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# Comment on Litigation Reform Proposals of the Committee Markets Regulation

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## Is Excessive Regulation and Litigation Eroding U.S. Financial Competitiveness?

AEI and Brookings

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## Focus of Comment

- Does the current level and form of U.S. civil liability create too much “regulatory intensity” in the securities area and is this reducing the competitiveness of U.S. capital markets?

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## Effects of U.S. Civil Liability System

- Much of U.S. “regulatory intensity” comes from civil liability based enforcement
- This enforcement-driven greater regulatory intensity does not have a uniform effect on foreign issuers’ desires to be listed in the U.S.
  - Repels some, as the Committee’s Report emphasizes
  - Attracts others
  - Attraction is demonstrated by the 30% listing premium

# Sources of 30% Listing Premium

- A foreign issuer that subjects itself to the US regulatory regime by listing in the U.S. is:
  - *signaling* that future cash flows, even with no changes in the way the corporation acts in the future, will be greater than the market previously perceived
  - *bonding* that the firm will be run differently than it would have been if it had not listed with the result that actual cash flows will be higher than if the company had not listed
  - *decreasing the discount rate* on the market's expectation of future cash flows (and hence the increasing the share price for any given expected level of future cash flows) by reducing the expected level of asymmetry of information and hence the expected bid/ask spread

## Committee Report's Implication of Uniform Treatment

- The Committee report seems to suggest that our choice is whether to decrease or keep the same level of regulatory intensity for all issuers listed on U.S. markets, both foreign and domestic.
- Under this uniform treatment assumption, given that our intensity attracts issuers as well as repelling them, we appear to face a tradeoff.

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## False Tradeoff

- Another alternative: give foreign issuers that list in the U.S. the *option* of committing themselves long term to the U.S. regime, including civil liability
  - the market can tell the difference and discount the non-U.S. regulated ones appropriately

# Benefits of the Option Approach

- Continue to attract the foreign issuers we attract now and attract the ones we repel as well
- Free our policy debate to focus on what is the U.S. regime's best level of regulatory intensity in terms of the needs of *U.S.* issuers.
  - recognizes that disclosure regulation is primarily a corporate governance device
  - our primary interest is the in the corporate governance of U.S. issuers, not foreign issuers

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## Are Fraud on the Market (FOM) Civil Liability Suits Desirable as a General Matter?

- Compensation rationale is weak: just chance transfers among investors
- Real social gain is increased incentives for corporate truth telling
  - more accurate share prices
  - better corporate governance
- Real social costs are the transaction costs of the litigation system
  - plaintiffs' and defendants' legal fees
  - diversion of managerial time

# Committee Report Understates Incentives for Truth Telling

- True that the corporation, and thus ultimately its shareholders, pays most of the settlements
- This is so for most other penalties and liabilities imposed on corporations as well, but we do not question the incentive value of these
- Real cost paid by investors is not the total payouts, it is the actual social costs

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## The Committee's Proposed Arbitration with No Class Action Option

- Really effectively an option to leave the FOM liability system
- Is a shareholder vote sufficiently reliable?
- Reduced effectiveness of mandatory disclosure, which has externalities