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IN DODD-FRANK'S SHADOW: THE DECLINING COMPETITIVENESS OF U.S. PUBLIC EQUITY MARKETS

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As we enter into 2011, things are looking up. The Dow Jones has recently broken through 12,000 and is climbing to pre-recession heights. The economy has emerged from the greatest downturn since the Great Depression and continues to show modest growth.[1] Unemployment is slowly decreasing.[2] But all is not well. A potentially worrying trend that gained traction at the beginning of the millennia continues to unfold: the decline of the competitiveness of U.S. public equity markets.

For example, consider the U.S. primary equity markets. In 2000, these markets attracted 54% of all global initial public offerings (IPOs)—IPOs by foreign companies issued on at least one public exchange outside the company's domestic market.[3] Similarly, foreign companies raised about 82% of the dollar value of all global IPOs on U.S. public exchanges.[4] The numbers were 26% and 10%, respectively, in 2010.[5] Foreign companies, it seems, have been increasingly likely to forego our public equity markets and list elsewhere. These figures, however, do not tell the whole story. So-called Rule 144A IPOs—issuances done on U.S. private equity markets—by foreign companies have risen markedly in proportion. Over the past ten years, the number of these issuances as a percentage of total global IPOs in the U.S. has increased from 62% to 81%.[6] The percentage value of these IPOs has grown even faster—from 60% to 95%.[7]

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[1] *National Income and Product Accounts Gross Domestic Product, 4th Quarter and Annual 2010 (Second Estimate)*, BUREAU OF ECONOMIC ANALYSIS (March 21, 2011), http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm.

[2] Unemployment Rate – Updated Monthly, http://employeeissues.com/blog/unemployment-rate/ (Mar. 21, 2011).

[3] Committee on Capital Markets Regulation, *Share of Global IPOs (Narrowly Defined) Captured by U.S. Exchanges* (December, 2010), http://www.capmktsreg.org/competitiveness/2010Q3update/(2A)Share_of_Global_IPOs_Captured_by_US_Exchanges(narrow).pdf .

[4] *Id.*

[5] *Id.*

[6] Committee on Capital Markets Regulation, *Rule 144A IPOs by Foreign Companies as a Percentage of Total Global IPOs in the U.S.* (December, 2010), http://www.capmktsreg.org/competitiveness/2010Q3update/(4)Rule_144A_IPOs_by_Foreign_Companies_as_a_Percentage_of_Total_Global_IPOs_in_the_US.pdf.

[7] *Id.*

The proportionate rise in private equity issuances is especially important. Although technology has improved access to foreign markets for retail investors, the private equity market continues to be accessible only to institutional entities and the very wealthy.[8] More tellingly, foreign companies cross-listed on U.S. exchanges incur, on average, a 2.47% lower cost of capital than in Rule 144A markets (11.54% vs. 14.01%, respectively).[9] Since companies accessing these private equity markets are free from most U.S. securities regulation, including registration and liability under the Securities Act of 1933 and the Sarbanes-Oxley Act,[10] the rising regulatory and litigation burden imposed by such legislation may be an important factor in accounting for the proportionate increase in Rule 144A market issues and foreign companies' shift to overseas exchanges.

Indeed, global financial services executives have confirmed that the litigious nature of U.S. capital markets is a central factor in undermining the competitiveness of those markets.[11] The perceived unfairness and unpredictability of the U.S. legal system have driven companies away from our public exchanges; 46% of executives surveyed believed the U.K. had more predictable legal outcomes compared with 16% for the U.S.[12] Likewise, 43% of executives thought the U.K. had a fairer legal process versus 14% for the U.S.[13] Furthermore, a majority of executives felt companies listed in the U.K. were less likely to be sued than those listed on our public exchanges.[14] However, while there are benefits of a stricter legal system, they may not outweigh the liability costs imposed on companies trading publicly in U.S. equity markets.

There is no doubt that tough enforcement mechanisms serve key deterrence and compensatory goals. Wronged shareholders should be compensated for their losses and corporate wrongdoers must be deterred from managerial shirking and self-dealing. Yet the U.S. legal system may not be accomplishing either of these goals in the securities litigation context. Deterrence of wrongdoing is undermined by corporations and their insurers typically bearing the full cost of any settlement against individual defendants.[15] Federal securities class actions, a feature unique to the American legal system,[16] fail to adequately compensate victims for their losses. Because the vast majority of federal security class actions are either settled or dismissed,[17] shareholder compensation often falls short. The median ratio of class action settlement to investor losses, which has steadily declined over the past fifteen years, is now at only 2.4%.[18] While average settlements, adjusting for outliers, are at an all-time high,[19] so are

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[8] Committee on Capital Markets Regulation, *Committee Interim Report,* 34 (November 30, 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[9] Luzi,Hail & Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations around U.S. Cross-Listings*, 52 (European Corp. Goverance Inst., Paper No. 46, 2006), http://www.law.yale.edu/documents/pdf/cbl/HL_ECGI_Fin461.pdf .

[10] Committee on Capital Markets Regulation, *supra* note 6, at 45.

[11] *See* Michael R. Bloomberg & Charles E. Schumer, *Sustaining New York's and the U.S.' Global Financial Services Leadership*, 73 (2007).

[12] *Id.* at 76.

[13] *Id.* at 76.

[14] *See id.* at 76.

[15] Committee on Capital Markets Regulation, *supra* note 6, at 78.

[16] *Id.* at 71.

[17] National Economic Research Associates, *Trends 2010 Year-End Update*, 13 (December 2010).

[18] *Id.* at 25.

[19] *Id.* at 18.

plaintiff's attorney fees that further reduce the value of what injured shareholders ultimately receive.[20] Section 308 of the Sarbanes-Oxley Act was intended to streamline the regulatory process by adding civil penalties obtained from defendants to a fund used to compensate plaintiffs,[21] but the number of federal securities class action filings has not significantly declined over the last decade.[22]

Several other factors have led to the decline in the competitiveness of U.S. public equity markets. Increasing liquidity in foreign and private markets and better regulation of foreign public markets have each eroded the competitive advantage that our public exchanges once had.[23] Improvements in technology have made it easier for U.S. investors to invest in foreign markets.[24] Not only is there little that can be done to reverse the impact of these factors; such advancements are actually beneficial for us. U.S. companies can safely tap into a wider range of markets for funding, and U.S. investors can better diversify their holdings by investing overseas with a smaller increase in risk or inconvenience. Instead, policy makers should focus on a fourth factor: the regulatory costs imposed on companies choosing to list on our public equity markets versus the foreign and private alternatives. Such costs have been cited by financial services CEOs as the most important issue in determining the international competitiveness of our public equity markets.[25]

Policy makers should be mindful, however, of reducing regulatory costs too much. A "race to the bottom" would not improve our markets' competitive position and would only harm their integrity. Instead, regulatory costs should be balanced against increasing transparency and accountability so that risk and agency costs are reduced. In turn, corporate borrowing costs would decrease and share prices should increase.

A commonly cited provision that goes too far in increasing costs without a commensurate increase in benefits is Section 404 of the Sarbanes-Oxley Act.[26] Envisioned as a way of bolstering the credibility of public companies' internal control systems, Section 404's costs of verification and disclosure have ended up being many times greater than expected.[27] First-year implementation costs of internal control systems for large companies were eighty times greater than originally planned and recurring costs vastly exceed initial estimates.[28] Worse yet, smaller companies were disproportionately burdened.[29] Although Section 404 addressed serious internal control issues that led to the corporate scandals of the dot-com era and likely increased intra-firm transparency, critics argue its benefits are difficult to measure, thus making its costs all the harder to justify. [30]

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

[20] *Id.* at 23.
[21] Committee on Capital Markets Regulation, *supra* note 6, at 82.
[22] *See* National Economic Research Associates, *supra* note 14, at 2.
[23] Committee on Capital Markets Regulation, *supra* note 6, at 4.
[24] *Id.* at 4.
[25] Bloomberg, *supra* note 9, at 79.
[26] Stephen M. Bainbridge, *Corporate Governance and U.S. Capital Market Competitiveness*, 16 (UCLA School of Law, Paper No. 10-13, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1696303.
[27] *Id.* at 23.
[28] *Id.* at 23–24.
[29] *Id.* at 24.
[30] *Id.* at 29.

(Dodd-Frank Act) was signed into law. One of the things it did was to ease the burden Section 404 had on small companies and introduce several corporate governance mandates that aim to increase transparency and accountability of companies listed on U.S. public equity markets.[31] Unfortunately, neither of these goals is likely to be met in the short term.

One of Dodd-Frank's most ambitious corporate governance provisions, Section 971, aimed to open up the director nomination process to shareholders via proxy and instill more accountability upon corporate directors.[32] Critics, however, argue that improved shareholder proxy access would lead to harmful investor activism[33] and an unnecessary focus on political issues diverting attention away from creating shareholder wealth.[34] Due to a legal challenge by the U.S. Chamber of Commerce, the SEC has stayed implementation of the provision until the 2012 proxy season.[35]

Another promising provision, Section 951, was designed to give shareholders a non-binding advisory vote on executive and director compensation,[36] but its efficacy in improving managerial accountability has also been called into question. Specifically, opponents contend it will shift power to proxy advisory firms and not to individual shareholders who are seldom involved in the voting process.[37]

Ultimately, the Dodd-Frank Act does not go far enough toward improving the competitiveness of our public equity markets. Much more needs to be done. Securities litigation reform is one possibility, but such change is unlikely. Instead, policy makers should focus on better balancing the costs of regulation against increased corporate transparency and accountability. If nothing is done, our leadership in providing the best public equity markets will continue to erode.

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[31] Stephen M. Bainbridge, *The Corporate Governance Provisions of Dodd-Frank*, 2 (UCLA School of Law, Paper No. 10-14, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1698898##.

[32] *Id.* at 2.

[33] *Id.* at 11.

[34] Paul Atkins, *The SEC's Sop to Unions,* WALL ST. J., Aug. 27, 2010, at A15.

[35] Bainbridge, *supra* note 29, at 11.

[36] *Id.* at 2.

[37] *See* Stephen M. Bainbridge, *Will the Unaccountable Power of RiskMetrics Put Teeth in the Dodd Bill's Say on Pay Provision?*, ProfessorBainbridge.com (Apr. 22, 2010), http://www.professorbainbridge.com/professorbainbridgecom/2010/04/will-the-unaccountable-power-of-risk-metrics-put-teeth-in-the-dodd-bills-say-on-pay-provision.html.