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Perspectives in Company Law and Financial Regulation

EDITED BY MICHEL TISON,
HANS DE WULF,
CHRISTOPH VAN DER ELST AND
REINHARD STEENNOT

CAMBRIDGE

Steps toward the Europeanization of US securities regulation, with thoughts on the evolution and design of a multinational securities regulator

DONALD C. LANGEVOORT

I. Introduction

The United States currently faces a set of regulatory issues that are profoundly important to the future of its form of securities regulation and hence its place in the global capital marketplace. Calls for extensive reform have come from a well-publicized set of studies that question the ability of the US to be competitive worldwide because of excessive regulation and an overdeveloped litigation culture.[1]

One of the principal moves being considered takes the form of mutual recognition.[2] The likely first stage of this would be the invitation to foreign stock exchanges and securities firms to have a presence in the US without registration with the SEC as a domestic exchange or broker-dealer firm, upon the determination that adequate home country regulation exists and can be relied upon as a substitute for direct SEC oversight. As part of this, however, would be some attention to a bigger project: the potential for mutual recognition of issuer disclosure and governance rules. Foreign trading screens and foreign broker-dealer presence in the US is meaningful largely as a means of making foreign securities more readily available to US investors, and the potential for increased competition and lower costs will hardly follow if making such securities available means intense US regulation of the issuers of those securities. Some mutual recognition of issuer disclosure standards is thus inevitable if

[1] Committee on Capital Markets Regulation, Interim Report, 30 November 2006, www.capmktsreg.org/research.html.

[2] E. Pan, 'The New Internationalization of US Securities Regulation: Improving the Prospects for an Trans-Atlantic Marketplace', *European Company Law*, 5 (2008), 1; E. Tafara and R. Peterson, 'A Blueprint for Cross-Border Access to US Investors: A New International Framework', *Harvard International Law Journal*, 48 (2007), 31–68.

the project is to succeed, and the SEC has already taken steps in this direction with the recent determination that foreign issuers do not have to reconcile their financial reporting to US generally accepted accounting principles.[3] Because financial reporting is at the heart of issuer disclosure, toleration of different sets of rules would presumably signal a willingness to do the same with respect to other aspects of disclosure.

Of course, we do not yet know that this willingness to experiment in mutual recognition will continue. There have been Republican chairmen of the SEC for the last eight years, and a shift in political control of the chairmanship and majority of the Commission might lead to a pull-back. Nor do we yet know the details of what might emerge even under the current administration. Quite possibly the eventual steps in the direction of mutual recognition will be small and disappointing to its adherents.

Because of this political uncertainty, my aim in this essay is not to explore mutual recognition in depth. Rather, it is to connect this and a number of other issues to what I regard as a deeper shift in the style and substance of US securities regulation that is likely to continue no matter who exercises political control. That shift comes as a result of the increasing institutionalization of both holdings and trading in stocks of widely-followed companies, or what Brian Cartwright, the SEC's general counsel, recently termed the resulting 'deretailization' of the US securities markets.[4]

Mutual recognition and the issues arising out of 'deretailization' have much in common. What makes them particularly appropriate to consider in this volume of essays in tribute to Eddy Wymeersch's masterful contributions both as regulator and scholar is that they both represent ways in which the US is increasingly open to a more European style of securities regulation, where institutionalization has long been dominant and mutual recognition a long-standing project within the EU.[5] I am not suggesting a perfect analogy, of course. Europe has determined that greater retailization of its capital marketplace is a worthwhile goal,[6]

[3] J. White, 'Corporation Finance in 2008 – International Initiatives,' London, England, 2008, www.sec.gov/news/speech/2008/spch011408jww/htm.

[4] B. Cartwright, 'The Future of Securities Regulation', University of Pennsylvania, Philadelphia, Pennsylvania, 24 October 2007, www.sec.gov/news/speech/2007/spch102407bgc.html.

[5] E. Ferran, *Building an EU Securities Market* (Cambridge University Press, 2004).

[6] N. Moloney, 'Building a Retail Investment Culture Through Law: The 2004 Markets in Financial Instruments Directive', *European Business Organization Law Review*, 6 (2005), 341–421.

so that what we may be seeing is movement toward a more mixed investor demography on both continents. And mutual recognition as it is developing in the US, at least, may actually be a form of deregulation aimed mainly at the more sophisticated, wealthy end of the market, not something that makes significant changes for the average American household.

But it does seem clear that US securities regulation is today willing to concede that for well-known issuers, the market is truly institutional, and that forms of regulation of these issuers (and their trading markets) that exceeds what institutional investors want or need does risk driving some business away to the detriment of the securities industry and its ancillary service providers such as lawyers and accountants. The fear in the US is that Europe's ability to focus on market building without the heavy baggage of historically large-scale retail participation is a competitive advantage in this respect.

Thus, I want first to think about how US securities regulation might change so as to become more European in style – that is, more consonant with institutional investor demands and preferences – with respect to the securities of larger issuers. (To be clear, I am not suggesting that Europe has built its markets and regulatory regime at the behest of institutional investors; rather, it has built its markets and regulatory regime in an environment where there has not been a strong, competing political voice by retail investors). It is important to emphasize that 'deretailization' does not imply a drop in the percentage of US households who hold securities, but just that more of those households have interests in securities held by institutional intermediaries. The political fact that still makes the US different from most of Europe is that far more US households see themselves as active investors, and hence the beneficiaries of relatively intense securities regulation. Thus the political demand for strong securities regulation will not change. What will change is the focus. There will still be emphasis on those segments of the market (e.g. microcap stocks) that remain largely retail, and – of course – greater emphasis on the need for protection of investors who participate in institutional portfolios of various sorts. The SEC will still have plenty of work to do in the name of retail investors. But where the interests of retail participants are relatively well aligned with those managing the institutional portfolios, the SEC is likely to defer increasingly to the professional investors' articulation of how they would like to see the law structured.

There is one additional form of Europeanization of US securities regulation that also strikes me as at least a strong possibility. It is probably still a fair assessment that Europe treats the public responsibilities of large corporations more seriously than the US does as a matter of corporate governance. There is more emphasis on disclosure of labour and environmental practices, and more strings that European governments can pull to rein in the private, competitive impulses of larger firms located within their jurisdictions. I have written elsewhere that even though the norm of shareholder primacy still officially holds in the US, there have been reforms in both securities law and corporate governance that hint strongly of greater public-regarding expectations with respect to the process of corporate decision making, which strikes me as a bit more like the European model. Sarbanes-Oxley is a good illustration, insofar as it introduces more transparency, accountability and public voice into the boardroom in order to check both excessive risk taking and private aggrandizement.[7] The effects of many of these rules (i.e. strong internal controls) are at best ambiguous in terms of value to investors, but that does not appear to be the test – the value to society in general from more open corporate decision making seems to be the point. Although its effects will not always dominate the political landscape, this increasing 'publicization' of the US corporation will persist. Such political demand is independent of any trend toward deretailization, and – at least through the voices of public pension funds, the most vocal of institutional investors – may actually be enhanced by it.

In the following pages, then, I want to look at a number of conceptual issues in securities regulation to see how a more European approach to US law might play out. The list of issues is not meant to be exhaustive of the important possibilities, but simply illustrative.

II. Jurisdiction and mutual recognition

The mutual recognition discussion that is on-going in the US is really the continuation of a much longer-running debate over the subject-matter jurisdiction of US securities law as applied to cross-border activity. In principle – and assuming a relatively high degree of market efficiency – it is easy to imagine a regime of issuer choice, where the issuer commits to a particular regulatory regime by some state or country.[8] It would then be

[7] D. Langevoort, 'The Social Construction of Sarbanes-Oxley', *Michigan Law Review*, 105 (2007), 1817–55.

[8] S. Choi and A. Guzman, 'Portable Reciprocity: Rethinking the International Reach of Securities Regulation', *Southern California Law Review*, 71 (1998), 903–52.

able to offer securities or trade in the capital markets in any other country based on its adherence to its 'home country' law. Sophisticated investors would assess the risks, costs and benefits associated with the chosen regulation and the markets would price the securities accordingly.

This, however, is not the European way. Though committed to a passport system of mutual recognition, the EU has insisted that Member States adhere to certain fairly demanding standards of regulation so that what is exported has a high degree of regulatory credibility. Many of the institutions of contemporary EU securities law are meant to force Member States into a stronger and more uniform commitment to regulation and enforcement so as to support a safer form of mutual recognition.[9]

The US does not have the same institutional tools to work with, and so mutual recognition would take a somewhat different form. Apparently, what would happen is that the US would set its own minimum standards for the quality of 'home country law' that would have to be satisfied before the SEC would allow the foreign exchange, securities firm or issuer to enter the US without the full application of US law. Importantly, there would be no deference to home country law with respect to instances of securities fraud that occur or have significant effects in the US.

Let us assume, as is likely, that this form of mutual recognition is limited to securities or services where the institutional presence dominates. It seems to me that institutional investors would have little reason to oppose this kind of liberalization. It offers somewhat lower transaction costs associated with doing business in foreign securities because of enhanced competition and disintermediation. To be sure, institutions that value the higher level of disclosure required by US law might prefer that it be available, but the evidence is that many foreign issuers are choosing to avoid listings in the US rather than submit to such requirements, and so that might not really be the choice.

The key to any workable system of mutual recognition is in assessing both *ex ante* and on an on-going basis the quality of the home country's securities regulation. Initially, it would seem, the EU would be the place to start: countries that indeed adhere to the requirements in the various Directives could be presumed to have acceptable regulation. No doubt more work needs to be done (as Europe already recognizes)

[9] N. Moloney, 'Innovation and Risk in EC Financial Market Regulation: New Instruments of Financial Market Intervention and the Committee of European Securities Regulators', *European Law Review*, 32 (2007), 627–63.

to bring the enforcement capacity of Member States' laws up to speed, but this is already on the agenda. So long as US and European regulators coordinate their demands appropriately, mutual recognition by the US could be helpful in moving the European efforts along. And with this experience as a guide, mutual recognition could be extended to other major capital marketplace countries.

What may be more difficult is in addressing the specific issues that are likely to arise *after* mutual recognition is granted. Suppose, for instance, that a particular problem were to arise, with disagreement about the home country's willingness to be as aggressive in applying its laws as the SEC would like. There is, of course, the possibility of withdrawal of mutual recognition, but this seems unlikely except in the most extreme circumstances. Instead, the likely response to a breakdown is that the US would invoke its reserved authority over fraud to act unilaterally. In fact, for a variety of reasons having to do with the way the federal securities laws were originally drafted, the SEC and private plaintiffs have learned numerous ways to turn virtually any form of misbehaviour into fraud.

If that happens frequently enough, however, it is unlikely that mutual recognition will succeed, because foreign participants will foresee this and find little comfort in entering the US under home country law that can so easily be displaced. For mutual recognition to succeed, then, there must be some dispute resolution mechanism that helps mediate these disputes before the US defects by unilaterally bringing fraud claims. Here is another place where the European experience may be a guide. The creation of CESR and other institutions of pan-European cooperation in securities regulation have many justifications, but one is their role as a dispute resolution mechanism where Member States might disagree about what the basic Directives requirements mean.[10]

Mutual recognition on a global scale requires a dispute regulatory authority on a comparable scale. This need not be a formal administrative body, but does need to be a reliable mechanism whereby skilled 'neutrals' are able to pressure individual countries and their regulators into either action or forbearance. One could imagine any number of forums that could be so designated, including some growing out of existing structures such as IOSCO. My prediction would be that the success of mutual recognition – and the willingness of countries such as the US to embrace broader versions of it, not simply limited to the institutional setting – is wholly dependent on this. To be sure, as is currently

[10] Moloney, 'Innovation and Risk in EC Financial Market Regulation', (note 9, above), 646.

an issue in the EU, the emergence of any mediator would raise questions of legitimacy and accountability, but these are familiar problems with respect to nearly all efforts at harmonization short of treaty-based formal authority.

In turn, the creation of such a global administrative body, even if advisory only, could become a platform for other tasks that are likely necessary for mutual recognition to succeed. As I have written about elsewhere in a volume that Eddy Wymeersch and Guido Ferrarini edited, cross-border securities enforcement is likely to be problematic unless some institutions of enforcement cooperation are created that overcome the 'home bias' of domestic regulatory authority.[11] Although the creation of a 'global SEC' may be beyond the politically practicable, it is not beyond imagination that if a group of major capital marketplace countries could agree on an informal dispute resolution mechanism authority, that that authority could also be a place where professional staff could guide a team of enforcement personnel from each of the participating countries in order to launch joint investigations and enforcement proceedings that invoke the existing laws of those countries in a coordinated fashion. To be workable, this would have to be limited to cases of fraud and manipulation about which there is no substantive disagreement. But with the growth of the dispute resolution process in the application of minimum global standards, a consensus on enforcement is itself more likely to evolve.

Mutual recognition, if successful in its earliest stages, naturally raises the question of how far it should extend. To what extent should it be extended to retail investors, or more thinly capitalized foreign issuers? Obviously, we can expect gradual extension insofar as there is strong confidence in home country regulation in terms of its ability to respond to issues and problems that arise. As a well-known and long-standing academic debate in the US has considered, one could eventually take mutual recognition to the point at which there is near-total 'issuer choice' – any issuer could simply choose its home jurisdiction, which would lead to competitive rewards to countries whose regulation that is most attractive, and competitive penalties to jurisdictions that either over- or under-regulate.

The vehicle through which mutual recognition would most likely evolve in this direction is exchange-based listings. To the extent that the

[11] D. Langevoort, 'Structuring Securities Regulation in the European Union: Lessons from the US Experience', in Ferrarini and Wymeersch (eds.), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (Oxford University Press, 2006), 485–506.

world is willing to accept that the appropriate securities regulator is the jurisdiction of the exchange on which the issuer has voluntarily chosen to list its securities for trading, then there will be a de facto regime of issuer choice.[12] Arguably, this is what is going on right now – New York is losing its relative position as a favourable site for cross-listings, and other jurisdictions are gaining. The call in the US is for relaxing the intensity of its regulation as a response, which if successful would presumably reverse the trend. That is exactly as it should happen.

But before getting carried away with this as the vision for global securities regulation generally, it is important to remember that this vision is one for cross-listings only, not listings generally. In fact, I am not convinced that listings will continue to play a pivotal role in securities regulation at all. They can to the extent that trading is centralized on a single exchange, which then has the incentive to seek regulatory enforcement to bond the credibility of the listing commitment. But if global securities trading instead moves in the direction of fragmentation rather than consolidation – with many different trading sites around the world sharing in the order flow – the incentive for any one exchange or regulator to devote the necessary resources to enforcement diminishes. In a fragmented trading environment, it is unlikely that any single country has good reason to devote adequate resources to the regulatory task, unless its own citizens are disproportionately at risk.

Whether or not there is continued fragmentation, however, there is a second reason to doubt that listings can truly be the primary jurisdiction nexus. The test is to consider the extent to which a country like the US would permit its own domestic issuers to migrate away from US regulation simply by listing solely on a foreign stock exchange, as a few have done. In fact, the issuer accomplishes relatively little by so doing. To be sure, the burdens of the Securities Act and its regulation of the public offering itself are removed, so long as the issuer submits to the heavy lock-ups required by Regulation S. But registration under the Securities Exchange Act – the on-going corporate disclosure obligations and resulting litigation exposure – are triggered whenever a domestic issuer comes to have 500 or more shareholders and more than $10 million in assets. For domestic issuers, there is nothing comparable to the reporting relief given to unlisted foreign issuers under Rule 12g3–2.

What we are observing, then, is an increasingly 'territorial' basis to jurisdiction. That is, there are two levels in terms of the intensity of

12 C. Brummer, 'Stock Exchanges and the New Market for Securities Law', *University of Chicago Law Review* 75 (2008), 1435.

securities regulation. For those issuers with a strong territorial nexus with the US – essentially, domestic issuers – there is a high level of regulation, and largely inescapable. For widely traded foreign issuers, there is increasingly less regulation.

My sense is that this is a stable equilibrium, which will eventually result in near-complete deregulation of such foreign issuers via a strong regime of mutual recognition if they choose to list in the US. In a marketplace characterized by high institutional holdings, the pricing efficiency and risk-absorbing feature of portfolio diversification make it reasonably safe to defer to competent foreign regulatory regimes, especially if aided by the kind of global inter-jurisdictional 'mediator' I described earlier.

What about the predilection of US retail investors to react to issuer misbehaviour and demand reforms in the face of scandal? What, in other words, will happen in the aftermath of the next large issuer meltdown involving a well-known foreign company that triggers losses by US investors? Mutual recognition is fairly well suited to weather foreign issuer scandals without triggering a Sarbanes–Oxley kind of reaction. First, the percentage of US investors affected by a foreign issuer scandal is less than for a domestic one, and there is less political potency for this reason alone. And those affected are more likely to be through diversified portfolios, so that the effects are even more softened. But the biggest difference – to me, explaining much about Sarbanes–Oxley and US regulation generally – is that the spillover effects of the foreign issuer scandal on other important constituencies, such as employees, company pensioners, local communities and the like, are dramatically smaller.[13] To the extent that these effects are what creates the political motivation for dramatic regulatory responses, the motivation will almost always be lacking when the main locus of the fraud is elsewhere. Conversely, this also explains why a listings-driven (as opposed to cross-listings-driven) regulatory regime would be unstable: the US will not give issuers with so great an ability to harm multiple US constituencies an ability to opt out from its preferences about the proper level of transparency and accountability.

I do not want to make too much of the analogy with Europe here. The EU, of course, has struggled with the right balance among sovereignty, subsidiarity and the free flow of economic activity – the desire of certain Member States, at least, to maintain 'home country' regulatory control

[13] D. Langevoort, 'The Social Construction of Sarbanes–Oxley', *Michigan Law Review*, 105 (2007), 1828–9.

over their domestic business entities is strong, presumably for reasons similar to those in the US. My simple point is that the compromises made in the US will increasingly resemble those made in Europe as the investment marketplace in the US becomes more heavily institutional and the institutional investor voice comes to dominate the retail voice in important segments of the capital markets.

III. Institutionalization and the litigation culture

By all accounts, the most troubling difference in terms of competitive appeal between the US and European approaches to securities regulation comes in terms of enforcement and litigation. On the public enforcement side, there are difficult questions regarding intensity: whether the US overdoes both criminal prosecution and agency (SEC) enforcement. This is another area where the relative degree of institutionalization makes a difference. With respect to repeat players, knowledge sharing among institutions and the need for regular access to the capital markets makes reputation a more formidable check on misbehaviour compared to retail markets in which new naïve investors regularly appear and old ones too often forget. But even in institutional markets, reputation is an imperfect check (last period problems, etc.) and so a reasonable degree of *ex post* enforcement is needed. It is certainly possible that European countries have found strategies, such as prudential oversight, that obviate the need for even this. But I am not aware that there has been any well-grounded explanation for precisely what forces would be at work that would lead to behaviours consistent with anything but the classical economic calculus: that what works in deterrence is the balance between the probability of detection and severity of sanction upon discovery. Given the immense profits that can be made by cheating in the securities markets, and the difficulties of detection, one is forced to believe that significant enforcement intensity is required. I am open to the possibility that other extra-legal influences (business culture, moral suasion, etc.) have some power, and that the close-knit nature of certain European money centres – the City of London being the most notable example – may utilize these more effectively than is practicable in a more diffuse capital market such as the US. If this is an explanation, then the interesting question becomes whether it is sustainable as these money centres gain greater geographic and cultural reach, becoming world markets in which it is harder for local elites to impose extra-legal discipline simply by invoking locally established behavioural norms. My suspicion is that

Europe will gradually adjust by intensifying public enforcement, while the US will more likely shift the focus of when and how public enforcement occurs.

The much more interesting question has to do with private securities litigation, which operates in the US in ways simply not replicated anywhere else in the world. The exercise, once again, is to think through how US attitudes toward private litigation might change, based on a shift to a more completely institutionalized market for the securities of well-known issuers. Some imagination is necessary because the voices of certain institutional investors are affected by conflicts of interest that make it hard to disentangle the economic from the political. Public pension funds have led aggressive litigation, but perhaps (though they certainly deny it) for reasons having to do with the interests of those in state governments. Conversely, the silence of mutual funds in the litigation area may be explained by their role in administering employer-sponsored retirement funds, which may be put at risk if they take on a visible plaintiff-side litigation posture.

The economics of private securities litigation are complicated, and by all accounts, differ depending on whether we are considering a lawsuit against a company that has directly benefited from an alleged fraud (as is the case in a public offering in which the company raises funds through a false or misleading prospectus) or not (as in the case of a typical 'fraud on the market' lawsuit). To be sure, the line between these two kinds of cases is blurred, but we can assume that at least a substantial portion of fraud was meant to enrich only the managers of the firm, not the firm itself.

In the latter instance, there is good reason to suspect that well-diversified institutional investors lose more than gain from litigation.[14] There are two well-known points here. First, consider that – apart from insider trading or other extractions of wealth by the wrongdoers – fraud is close to a zero-sum game for investors. Those fortunate enough to sell stock when the price is artificially inflated win, while those unlucky enough to buy lose. Over time, for well-diversified active investors, one would expect the gains and losses to even out – indeed, for active traders, we would expect some evening out because the investor both bought and sold during the class period. Absent a theory about why any given investor would expect systematically to be a loser over time (which is

[14] J. Coffee, 'Reforming the Securities Class Action: An Essay on Deterrence and its Implementation', *Columbia Law Review*, 106 (2006), 1534.

especially difficult to imagine for a professionally managed portfolio), it is not clear that institutions in general would demand much at all in litigation rights if the gains and losses are internalized within the capital markets. Certainly, they would not pay heavily for any such protection.

The second point is related. The vast majority of all payouts in private securities litigation come from the issuer, either directly or (to a far greater extent) insurance paid for by the issuer and for which the issuer is the named beneficiary. In essence, then, payments in settlement or judgment come largely from the pockets of some investors to the pockets of others, which merely reallocates funds rather than transfers money from the guilty to the innocent. Recent research has confirmed that the insurer's role in private securities regulation comes with little benefit in terms of doing justice.[15] Insurers do not vary their price much to reflect the corporate governance risk, nor are they particularly sensitive to the merits of the underlying claims. They settle when their customers (company management) ask them to settle.

This system has some benefits, to be sure. Investors do receive some compensation, which may be significant when the investor was insufficiently diversified or otherwise systematically or especially unlucky. It also has a somewhat greater rationality from a deterrence perspective when the fraud was intended to benefit the company as well as its managers, although even this is negated when the payments come entirely from the insurers. The key point comes in the costs: the very high legal fees paid to both plaintiffs' and defendants' law firms, plus the profits made by the insurance companies for funding such a system of transfer payments.

The problem is a collective action one, once again. Even if investors lose more than gain from the system in general, they will invoke whatever rights they are given in those circumstances when they are hurt by fraud. In turn, the compensation recovered is tangible and visible, whereas the costs paid over time are diffuse and largely invisible. My suspicion is that on an entirely rational calculus, institutional investors have little reason to support such a litigation system, and that the political support for it comes mainly from retail investors much more affected by the differences in saliency between costs and benefits and inclined to see litigation as an exercise in retribution.

If so, then this should be another area where the increasing voice of the institutional investor should lead to a shift in regulatory attitude.

[15] T. Baker and S. Griffith, 'The Missing Monitor in Corporate Governance: The Director and Officer's Liability Insurer', *Georgetown Law Journal*, 95 (2007), 795–845.

We know that private securities litigation is effectively limited to highly institutionalized settings, both because courts require a showing of high market efficiency to afford the class a presumption of reliance, and because plaintiffs' law firms tend only to target high-capitalization issuers because that is the only setting where there is enough money to be found. The so-called 'Paulson Committee' report recommends that issuers be allowed to opt out of class action exposure by placing limitations on the right to sue in a company's charter or articles.[16] The hypothesis is that this will lead to forms of alternative dispute resolution, such as arbitration, as an alternative. Whether this is plausible depends on whether there are forums that can handle large-scale, fact-intensive inquiries; the current models for arbitration in the securities area (e.g. customer-broker disputes) are not suited for this. Nor is it clear that it would be easy to design an incentive structure that would encourage good actions to be brought, given the expenses associated with such actions. A reasonable fear is that no adequate alternative system would emerge, and that the opt-out would be in the direction of no significant deterrence at all.

There are others changes that would be more investor-friendly. Remember that an important objective from the standpoint of the sophisticated investor is to recoup the fruits of fraud from insiders who do capture the benefits. Some investors in the US are pushing revisions in executive employment contracts that allow for clawbacks of incentive compensation and trading profits after the discovery of significant corporate misconduct. There are ways the law could be revised to encourage greater use of disgorgement and other equitable remedies that target such insider gains, which institutional investors might well also find appealing.

One of the most interesting lingering questions in the building of a more institution-friendly litigation system has to do with public offerings. If we think in terms of an initial public offering, the idea of a lawsuit seems relatively efficient: the money raised in the first stage of public financing is a transfer from public investors (including many institutions) to the promoters, backers and other insiders of the start-up firm. Recapturing this money in the event of fraud resembles the disgorgement of insider gains from fraud-on-the-market, rather than simple pocket-shifting. This, however, becomes less so with respect to

[16] Committee on Capital Markets Regulation, *Interim Report*, 30 November 2006, www.capmktsreg.org/research.html.

distributions by seasoned firms. Moreover, it is not clear that sophisticated investors would necessarily want to base recovery on the current standards in US law: strict liability for the issuer (assuming that the stock price drop that triggers the lawsuit can be associated with discovery of some material misrepresentation) or due diligence liability for directors, underwriters and others who, especially with respect to some kinds of financing, have little practicable ability to discover the truth. This liability arguably leads either to under-pricing of the deal or higher fees charged by deal participants. Hence, this is another area where reform might be supported by unconflicted institutional investors.

The potential roadblock to reform here is that, thus far, it appears that US retail investors see themselves as beneficiaries of the current litigation system. In this sense, they are political allies with those – plaintiffs' law firms and public pension funds – who have staked the clearest claims to the efficacy of strong private rights of action. Overcoming this requires stronger empirical evidence that retail investors as a whole lose more than they gain, and that the hidden costs associated with the meagre recoveries that occasionally occur are significant. Politically, even if institutional investors as a group were persuaded, selling this to broader segments of market participants probably requires that there be evidence that some alternative mechanisms will emerge to address the need to target wrongdoers,[17] and to gain compensation for those retail investors (e.g. pensioners with portfolios heavily weighted with the stock of a single issuer) where the costs of issuer fraud are most vivid.

IV. Conclusion

My hypothesis is that US securities regulation as it relates to foreign issuer disclosure, corporate governance and litigation will gradually shift in the direction of policies that sophisticated institutional investors find comfortable, which will mean significant shifts from the legacies created during the times (from the 1930s through to the early 1980s) when the US had a more thoroughly retail investment culture. It is interesting to think of how many of the rules and procedures in US laws that are currently under criticism – the structure of the two main securities statutes and the fraud-on-the-market lawsuit, for instance – date from

[17] D. Langevoort, 'On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability', *Wake Forest Law Review*, 42 (2007), 627–61.

this time period. Once again, however, I would emphasize that even a strong institutional voice will not check the demand for regulation that comes from domestic stakeholders when serious negative externalities result from a US-based breakdown in corporate governance.

Mutual recognition is a healthy exercise through which to wean US law away from these legacies in the settings in which the markets are sufficiently institutional. In turn, as this occurs, those segments of the US market will take on a more European character. To be sure, not all forms of investing in the US are making this shift: there will always be a robust retail presence in the markets for smaller stocks. And just as in Europe, the retail nature of the markets *for* institutionalized investments will continue to pose regulatory challenges and a demand for significant protections. The more complicated the portfolio strategies of institutional investors, the more opaque and potentially risky the individual accounts.

My prediction, then, is that US securities regulation will significantly reduce its intensity vis-à-vis foreign issuers, and partially reduce its intensity vis-à-vis domestic issuers. The reduction will take place with respect to litigation as to both domestic and foreign issuers so long as some 'safety-valve' remains in place for disciplining and recouping wealth from insiders who cause serious economic damages to investors and other stakeholders. This would be a distinctly European turn. As to retail investor interests, the shift will be towards seeing the ultimate problem in securities regulation as addressing the relationship between public investors and those who manage large portfolios. I make no claim to see Europeanization coming here – rather, regulators on both continents will find this the common challenge in coming decades.