 332 U.S. 847 (1948)

[19] Proposed Rule: Security Holder Director Nominations, SEC Release No. 34-48626 (October 14, 2003). The rule is currently being revised after receiving strong criticism.

[20] 17 CFR §240.19c-4.

federal court ultimately held that the SEC had overstepped its statutory authority.[21] But the SEC has managed to use its substantial power over the exchanges to persuade them to "voluntarily" regulate corporate governance (Thompson 2003). This has included an eventual exchange consensus over dual class stock,[22] rules regarding shareholder voting on compensation plans,[23] and rules requiring boards to have a majority of independent directors and that would define independence.[24]

Apart from the SEC's broad power under existing laws, the federal securities laws themselves have been expanded into substantive regulation of corporate governance (Thompson and Sale). This regulation included the Williams Act, which regulates both disclosures connected with takeover bids and the terms of tender offers;[25] the Foreign Corrupt Practices Act,[26] which added bookkeeping duties; and regulation of insider trading under Section 10(b) of the Securities Exchange Act.

More generally, Roe (2003) argues that the federal government can exercise considerable influence simply because the states in general, and Delaware in particular, know that the federal government can step in and regulate at any time – at the extreme, by enacting a federal corporation law. Thus, federal legislation, and not legislation by other states, provides the most important competition for Delaware law.

As extensive as this federal regulation of corporate governance is, at least until recently it did not impose duties on foreign firms that were inconsistent with the internal structure imposed by foreign law. Most importantly, foreign issuers 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.[27] However, as discussed immediately below, the Sarbanes-Oxley Act of 2002 has brought the potential conflict between US and foreign law to a head. As discussed in subpart E, this has, in turn, forced Washington to face *its* competition – the international market for securities regulation.

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21 Business Roundtable v. Securities and Exchange Commission, 905 F.2d 404 (D.C. Cir. 1990).

22 See Order Granting Approval to Rule Changes Relating to Exchanges' and Association's Rules Regarding Shareholder Voting Rights, Exchange Act Release 34-35121 (1994).

23 See Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and NASDAQ Proposed Rule Changes and NASDAQ Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments No. 1 and 2 and NASDAQ Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans, SEC Release No. 34-48108 (June 30, 2003).

24 See NYSE Listed Company Manual, §303A, http://www.nyse.com/pdfs/finalcorpgovrules.pdf (June 30, 2003).

25 Securities Exchange Act of 1934, §§ 13(d) and 14(d)-(e).

26 *Id.* §13(b(2).

27 *See* 17 CFR Section 240.3a12-3(b).

2. Sarbanes-Oxley and cross-listings

The adoption and subsequent history of the US Sarbanes-Oxley Act of 2002 illustrates the political dynamic described in subpart 1. That Act significantly expanded federalization of corporate law by providing for stringent monitoring standards. The law included the following regulation of substantive corporate governance: regulation of firms providing audits for firms publicly trading in the US; requirement of independent audit committees; certification of financial statement accuracy and internal controls by executive and financial officers; executive reimbursement of incentive compensation from an accounting period for which earnings had to be restated; lawyers' duty to report evidence of securities violations; prohibition on issuer loans to executive officers or directors; annual report disclosures of managers responsibilities for setting up internal control and financial reporting structure and procedures; disclosures regarding an issuer's code of ethics; disclosures regarding audit committee "financial expert;" and whistleblower protection (Ribstein 2002).

Sarbanes-Oxley creates new problems for foreign-based firms listed in the US. Because of the poor fit between Sarbanes-Oxley provisions and European governance, the compliance costs of these requirements for non-US corporations may outweigh the bonding benefits. To begin with, Sarbanes-Oxley imposes new substantive requirements that may conflict with or duplicate the home-country law of foreign firms to which the Act applies. For example, while SOX prohibits loans to executives,[28] German law restricts such loans in large public companies unless they are approved by the supervisory board.[29]

Much attention has been focused on the Sarbanes-Oxley requirement that firms have an independent audit committee that is responsible for hiring and oversight of auditors. The audit committee cannot include an "affiliated person" of the issuer.[30] The SEC defines "affiliated person" as one who "controls, or is controlled by, or is under common control with, such issuer."[31] "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."[32] There is a safe harbor for beneficial owners of 10% or less of any class of equity securities of the issuer who are not also executive officers or directors,[33] and one member may represent majority shareholders as an observer.[34] But the Act otherwise excludes significant shareholders who otherwise might insist on more of a voice in this powerful committee. 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 (Faccio

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[28] Sarbanes-Oxley Act of 2002 § 402, 15 U.S.C.A. § 78m(k) (West Supp. 2003).

[29] Aktiengesetz § 89.

[30] 15 USC Section 78j-1(m)(3).

[31] 17 CFR Section 240.10A-3(e)(1)(i).

[32] 17 CFR § 240.10A-3(e)(3)

[33] *Id.* §240.10A-3(e)(1)(i).

[34] *Id.* § 240.10A-3(b)(1)(iv)(D).

& Lang).

The SOX audit committee provisions may force some non-US firms to fundamentally restructure. In particular, German firms must have both a “managing board” composed of corporate insiders, and a “supervisory” board, composed half of labor and lower-level managers and half of shareholder representatives, which monitors management.[35] In German companies with two-level boards, the auditor is appointed at the shareholders’ annual general meeting upon nomination and determination of the auditor’s independence by the supervisory board.[36] Thus, establishing an audit committee that complies with Sarbanes-Oxley may usurp the appointment powers already assigned to the shareholders. Also, Sarbanes-Oxley’s exclusion from the audit committee of anyone who receives a "consulting, advisory or other compensatory fee from the issuer" or is “an affiliated person” of the issuer[37] seems to exclude most labor members of the board, representatives of a controlling shareholder, and shareholders or their representatives who have commercial or professional relationships with the firm, and possibly even *all* supervisory board members because these members are eligible for compensation.[38] Even outside of Germany, these provisions may exclude representatives of banks and other large shareholders who have significant monitoring functions.

More generally, Sarbanes-Oxley raises problems because its rules do not fit the very different governance of non-American firms. This is particularly clear regarding regulation of the conduct of corporate executives. In US corporations, executives have significant power, subject only to general supervision by the board. It follows that it may make sense for firms to tightly police potential conflicts of interest between executives and shareholders. In other countries, the hierarchy may be more complex and executive officers may have less power. For example, Japanese corporations do not have executive officers in the sense referred to in Sarbanes-Oxley, but rather are managed by a complex hierarchy of committees (Cunningham). This suggests potential difficulty in applying Sarbanes-Oxley provisions dealing with executive certification of financial reporting and monitoring devices. It also raises questions about applying Sarbanes-Oxley’s prohibitions on trading during restrictions on pension plan participants (Cunningham), and various provisions imposing liability on executives.

Similar considerations apply to lawyers and other professionals. Professionals’ liability for failure to monitor clients should depend significantly on their costs and benefits of monitoring, which in turn depend in turn on their relationships with clients and the market for professional services (Ribstein 2004a). Specifically, if professionals lack the clout to insist on disclosures from their clients, imposing whistle-blowing responsibilities on them is likely to sharply decrease information flows between professionals and their clients (Painter). Because the relevant factors vary among jurisdictions, there is no reason to believe that rules appropriate in the cross-listing jurisdiction should be applied to cross-listing firms based in other countries.

Even if Sarbanes-Oxley provisions can be applied straightforwardly to foreign

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[35] Section 111 I AktG.

[36] AktG Section 119 I Nr. 5; HGB §318 I.

[37] 17 CFR Section 78j-1(m)(3).

[38] Section 113 I 1 AktG.

firms, they do not have the same benefits and costs in this context as when applied to US firms. European firms rely on monitoring of executives by large shareholders rather than on incentive compensation, particularly given the constraints on executive pay in social democratic system (Kraakman, et al, at 118). By contrast, US managers get high-powered incentive compensation, and are subject to a strong duty of loyalty administered by active courts and by stronger social norms, all reinforced by extensive mandatory disclosure (id at 114, 116). Given these basic differences between the two systems, there is no reason to assume that more US-style monitoring and liability would be appropriate for European executives. Yet Sarbanes-Oxley imposes personal liability on executives for certifying false financial information and requires return of compensation and stock profits following earnings misstatements even if the executive was entirely without fault or knowledge of the misstatement. Even in US corporations there is evidence of a decline in incentive compensation of executives and risk-taking (measured by research and development expenses and capital investment) following Sarbanes-Oxley (Cohen, et al). The effect could be even more significant in non-US corporations, where incentives of non-owner executives are traditionally weaker than in the US.

3. Reaction and political response

After adoption of Sarbanes-Oxley, there was an outcry from non-US firms subject to the law that indicated that Sarbanes-Oxley might threaten cross-listings. The loudest reaction to Sarbanes-Oxley was by 24 major German corporations, including DaimlerChrysler, Bayer, and Deutsche Telekom, requested an exemption from the Act.[39] Foreign law firms also strenuously objected to the obligations imposed on lawyers under Section 307 of the Act (Lucci). There is anecdotal evidence that foreign firms are less willing to cross-list in the U.S. after Sarbanes-Oxley.[40] John Thain, CEO of the New York Stock Exchange, reports that, while the NYSE listed an average of 50 non-US companies a year between 1996 and 2001, in the past two years the average fell to 25, with a particularly sharp decline from 19 to 6 European companies. He attributes the drop, among other things, the cost of internal control requirements under Sarbanes-Oxley, the rise in securities litigation in the US, and the rise of European capital markets.

To be sure, there is so far no hard data on the effect of Sarbanes-Oxley on cross-listing. Perino notes that firms will continue to cross-list because they derive significant benefits from doing so. While this may be true, the question is whether Sarbanes-Oxley will cause a substantial number of firms that are on the margin to withdraw or forego cross-listing. It is difficult to get reliable data on non-listings.

The SEC responded to the criticisms by German and other companies by issuing a rule that partially exempts foreign firms from some Sarbanes-Oxley requirements.[41] The rule permits non-executive employees in foreign-based issuers to serve as audit committee members, large shareholders to send observer representatives, and foreign firms to substitute for the audit committee a board of auditors or similar body whose independence and responsibility for appointing and overseeing the firm's auditor is

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[39] *See* Petition for Rulemaking submitted by the Organization for International Investment, File No. 4-462 (Aug. 19, 2002).

[40] *See* Craig Karmin, Foreign Firms Lose the Urge To Sell Stock in U.S. Market, Wall St. J., July 24, 2003 at C1.

[41] 17 CFR Section 240.10A-3.

provided for in home country legal or listing provisions.[42] The SEC also clarified in its release accompanying the rule that in foreign private issuers with two-tier boards, "the term "board of directors" means the supervisory or non-management board.[43] Thus, this board could serve as the audit committee if it was independent under the proposed rule.

Other SEC exemptions from Sarbanes-Oxley also reflect the problems described above. Sarbanes-Oxley's prohibition on trading during pension blackouts was applied only to a foreign private issuer's principal executive, financial and accounting officers of the registrant.[44] The SEC's rule under Section 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.[45]

D. POLICY IMPLICATIONS OF EXEMPTING FOREIGN FIRMS

This subpart discusses the normative aspects of exemptions of foreign firms from the cross-listing jurisdiction's law. Most importantly, exempting foreign stocks may undercut the rationale for mandatory disclosure. If investors do not know which firms are withholding information, there may be a "lemons" market in which investors must discount the prices of all securities. Coffee (1999) uses this as the basis of an argument against exempting foreign firms from US requirements. Specifically, he argues (at 694) that domestic firms might be "stigmatized" because of investors' inability to distinguish such firms from non-complying foreign firms, and that trust in the securities markets may decline if foreign firms trading in the US permit opportunism by controlling shareholders.

These arguments do not, however, justify across-the-board mandatory disclosure. The "lemons" argument assumes that investors cannot easily distinguish truthful from fraudulent firms. However, investors easily can determine where the firms are based and who is regulating them. Firms can, therefore, signal their level of disclosure by choosing from multiple regimes. The evidence on the bonding theory of cross-listing discussed above indicates that investors can make these distinctions by showing that firms' cost of capital reflects the level of bonding. There is also evidence that investors have distinguished between listing and "pink sheet" domestic firms that are subject to different levels of regulation (Bushee & Leuz).

Mandatory disclosure for both foreign and domestic firms arguably is justified to the extent that these firms compete in product markets. Coffee (1999) argues that US firms will be disadvantaged by foreign firm exemptions because they will have to disclose proprietary information that their foreign rivals can hide. Analogously, firms in the US evidently have been going private in response to the increased disclosure requirements under Sarbanes-Oxley (Block).

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42 *Id.* §240.10A-3(c)(3).

43 *Id.* §240.10A-3(e)(2).

44 *See* SECURITIES AND EXCHANGE COMMISSION, INSIDER TRADES DURING PENSION FUND BLACKOUT PERIODS, 17 CFR Parts 240, 245 and 249 [Release No. 34-46778; IC-25795; File No. S7-44-02] (Nov. 6, 2002).

45 *See* Implementation of Standards of Professional Conduct for Attorneys, Release 33-8185, 17 CFR 205.2(j) (defining "non-appearing foreign attorney") (August 5, 2003), http://www.sec.gov/rules/final/33-8185.htm.

Even if firms have incentives to disclose voluntarily, it may be costly for them to jointly devise a system that would make investments comparable. Mandatory disclosure solves this problem (Easterbrook & Fischel). Applying this to the cross-listing context, Coffee (1999) argues that applying different standards to foreign and domestic firms makes inter-firm comparisons more difficult. There is, in fact, evidence of a lemons or comparability problem if foreign firms are not required to disclose. Even after Enron, US firms have better accounting than non-US firms (Lang 2004). Also, cross-listed firms have better accounting than non-cross-listed firms (Lang, et al).

Thus, there are benefits of requiring all firms in a market to be subject to the same disclosure rules. While these this consideration is not conclusive, when combined with the benefits of mandatory disclosure for the foreign firms themselves it bolsters the case against a foreign firm exemption from mandatory disclosure.

E. THE SCOPE OF THE FOREIGN-FIRM EXEMPTION

Given the reaction of foreign firms to Sarbanes-Oxley, it is logical to conclude that the US should follow a broad strategy of exempting foreign firms form any new expansion of the US securities laws. Moreover, at least a partial exemption is a likely result from a positive political standpoint. Given the protest from foreign firms over Sarbanes-Oxley, and the interest groups in the US that have a stake in preserving cross-listing business, Congress is likely to take their interests into account the next time it seeks to significantly expand the federal securities laws.

Cunningham suggests that Congress "should automatically exempt non-US issuers pending SEC determinations of the necessity of applying the reforms to them." He argues that Sarbanes-Oxley should have been explicitly inapplicable to non-US SEC registrants unless the SEC rules otherwise. However, in crafting exemptions the cross-listing country faces the problem of providing the bonding benefits foreign firms seek without imposing burdens these firms, and particularly their insiders who make the listing decision, are unwilling to bear. At the same time, as discussed in subpart IV.D., the cross-listing country must avoid exemptions that reduce the value of mandatory disclosure for all firms in the market by creating a "lemons" market, reducing the comparability of information, or by disadvantaging companies that compete in the same markets as exempt firms.

The following subsections show how the cross-listing country can address both of these concerns by exempting foreign firms from its *internal governance* law but not its *disclosure* law.[46]

1. The problems of applying internal governance law

Imposing the cross-listing jurisdiction's internal governance law is likely to impose significantly greater costs on cross-listing firms than imposing disclosure law on such firms. As discussed above in subpart I.B, firms' internal structure is likely to be the product of local historical, cultural and political influences. Indeed, this is an important reason why micro-level change through cross-listing may be preferable to attempting macro-level legal change. Most importantly, the law of the cross-listing country is

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[46] This analysis focuses on explicit exemptions by legislators in the cross-listing country. There may also be a question whether the cross-listing country's law applies on issues such as internal governance, particularly where the cross-listing country's law is not explicit on this point. See Vancea.

designed for firms that have dispersed ownership rather than for firms from countries that are seeking to make the transition from concentrated to dispersed ownership. While cross-listing firms ultimately may want and need dispersed-owner rules, it may be costly to apply these rules before firms' home countries have developed accommodating structures.

This point becomes more apparent in light of tradeoffs between the various strategies for dealing with firms' governance and agency problems (Kraakman, et al). In general, in dispersed ownership markets, firms tend to rely on some combination of board monitoring, incentive compensation, a duty of loyalty enforced by strong judicial remedies, an active market for corporate control and mandatory disclosure to ensure that executives act in shareholders' interests. For example, US state corporation law gives specific powers and duties to the board of directors, has elaborate rules regarding how the board exercises this power, and assigns fundamental power over the board to the shareholders (Ribstein 2004). By contrast, in concentrated-owner firms, the owners can effectively monitor managers because they can overcome the free rider problem. Accordingly, the devices employed in dispersed-shareholder markets are less important in this setting. It follows that increasing managerial liability and board monitoring may simply add costs without commensurate benefits in such firms.

Another key difference between countries concerns the board's role. There are significant differences across countries between the monitoring and mediating roles of the board. In social democracies, the board may be significant as a mechanism for mediating between labor and capital. By contrast, in the US and the UK, the board theoretically operates exclusively on shareholders' behalf. It follows that rules requiring strict independence of board members, even if appropriate for US-type shareholder-wealth-maximization firms, may disrupt the politically sensitive balance of power in countries where labor participates in management.

There may, of course, be governance deficiencies in non-US-style firms. However, the above discussion suggests that applying US-style reforms to these firms would not necessarily address their problems. In particular, the main monitoring problem in firms based in dispersed-owner countries concerns the possibility that controlling owners will steal from minority shareholders. But rules designed to empower shareholders or make the board more responsive to their interests are unlikely to be effective in firms that already have powerful owners.

It may also be the case that the costs Sarbanes-Oxley imposes on foreign firms are best addressed by convergence of home-country laws toward the US model. In particular, pro-shareholder groups in Germany may welcome the pressure Sarbanes-Oxley puts on codetermination. However, if the political forces favoring the status quo are strong enough to resist fundamental change in the home countries of cross-listing firms, this may reduce the level of cross-listing.

This analysis presents a conundrum. On the one hand, cross-listing can bridge the gap between dispersed-ownership and concentrated-ownership regimes. On the other hand, the difference between these regimes undermines the usefulness of cross-listing. One way to resolve this conundrum is to view cross-listing as a transitional mechanism rather than a way for firms in one regime to fully adopt the laws of another. Although the cross-listing country may offer its own firms the first-best regulatory environment for dispersed ownership, it does not necessarily follow that these rules are equally appropriate for firms that are *also* subject to a different regulatory regime in their home countries.

Indeed, the history of cross-listing suggests that application of internal governance rules is not essential to attracting cross-listing. Most cross-listing has occurred without offering much direct protection against insider abuse. In the US, at least prior to Sarbanes-Oxley, cross-listing firms have been subject only to federal disclosure law. They do not necessarily subject themselves to internal governance regulation under state law, and are exempt from internal governance regulation at the exchange level. For example, though Coffee (2002) argues for application of substantive governance rules, particularly including minority "tag-along" rights in control sales, US law does not provide for such rights across the board, instead leaving this to individual charters and case by case judicial rules.

Just as cross-listing country internal rules may be costly when combined with home country rules because they are designed for different types of firms, so they may not be much benefit. For example, rules that protect shareholder voting may do little good to protect minority from controlling shareholders,[47] and cumulative voting for directors may even increase the power of large but not controlling shareholders.

2. Applying disclosure rules

In contrast to internal governance rules, disclosure is likely to be the type of legal rule that matters most to cross-listing firms under a bonding theory of cross-listing. Investors need enough information to evaluate and compare their investments, including the rules by which they are governed. As long as investors have this tool, stock prices can reflect the level of shareholder protection, and cross-listing firms will have an incentive to offer this protection in order to reduce their cost of capital. Moreover, mandatory disclosure serves governance functions, including enabling minority shareholders to enforce duties of controlling shareholders (Kraakman, et al at 195).

Mandatory disclosure is a key advantage of the US market over other markets and regulatory systems. The US has the most extensive disclosure requirements for public issuers, including requiring reporting of "soft" or evaluative information and more detailed accounting requirements (Kraakman, et al at 197-201). The US litigation system also provides stronger enforcement of disclosure violations (212).

Disclosure and governance rules also differ concerning the cross-listing jurisdiction's costs of exempting foreign firms. The arguments discussed above against exempting foreign firms from mandatory disclosure do not necessarily apply to exemptions from substantive governance rules. With appropriate disclosure, there would seem to be no "lemons" problem with allowing firms trading in the same market to be governed by different rules, just as US firms trade under different governance rules both in their certificates and in the law of the incorporating state. Investors may lack experience with the background governance rules applying to foreign firms, so that these rules will not be discounted into stock prices as efficiently as the governance differences among locally-based firms. But investors at least will be aware of the extent of their ignorance regarding specific foreign stocks, and will not apply valuation discounts across the board as they might where there is no mandatory disclosure.

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[47] Requiring decisions by a majority of the minority shareholders may be useful in such firms, but the LLSV data does not isolate these rules.

3. Refining the disclosure/governance distinction

Although a general distinction between disclosure and internal governance rules seems appropriate from the standpoint of exempting cross-listing firms, there are questions at the margins in distinguishing these two categories. The main problem concerns the arguable need for rules requiring internal monitoring of disclosure. Simply requiring disclosures may provide little comfort without some assurance regarding the accuracy and completeness of the firm's disclosures. For example, the Sarbanes-Oxley Act mandates independence of the firm's auditors and of its auditing committee, increased penalties for misinformation, requirements of disclosure of internal controls and protection of whistleblowers. Some of these provisions, particularly including those concerning the audit committee, cross the line into regulation of internal governance.

One possible approach is to focus on liability rules rather than the design of governance structures. As long as liability is applied at appropriate places in the corporate structure (Kraakman), the firm arguably will have the incentive to adopt governance rules that are appropriate in light of other aspects of its governance structure. Although liability may be an imperfect constraint because of problems enforcing it beyond the cross-listing country's borders (Siegel), this is an inherent problem with any form of regulation. In other words, the value of substantive regulation is not clear in the absence of some means of penalizing non-complying firms and their agents.

The risk of liability may be higher than socially optimal for both US and non-US firms. Firms in the US or other established securities markets may be able to rely on certification and other voluntary disclosure mechanisms (Kraakman, et al at 213). Thus, it may seem that the excessive litigation is more of a problem for US firms. On the other hand, the risk of excessive litigation may be a significant concern for cross-listing firms that are unfamiliar with our legal system. But even if liability is excessive for US firms, it may make sense for firms based in countries with weaker disclosure systems. That is particularly likely under the signaling theory of cross-listing (subpart I.B; Iacobucci). Specifically, it may be efficient to allow firms that are high quality and less likely to be sued to signal their type by subjecting themselves to a high risk of litigation.

F. BROADER IMPLICATIONS OF CROSS-LISTING FOR US LAW

The foregoing analysis and history has broad potential implications for the effect of cross-listing on the future of US corporate law, and perhaps for the law of other countries that are significant cross-listing targets. Section 1 looks beyond exemption strategies to other ways the US and other cross-listing countries might approach regulating cross-listing firms. Section 2 explores the implications of exempting foreign firms for the regulation of US firms. Section 3 discusses how cross-listing might affect the content of US law and not merely the firms to which it is applied. Finally, section 4 explores some implications of cross-listing for the international convergence of corporate law.

1. Establishing regulatory tiers

An effect of exempting foreign firms would be to divide the regulatory scheme of the cross-listing country into "export" and "domestic" laws. The current US system offers foreign firms multiple levels of regulation. Foreign firms can decide to be full-fledged US corporations, Level 2 or 3 issuers that must comply with some but not all US disclosure laws, or Level 1 or 4 issuers that are subject only to US anti-fraud law. The US now offers the same options to all foreign-based firms. It might instead tailor exemptions to the type or origin of the firm. For example, firms from emerging or transitional countries may be subject to mandatory rules, while those from European countries, where market structures are more developed, might be offered more opportunity to opt out of US law than they have now (Fuerst).

The cross-listing country's regulatory scheme need not stop with exemptions. It might instead subject cross-listing firms to an "export" law that differs substantively from its "import" law. For example, Congress or the SEC might impose requirements that mesh with foreign firm governance rather than simply exempting those firms. Indeed, the SEC has attempted a similar approach in prescribing audit committee independence (see subpart IV.C, above). As with exemptions, the cross-listing country could move beyond a two-tier approach to designing different provisions for firms from different countries.

Multiple types of substantive laws for different types of foreign firms might, however, be impractical. US lawmakers would, in effect, be selling their general sophistication in crafting corporate and securities laws and rules and infrastructure for enforcing these rules. But they may lack the requisite knowledge and skill to design laws that mesh with non-US laws and institutions. Moreover, there is a serious question as to incentives. Each submarket of cross-listing firms probably does not generate enough business for any particular interest group, and therefore enough rents for lawmakers, to give lawmakers or regulators a significant incentive to craft laws for these firms.

2. Exempting US-based firms

Exemption from regulation of substantive governance might extend even to firms that are based in the US. Specifically, this would entail exempting firms that are incorporated or organized under non-US law even if their trading and activities occur substantially in the US. Thus, US-based firms might be exempted from US disclosure law if they submit to foreign country regulation of their internal affairs. However, in adopting such exemptions, it is necessary to avoid facilitating inefficient evasion of regulation by such firms (Coates).

Under current rules, the application of US law to foreign firms turns *both* on place of incorporation and organization[48] and on location of its business, shareholders or management.[49] If the firm meets these conditions, it is excused from US regulation, depending on how it trades in the US (see subpart II.A, above). Coffee (2002) suggests focusing on the US float in determining whether to apply US governance rules to foreign firms.

The significance of the physical location of the firm or its shareholders, however, seems to turn more on the company's ability to avoid stringent regulation by exiting the country than on the need to apply US regulation. If anything, the presence of local assets and operations makes mandatory disclosure *less* necessary. What should matter to the application of US governance rules is whether the firm's governance is controlled by the law of another country. In this situation, there may be a problem meshing US internal

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[48] See 17 CFR §240.3b-4(b).

[49] *Id.* 240.3b-4(c) ("foreign private issuer" does not include firm held more than 50% by US residents, or firm that has majority US executive directors and officers, majority of assets in the US, or administered principally in the US.

governance rules with those of the firm's place of incorporation.

In other words, politics seems to conflict with policy regarding the scope of the exemption. Foreign-based firms are exempted only because they can more easily respond to increased regulatory costs by exiting, and not because there is less justification for regulating them. However, politics might ultimately align with policy. US-based firms would incur costs if the securities laws disadvantaged them in competing with their foreign-based rivals in capital and product markets. This would encourage them to use their greater voice in US politics to lobby for exemptions similar to those accorded foreign-based firms. Thus, if US securities laws do expand into significant regulation of internal governance, the ultimate result might be a broader exemption of all foreign-incorporated firms.

Application of such an exemption could encourage countries to compete to attract incorporation business from US firms exiting US federal regulation of corporate governance. Countries would find it easier to attract such firms if they applied their law solely on the basis of local incorporation rather than applying a "real seat" rule because this would make it cheaper for US firms to move. This would give countries an additional reason to adopt an incorporation rule, as Europe has begun to do in *Centros* and *Inspire Art*. Real seat jurisdictions already have an incentive to move toward an incorporation rule in order to keep their domestic companies from relocating assets elsewhere in order to take advantage of other countries' corporate laws. Under the analysis in Part III, non-US companies have an incentive to relocate in order to take advantage of US corporate law that facilitates dispersed ownership. This is similar to the dynamic in the US regarding contractual choice of law (Ribstein 2003).

Disclosure regulation, however, probably would continue to be applied on the basis of where the securities trade, even if there are strong arguments for a contractual choice in this respect as well. In other words, jurisdictional choice for securities regulation probably will continue to be of the opt-in variety that characterizes cross-listing, while choice for internal governance may tend to move toward the opt-out incorporation approach. This is supported by the fact that, while non-US firms can list in the US, US firms lack a comparably good alternative to their home country law (Tung). Weaker regulating countries lack the strong protection of property rights that the US can offer and that investors would demand.

3. Implications for the content of US law: Washington's competition

The discussion so far in this Part suggests, first, that the US will be forced to exempt *foreign-based* firms from any further significant expansions of the federal securities laws into substantive governance and, second, that such exemptions may put pressure on the US to provide for similar exemptions for *US-based* firms that incorporate in other countries. The latter effect could, in turn, open up an international competition for incorporations of US firms.

In other words, mere exemption of foreign firms from internal governance provisions of federal law may be an unstable equilibrium. Faced with pressure to give US-based firms the benefit of a comparable exemption, Congress and the SEC may choose to forego further expansion of US federal law into areas formerly occupied exclusively by the states. Thus, the cross-listing market limits the extent to which the US federal government can compete with Delaware.

The effect of the cross-listing market on the law of the cross-listing jurisdiction bears on the hypothesis that corporate governance ultimately may converge on a single standard (Coffee 1999, 2002). This paper has shown that the US and other cross-listing countries face constraints in marketing their substantive governance law to firms that are subject to markedly different regulations, customs and institutions in their home countries. Accordingly, the cross-listing market is likely to focus on *disclosure* rather than *internal governance* regulation. It follows that cross-listing may exert less of a force toward convergence than might originally have been supposed.

To be sure, as discussed above, it is difficult to neatly separate disclosure and internal governance, and there may be convergence in the marginal territory. Moreover, convergence may occur in the important respect of a broad movement toward dispersed ownership. And convergence might occur indirectly because increased disclosure alone exposes any defects of non-US approaches to governance. But convergence regarding disclosure norms alone may make it possible to preserve significant variation in substantive governance.

V. CONCLUDING REMARKS

This article has examined cross-listing from the general perspective of regulatory competition. In general, cross-listing may affect not only the governance of individual firms, but also the law of both home jurisdictions of cross-listing firms and of the jurisdictions in which they cross-list. Home jurisdictions may be forced to change their laws so that they better accommodate dispersed ownership.

At the same time, the US, as a leading cross-listing jurisdiction, has a strong incentive to design its law to attract the burgeoning market for cross-listing. The US has a unique advantage in terms of being able to offer a regulatory system that has successfully supported the development of a strong and liquid stock market. The US securities industry and US lawyers and accountants will not willingly relinquish this competitive edge. Accordingly, they can be expected to lobby against any expansion of the federal securities laws that will threaten the cross-listing market.

This is likely to entail at least exemptions for foreign-based, or even all foreign-incorporated, firms from the regulation that imposes the highest costs on such firms – the regulation of internal governance. This may have even more far-reaching effects on the future of choice of law rules for corporations which could, in turn, promote more regulatory competition regarding internal governance rules. Alternatively, the need to couple expansion into regulation of internal governance with broad exemptions of foreign-incorporated firms may deter further moves toward federalization of US corporate governance. In short, just as US federal law has been characterized as "Delaware's Competition" (Roe 2003), the cross-listing market may become "Washington's Competition."

This, in turn, relates to the potential effect of cross-listing on home country law. If cross-listing firms need not be concerned with meshing their governance with US substantive governance standards, they also need not pressure their home countries to change governance standards at the macro political level. This might slow any convergence effect of cross-listing. More importantly, it would ensure that the ultimate decision as to convergence is made by individual investors and non-US firms rather than US political actors.

Table 1: Foreign Listed Companies on the New York Stock Exchange[50]

	Total	Foreign	Domestic	Foreign %
1975	1557	33	1524	02.12%
1980	1570	37	1533	02.35%
1985	1541	54	1487	03.5%
1990	1174	96	1678	05.4%
1991	1885	105	1780	05.6%
1992	2089	120	1969	05.7%
1993	2361	153	2208	06.5%
1994	2570	216	2354	08.4%
1995	2675	247	2428	09.0%
1996	2907	304	2603	10.5%
1997	3047	356	2691	11.7%
1998	3114	379	2735	12.2%
1999	3025	406	2617	13.4%
2000	2862	434	2428	15.2%
2001	2798	462	2336	16.5%
6/30/02	2796	468	2328	16.8%

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