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# The Canary in the Coal Mine: What the Growth of Foreign Securities Markets and Foreign Financing Should Be Telling Congress and the SEC

## By Peter J. Wallison

*The warning signs are there: in the securities markets, in global financial transactions, and in the withdrawal of U.S. companies from public ownership, U.S. financial markets are no longer seen as hospitable either to companies or financial transactions. Although capital continues to flow into the United States for wealth-protection, foreign companies are avoiding the United States, and financing transactions are increasingly carried out in freer and more efficient markets abroad. What this should tell us is that U.S. regulation has now gone over the tipping point. The Sarbanes-Oxley Act was the last straw. Urgent action by the Securities and Exchange Commission (SEC) and Congress is necessary if the United States is to retain its preeminence in the financial world.*

Like taxes, regulation is a burden on the economy. Since the Reagan presidency, most of us have come to understand that the economic sector expands when taxes are reduced, and stagnates—or worse—when taxes are too high. No one knows where the tipping point is, although the famous Laffer curve irrefutably demonstrates that there are two points where the government gets no revenue: when taxes are zero and when they are 100 percent (in the latter case, there is no economic activity to tax). Somewhere in the middle is that unknown and unknowable point where the government's revenue is maximized with the smallest burden on the private sector. How do we know whether the government is taxing too much or too little? We watch the economy: if it is expanding rapidly with low inflation, as it is today, we know fiscal policy is about right; if we have stagflation, like in the late 1970s, we know taxes are too high. It is an art, not a science.

The same is true of regulation. Some regulation can create confidence in the fairness of markets or in the stability of financial institutions, which encourages an inflow of foreign capital and the domestic economic activity that capital generates. But excessive regulation can impose costs that have the opposite effect: foreign companies stop coming into the U.S. market for financing transactions, and U.S. capital begins to flow to foreign markets where it is more efficiently employed. Again, no one knows where that tipping point is, but if we watch the economy, we can get an idea of where we are on the curve.

This explains why the growth of foreign securities markets and foreign financings and the sharp increase in going-private transactions in the United States should be taken as warning signs that the government has gone too far in placing regulatory burdens on the private sector. To be sure, the United States still has the largest, deepest, and most liquid capital markets in the world—and will continue to have such markets because of its role as the world's wealth storage facility[1]—but a look at recent trends suggests that while the United States continues to hold its own as a place to invest, it is losing its preeminence as a venue for raising capital.

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**Markets and Exchanges.** Between 1996 and 2001, the New York Stock Exchange (NYSE) averaged fifty new non-U.S. listings annually; in 2005, it gained nineteen. In the same year, the London Stock Exchange, including its small-company affiliate, the Alternative Investment Market (AIM), gained 139 new listings; Nasdaq gained nineteen. Since the end of 2004, thirty foreign companies have left the NYSE and Nasdaq. London's AIM had 335 initial offerings of securities in 2005—twice the total in 2000—while Nasdaq had 126, down 65 percent. The AIM has even attracted thirty-five U.S. companies. Clearly, one of the reasons that the NYSE and Nasdaq are attempting to acquire positions in foreign exchanges is that they see a long-term trend away from the United States and are attempting to follow their customers as they move to more felicitous financial environments.

**Financing.** Capital has no natural home and moves to places where transactions can be completed most efficiently—at the least cost, in the most expeditious manner, and with a minimum of government regulation. This tells us why many financial transactions that could be executed anywhere have moved in recent years from U.S. markets to markets elsewhere in the world. In 2000, for example, nine of every ten dollars raised by foreign companies were raised in the United States; in 2005, nine of the ten largest offerings were not registered in the United States, and of the largest twenty-five global offerings, only one took place here. The largest Chinese offering was registered in Hong Kong, and the largest offering in Korean history was listed in London and Korea. The large Russian oil company Rosneft listed its $10 billion offering in London.

The United Kingdom is a particularly strong competitor for the United States, offering a stable and predictable legal system and the English language, in which many financial contracts are written. A recent report by the British Treasury notes: "London's importance in the world's financial system is apparent when the scale of its markets is compared with other centres. London is the location for 70 per cent of the global secondary bond market; over 40 per cent of the derivatives market; over 30 per cent of world foreign exchange business; over 40 per cent of cross-border equities trading; and 20 per cent of cross-border bank lending. No other financial centre in the world can equal the depth and scale of London's international markets."[2] This is quite an achievement for an economy that is only a fraction of the size of the U.S. economy.

**Going-Private Transactions.** In recent years, U.S. companies have encountered rising costs for remaining public and have turned to private equity investors for the funds to buy out their public shareholders and "go private." Private equity, unregulated in the United States, is booming. For many companies, especially smaller and entrepreneurial ventures, the once-significant advantages of public ownership have now fallen behind the reporting costs, regulations, and litigation risks associated with having public shareholders. In a 2005 report, the Government Accountability Office (GAO) found that the number of public companies going private increased from 143 in 2001 to 245 in 2004, and projected that the number would reach approximately 267 by the end of 2005. "The costs associated with public company status were most often cited as a reason for going private," said the GAO.[3]

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It is not only small companies that are going private. In recent years, Hertz, Neiman Marcus, Metro-Goldwyn-Mayer, Toys "R" Us, Sungard, and Kinder Morgan have all decided to remove themselves from public ownership. This is a highly adverse trend, since it reduces both the potential investments of Americans who are relying on defined contribution and 401(k) plans for their retirement and the access of smaller companies to the inexpensive capital that will help them grow. And as might be expected, the willingness of private companies to go public has also been impaired. In testimony before a House subcommittee, Marshall Carter, chairman of the NYSE Group, reported: "In 2000, nearly half, 46.8%, of the global IPO equity was raised on U.S. exchanges. However, in 2005 only 5.7% of the dollars raised by non-U.S. company IPOs was raised through shares listed on U.S. stock markets subject to U.S. regulatory rules and oversight. Unfortunately, we do not believe this is a one-year phenomenon."[4]

One observer accurately sums up where things now stand: "[T]he costs of regulation clearly exceed its benefits for many corporations. . . . The relevant question today is whether regulation has gone so far as to force honest businesses, at least those of modest size, to consider abandoning public markets for less regulated private markets. Similar questions arise with respect to foreign issuers that have the option of foreign markets of increasing competitive quality."[5]

## Regulatory Culprits

Although the Sarbanes-Oxley Act of 2002 is generally cited as the worst case of regulatory overreach, that ill-considered legislation is by no means the only culprit. In recent years, a number of other regulations have been piled onto the financial markets, and their cumulative effect has finally caused what now appears to be a growing exodus of financial capital to foreign markets. Yet any analysis of this phenomenon must begin with Sarbanes-Oxley, the legislation that, more than anything else, must be considered the last straw.

**Sarbanes-Oxley.** Despite its popularity with the media, which still see the act as a great reform, few managements that have had sustained experience with Sarbanes-Oxley have anything good to say about it. From the perspective of the U.S. position in the financial world, it has been an unmitigated disaster. According to reports from Europe, the principal obstacle to the NYSE's effort to acquire the French stock exchange Euronext is the Europeans' fear—despite assurance from NYSE officials and the SEC—that somehow European companies listed on Euronext will become subject to Sarbanes-Oxley. Because of this fear, Euronext shareholders may vote down the acquisition, or an EU government with jurisdiction over the transaction may step in to prevent it.

Although the Europeans' concern is probably unfounded, they are right in their assessment of the act. It has already cost the U.S. economy untold billions of dollars in direct tangible costs. One careful study puts the cost in lost market value of U.S. companies at $1.4 trillion, as investors anticipated the regulatory costs associated with the new act.[6] Probably the greatest direct and tangible costs were imposed by the now-infamous Section 404, which requires companies to establish internal controls and have their auditors certify the controls' effectiveness. Although thoroughly reliable figures are not yet available, anecdotal and survey evidence point to billions of dollars in economic costs for internal controls and the accompanying auditor's certification. In one frequently cited 2005 survey, 217 companies with average revenues of $5 billion reported average compliance costs of $4.36 million for Section 404 alone in 2004, without considering the significantly higher general audit costs that followed the adoption of the act. Regular audit costs themselves were up 57 percent.[7]

The act has also added costs by creating a new regulatory structure for auditors called the Public Company Accounting Oversight Board (PCAOB). The additional costs of this regulation are passed on to clients, and regulation itself limits the ability of smaller accounting firms to compete with the big four, giving the largest firms added pricing power in negotiating with their clients. Most important, the PCAOB—which was created as a District of Columbia not-for-profit corporation—was given what was essentially taxing authority, or the ability to fund its activities by levying fees on all public companies in proportion to their market capitalization. The agency's costs have already reached well over $100 million, and since it has no oversight (except SEC approval of its budget), it can be expected to grow in size and cost—as all bureaucracies do—in the future. What's more, the PCAOB was unnecessary; the SEC had all the authority it needed to regulate accountants and auditors, using appropriated funds that would not have placed the burden on public companies.

Major intangible costs of the act were perhaps more significant, but much more difficult to measure. The act required that all audit committees be composed solely of independent directors, but the SEC apparently used this requirement to pressure the NYSE and Nasdaq to require that the boards of directors of all listed companies be composed of a majority of independent directors. The exchanges, under the SEC's regulatory thumb, of course complied, including this requirement in their listing rules. Independent directors, almost by definition, know relatively little about the business of the companies with which they are involved and have different incentives from management. While managements generally want to expand the company's activities and enter new markets, independent directors reap few benefits and incur many potential costs from the risks associated with these efforts at growth. There are indications, accordingly, that the independent-director majorities on corporate boards are exercising their new Congressionally sanctioned authority to reduce corporate risk-taking. Recent news stories about huge cash hoards building up at corporations[8] and at least one academic study[9] suggest that corporate risk-taking has indeed been suppressed—a fact that will have a long-term adverse effect on U.S. economic growth.

Other intangible effects of the act could be equally serious. The requirement that the CEO and CFO certify their company's financial statements, coupled with the act's implicit notion that the directors are "gatekeepers" capable of preventing fraud, has focused boards of directors on compliance matters instead of corporate strategy; anecdotal evidence suggests that more time is spent on compliance in today's boardrooms than on the business of the

company. In addition, the act's requirement that auditors be engaged by and report only to audit committees has in many cases created an arm's-length relationship between auditors and managements that has prevented managements from receiving useful advice on accounting matters from their auditors.

The combined effects of these and other elements have clearly had an adverse effect on the willingness of foreign companies to subject themselves to the regulatory costs associated with a financial connection to the United States.[10]

**Regulation NMS.** This entirely unnecessary regulation was adopted by the SEC in April 2005 in response to the growth of an unregulated market in electronic stock exchange services. Although advertised as necessary to assure that those who place limit orders on electronic exchanges get the "best price" then available in the market, it is more likely that its purpose was to protect the NYSE against competition from Nasdaq and the new, efficient, and largely unregulated electronic trading venues that were known as Electronic Communications Networks (ECNs). When the regulation was adopted, the NYSE was subject to a "trade-through rule," which purported to protect investors who placed limit orders on the exchange against being bypassed (i.e., "traded through") by other traders. Nasdaq and the ECNs were not subject to this rule, and for that reason were more attractive to large institutional traders that were seeking to fill large orders quickly, anonymously, and inexpensively.

In effect, the SEC's choice was either to eliminate the trade-through rule at the NYSE or to apply it to the electronic markets. It chose the latter. Although the rule has not yet gone fully into effect—it has been delayed for various technical reasons—brokerage firms have had to assume the costs of revising their trading facilities to take account of its requirements. One of these requirements is that the broker assure, when he effects a trade, that he transacts with the best price available anywhere in the market, even if the volume available at that price is not what his customer wants. Moreover, the transaction must have an audit trail so the broker can prove to the SEC that he complied with the requirements of the rule. The search costs associated with assuring that one has found the best price in the market are not inconsiderable, and investors will have to settle for higher costs on purchases and lower costs on sales because their orders cannot be filled as quickly as possible in a rapidly moving market. One estimate places the compliance costs for brokers at $544 million over the next four years.[11] In addition, the Securities Industry Association recently estimated that the U.S. securities industry spends $25 billion annually on SEC compliance costs.[12]

These costs will of course be passed on to investors in U.S. markets, increasing trading costs and lowering their incentives to trade in the United States. The NYSE and Nasdaq have seen the handwriting on the wall; they are acquiring foreign securities markets so they can provide trading services at the lower costs these foreign markets will be able to offer.

**Regulation FD and Analyst Coverage.** Regulation FD is another SEC rule that is both unnecessary and costly, although its costs are indirect. The rule took effect in October 2000 and requires that a company make available to the market "material" information that it provides to analysts. While attractive in theory, the rule is a perfect example of the best functioning as the enemy of the good. When material information is imparted to analysts, it is quickly absorbed into the market, assuring that market prices reflect all the information available. It is true that some uninformed buyers or sellers might trade without this information, but these cases are rare, and the kind of information imparted by companies through analysts is almost never of the blockbuster variety about acquisitions, mergers, or major new discoveries. Companies recognize that information of that importance has to be disseminated through a press release.

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Determining what is material information, however, is the problem with Regulation FD. Company officers meeting with analysts now believe they need lawyers at their elbows, and even then risk being charged with a violation of the rule for a disclosure they had not regarded as material. To avoid this risk, companies stopped meeting with or disclosing information to analysts. This increased the search costs of analysts seeking information about companies and caused many of them to abandon coverage of companies—primarily the smaller ones—for which information was not readily available.

The result was a precipitous drop in analyst coverage of small- and mid-cap companies and a corresponding increase in coverage of large companies, for which more information was available. A 2005 Accenture report noted: "In 2004, of the 2,400 small-cap and mid-cap U.S.

publicly listed companies in the Reuters research database, 53% had lost coverage over the previous two years (29% gained coverage, and 18% stayed the same). Approximately 31% of large-cap companies had lost coverage while 56% gained it and 13% recorded no change. Overall, as of mid-2003, the number of companies with Wall Street coverage declined by nearly 25% from 1999 levels. . . . Another study found that out of 4,075 public companies, 666 had been abandoned completely by sell-side analysts as of January 2004. All but 85 of those companies had been covered by at least one analyst in 2002. . . . Overall, more than 1,500 (37.3%) of the companies in the Reuters database have two or fewer analysts tracking their stock."[13]

Without analyst coverage, small- and mid-cap companies see much less value in remaining public companies—accounting, together with Sarbanes-Oxley, for the steep climb in going-private transactions recorded in recent years. In addition, the decline in coverage provides the public with less useful information about companies and impairs the ability of investors to make choices among stocks, just as the trend toward privatization reduces the choices available to investors. Like so many SEC efforts to "reform" the markets, the cure turned out to be worse than the disease.

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**SEC Enforcement Abuses.** Apart from its costly regulations, the SEC imposes significant costs on the U.S. securities market through excessive and abusive enforcement activity. Advancement within the SEC's enforcement division comes from finding and pursuing dramatic cases, which create incentives on the part of the enforcement staff to be the first to discover and take ownership of such a case. Under existing enforcement division procedures, any attorney in the division may initiate a matter simply by sending a request for information to a person or company that has been charged—in a newspaper article or elsewhere—with a possible violation of the securities laws. This request is known as a matter under inquiry (MUI). If the MUI produces no useful information, it can be terminated easily within sixty days of its inception, but if it is not closed during that period, it automatically becomes an informal investigation. At that point, most U.S. securities counsels will advise their clients to disclose the existence of the proceeding, which usually results in a decline in the price of the company's stock. Thereafter, the matter might be abandoned by the attorney who initiated it, but no division procedure requires that companies subject to informal investigations be advised that no further action will be taken against them. In fact, these matters often remain open for years because the attorney who initiated the MUI has lost interest in the case. But with a public announcement having been made about an SEC enforcement proceeding, the stock price of the company will continue to reflect this unresolved matter.

Apart from MUIs, regulated companies are also subject to sweep requests—demands from the SEC staff for information about matters they have found to exist in other companies in the same industry. These requests can involve years of e-mail, which must be reviewed by the company's lawyers for relevance or privileged information before they can be turned over. The costs of these reviews can run into many millions of dollars even though the company has done nothing more than operate in the same industry as another company that is thought to have engaged in wrongdoing.

If a matter turns out to be serious enough to be brought to the SEC for a formal order, the defendant is afforded an opportunity to make a written submission—known as a Wells submission—defending its position. However, it is not permitted to argue orally to the commission and is frequently not fully informed of the facts that the enforcement division will use in making its case to the commissioners. Since most defendants know that in these circumstances they will not be able to avoid a formal charge by the commission, they feel compelled to settle cases that they might otherwise win in court. Few companies can suffer the adverse publicity associated with litigating with the SEC after they have been formally charged, even if in the end they are found not to have violated the securities laws. These settlements often result in very heavy monetary fines as well as injunctive remedies, and although the commission has recently begun to establish reasonable rules about the imposition of fines, the pressure to settle remains.

This star chamber–like proceeding creates risks for companies offering their securities in the United States and thus adds to the intangible cost of participating in the U.S. securities markets. Of course, if a company is actually charged with wrongdoing, the tangible costs are considerably higher, even if the company might ultimately be vindicated in a fair proceeding. Under these circumstances, companies are reluctant to subject themselves to the

jurisdiction of the SEC by offering securities or having contacts with the U.S. securities markets. This attitude has been reinforced by the Sarbanes-Oxley Act, which attempts in many instances to apply U.S. law extraterritorially, prompting foreign companies to eliminate any jurisdictional basis on which the SEC or private plaintiff might move against them—a fact that explains the striking decline in global offerings in the United States since 2000. Because of the mobility of capital, issuers of securities are able to attract capital—even capital from the United States—in many other markets, without the risks of a U.S. offering.

**Class Action Suits.** No discussion of the risks of operating in the United States would be complete without addressing private class actions. While securities class actions are not strictly government regulation, they are carried out under the authority of U.S. law and are simply a supplement to government enforcement action. Despite efforts over the years to reform this area and reduce the costs to companies and shareholders, relatively little progress has been made, and private class actions remain one of the most serious impediments to foreign participation in the U.S. securities markets.

In a February 2006 article in the *Wall Street Journal*, Kenneth M. Lehn, a former chief economist of the SEC, outlined the problem: "Since the passage of the [Public Securities Litigation Reform Act of 1996], the size of securities class-action settlements and the number of companies involved in this litigation have grown substantially. . . . [T]he total inflation-adjusted value of securities class-actions settlements increased to $9.6 billion in 2005 from $150 million in 1997. Over the same period, the average inflation-adjusted size of settlements increased over sevenfold, to $78 million from $10.7 million."[14]

The situation is exacerbated by the fact that U.S. courts have now shown some willingness to apply U.S. securities law in cases involving foreign companies that have had some nexus to the U.S. securities market, such as a road show or some other substantial contact. This means that foreign securities holders may gain access to U.S. courts to prosecute foreign companies under U.S. laws—another reason for foreign companies to avoid any contact with the United States.[15]

## Fair Warning

The flight of foreign corporations and transactional activity from the United States is neither a transitory event nor a surprising one. Like the canary in the coal mine, it signals a serious problem—excessive regulation—that must be addressed if the United States is to retain its preeminence in the financial world. Sarbanes-Oxley, certainly the most serious of these problems, is only one of many that need urgent attention by the Congress and the SEC.

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AEI staff assistant Daniel Geary and AEI editorial associate Nicole Passan worked with Mr. Wallison to edit and produce this *Financial Services Outlook*.

## Notes

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11. Frances Denmark, "Implementing Reg NMS; Costly-Systems Changes Coming," *Institutional Investor*, January 13, 2006.

12. Stephen L. Carlson and Frank A. Fernandez, "The Costs of Compliance in the U.S. Securities Industry," *SIA Research Reports* 7, no. 2, February 22, 2006, available at www.sia.com/research/pdf/RsrchRprtVol7-2.pdf.

13. Jeanne G. Harris, Roland J. Burgman, and Thomas H. Davenport, "New Frontiers of Operational Reporting," *Accenture Research Note* 2, February 2005, 5, available at www.accenture.com/Global/Research_and_Insights/By_Role/CFO/NewReporting.htm.

14. Kenneth M. Lehn, "Private Insecurities," *Wall Street-Journal*, February 15, 2006. The numbers are inflated by the WorldCom settlement of more than $6 billion in 2005, but still represent a considerable growth over 1997.

15. See *In re Vivendi Universal*, No. 02, Civ. 5571, 2004, U.S. Dist. LEXIS 21230 (S.D.N.Y. Oct. 19, 2004) and *In re Nortel Networks Corp. Sec. Litig.*, Civ. No.01-1855, 2003 U.S. Dist. LEXIS 15702 (S.D.N.Y. Sept. 5, 2003).