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THE EFFECTS OF THE SARBANES-OXLEY ACT BY EXAMINING FOREIGN LISTING BEHAVIOR OF NON-US COMPANIES

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I List of Abbreviations

ADR	American Depository Receipt
AIM	Alternative Investment Market
AMEX	American Stock Exchange
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COSO	Committee of the Sponsoring Organisations of the Treadway Commission
DR	Depository Receipt
ERM	Enterprise Risk Management
IAS	International Accounting Standards
i.e.	id est; that is
LSE	London Stock Exchange
NASDAQ	National Association of Securities Dealers Automated Quotations
NYSE	New York Stock Exchange
OECD	Organization for Economic Co-Operation and Development
OTC	over the counter
PCAOB	Public Company Accounting Oversight Board
SEC	Securities Exchange Commission
SOA	Sarbanes-Oxley Act
SOX	Sarbanes-Oxley Act

SARBOX	Sarbanes-Oxley Act
US	United States of America
US GAAP	US Generally Accepted Accounting Principles
UK	United Kingdom

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1 Introduction

Looking back to the last decades, corporate governance has become a fundamental element for an efficient corporate management.

Numerous corporate and accounting scandals and the Financial Crisis of 2008 led to a lack of investor confidence. This emerging doubt of the public moved corporate governance into center of attention. But increasing investor activism and globalization intensified the interest in corporate governance as well. Having an effective corporate governance system, whether in an individual company or in an economy as a whole, supports to restore confidence. Confidence, that is necessary for the appropriate functioning of a market economy.¹

Corporate governance is not only about enhancing investor confidence, it is also about promoting competitiveness and improving economic growth. Good corporate governance enables companies getting better access to financing, smaller cost of capital, better valuation and an overall improved performance.²

But corporate governance itself was not enough. As a reaction to further high-profile accounting scandals, such as Enron's accounting fraud and WorldCom's misstatement of their balance sheet, the Sarbanes-Oxley Act of 2002 has been enacted. This legislation is a consequence of the lacking sense of responsibility of managers. The Act is intended to ensure the reliability of financial information reported to the public and to protect shareholders and the future investors from corporate accounting errors and frauds in order to restore confidence in US capital markets.

The Sarbanes-Oxley Act, called SOX or SARBOX, applies almost exclusively to public held companies. But even non-US foreign-listed companies who want to

¹ see OECD (2004), p. 11

² see Claessens and Yurtoglu (2012), p. 30

list in the US meet the same by SOX demanded legal and listing conditions as any other listed attendant of the exchange. ³

In the last years, the incentive to offer stock on foreign stock exchanges increased tremendously. One reason for this tendency is the fact that shareholders discovered the necessity for risk diversification of their portfolios on an international basis. Another reason represents the company's wish to broaden their shareholder base and acquire funds cost-effectively. ⁴

The Sarbanes-Oxley Act affects the foreign listing behavior of a company: non-US companies have to apply the Sarbanes-Oxley Act in case they decide to cross list at an American stock exchange. Non-US companies not being listed at an American Stock exchange are able to avoid this legislation.

This work deals with the influence of the Sarbanes-Oxley Act on the foreign listing behavior of non-US companies. Do they rather cross list at NASDAQ or NYSE and apply to SOX? Or do they decide to list at LSE's Alternative Investment stock market trying to avoid SOX?

Due to its shareholder rights and investor safeguard UK stock exchanges are the most comparables ones to US stock exchanges. Because of the absence of SOX, UK stock markets build the most similar counterpart to compare to US listing activities. Therefore I put focus on these exchanges analyzing different listing activities and comparing United States based and United Kingdom based stock exchanges in order to discover advantages and disadvantages for companies choosing a host market after the implementation of the Sarbanes Oxley-Act.

³ see Investopedia webpage [20.02.2011]

⁴ Karolyi (1999), p.10

2 Corporate Governance

With the increasing importance of corporate governance, the size of the literature about that subject increased as well. In the last few years, hundreds of books and tons of articles have been written about corporate governance. Hence, a massive range of definitions exists. Reinhart Schmidt defines corporate governance in a very explicit way:

“Essentially, corporate governance is about the distribution of decision and control rights; it is about governing and monitoring management, which typically has important residual decision rights; it is about influencing business policy; and it is about protecting stakes which are exposed to the risks arising from the incompleteness of contracts and markets and the asymmetric distribution of information and decision rights.”⁵

Shleifer and Vishny keep their definition of corporate governance short and concise:

“Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”⁶

In a nutshell, corporate governance is some sort of approach by which companies are managed and directed. It involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders.⁷ Good corporate governance should dispose the board of directors and the management to pursue objectives that are in the interests of the company and its shareholders.⁸

⁵ Schmidt (2004), p. 390

⁶ Shleifer and Vishny (1997), p.737

⁷ see OECD (2004), p.11

⁸ see OECD (2004), p.11

Since investors can't control the company themselves, they need to trust management's performance. Thereby shareholders could possibly underlie opportunistic behavior, which is an outcome of the agency problem. This point will be covered in chapter 2.3.

Corporate governance is about keeping the balance between economic and social intentions, as well as societal and individual intentions. This balance can be reached by transparency, which ensures that the interests of all shareholders, including minority and majority shareholders, are protected. The company should recognize the rights of their shareholders in order to enable them to fully exercise these interests.⁹

Corporate governance principles and codes have been developed in different countries. With the support of governments and international organizations, they have been issued from stock exchanges, institutional investors, corporations or associations of managers and directors. "The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success."¹⁰ "The United States, Germany, Japan and the United Kingdom have some of the best corporate governance systems in the world."¹¹ This can be based on the fact that corporations in these market economies "are governed through different combinations of legal protection and concentrated ownership."¹²

2.1 The OECD Principles of Corporate Governance

The Organization for Economic Co-Operation and Development (OECD) is a great example of an international organization being committed to market economy and democracy.

⁹ see OECD (2004), p.12

¹⁰ OECD (2004), p.12

¹¹ Shleifer and Vishny (1997), p.737

¹² Shleifer and Vishny (1997), p.739

Since 1961 the OECD represents one of the biggest and most trustable sources of comparable statistics and social and economic data worldwide. Besides monitoring trends, analyzing and forecasting economic developments and researching social changes, the OECD is one of the world's largest publishers in the fields of economics and public policy.¹³

In 1991 the OECD Ministers endorsed the OECD Principles of Corporate Governance. Ever since they become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. Furthermore, these Principles of Corporate Governance regulate a foundation for corporate governance initiatives between OECD and non-OECD countries.¹⁴

¹³ see OECD webpage

¹⁴ see OECD (2004), p. 3-9

The OECD Principles of Corporate Governance	
I	Ensuring the Basis for an Effective Corporate Governance Framework
	The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
II	The Rights of Shareholders and Key Ownership Functions
	The corporate governance framework should protect and facilitate the exercise of shareholders' rights.
III	The Equitable Treatment of Shareholders
	The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
IV	The Role of Stakeholders in Corporate Governance
	The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
V	Disclosure and Transparency
	The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
VI	The Responsibilities of the Board
	The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Table 1: The OECD Principles of Corporate Governance (Source: OECD (2004), p.17ff)

2.2 The Agency Problem

One important perspective of corporate governance is the agency perspective, which is about the separation of ownership and control – or management and finance.¹⁵ Other perspectives of corporate governance are the shareholder theory and the stakeholder theory. According to the shareholder theory a company should act in the interests of its investors since they own a share of the company and therefore have voting rights. The stakeholder approach orders

¹⁵ see Shleifer and Vishny (1997), p.738

the firm to act in the interests of its stakeholders that can be managers, customers, creditors, suppliers and the public in general.

Back in 1776 Adam Smith has dealt with the Agency Problem already. In his book "The wealth of Nations" he describes this issue in the following way:

"The directors of companies, being managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."¹⁶

Jensen and Meckling have been the first authors applying the agency theory to the modern corporation defining an agency relationship as "a contract under which one or more persons - the principal(s) - engage another person - the agent - to perform some service on their behalf that involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal."¹⁷

Roughly speaking, the manager, representing the agent, has to raise funds from investors, representing the principal, in order to use them in a productive way or to cash out his holdings in the corporation. In return, they need the manager's specialized human capital in order to obtain returns on their funds.¹⁸ Thereby a separation of ownership and control is formed.¹⁹ Conflicts of interest between investors and managers occur making this situation the initial point of the agency problem.

The principal wants the value of his shares to increase in an immense way and to be extraordinary high, thus his interests are downright financial. The agent does not aim for an increasing share value – he is rather looking for private benefits. Those benefits are reflected in the economic chance to change the world, achieve power, gain recognition and stepping into some sort of

¹⁶ Smith (1776), p. 330

¹⁷ Jensen and Meckling (1976), p.5

¹⁸ see Shleifer and Vishny (1997), p. 740

¹⁹ Berle and Means (1932), p.302

challenge.²⁰

The following questions are raised: How can the shareholder assure that he gets returns out of this project? How does he know whether the agent manages his funds in a rational economic way?

Denis (2001) presents three possible solutions in order to increase the chance that the agent acts in concern of the principal:

- Bonding solutions

A contract, bonding the agent to act in the principals' interests, seems to be the most realizable solution. This contract contains how the returns of the investment should be allocated and what to do with the funds. In order to have a complete contract, every eventuality and possible future situation should be specified. I.e. the shareholders even would have to estimate what would be a value-maximizing decision in every state of affairs. Since we find ourselves in an uncertain world, arranging a complete contract including every eventuality is nearly impossible.²¹

- Monitoring Solutions

Finding threats to management having the function to monitor these agents would be another possible solution in order to maximize shareholder value. The investors themselves seem to be the perfect monitors, but most of them lack the know-how and are not informed enough to make adequate decisions. Additional, the average shareholder owns a small fragment of the firm, i.e. monitoring the management would cause additional costs preponderating the benefits. However, the board of directors, the management, creditors and large shareholders present existing potential sufficient control units.²²

²⁰ see Denis (2001), p.193

²¹ see Denis (2001), p. 196

²² see Denis (2001), p. 196

- Incentive alignment solutions

Providing an incentive contract ex ante could cause the agent to act in the principals' interest. Compensation incentives encourage the agent to make decisions that are able to maximize the agent's return.

But such contracts can represent an expensive option if the contract provides irrational high incentives.²³

The manager can get incentives in terms of stock options, share ownership or even in a threat of discharge in case of poor performance.²⁴

These conflicts of interest between the principal and the agent, caused by the separation of ownership and control, can lead to agency costs. Agency Costs are composed of the total of the bonding expenditures by the agent, the monitoring expenditures by the principal and the residual loss.²⁵

2.3 Consequences of Weak Corporate Governance²⁶

As already mentioned above, economic incidents like the falsification of WorldCom's balance sheet, audit fraud provided by Arthur Anderson and managerial corporate plundering by Tyco showed that bad corporate governance has a negative impact on investor's confidence leading to a decrease in stock markets. But there are many other consequences resulting from poor corporate governance.

Weak corporate governance can influence financial markets leading to an increased financial volatility and even financial distress. In contrast, good corporate governance can minimize the risk of financial crisis.

Stocks from areas offering poor investor protection exchange at higher bid-as-spreads and feature thinner expense than stocks with better protection. Additional, stock markets in countries with good governance are better transmitters of information than stock markets of countries with weak

²³ see Shleifer and Vishny (1997), p. 744

²⁴ see Jensen and Meckling (1976) p. 66

²⁵ see Jensen and Meckling (1976) p. 6

²⁶ see Claessens and Yurtoglu (2012), p. 16-18

governance. Stock return distributions also get affected leading to a decrease of share values indicating that firms with good corporate governance have higher rates of return.

Net capital incomes of countries with poor governance react to negative events more sensitively affecting investor's confidence. Since the expected return of investment is smaller and downfalls in currency in stock prices are observed, the risk of expropriation rises.

Having a closer look at M&A activity highlights the importance of good corporate governance: the last two decades show an increased M&A action for countries with enhanced investor protection showing that these well governed countries build the market for M&A. Acquiring firms tend to offer better investor protection than their target firms which can improve the corporate governance system of the goal company after accessing.

2.4 Attractiveness of the US Stock Market

2.4.1 Legal Origin

Differences in the quality of financial systems can be attributed to different legal systems that offer protection for their investors in order to avoid expropriation by insiders. These legal systems either have English, French, German or Scandinavian origin. French, German and Scandinavian legal systems emerge from the Roman law and form the representatives for civil law countries. English law is formed by judges and subsequently integrated into law generating the common law. Depending on its occupation and colonization countries adopted one of these legal systems after achieving independence.²⁷

When it comes to expropriation by insiders, common law countries protect shareholders and creditors the most while French civil law countries offer the worst protection. The quality of Scandinavian and German civil law countries lies in between.²⁸

Investors receive weaker legal rights from civil laws than from common laws.

²⁷ see La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997), p. 1131

²⁸ see La Porta et al. (1997), p. 1132

While French civil law countries offer the weakest protection, common law countries permit creditors and shareholders the strongest protection.²⁹

A good legal atmosphere protects investors and motivates them to drop funds in exchange for stocks enhancing size and range of capital markets. Civil law countries (especially French civil law) offer the worst investor protection leading to poor developed capital markets.³⁰ This might explain the popularity of US stock exchanges since these markets offer the best investor protection due to their common law origin. Therefore the excellent legal protection a US stock exchange has to offer attracts investors.

Additional countries with good protection within the law have more external investment in terms of wider and more valuable capital markets. So the legal environment does influence a company's possibility to raise capital.³¹ The US stock market definitely benefits from this aspect since firms draw attention to markets offering good investor protection and enable external financing.

2.4.2 Anti-self-dealing Index

Every company has certain controlling bodies (managers, controlling shareholders etc.) that might abuse their power in order to expropriate investors by reaping money. This action, which is referred to self-dealing, implies theft of corporate assets, exaggerated compensation, executive perquisites, self-serving financial activities (personal loans to insiders or directed equity issuance) and detention of corporate opportunities. Legal protection supports avoiding expropriation by insiders and therefore induces market development by improving trust in markets.³²

Common law countries feature a higher index than civil law countries. Additionally the anti-self-dealing index presents a way to measure the development of stock markets across countries.³³ Because of this finding and the excellent investor protection, the US stock exchange presents an attractive market for investors.

²⁹ see La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998), p. 1115

³⁰ see La Porta et al. (1997), p. 1149

³¹ see La Porta et al. (1997), p. 1132

³² see Djankov, La Porta, Lopez-de-Silanes and Shleifer (2008), p. 430-431

³³ see Djankov et al. (2008), p. 461

2.5 Shareholder Rights and Creditor Rights

Capital markets feature a better overall development in case of offering improved shareholder and creditor rights. Due to an improved definition of creditor rights, more lenders tend to expand financing. Countries who made the decision to enhance their creditor rights even experienced an improvement of their financial growth. Additional literature shows that the development of a country's financing market is associated with the magnitude of investor protection. In countries with superior property rights firms receive better access to capital. As a result, companies are able to make higher investments and expand faster due to this access to capital. Weak corporate governance would affect the development of small firms leading to less firms being founded caused by a lack of capital.³⁴

2.5.1 Shareholder Rights

Shareholders have the right to vote for directors and decide on major corporate concerns. Shareholder rights include remedial rights, voting rights connected to shares and rights in the course of voting mechanism against meddling by insiders.³⁵

³⁴ see Claessens and Yurtoglu (2012), p. 12 -13 in conjunction with Djankov et al. (2008)

³⁵ see La Porta et al. (1998), p. 1126

	Common Law	Civil Law - French	Civil Law - German	Civil Law - Scandinavian
one share - one vote	17%	29%	33%	0%
proxy by mail allowed	39%	5%	0	25%
shares not blocked before meeting	100%	57%	17%	100%
cumulative voting / proportional representation	28%	29%	33%	0%
oppressed minority	94%	29%	50%	0%
preemptive right to new issues	44%	62%	33%	75%
% of share capital to call an extraordinary shareholder meeting	9%	15%	5%	10%
antidirector rights	4,00	2,33	2,33	3,00
mandatory dividend	0%	11%	0%	0%

Table 2: Shareholder Rights around the World (Source: La Porta et al. (1998), p. 1130-1131)

Indicators of shareholder rights are pictured in Table 2. One-share-one-vote rules show a better investor protection since dividend rights are attached to voting rights. This way deprives insiders of significant control of the firm due to the lack of important ownership of its cash flows. Therefore expensive diversion of cash flows in relation to payment of dividends is balanced.³⁶

The six rights “proxy by mail allowed”, “shares not blocked before meeting”, “cumulative voting / proportional representation”, “oppressed minority”, “preemptive right to new issues” and “percentage of share capital to call an extraordinary shareholder meeting” describe the strength of a legal system when it comes to encouraging minority shareholders against dominant shareholders or managers. The “antidirector measure” receives a score of “1” in case of protecting minority shareholders, otherwise it obtains a score of “0”. Mandatory dividends are a remedial measure since certain countries are obligated to pay out dividends. Firms offering rights for mandatory dividends might compensate this feature with another weakness concerning minority

³⁶ see La Porta et al. (1998), p. 1127

shareholder protection.³⁷

Table 2 points out that the legal environment matters for shareholder rights. With the exception of “one-share-one-vote” and “cumulative voting / proportional representation”, the variables represent significant differences between the law of origins. Common law countries definitely show the strongest legal protection to shareholders while countries with French civil law offer the worst protection.³⁸

2.5.2 Creditor Rights

Creditor rights represent a more complicated task since there exist different kind of creditors with different concerns: in case of default senior creditors wish to possess collateral security while junior creditors hope for the company as going concern in order to get at least some cash back. Therefore interests of these two members tend to collide. A defaulting firm has two ways to handle default, namely reorganization or liquidation.³⁹

	Common Law	Civil Law - French	Civil Law - German	Civil Law - Scandinavian
no automatic stay on assets	72%	26%	67%	25%
secured creditors first paid	89%	65%	100%	100%
restrictions for going into reorganization	72%	42%	33%	75%
management does not stay in reorganization	78%	26%	33%	0%
creditor rights	3,11	1,58	2,33	2,00
legal reserve required as a percentage of capital	1%	21%	41%	16%

Table 3: Creditor Rights around the World (Source: La Porta et al. (1998), p. 1136-1137)

Table 3 represents creditor rights around the world including five variables: “no automatic stay on assets”, “secured creditors first paid”, “restrictions for going into reorganization”, “management does not stay in reorganization”, “creditor

³⁷ see La Porta et al. (1998), p. 1128

³⁸ see La Porta et al. (1998), p. 1129

³⁹ see La Porta et al. (1998), p. 1134

rights” and “legal reserve required as a percentage of capital”.

The origin of law matters and again common law countries propose creditors the best legal protection while French civil law countries offer the least protection. Comparing the shareholder rights of table 2 to the creditor rights of table 3 one can clearly see that the ranking of legal systems seem to be the same. However there exist two minor exceptions: First, poorer countries seem to offer stronger creditor rights than richer countries, which might result from their rules to simplify lending as a consequence of missing alternative finance opportunities. Second, German civil law countries do not seem to protect shareholders but take care of creditors.⁴⁰

⁴⁰ see La Porta et al. (1998), p. 1138 - 1139

3 Foreign Listing Behavior

If a company decides to list its common shares on a different stock exchange than its domestic or primary stock market, it enters the world of foreign listing.

Generally, foreign listing is frequently equalized with the term of cross listing, which assumes that a firm previously trades its shares on its home market before offering its stock on a foreign stock exchange.

One of the fastest developing businesses of stock markets is foreign listing. There exists an ongoing competition between stock exchanges obtaining emitters in their home markets.⁴¹ An increasing number of firms listing on a certain stock exchange signals its capability being a financial center and therefore continually attracts foreign companies.

The enthusiasm to trade instruments possessing equity nature on stock markets outside of a company's home market emerged in the late 1900s already. However, since the 1960s the UK and the US have been the primary host markets making New York and London to the leading international financial hubs. New York and London based stock exchanges won over a tremendous amount of all foreign listing companies since they have been appreciated for offering corporate governance regimes being the most shareholder friendly.⁴² Because of its enhanced shareholder rights and investor safeguard, the UK stock exchange is the most comparable one to the US stock exchange.⁴³

Due to its stringent legal requirements caused by the Sarbanes Oxley Act, the desire to list at an American stock exchange might be the most challenging one, but at the same time the most interesting choice.

⁴¹ see Wójcik and Burger (2009), p.18

⁴² see Wójcik and Burger (2009), p.4

⁴³ see Piotroski and Srinivasan (2008), p. 4

3.1 Reasons for Foreign Listings

The number of challenging hurdles for many companies to list at an American stock exchange makes it even more interesting to examine the reasons for foreign listings.

One of the most common reasons for foreign listings is incorporated in the **bonding theory**. If the foreign or destination market's corporate governance system is better than the regime in the origin country and the destination's market regime is more strictly regulated, this theory applies.

“Large firms can choose the stock exchange(s) on which they are listed, and in so doing can opt into governance systems, disclosure standards, and accounting rules that may be more rigorous than those required or prevailing in their jurisdiction of incorporation. [...] Yet, the most visible contemporary form of migration seems motivated by the opposite impulse: namely, to opt into higher regulatory or disclosure standards and thus to implement a form of bonding under which firms commit to governance standards more exacting than that of their home countries.”⁴⁴

The bonding theory indicates “that international firms can improve their **corporate governance** standards by cross listing in the United States in order to bond themselves to US accounting, disclosure, analyst report, securities coordination and legal practices.”⁴⁵ Authors often talk about “piggybacking” since non-US companies are borrowing the American corporate governance system in order to commit to a better corporate governance regime.⁴⁶

Bonding can be classified into **legal bonding** and **reputational bonding**. Legal bonding defines the requirements determined by a stock exchange and its managers of capital markets a cross-listed company is subject to. In contrast, reputational bonding deals with the industry and finance community in terms of

⁴⁴ Coffee (1999), p. 23

⁴⁵ Ammer, Holland, Smith and Warnock (2008), p. 5

⁴⁶ see Licht (2003) p. 2

investment banks, investors, investment advisors, analysts, rating firms and audit companies.⁴⁷

This enhanced corporate governance standards cause an increased issuer's **visibility** leading to the so-called "recognition hypothesis".⁴⁸ A company listing its shares abroad has to provide relevant information to the local capital market and consecutively the steady flow of information gives the capital market the opportunity to react in a faster way and to make more accurate decisions.⁴⁹

With this adjustment to a better corporate governance regime, a non-US company's enthusiasm to comply with US disclosure requirements and securities regulation signals its capacity and provides an improved **protection of shareholders' interests**.⁵⁰ Furthermore, the strong legal protections determined by the SEC (Securities and Exchange Commission) disclosure requirements, as a result of a listing on the US market, increase the protection of minority shareholders.⁵¹ Thus, investors have an overall improved trust in the company and institutional investors are attracted.

The United States of America are known for offering their shareholders a stronger protection. Because of the greater investigation, observation from the press and from the investment association, firms listed in the US are subject to enhanced protection of their **minority investors**.⁵² Therefore controlling shareholders are not able to excerpt benefits on a private level of a company they are taking control of.⁵³

Moreover, cross-listing increases a company's **shareholder base** and the company is able to diversify its portfolio internationally since a firm's risk is now divided among more shareholders. As a consequence a company's cost of capital decreases.⁵⁴ This decrease caused by the risk diversification can be justified by overcoming investment barriers that have been caused by

⁴⁷ see Wójcik, Clark and Bauer (2005), p. 5

⁴⁸ see Foucalt (2007), p.2

⁴⁹ see Licht (2003). p.6

⁵⁰ see King and Mittoo (2007), p. 62

⁵¹ see Coffee (2002), p.4

⁵² see Doidge, Karolyi and Stulz (2003), p. 209

⁵³ see Doidge, Karolyi and Stulz (2007), p. 2

⁵⁴ see Foerster and Karolyi (1998) p. 31

international discrepancies in disclosure requirements, accounting guidelines and regulation of taxes.⁵⁵

The decision to list at a US stock exchange can be part of a company's global business strategy signaling to the market that it has become a global player. A company's compliance with the quite high US disclosure standards shows its **prestige** and supports the company to earn the trust of either US or home country shareholders. The improved credibility leads to a higher confidence by the customers of the firm. Due to the high standards the company has to meet as a consequence of a US listing, brand recognition among US clients, potential future clients and also among international customers is build.⁵⁶ Overall, a company improves its relationship with the host market and costs of trading and acquisition of a non-US company's shares are declining.⁵⁷

The **signaling** or **information hypothesis** indicates that a US listing is some sort of statement of the company's commitment to the US market and therefore a form of inexpensive announcement.⁵⁸ A company can convince the market that it is in a strong financial condition.⁵⁹

Foreign listings feature other motivations in terms of **liquidity**. With the decision to list at an US stock exchange, a company trades its shares on the world's largest stock markets. Simultaneously the liquidity of a firm increases due to higher valuations. A company observes this enhanced liquidity in higher trading volumes, increased share turnover, a lower price impact of trades and an increased share price due to a narrower bid-ask spread.⁶⁰ The market reacts positively to a company's movement to high disclosure since the stricter requirements the firm is subject to signals its capacity and financial strength to outside investors. Additional disclosure is an important part of investor protection.

⁵⁵ see Karolyi (1998), p.2

⁵⁶ see Schrage and Vaaler (2007) p. 17

⁵⁷ see Karolyi (1998), p.2

⁵⁸ see King and Mittoo (2007), p. 60 - 61

⁵⁹ see Bianconi, Chen and Yoshino (2010), p. 3

⁶⁰ see King and Mittoo (2007), p. 69

In general, a foreign **firm's share value** increases after the announcement of a dual listing on an American stock exchange. Additionally, the firm value undergoes a rise due to the improved analysts coverage.⁶¹

A company's step into the American stock markets establishes a better entrance to larger capital markets. Additionally it offers an increased capability to **raise equity**. With this lightened access to the American equity markets, the financing of investment is simplified and due to foreign listing a company's cost of raising capital decreases. This leads to the "segmentation hypothesis" allowing companies to overcome investment barriers.⁶²

However, for many companies in emerging countries the main reason to list their shares on a foreign stock market is the possibility to raise capital through equity issues at the US capital market.⁶³

Due to its liquidity and depth, the US capital markets offer a way cheaper opportunity for foreign companies to raise funds.⁶⁴

The "**avoiding hypothesis**" suggests that "cross-listing reduces market segmentation and that legal and regulatory structures impose a costly burden."⁶⁵ Cross-listing offers investment possibilities to a wider range of investors. Additionally the listing on a foreign exchange raises awareness that expands a company's shareholder base and at the same time facilitates access to financing. The cost of capital decreases due to a better diversification of securities leading to distribution of risk. According to this hypothesis enhanced corporate governance is just the second most important reason to cross-listing since the primary factors are access to cheaper capital and improved emitter's visibility.⁶⁶

⁶¹ see Coffee (2002), p. 31

⁶² see Foucault et al. (2007), p. 2

⁶³ see Karolyi (1998), p. 2 in conjunction with King and Mittoo (2007), p. 61

⁶⁴ see Doidge et al. (2003), p.208

⁶⁵ Silvers and Elgers (2010), p. 4

⁶⁶ see Silvers and Elgers (2010), p. 4 in conjunction with Licht (2003), p. 2

Another reason commending to cross-list is the option to improve a company's ability to achieve structural transactions abroad such as tender offers, stock swaps and foreign mergers and acquisitions.⁶⁷

3.2 Who Cross-lists?

Until the late 1900s companies from Europe, North America and Australia entered stock markets outside of their home country. But with the turn of the century emerging markets decided to trade their corporate shares on foreign markets as well.⁶⁸

An analysis provided by Wójcik and Burger (2009) indicates that most of the foreign listings are performed by large firms with their headquarters situated in significant economic centers arising from international orientated high-growth sectors.

For non-US companies listing at an American stock exchange a very popular alternative is the ADR program. It is widely used among emerging markets that represent 73% of all non-US companies listing their securities in the US in 1994.⁶⁹

Apart from weaker investors protection at the home market, companies with less developed capital markets and a lack of information quality are eager to list their shares at the US stock exchange.⁷⁰ Emerging markets are ambitious to bond to stricter regulations and corporate governance rules than in their home market.⁷¹

Stock markets of emerging countries have insufficient disclosure methods and higher transaction costs. So if a company decides to trade its shares on a foreign market, it does have the opportunity to lower the investor's transaction

⁶⁷ see Karolyi (1999)

⁶⁸ see Wójcik and Burger (2009), p.2

⁶⁹ see Miller (1999), p.104

⁷⁰ see Nguyen and Berkman (2008), p.5

⁷¹ see Schrage and Vaaler (2007), p.3

costs. Better access to capital and a more revealing financial reporting is fulfilled as well.⁷²

According to Schrage and Vaaler (2007) the origin of Law and the Rule of Law matter. They mention that non-US firms from Civil Law countries providing weaker corporate governance regimes and offering stronger rule of law are more likely to cross-list in the US. Cross-listing levels are lower for non-US companies based at Common Law countries providing stronger investor protection with weaker rule of Law.⁷³

Additionally, the company's origin does involve different incentives for its listing decision: While firms situated in emerging countries are driven to list the shares on a foreign stock exchange due to the possibility to raise equity capital, European countries are eager to gain an additional currency in order to operate stock-for-stock purchases.⁷⁴

3.3 Costs of Foreign Listings

Besides the tremendous amount of advantages a foreign listing involves, a company also has to consider its hurdles – mainly in terms of costs.

3.3.1 US Stock Exchange

Non-US companies deciding to list their shares at a US stock exchange are required to reconcile to American accounting standards. Besides the fact that the reconciliation of a company's financial statements to US Generally Accepted Accounting Principles (US GAAP) involves high costs, this procedure is known for being the greatest challenge.

Foreign firms choosing an US exchange as a host market have to register with the Securities and Exchange Commission (SEC) and should comply to US securities laws. Companies considering the US over-the-counter (OTC) market

⁷² see Wójcik and Burger (2009), p.4-5 in conjunction with Edison and Warnock (2008), p.9

⁷³ see Schrage and Vaaler (2007)

⁷⁴ see Coffee (2002), p.21

to list their shares at or trade stock according to Rule 144a are not obligated to the SEC registration.⁷⁵

Direct legal and accounting costs as well as investment banking fees are part of the preparation for an upcoming listing.⁷⁶ All reports including annual reports have to be translated into the foreign language in order to meet SEC disclosure requirements.

Furthermore, the company has to face listing fees divided into an initial listing fee to be due once, and an annual fee that has to be paid on an annual basis. The annual listing fee presents some sort of assurance for the company for continuing to list its shares on the particular stock exchange. The amount of listing fees are conditioned by the number of shares a company is planning to issue. Every stock exchange demands its own listing fee making the NYSE to the most expensive way to list in the US.⁷⁷

With the implementation of the Sarbanes-Oxley Act (SOX) in 2002, a US listing implicates additional costs due to the stricter reporting and corporate governance standards. Especially the Section 404 introduces further charges for companies and executives.⁷⁸

3.3.2 UK Stock Exchange

LSE's Main Market enables companies to list ordinary shares and depository receipts (DRs).

In order to list their corporate shares at this stock exchange, a firm has to be approved by the UK Listing Authority. Additional, financial statements have to be reconciled to either the UK or US GAAP, or have to be provided in compliance with the International Accounting Standards (IAS).⁷⁹

In contrast, a company eager to trade its shares at an UK stock exchange can choose the Alternative Investment Market (AIM), which is well known for

⁷⁵ see Doidge et al (2007), p.8

⁷⁶ see King and Mittoo (2007), p.61

⁷⁷ see Perotti and Cordfunke (1997), p.4-5

⁷⁸ see Doidge et al (2007), p.1

⁷⁹ see Doidge et al (2007), p.9

insisting listing requirements at the minimum. A firm has to be encouraged by a nominated advisor and fulfill the exchange's weak disclosure duty.⁸⁰

However, offering its shares at an UK stock exchange is a less expensive way for a company eager to enter foreign stock markets.

3.4 Does Foreign Listing increase Firm Value?

Listing on a US stock exchange provides companies the possibility to raise capital in a simpler way although a firm has to face increased costs as a result of better corporate governance regimes. Controlling shareholders are willing to face these costs in order to cross-list, even though this improved corporate governance diminishes their private benefits and they have to reduce their flexibility. As a consequence, firms with benefits exceeding the costs are willing to list their shares on a US stock exchange. Accordingly, corporations with foreign listings on the American stock markets are of greater value due to a cross-listing premium (which implies a higher Tobin's Q than non cross-listed companies are offering). This hypothesis supports the assumption that a company has access to a greater amount of capital.⁸¹

Additional, this cross-listing premium is measured to be higher for companies with fragile legal protection for minority investors. This conclusion confirms the bonding hypothesis caused by cross-listing due to the stricter requirements in the US.⁸²

Summing up, companies cross-listing their shares should be worth more because of two reasons:

- They benefit from possible growth chances that will not be accessible for corporations without a foreign listing.⁸³
- Due to the missing power of controlling shareholders cash flows achieved by companies are abducted as private profits to a lesser extent.⁸⁴

⁸⁰ see Doidge et al (2007), p.10

⁸¹ see Doidge et al. (2007), p.3

⁸² see Foucault and Gehrig (2007), p. 2

⁸³ see Doidge et al. (2003), p. 215

⁸⁴ see Hail and Leuz (2008), p. 8

3.5 Types of Foreign Listings

Besides the common way to list on a foreign stock exchange as an ordinary share, alternatively a company can get access to a capital market from abroad by joining a Depository Receipt (DR) program. In 1927 J. P. Morgan build depository receipt programs making them to attractive investment options and investment vehicles.⁸⁵

Basically there are two different types of certificates:

- **American Depository Receipt** programs (ADRs) offering foreign companies access to the US capital markets.
- **Global Depository Receipt programs** (GDRs) providing entrance to global markets beyond the listing firm's domestic market.⁸⁶

Consequently companies get the possibility to register and earn dividends on US stock markets without direct access to the foreign stock market itself.

DRs are negotiable certificates that indirectly represent ownership of shares in a non-US corporation for domestic investors. These instruments register depository shares that represent a specific number of underlying shares still being located on the deposit in the emission source's home market.⁸⁷

Practically, a company decides to place its stock with a US depository bank. In return, the bank retains these shares and offers ADRs. These ADRs are quoted and traded in US Dollars, as well as dividends are rewarded in US Dollars.⁸⁸

ADRs being offered on an US stock exchange feature investors the same information as any other ordinary listed US share. Thus, non-US companies can offer their shares more easily to American shareholders.

There exist four different levels of ADR programs giving companies the opportunity to invest in foreign markets in a cost efficient way:

⁸⁵ see JPMorgan Depository Receipt Guide (2010), p.3

⁸⁶ see JPMorgan Depository Receipt Guide (2010), p.3

⁸⁷ see Karolyi (1998), p.4 in conjunction with JPMorgan Depository Receipt Guide (2010), p.3

⁸⁸ see Higgings (2003), p.7 in conjunction with Citigroup Depository Receipts Information Guide, p.2

ADRs	Level I	Level II	Level III	Rule 144A DR
Description	unlisted in US	listed on major US exchange	offered and listed on major US exchange	Private US Placement to Qualified Institutional Buyers (QIBs)
Trading Location	OTC Pink Sheet Trading	NYSE, AMEX or NASDAQ	NYSE, AMEX or NASDAQ	US Private Placement Market using PORTAL
SEC Registration	Registration Statement Form F-6	Registration Statement Form F-6	Form F1 and F-6 for initial public offering	none
US Reporting Required	Exemption under Rule 12g3-2(b)	Form 20-F filed annually	Form 20-F filed annually, short forms F-2 and F-3 used only for subsequent offerings	12g3-2(b) exemption or agree to provide info on request
GAAP Requirement	no GAAP Reconciliation required	only Partial reconciliation for financials	full GAAP reconciliation for financials	no GAAP Reconciliation required
SOX required	no	must comply with SOX	must comply with SOX	no

Table 4: ADR Programs⁸⁹

A Level II ADR enables a company to list their securities on a US exchange market but with this type a company can't raise capital on a foreign market.

Level III ADRs are certificates with the best reputation since they even provide an element of capital-raising for companies.

Foreign companies listed on Level II or Level III ADRs are subject to the Sarbanes-Oxley Act.

3.6 The Influence of Cross-listing on Corporate Governance

According to an analysis by Wójcik, Clark and Bauer (2005) companies offering its stock with Level II or Level III ADRs feature higher corporate governance ratings than corporations without a cross-listing on the US stock exchange. Even two years before the time of cross-listing and up to three years after the beginning of the cross-listing activity, companies experience benefits of corporate governance. These benefits include reduced capital costs, diminished investment risks and improved financial worth of asset shares. The previous corporate governance advantage can be caused by a company's preparation for the US-listing including an adjustment of corporate governance. Then again, companies deciding to list in the US are likely to have high corporate governance ratings already. Offering stock on the US stock exchange

⁸⁹ see Citigroup Depository Receipt Guide (2005) in conjunction with Karolyi (1998), p.7

implicates advantages in the area of disclosure, take-over safeguard and board organization and operation method. On the other hand, Level II or III ADR companies do not exhibit increasing ranks of shareholder rights and obligations.⁹⁰

An analysis comparing companies with Level I or Rule 144 ADR listings and companies without a US listing showed no advantages for the year 2000, but presents corporate governance benefits like takeover protection and the board organization and operation.⁹¹

Overall, offering its stock on the US stock market does have a positive impact on a company's corporate governance ratings although the real reasons for the migration are unclear: do foreign companies move away to the US markets because they already have higher corporate governance ratings or do these migrating companies receive corporate governance ratings because of their move.⁹²

According to a survey contributed by Foucault and Gehrig (2007) cross-listing has two impacts improving the informational value of a cross-listed company's stock price:

- Cross-listing provokes stockbrokers to trade on their information more offensively.
- Because of frequent listing on foreign stock exchanges more informed traders occur.

Because of cross-listing managers receive more accurate stock price information and are able to decide on investment decisions in an improved economic way. In consequence, with the range of growth probabilities the value of foreign listings increases. Accordingly, companies with large growth probabilities take advantage of a company's cross-listing.⁹³

⁹⁰ see Wójcik et al. (2005), p. 13 and 19 in conjunction with Silvers et al. (2010), p. 26

⁹¹ see Wójcik et al. (2005), p. 19

⁹² see Wójcik et al. (2005), p. 20

⁹³ see Foucault and Gehrig (2007), p. 1-2

3.7 The Influence of Cross-Listing on Domestic Markets

There exist two mechanisms describing the relation between liquidity of domestic firms and internationalization: migration and spillover.

Migration describes the move from the trading of international firms leaving the domestic market and entering international financial hubs as a consequence of internationalization. This might be a result of lower transaction and information costs, smaller settlement risk and better risk pricing in international markets.

Spillover describes the relation between aggregate trading in a certain market and liquidity of individual firms. There might exist spillovers through which aggregate market action impacts the liquidity of individual companies.

Both, migration and spillovers, indicate that the issuance of depository receipts and cross-listing at international stock exchanges have a negative impact on the liquidity of domestic companies.⁹⁴

Besides migration and spillover, risk-shifting is another factor affecting the competitiveness of domestic markets: if companies decide to trade its shares in well-respected international financial centers, shareholders will relocate their risk trading into international companies out of domestic firms. This decline of tradings on domestic markets does influence the liquidity of domestic companies negatively. Since investors are well aware of the bonding effect a firm gets through commitment to stricter disclosure requirements, internationalization signals a company's quality hurting the liquidity of companies remaining in the domestic market.⁹⁵ After deciding to trade abroad the turnover of international companies increases by approximately 38%. Domestic trading decreases by 58% as a consequence of internationalization.⁹⁶

In terms of market capitalization, turnover in the market and number of listed firms ADRs had a negative impact on domestic market condition. The development of domestic stock exchanges seems to be harmed.⁹⁷

However, companies issuing Level I ADRs and raising capital under rule 144A (in the US) compose an exception: if firms decide to internationalize in one of these ways liquidity of local firms does not get reduced. These types of listings

⁹⁴ see Levine and Schmuckler (2005), p. 2

⁹⁵ see Levine and Schmuckler (2005), p. 2-3

⁹⁶ see Levine and Schmuckler (2005), p. 17

⁹⁷ see Karolyi (2002), p. 18, 27

tend to boost a company's shares and therefore increase the liquidity of domestic markets.⁹⁸

⁹⁸ see Levine and Schmuckler (2005), p. 14-15

4 The Sarbanes-Oxley Act

The Sarbanes-Oxley Act is a corporate governance law with preventative character in order to avoid possible cases of damage and accordingly identify them at an early stage.⁹⁹ SOX constitutes the background for regulatory initiatives in the field of transparency, corporate governance and internal control.¹⁰⁰

The Act is intended “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”¹⁰¹

4.1 Reasons for the Implementation of the Sarbanes-Oxley Act

Investors and capital markets rely on the financial information provided by a company. Based on these statements reported to the public, private and institutional investors adapt their investment behavior.

In the last decades, due to incidents like the Wall Street Crash of 1929, impending company crashes and numerous corporate and account scandals, like the ones provoked by Enron, WorldCom or Arthur Anderson LLP, investors started to develop doubts. Shareholders have been confronted with issues making their investment decisions due to oppositional and falsified information. Internal and external monitoring processes have not been sufficient any more. Because of the emerging lack of investor confidence and as a reaction of further occurring high-profile accounting scandals, the Sarbanes-Oxley Act of 2002 has been enacted on 30 July 2002.

The Sarbanes Oxley Act is designed to ensure the reliability of financial information reported to the public and in general announced to every firm a company does business with. For example accountants, attorneys, banks and

⁹⁹ see Menzies (2004), p.12

¹⁰⁰ see Menzies (2004), p.7

¹⁰¹ The Sarbanes Oxley Act (2002)

other lenders, insurers, government contract issuers and of course shareholders and future investors should be protected from corporate accounting errors and frauds in order to restore confidence in US capital markets. All these institutions need to know whether a company's management holds the purse strings, is aware of its reporting being accurate and honest and whether the management is willing to assume obligation for the company's activities. Additionally, a company's management is requested to feature a competent internal control system.¹⁰²

Despite some difficulties in order to adopt the rules of the Sarbanes-Oxley Act to a company, this Act has been enacted to solve problems that occurred in the past. Besides regaining lost shareholder confidence, becoming compliant in terms of SOX helps a company becoming more efficient and encourages reducing negative influences like dishonest dealings, theft, redundancies and incompetence.¹⁰³ It encourages companies to meet the requirements provided by investors.¹⁰⁴ Additionally, adopting the rules of the Sarbanes-Oxley Act offers a competitive advantage to a company.¹⁰⁵

The Sarbanes-Oxley Act manages the failure to comply with corporate governance codes and the insufficient self-regulation of external auditors. While audit companies have to follow tightened regulations concerning their independence, SOX defines additional implementations of corporate governance duties for the business corporation itself. Primarily these new implementations involve the management of internal controls.¹⁰⁶ The system of internal controls requires specific process structures and supports the management in order to improve transparency and financial reporting.¹⁰⁷

¹⁰² see Holt (2007), p.25

¹⁰³ see Holt (2007), p.27

¹⁰⁴ see Menzies (2004), p.12

¹⁰⁵ see Menzies (2004), p. 1

¹⁰⁶ see Menzies (2004), p.35

¹⁰⁷ see Menzies (2004), p.1

4.2 The History of the Sarbanes-Oxley Act

The idea of generating an internal control framework over financial reporting in order to promote transparency and assure effectiveness, and reporting material weaknesses to an external auditor is not completely new. In 1978 the Commission on Auditor's Responsibility, called the Cohen Commission, has introduced the same concept already. Unfortunately, auditing professions decided to not attend to these concerns back then. Only after frauds like the ones caused by Enron, WorldCom and Arthur Anderson LLP have been revealed, the Sarbanes-Oxley Act has been signed into law with the very same key thoughts that the Cohen Commission has been presenting almost 25 years ago.¹⁰⁸

The Sarbanes-Oxley Act has been named after the Senator Paul Sarbanes and the House Representative Michael Oxley who both had principal authority for introducing a law that is nowadays known as SOX. Back in 2002, Senator Paul Sarbanes has been the chairperson of the Senate Banking, Urban Affairs and Housing committee. Michael Oxley was the spokesman of the House Financial Services Committee commissioned to monitor banks, insurance corporations and all actions going on at the Wall Street. At the end of 2006, Sarbanes and Oxley went into retirement.¹⁰⁹

On the 30th July of 2002, President George W. Bush signed the Sarbanes-Oxley Act into law, declaring that this Act is "the most far-reaching reforms of American practices since the time of Franklin D. Roosevelt."¹¹⁰

4.3 Scope of the Sarbanes-Oxley Act

The Sarbanes-Oxley Act holds for every company being subject to registration of the SEC under the Securities Exchange Act of 1934, and its auditor or audit company providing examination services. These include companies offering their shares on an American stock exchanges (NYSE, NASDAQ and AMEX) or somewhere public in the USA. They are called **issuers**. The Act does not address privately held companies.

¹⁰⁸ see Gupta and Leech (2005), p.30

¹⁰⁹ see Bainbridge (2007), p.3

¹¹⁰ Holt (2007), p. 5

The rules provided by the Sarbanes-Oxley Act have not been constricted in terms of **foreign private issuers**. The term “foreign private issuer” indicates companies being addressed by SEC and having their headquarters abroad.

Even subsidiary companies of SEC-registered companies not being located in the US are subject of the Sarbanes-Oxley Act.¹¹¹ Thus the Act appeals to foreign firms offering their shares in the US through Level II or Level III ADRs. Companies being cross-listed in the US with Level I or Level IV ADRs do not underlie SOX.¹¹²

Delisting is the only option enabling a company to exempt the rules of the Sarbanes-Oxley Act. This procedure requires the corporation to withdraw from the US stock exchange, which is only possible if less than 300 investors with US residence are holding shares of the particular company.¹¹³

4.4 Outline

The framework of the Sarbanes Oxley Act consists of 11 titles presenting 65 subtitles altogether.¹¹⁴

These 11 titles describe actions and their consequences to different target audiences like the management, auditor or the company itself.¹¹⁵

¹¹¹ see Menzies (2004), p. 13

¹¹² see Litvak (2007a), p. 1858

¹¹³ see Menzies (2004), p.14

¹¹⁴ see The Sarbanes Oxley Act (2002)

¹¹⁵ see Menzies (2004), p.14

Title	Topic	Description
I	Public Company Accounting Oversight Board (PCAOB)	Regimentation of a supervisory committee's organization and function for the financial statement provided by a company listed on the US stock exchange
II	Auditor Independence	Regulations for the auditors independence
III	Corporate Responsibility	Explanations and enhancement of a company's responsibilities
IV	Enhanced Financial Disclosures	Regulation of extended disclosure requirements of financial information
V	Analyst Conflicts of Interests	Regulations to prevent conflicting interests of financial analysts in order to restore investor confidence
VI	Commission Resources and Authorities	Guidance for financing and authorities of SEC
VII	Studies and Reports	Definition of the topics US public authorities have to establish studies and reports
VIII	Corporate and Criminal Fraud Accountability	Regulation of fraud and enhanced record retention of documents
IX	White-Collar Crime Penalty Enhancements	Tightening of provisions of criminal law in case of false statutory declaration
X	Corporate Tax Returns	Regulation to subscribe a company's tax return by the CEO
XI	Corporate Fraud Accountability	Regimentation for the management's responsibility in case of uncommon irregularities

Table 5: Titles of the Sarbanes-Oxley Act of 2002 (Source: Menzies (2004), p.14)

In general, the Sarbanes-Oxley Act pursues two objectives incorporated in these sections:

- **Section 302:** Corporate responsibility for financial reports
- **Section 404:** Management assessment of internal control

The Act formulates specified standards for Section 302 and 404 and even mandates a CEO's and CFO's personal liability in case of failure to comply with these Sections.¹¹⁶

Since Sections 302 "corporate responsibility for financial reports" and 404 "management assessment of internal control" are known for causing the most difficulties and the greatest expenditure, the following subchapters will put a focus on them.

4.4.1 Section 302 - Corporate responsibility for financial reports.

Section 302 demands from CEOs and CFOs to own an efficient Internal Control System and to feature proper reports.¹¹⁷ The management has to make sure that all required publications are complete and correct.¹¹⁸

¹¹⁶ see Menzies (2004), p.1

¹¹⁷ see Holt (2007), p.6

This chapter of the Sarbanes-Oxley Act obligates the CEO and CFO to make sure that all business related reports are published. This requires the establishment of effective disclosure controls and procedures. Additional a certification has to be provided by the CEO and CFO.¹¹⁹

4.4.2 Section 404 - Management assessment of internal control.

Section 404 obligates every management to build an effective Internal Control System.¹²⁰ Basically, a framework consisting of internal controls defines procedures a company has to make and how to operate these procedures.¹²¹

Every annual financial statement being generated according to Sections 13(a) or 15(d) of the Securities-Exchange Act has to include a report about the internal control system of a company. Additional, it has to feature the management's evaluation about the effectiveness of the internal control system.¹²²

The internal control system has to assure the financial reporting's reliability. Additional it has to confirm that the preparation of annual statements has been provided in accordance with the Generally Accepted Accounting Principles.¹²³

In contrast to Section 302, in the framework of the annual statements an auditor has to testify an internal control framework's effectiveness due to section 404b. The PCAOB has to release an auditing standard as a basis for this attestation.¹²⁴

Being compliant according to Section 404 "Management Assessment of Internal Control" does exhibit the most demanding effort of implementation of all Sections provided by the Sarbanes-Oxley Act. The implementation of this section should avoid the incorporation of false and insufficient information into the financial reporting and the misguidance of investors due to the lack of internal controls.¹²⁵

¹¹⁸ see Menzies (204), p.1

¹¹⁹ see Menzies (2004), p.35

¹²⁰ see Holt (2007), p.6

¹²¹ see Panki (2006), p.12

¹²² see Menzies (2004), p.2 and 21

¹²³ see Menzies (2004), p.84

¹²⁴ see Menzies (2004), p.21

¹²⁵ see Menzies (2004), p.21

Besides demanding companies to testify their annual and quarterly statement, Sections 302 and 404 of the SOA prescribe that, along with the management's evaluation of their internal controls about the financial reporting, external auditors have to judge separately the effectiveness of a firm's internal control framework. Companies have to reveal material changes of their internal controls in their quarterly SEC filings. Material deficiencies of internal controls have to be exhibited in a company's annual form 10k filings and reported to the SEC.¹²⁶

4.5 Focus on Selected Sections

The following sections contain interesting aspects supporting the Sarbanes-Oxley Act to generate environment for the numerous company and regulatory initiatives in the areas corporate governance, internal control and transparency.¹²⁷

Section 101 to 109 of Title I - Public Company Accounting Oversight Board (PCAOB)

This Title of the Sarbanes-Oxley Act builds the Public Accounting Oversight Board with the task of watching the auditing firms of public companies. The PCAOB cooperates with the SEC and works under the same rule like it. Besides pointing out rightly lawbreakers of the SOA and declaring punishments, the PCAOB offers regulations determining standards for audit, quality control and independence, and additional actions in case of disregard of guidelines.¹²⁸

Section 806 – Protection of employees of publicly traded companies who provide evidence of fraud.

This Section of the Sarbanes-Oxley Act sets the focus on the protection of **whistleblowers** establishing safety for employees who announce possible

¹²⁶ see Gupta and Leech (2005), p.28

¹²⁷ see Menzies (2004), p. 21

¹²⁸ see Bianconi et al. (2010), p. 3

fraud, falsification of business documents and other suspected accounting activities. The announced fraud might concern internal control matters, auditor activities and even abuse of governmental regimentation. The entrepreneur has to enable its employees to report these irregularities anonymously and he has to ensure that whistleblowers do not suffer disadvantages because of passing their considerations.¹²⁹

“No company [...] or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee.”¹³⁰

4.6 COSO

Section 404 of the Sarbanes-Oxley Act asks companies to generate an Internal Control Framework. The Securities and Exchange Commission and the Public Company Accounting Oversight Board (PCAOB) recommends adopting the framework provided by the Committee of the Sponsoring Organizations of the Treadway Commission (COSO) in order to manage internal controls. However, SEC does not prescribe the COSO framework as mandatory.¹³¹ The PCAOB points out that other control frameworks than the one provided by COSO can be employed, as long as they feature the same by COSO addressed topics.¹³² According to SEC and COSO, internal controls have to ensure compliance and reliability of financial reporting. Additionally they cover safeguarding of assets.¹³³

Since its formation in 1991, COSO has been incorporated more and more into US audit standards. Meanwhile, more than 63 % of US listed companies have adopted COSO as their leading framework in order to manage internal controls.¹³⁴

In 2004, an addition to the COSO 1991 framework, called the COSO Enterprise

¹²⁹ see Jackson (2006), p. 30-31

¹³⁰ The Sarbanes-Oxley Act (2002)

¹³¹ see Menzies (2004), p.75 in conjunction with Panko (2006), p.12

¹³² see Menzies (2004), p. 84

¹³³ see Menzies (2004), p.75-76

¹³⁴ see Menzies (2004), p. 81

Risk Management (COSO ERM), has been published. Compared to the initial framework, the COSO ERM cube (pictured below in Figure 1) features additional elements like **international environment** (which has been labeled “control environment” in the 1991 version), **objective setting**, **event identification** and **risk response**.

The extended cube supports companies to provide compliance with regulations and laws, and to feature reporting in an effective way. This framework helps a company’s management to achieve their objectives and to prevent unexpected risks and downfalls.¹³⁵

The following cube illustrates the relationship between a company’s objectives and its enterprise risk management elements. These enterprise risk elements demonstrate what is needed to obtain by a company certain aspired objectives.¹³⁶

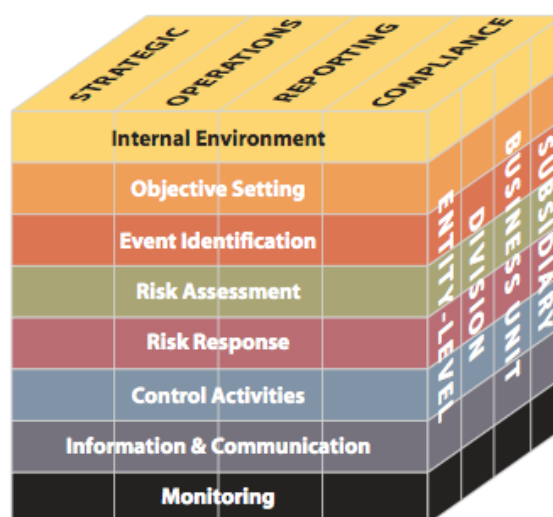


Figure 2: The COSO Cube (Source: COSO webpage)

In the horizontal columns the COSO ERM displays eight components assigning that a company’s enterprise risk management is effective in case of featuring and running these factors effectively. Functioning calls for a detailed description of upcoming risks in the framework’s risk areas and the lack of material weakness. Furthermore, effectiveness has to be assured in every of the four objectives sections illustrated in the vertical rows.¹³⁷

¹³⁵ see COSO (2004), p.1

¹³⁶ see COSO (2004), p. 4

¹³⁷ see COSO (2004), p.5

In order to accomplish an effective enterprise risk management a company has to feature a strong framework of internal controls.

Since the COSO model has been invented back in 1991, long before the implementation of the Sarbanes-Oxley Act, authors did not predict that someday their conceptual model would support the internal control framework of a company. For that reason, it is absent of instruction and practical procedures demonstrating the management how to transform the law into a company's control framework. Additional, a company's management as well as their external auditor misses a guidance illustrating how to recognize whether a firm has an effective internal control system in order to monitor its financial reporting.¹³⁸

¹³⁸ see Gupta and Leech (2005), p.32

5 The Impact of the Sarbanes Oxley Act on the Listing Behavior of Companies

Due to the more stringent regulations provided by the Sarbanes-Oxley Act, companies being eager to cross-list their shares on the US stock exchange have to face stricter requirements. US exchanges remark their concern whether these recent developments in law impact their competitiveness. The following chapter gives a brief overview about the possible financial consequences a company has to deal with in case of offering its stock on the US stock exchange after the enactment of SOX.

5.1 Direct and Indirect Costs

The Sarbanes-Oxley Act implicates costs that can be grouped into direct and indirect costs.

Direct costs are provided by the additional fees due the section 404 and the involved expenses for the implementation of internal controls. In order to assure the company's compliance with the internal controls, further audit fees are due. In addition to these audit fees and costs of compliance, personnel expenses occur which are divided into the following way: due to the minimized accounting deadlines (e.g. the timeframe for the filing of 10-K has been reduced from 90 to 60 days) and the raised disclosures, additional staff in the accounting department is needed provoking increased personnel expenditures. New senior positions like chief compliance manager are demanded in order to meet the reconditioned demands. Furthermore, the audit committee requires financial specialists and additional outside directors rising risk and power of executives and enlarging insurance expenditures and compensation of corporate officers.¹³⁹

¹³⁹ see Ahmed, McAnally, Rasmussen and Weaver (2009), p. 6 – 7 in conjunction with Carney (2006), p. 5

Opportunity costs combined with enhanced risk aversion of managers and distracted managers form **indirect costs**.

Opportunity costs occur because the company's management spends a massive amount of time with constructing, implementing and assuring the compliance of the internal control framework. These actions deviate the staff from the day-to-day business activities and even new profitable projects could be declined. Small firms could face more issues concerning these costs due to their smaller amount of executives and as well growth firms due to their downsizing of intangible assets executives.

The management's enhanced risk aversion is based on section 302 of the Sarbanes-Oxley Act and its liability of CEO and CFO to assure the annual statement. Accordingly, they face private lawsuits, prison and labor market fines. As a reaction of these tightened penalties, risk-taking of managers declined resulting in decreased capital expenditures short-term. But long-term, companies would miss the chance to present new products and lose their competitive power.¹⁴⁰

5.2 Audit Costs

Being compliant according to the Sarbanes-Oxley Act is a costly process. The formation and management of the internal control framework and continuative the raised auditing expenses are the most expensive implications of the Sarbanes-Oxley Act. The other components required by SOX are not as expensive to achieve.¹⁴¹

The COSO framework does not offer guidance how to implement an effective internal control framework and how to measure a company's effectiveness. This issue affects both – the corporation's management and the external auditor - since both institutions have to battle with the realization of control assessments. Additional, the question occurs: how much testing and documentation of internal controls is necessary in order to evaluate them and name a system an "effective" one? Due to this lack of generally accepted control assessment

¹⁴⁰ see Ahmed et al. (2009), p.2

¹⁴¹ see Holt (2007), p.8 - 9

standards, external auditors try their best do avoid risks and tend to **over-audit**. Thereby they pass these additional arising auditing costs to their clients. Thus the company's auditing costs increase tremendously.¹⁴²

The existence of a detailed guidance describing mechanisms how to analyze, report and evaluate risk, and continuative control failures, would help to diminish costs of compliance. The management could constitute an improved responsibility in order to generate trustable financial publications and control assessments. Furthermore, debates between the company's management and its external auditor would be prevented.¹⁴³

Since Section 302 and 404 do not feature directions to registrants how to evaluate their control effectiveness, the management follows the external auditor's rules, as ultimately the audit company has to decide when a company completed their audit requirements in an efficient and effective way.¹⁴⁴

Eldridge and Kealey (2005) arrive at the conclusion that audit fees of SOX tend to increase with firm size while the audit SOX audit unit fees decrease.¹⁴⁵ They observed audit costs reported by a sample of Fortune 1000 companies. For the 97 companies representing a subsample due to their full disclosure of SOX audit fees, the average audit fees increased from \$3.5 million to \$5.8 million after implementing the rules of the Sarbanes-Oxley Act.¹⁴⁶

However, audit fees have increased by almost 20 to 40% depending on which industry is responsible for the estimation.¹⁴⁷ The Wall Street Journal even reports that audit costs of American publicly traded corporations increased to 30% or higher after the implementation of more stringent accounting rules according to SOX.¹⁴⁸

¹⁴² see Gupta and Leech (2005), p.32 - 34

¹⁴³ see Gupa and Leech (2005), p. 44 - 45

¹⁴⁴ see Gupta and Leech (2005), p.33 - 34

¹⁴⁵ see Eldridge and Kealey (2005), p.15

¹⁴⁶ see Eldridrge and Kelaey (2005), p.21

¹⁴⁷ see Holt (2007), p. 13

¹⁴⁸ see Bainbridge (2007), p.3

5.3 Costs vs. Benefits

In contrast to costs, benefits are difficult to measure. The main **benefits** resulting from the implementation of the Sarbanes-Oxley Act are the enhanced corporate disclosure, more trustworthy financial data due to the design of an effective internal control framework, improved investor confidence relating to financial reporting and the identification and prevention of financial fraud at an early stage.¹⁴⁹ But since fraud occurs much less frequently, this benefit applies to a small amount of companies. The increased public trust caused by the implementation of the Sarbanes-Oxley Act provides benefit for companies as well.¹⁵⁰

Companies listing on the US stock market in order to bond to stricter regulations and better corporate governance systems can even benefit from a US listing after the enactment of SOX. Because of the Sarbanes-Oxley Act the degree of listing requirements increases and therefore the benefits of a US listing rise as well since companies now have to meet the highest listing requirements. Hence, the bonding mechanism gets intensified and gains additional reliability.¹⁵¹

Offering foreign stock on a US stock exchange always means for controlling shareholders of the said company dealing with more liabilities and constraints than on every other exchange. Therefore, the company can control its funds more easily since analysts and institutional stockholders observe controlling shareholders.¹⁵² Due to the tightened investigation and demanding transparency of SOX, benefits of controlling shareholders are diminished.¹⁵³ This enhanced monitoring and protection of minority shareholders definitely is a plus for the decision to cross-list in the US.

Costs provided by Section 404 occur due to the preparation of the auditor's affirmation report and the management's establishment of the needed report on its internal controls. Before a company is qualified for the auditor's attestation, it has to assess and keep records of its internal controls. Furthermore it has to

¹⁴⁹ see Eldridge and Kealey (2005), p.5

¹⁵⁰ see Ahmed et al. (2009), p. 3

¹⁵¹ see Piotroski and Srinivasan (2008), p. 12

¹⁵² see Doidge et al. (2007), p.9

¹⁵³ see Hostak, Lys, Yang and Karaglou (2011), p.7

decide what adjustments are required in order to enhance its internal control system, apply these adjustments and ultimately recheck the effectiveness of the updated and improved internal controls. This procedure causes costs due to the enlarged personnel expenditures, additional investment costs for new or improved technology and the increased external auditing fees.¹⁵⁴

The Sarbanes-Oxley Act involves compliance costs being fixed in large part. Most likely economies of scales occur while implementing SOX making small companies being worse off than large companies.¹⁵⁵ Companies with already good corporate governance tend to feature costs exceeding benefits after the implementation of SOX.¹⁵⁶ While around 60% of European managers state that in case of cross-listing benefits exceed the costs, approximately 29% claim the opposite. Also Canadian managers constituting 61% are certain that the benefits of foreign-listing exceed costs.¹⁵⁷

5.4 Firm Value

In literature opinions differ whether the Sarbanes-Oxley Act has influence on a company's listing decision and whether this implemented Act has impact on a corporation's firm value.

Bianconi, Chen and Yoshino (2010) claim that the firm value has been impacted negatively by SOX. This Act induced a segmented market situation implying a smaller but more profitable amount of firms as members of the US market. But a larger amount of companies with low firm value decide to cross-list at stock exchanges in Hong Kong or Germany investigating benefits of cross-listing by signaling.¹⁵⁸

In contrast, Li, Pincus and Rego (2006) argue that the Sarbanes-Oxley Act has a positive influence on the firm value of a company cross-listing in the US. Their univariate analysis shows positive abnormal returns in connection with events of

¹⁵⁴ see Eldridge and Kealey (2005), p.5

¹⁵⁵ see Litvak (2007), p. 5

¹⁵⁶ see Litvak (2007a), p.1896

¹⁵⁷ see King and Mittoo (2007), p. 61

¹⁵⁸ see Bianconi et al. (2010), p. 15-16

SOX like the publication of the House Senate Conference report and execution of the Act shown by various actions of SEC. These events coincide with the shareholders' assumption that the Act as a net beneficial outcome. The event study shows the positive and significant relation between company's income management and abnormal stock returns after the implementation of SOX. An increasing quality of annual report information leads to an improved ability of a firm to manage its income.¹⁵⁹

Jain and Rezaee (2004) suggest that the benefits of SOX definitely outweigh the costs resulting from this Act. They used a cross-sectional analysis to assign market reaction to costs and benefits of SOX. The finding shows positive abnormal returns during the events of the Act. Measured by factors like corporate governance, audit functions and financial reporting SOX shows an increasing firm value and furthermore points out that positive market reactions are more likely for companies already having an excellent compliance similar to the Act.¹⁶⁰

Zhang (2005) insists that the Sarbanes-Oxley Act has a negative effect on firm value since the abnormal returns during the events concerning this Act are negative. Findings show that companies with poor corporate governance tend to feature even lower abnormal returns and therefore they do not profit from improved governance rules at all.¹⁶¹

5.5 Corporate Governance

The Sarbanes-Oxley Act implicates requirements having positive and negative influence on a firm's governance.

Companies already having good governance might react more negatively since they do not achieve the same amount of benefits. Having good corporate governance includes the competence to raise capital. High growth companies being in need for external capital and not being able to oblige themselves to

¹⁵⁹ see Li, Pincus and Rego (2006), p. 20

¹⁶⁰ see Jain and Rezaee (2004), p. 2-3 and 30-31

¹⁶¹ see Zhang (2005), p. 36

domestic corporate governance standards should profit by improved requirements caused by SOX.¹⁶²

Additional, companies being located in countries with disclosure requirements of higher value have to bear larger costs caused by SOX than companies being located in countries with poor disclosure rules.¹⁶³

5.6 Event Study

A study provided by Litvak (2007) analyzes share price reactions of cross-listed companies being subject to the requirements of the Sarbanes-Oxley Act. After the announcement saying that SOX will apply to foreign-listed issuers, cross-listed companies underlying SOX show declining stock prices in comparison to foreign-listed companies not being subject to SOX. Declines have been the strongest for high-disclosing companies while companies with faster growth bear weaker decreases.¹⁶⁴

There have been different events in conjunction with the adoption and interpretation of SOX causing a whole event history, e.g. the clarification of the term “issuer” by Senator Sarbanes, the decision to not exclude foreign companies from assuring financial statements, the implementation of Section 302 of SOX (“Certification of Disclosure in Companies’ Quarterly and Annual Reports”), introducing the disclosure requirements described in Section 404 and many more. Every event relates to a negative stock price reaction except the announcement of a possible exemption for foreign companies being cross-listed in the US, which was related to a positive stock price reaction.¹⁶⁵

In a nutshell, firms either being subject to high-disclosure rules or featuring low growth have to face larger costs while firms with high growth being located in countries offering poor governance have to bear smaller costs after the implementation of the Sarbanes-Oxley Act.¹⁶⁶

¹⁶² see Litvak (2007), p. 5

¹⁶³ see Litvak (2007), p.28

¹⁶⁴ see Litvak (2007), p. 29

¹⁶⁵ see Litvak (2007), p. 11-12 in conjunction with p. 23

¹⁶⁶ see Litvak (2007), p. 29

5.7 The Delisting Decision

SOX implicates additional costs of complying that are responsible for the increase of cross-listing expenses. Companies might decide to deregister their shares in order to avoid upcoming expenditures and additional corporate governance requirements.

The deregistration decision has different effects on certain participants of a company: if a company decides to delist from a US stock exchange because of the enhanced costs of compliance, non-controlling and controlling shareholders benefit from this decision. But in contrast, if a company decides to delist due to enhanced governance mandates, controlling shareholders profit being stacked against non-controlling shareholders.¹⁶⁷ Minority shareholders of companies deciding to delist would profit from SOX caused by the possible reduction of agency costs.¹⁶⁸

The controlling shareholder's private benefit of control is known as agency costs.

A company will always try to leave the US stock exchange if controlling shareholders happen to be placed in a worse position because of increased compliance costs and tightened governance requirements. In this case, controlling shareholders will not benefit from a cross-listing at the US stock market any longer.¹⁶⁹

Analyses demonstrate that the discussions about SOX did not have a negative impact on stock prices, but the announcement of a company to deregister from the US stock market definitely was associated with stock price decline. Additionally, firms deciding to delist often feature weaker corporate governance performances. In a nutshell, the importance of controlling shareholder's profits has been of major influence for the delisting determination and exit from the US stock market as well.¹⁷⁰ Therefore, companies are likely to delist because controlling shareholders are afraid of being worse off.

Observing the number of deregistered firms before and after the implementation of SOX one can see that this Act definitely has distinct influence on foreign companies: Only 22 foreign companies delisted in the timeframe covering 1990

¹⁶⁷ see Hostak et al. (2011), p.7

¹⁶⁸ see Hostak et al. (2011), p. 3

¹⁶⁹ see Hostak et al. (2011), p.7

¹⁷⁰ see Hostak (2011), p.29

to 2001, while 96 companies deregistered between 2002 and 2005.¹⁷¹ 77% of companies deciding to delist from the US stock exchanges mentioned costs of compliance as a reason to deregister while more than 40% of them named the Sarbanes-Oxley Act as a cause to delist. Companies referring directly to SOX had to face a significantly more negative market response than firms that referred to costs of compliance being the cause for their delisting decision. In contrast, only 21.6% of firms delisting from the LSE referred to “costs” as a reason for this decision while 9.8% cited “costs and other reasons” as an incitement.¹⁷²

Additional, research provided by Hostak, Karaglu, Lys and Yang (2011) shows that these deregistered companies feature corporate governance characteristics, like high range of separation of cash-flow rights and control and poor amount of independent directors, being weaker. Comparing these steps backwards from the US stock exchanges with delistings from the LSE Main Market, compliance costs and corporate governance representatives do not influence UK deregistrations.¹⁷³

Since the stricter requirements involved by the Sarbanes-Oxley Act are likely to have severe effects on small companies, one can assume that these firms tend to deregister in order to avoid upcoming costs.

¹⁷¹ see Piotroski and Srinivasan (2008), p. 13

¹⁷² see Hostak et al. (2008), p. 3

¹⁷³ see Hostak et al. (2011), p. 3

6 Comparison of Different Countries

Literature shows different approaches identifying whether the Sarbanes-Oxley Act and the involved stricter regulations have harmed the competitiveness of the US stock markets. Doidge, Karolyi and Stulz (2007) claim that the implementation of SOX did not harm the attractiveness of the US stock exchanges. Since the US stock market is the only one generating a listing premium, which is extremely strong and did not decrease after 2001, firms still benefit from a US listing.¹⁷⁴ In contrast, Engel, Hayes and Wang (2005) argue that SOX had a negative impact on the foreign listing behavior leading to fewer listings on US stock exchanges. After the enactment of SOX especially small firms decided to go private as a consequence of the increasing costs caused by the Act. Costs of compliance with SOX account for almost \$ 5 million without taking account for opportunity costs like attention and time of management and board members. Thus, post-SOX going-private might be more economically advantageous since the net benefits of SOX do not outweigh the compliance costs.¹⁷⁵

Authors indicate the UK stock exchanges for being the biggest competitors for the US after the implementation of SOX. That represents an issue being addressed in this chapter.

6.1 The Listing Decision

Companies willing to list first need to analyze benefits and costs of listing exchanges in order to choose a host market. Benefits vary depending on what a company's manager is looking for: liquid capital market, briefed shareholder base or positive effects through bonding. These factors influence a company's decision to either list on a US or UK stock exchange.¹⁷⁶

¹⁷⁴ see Doidge et a. (2007), p. 42

¹⁷⁵ see Engel, Hayes and Wang (2005), p. 8-9, 24

¹⁷⁶ see Piotroski and Srinivasan (2008), p. 14

Events like the establishment of the NYSE Euronext caused by the merger of already existent stock exchanges and the globalization originated by trading electronically have changed the possibilities of cross-listing. It is difficult to distinguish these factors and the foundation of the highly successful AIM from SOX and its effect on a company's listing decision.¹⁷⁷

6.1.1 Industrial Specialization

Costs and disclosure requirements are not the only factors, which affect the listing decision. Companies often examine the industrial specialization of the foreign market before trading their shares abroad. They are drawn to stock markets that host prestigious firms coming from the same sector since those markets feature analysts specializing in this area and shareholders scan the market for companies from the sector to invest in. NASDAQ is known for being the host market for firms of the technology sector. In contrast, the NYSE hosts telecommunication and health care specialized firms. The LSE Main Market presents companies from oil & gas, basic materials and utilities divisions.¹⁷⁸

According to an analysis provided by Piotroski and Srinivasan (2008) the NYSE and the LSE Main Market are the preferred stock exchange for financial service companies like insurance firms or banks. 40% of all AIM listings represent companies from the Chemicals/Oil & Gas/Metals/Mining/Forestry sector while only 10% of all companies listed on NASDAQ are businesses operating in this sector. The NASDAQ hosts companies from the Software/Technology and Pharmaceutical/Biotechnology sector that account for 40% of all its listings. Only 15% of the AIM holds listings appearing in this sector.¹⁷⁹

But even time influences a company's decision where to list its shares. For example, in the 1990s the Internet boom disposed a massive amount of foreign firms (especially technology firms) to trade their stock at the American NASDAQ.¹⁸⁰

¹⁷⁷ see Lang (2008), p.2

¹⁷⁸ see Wójcik and Burger (2009), p.18

¹⁷⁹ see Piotroski and Srinivasan (2008), p. 18

¹⁸⁰ see Wójcik and Burger (2009), p.4 in conjunction with Pagano, Roell and Zechner (2002)

6.1.2 Signaling

According to a model generated by Bianconi et al. (2010) cross-listed firms have a lower Tobin's Q¹⁸¹ after the implementation of SOX in 2002. Additionally, companies having a low Tobin's Q before 2002 rather started to cross-list their shares on a foreign stock exchange after the beginning of the liability of SOX than they did before. This movement can be caused by the company's attempt trying to signal a well financial condition to the market and therefore persuading potential investors of their simulated financial power. Therefore, these companies utilize the raised rules of SOX and the signaling hypothesis. Usually, the latter is used by a company to show its ability to deal with the more stringent liabilities of foreign listing requirements due to its financial capacities.¹⁸²

6.2 UK vs. US Stock Exchanges

Due to its investor protection and liquidity, the UK stock exchange is the most comparable one to the US stock market.

In the last years, the UK stock exchanges became more and more popular. But London's fascination does not necessarily find its cause in the Sarbanes-Oxley Act. The foundation of the AIM (Alternative Investment Market) successfully attracts a large amount of companies making the UK stock market to a popular and appealing alternative to the US stock exchanges.

Larger and more lucrative companies tend to cross-list on the bigger exchanges like the NYSE and the LSE. In return, smaller firms with chances of anticipated growth feel attracted to the NASDAQ or AIM. Although AIM and NASDAQ are pretty similar, slightly larger and more lucrative companies tend to choose the NASDAQ to cross-list while the AIM attracts companies from arising markets.¹⁸³ Companies with poor corporate governance tend to avoid listing on a US stock exchange, while large companies with the intention to raise equity in the foreign

¹⁸¹ Tobin's Q = (Market Value of the Firm) / (Replacement Value of the Firm's Assets)

¹⁸² see Bianconi et al. (2010), p.12-13

¹⁸³ see Piotroski and Srinivasan (2008), p 17

market feel attracted to the US stock exchange.¹⁸⁴ These factors influence a company's listing decision absent the existence of SOX.

6.2.1 The Rise of the Alternative Investment Market

In 1995 the AIM has been founded with its focus on small local companies. Corporations decided to list their shares on this less regulated and more inexpensive market, which is known for companies exceeding venture capital markets but not being ready to offer their stock on a usual exchange. In 2002 the AIM experienced a tremendous increase since foreign companies opened up to this market. 31 international listings in 2001 went up to 310 global listings in 2007. But this gain in UK listings does not mean losses in the US listings since the AIM often appeals to firms that typically do not list. Furthermore, it is difficult to examine whether companies now listing on the AIM would have decided to offer their shares on a US stock exchange in absence of SOX.¹⁸⁵

Since the AIM mostly attracts small companies one can assume that these corporations would not have listed in the US and therefore the US stock exchange did not lose any members to the AIM.¹⁸⁶

Listing companies still have the same criteria they used to have before the implementation of SOX. Just little proof exists demonstrating that corporations make their listing decisions in a different manner compared to the years before SOX.¹⁸⁷

The LSE is offering companies strong investor protection and liquidity like the US does, but this UK stock exchange is advertising their lack of regulatory hurdles caused by the Sarbanes-Oxley Act.¹⁸⁸

6.2.2 The Effect of SOX on the Attractiveness of US Stock Exchanges

Research covering the time period from June 1995 to June 2009 and provided by Piotroski and Srinivasan (2008) shows that common listing behavior

¹⁸⁴ see Piotroski and Srinivasan (2008), p. 26

¹⁸⁵ see Lang (2008), p.4-5 in conjunction with Acrot, Black and Owen (2007), p.5

¹⁸⁶ see Doidge et al. (2007), p.42

¹⁸⁷ see Doidge et al. (2007), p.42

¹⁸⁸ see Piotroski and Srinivasan (2007), p.4

changed after the enactment of the Sarbanes-Oxley Act: in comparison to the period before SOX, listing activity on the NYSE, NASDAQ and LSE decreased while listing activity on a monthly basis on the AIM increased by approximately 775%.¹⁸⁹ After the implementation of SOX a company's likelihood choosing the US stock market as a host market decreased by 16%. Some corporations might choose the UK stock exchange instead of the US stock exchange.¹⁹⁰

The US listing activity declined after the implementation of the Act. 82% of companies avoiding US stock exchanges in favor of listing on UK stock exchanges tend to list on AIM. Unsurprisingly, these corporations are less lucrative, smaller and do not use high quality auditors like the typical firm listing on American stock exchanges. These companies find costs provided by SOX harder to bear with than large companies do.¹⁹¹

But one has to differentiate between attributes of companies bypassing a US listing and choosing one of the UK exchanges:

- larger and more profit-making companies from countries with poor shareholder protection and little economic growth being attracted to LSE Main Market and
- even smaller and less profitable companies from common law or developed countries engaging less prestigious auditors being attracted to AIM.

There exists a small amount of firms listing in the US but being supposed to list in UK according to their industry-specific, home country and firm characteristics. These companies are most certainly from emerging economic systems assembling bonding benefits and increased reputation of a US listing following the Act. Additionally these firms show approximately 24.6 Billion Dollar market capitalization and are more beneficial and larger than the common UK listing.¹⁹²

Another research developed by Piotroski and Srinivasan (2008) shows that companies from Code Law countries and companies from countries with poor

¹⁸⁹ see Piotroski and Srinivasan (2008), p. 19

¹⁹⁰ see Piotroski and Srinivasan (2008), p. 26

¹⁹¹ see Piotroski and Srinivasan (2008), p. 33

¹⁹² see Piotroski and Srinivasan (2008), p. 33

shareholder protection both tend to list in the US after the enactment of SOX in order to profit from the benefits provided by the Act.¹⁹³

Having a look at smaller companies and their decision between listing on either NASDAQ or AIM (in case of being eligible for both exchanges), the listing activity on the American NASDAQ decreased by 28% after the enactment of the Sarbanes-Oxley Act. The additional costs provided by the Act and AIM being a home for companies with growth probabilities prevents small companies from listing on the NASDAQ.¹⁹⁴ Then again the probability of a listing on the US stock exchange increased by 1% in case of comparing NASDAQ and LSE Main Market listings. Since larger firms tend to list on the LSE it seems like benefits caused by SOX might exceed the costs involved by the Act.¹⁹⁵

In a nutshell, large companies did not change their likelihood to list at US stock exchanges. The American exchanges might have gotten more popular due to the stricter regulations and involved shareholder protection. Additional, large companies have less issues dealing with the extra costs the implementation of SOX implicates.

Small companies did change their listing choices after the implementation of SOX, which causes a decline in US listings.¹⁹⁶

The Sarbanes-Oxley Act did not have an impact on large companies deciding between US and UK stock exchanges, but small firms definitely got influenced by SOX concerning their choice of listing exchanges. The attractiveness of listing on NASDAQ definitely declined after the implementation of SOX making AIM to an appealing stock market. The AIM attracts foreign listings because of its strong expansion in local listings.¹⁹⁷

Piotroski and Srinivasan (2008) come to the conclusion that small companies did experience effects caused by the Sarbanes-Oxley Act while large firm did not get affected. The market capitalization of companies being affected is

¹⁹³ see Piotroski and Srinivasan (2008), p. 31

¹⁹⁴ see Piotroski and Srinivasan (2008), p. 28

¹⁹⁵ see Piotroski and Srinivasan (2008), p. 28-29

¹⁹⁶ see Piotroski and Srinivasan (2008), p. 30-31

¹⁹⁷ see Piotroski and Srinivasan (2008), p. 34-35

smaller in a significant way than the one of firms not being affected by the stricter requirements of the Act resulting in a changed listing decision.¹⁹⁸

6.3 The Listing Premium

Another way to analyze the impact of the Sarbanes-Oxley Act on foreign listings is having a closer look at the valuation premium for cross-listings in the US. Did the listing premium declined as a consequence of SOX? Does the UK offer a superior listing premium?

Cross-listing entails large costs (e.g. more stringent accounting and corporate governance rules) that might be compensated by a premium. In case this premium decreases, the attractiveness of US stock markets decreases simultaneously.¹⁹⁹

Premium of cross-listings are kind of linked to regulatory modifications giving the chance to evaluate regulatory modifications observed by shareholders. If SOX involves more costs than benefits, premia for companies listed with Level II or III should fall. In case of improving investors' belief, SOX generates an increase of premia for Level II or III companies in contrast to a decreasing premium for Level I or IV companies.²⁰⁰

Although the premium for listings in the US has been reported to be constant and significant in data of all reviewed years, there occurs a slight change: the valuation premium of 17.5% over the period from 1990 to 2001 declined to a valuation premium of 14.3% from 2002 to 2005.²⁰¹

According to the analysis of Doidge et al. (2007) SOX did not have an impact on the valuation premium of foreign companies offering their stock on US markets. But since this panel regression includes companies with good and weak remedy, the outcome might be falsified due to an "averaging effect".²⁰²

¹⁹⁸ see Piotroski and Srinivasan (2008), p. 38

¹⁹⁹ see Litvak (2007a), p.1862

²⁰⁰ see Litvak (2007a), p. 1862

²⁰¹ see Doidge et al. (2007), p.36

²⁰² see Doidge et al. (2007), p.37

Additionally, SOX does not necessarily have to be the reason for a decline of listing premium. The scandals leading to SOX might be the cause for a weaker premium since US governance might have lost confidence. But since there was no significant price reaction after the publication of the WorldCom incident back in the middle of 2002, this theory can be ruled out.²⁰³

Unlike the permanent listing premium provided by US stock exchanges, the UK stock market does not even feature a cross-listing premium.²⁰⁴ Therefore cross-listing in the US definitely is a plus for companies attaching importance to receive a premium.

An analysis provided by Litvak (2007a) also investigates the influence of the Sarbanes-Oxley Act on a company's cross-listing premium. Firms from countries with low corporate governance communicate its capabilities by complying themselves to stricter rules and requirements. This move reflected in the bonding theory minimizes a company's cost of capital due to abandoning concealment and chances for self-dealing by controlling shareholders. In addition, in comparison to firms with Level I or IV listings, companies with Level II or III listings feature higher premium by the use of cross-listing.²⁰⁵

Tobin's Q and market-to-book ratio of companies with Level II or III ADRs declined significantly in comparison to Level I or IV companies and companies not being cross-listed at all. More beneficial firms, companies found in high disclosure countries, firms offering a high disclosure (before SOX) and firms with larger GDP per capita have to bear larger descents.²⁰⁶ Tobin's Q declined by 17.5% for Level II or III listed companies in comparison to a decline of 6.7% of Level I or IV listed companies. This difference is significant as well as the difference between Level II or III listed firms and companies not being cross-listed at all (7.2% loss). Level I or IV listed firms and firms not being cross-listed on foreign exchanges at all show similar shifts of market-to-book-ratios. Cross-listed companies not applying to SOX show an increase of listing premium while

²⁰³ see Litvak (2007a), p.1863

²⁰⁴ see Doidge et al. (2007), p.29

²⁰⁵ see Litvak (2007a), p.1860

²⁰⁶ see Litvak (2007a), p.1861

cross-listed companies being subject to SOX feature a decrease of listing premia. This decline can be explained by investors' negative reaction to the Sarbanes-Oxley Act and the implementation of the Sarbanes-Oxley Act.²⁰⁷

²⁰⁷ see Litvak (2007a), p.1878

7 Conclusion

In the last decades the importance of corporate governance increased tremendously. Incidents like the Financial Crisis back in 2008 and ongoing accounting scandals of companies (WorldCom, Enron, Arthur Anderson etc.) led to a decreasing investor confidence. There are numerous negative influences a company has to deal with in case of having a weak corporate governance system. The incidents of WorldCom and Enron illustrate exemplary what consequences occur in case of failure to comply with corporate governance rules and insufficient self-regulation of auditors. Having a good corporate governance system reduces a firm's risk of ending up in a financial crisis. Therefore establishing a corporate governance system including the protection of minority as well as majority shareholders is fundamental.

Since the 1900s companies raised their incentive to offer stock on foreign exchanges. The option to bond themselves to a better corporate governance system and to diversify the risk of their portfolios internationally are just two of the many reasons why foreign listing enhances a company's quality.

Due to the emerging doubts of investors the Sarbanes-Oxley Act has been enacted on 30 July 2002. This Act is a corporate governance rule with the intention to avoid additional cases of financial damage and demonstrates a global development in order to restore shareholder confidence. Consisting of 11 titles with 65 subtitles altogether SOX describes actions and consequences to different audiences to ensure the reliability of financial information reported to the public. Since the Sarbanes-Oxley Act holds for every public company being subject to the Securities Exchange Commission, even foreign companies have to deal with this enhances requirements in case of listing on a US stock exchange.

In this paper I compare US and UK stock exchanges to analyze whether the stricter rules of SOX had a negative impact on the cross-listing behavior of

foreign companies. Due to its improved shareholder rights and investor protection the UK stock exchanges display a serious competitor for US stock exchanges. After opposing costs (direct and indirect), audit costs, benefits, firm value and influence on corporate governance of companies listing on the US stock market after the implementation of SOX it is pretty obvious that the Act changes US listing conditions enormously.

The Sarbanes-Oxley Act involves additional costs a company has to bear in case of offering its stock on foreign exchanges via Level II or Level III ADRs. Companies trading with Level I and IV ADRs are able to avoid stricter rules since there are not subject to SOX. These costs might not be significant for large firms, but they incriminate small companies. While the Act does not seem to affect large companies, the costs put a much bigger strain on small companies with weak corporate governance. But besides costs SOX even entails additional work for a company since an internal control system has to be implemented and tested by the auditor (Section 404).

After the implementation of SOX in 2002 the amount of foreign listings on US stock exchanges has declined. There exist several reasons for this decrease showing that the Sarbanes-Oxley Act might not be the only cause for the diminishing attractiveness of the US stock market:

- The increasing attractiveness of regional exchanges may have outshined the preferences of US stock exchanges.
- The nature of foreign companies looking for stock exchanges from abroad might became different.
- The rising popularity of a listing on UK stock exchanges might have increased due to the positive development of the Alternative Investment Market.²⁰⁸ With the increase from 31 international listings in 2001 to 310 global listings in 2007 the AIM definitely shows its competitiveness. While NYSE, NASDAQ and LSE showed a decreasing listing activity during the time period from June 1995 to June 2009, listing activity on AIM showed an increase of approximately 775%. After the implementation of SOX a company's likelihood to list on a US stock exchange decreased. 82% of

²⁰⁸ see Piotroski and Srinivasan (2008), p. 3

the firms bypassing a US listing in favor of listing at the UK stock market tend to choose AIM.

Listing on a US stock exchange still has its advantages and shows the world a company's capacity to comply with stricter requirements and being a global player. But the additional costs and disclosure requirements involved by the Sarbanes-Oxley Act might not be factors every company is able to deal with. A company has to decide for itself whether SOX has a positive or negative influence on its listing behavior. Firms have to analyze whether they face the stricter requirements caused by SOX or are better off listing on an UK stock exchange to avoid the Act.

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V Appendix

1 Abstract

Having a look to the last decades, the importance of having a good corporate governance system increased tremendously. Incidents like the Financial Crisis back in 2008 and ongoing accounting scandals of companies like WorldCom and Enron leading to a decrease in shareholder confidence confirm the relevance of corporate governance.

On July 2002 the Sarbanes-Oxley Act has been enacted with the intention to restore investor confidence and ensure the reliability of financial information. The Act involves stricter legal requirements and obligates the management to establish an internal control framework. Since SOX exclusively applies to all public companies listing on US stock exchanges and being subject to the registration of SEC, even foreign firms have to underlie these stricter rules.

As a consequence of globalization, companies raised their intention to list abroad in order to enter international markets and diversify the risk of their portfolios. Therefore many companies became subject to SOX.

This work examines the influence of the Sarbanes-Oxley Act on the foreign listing behavior of non-US companies. The amount of foreign listings on the US stock exchanges declined after 2002, which does not have to be caused by the Sarbanes-Oxley Act. Due to its enhanced shareholder rights and excellent investor protection the UK stock exchange features a serious competitor for US stock markets. Therefore I compared listing requirements, costs and benefits of these two stock exchange to examine whether companies feel deterred from SOX and rather list on the UK stock market or decide to be subject to SOX in order to profit from a US listing and its positive signal to the financial market. Literature shows that mostly small companies are worse off listing on the US stock exchanges after the implementation of the Act while large companies do not necessarily get affected. In the end every company has to decide for itself whether a US listing makes benefits exceeding costs even after the establishment of the Sarbanes-Oxley Act.

2 Abriss

In den letzten Jahrzehnten ist die Relevanz von Corporate Governance beträchtlich gestiegen. Vorfälle wie die Finanzkrise im Jahr 2008 und das Aufdecken von zahlreichen Bilanzfälschungsskandalen von Unternehmen wie WorldCom und Enron haben das Vertrauen von Aktionären negativ beeinträchtigt. Diese Vorfälle zeigen allerdings wie wichtig ein gutes Corporate Governance System für die Wirtschaftlichkeit eines Unternehmens ist.

Am 30. Juli 2002 wurde der Sarbanes-Oxley Act mit dem Ziel erlassen das Vertrauen von Aktionären zurück zu gewinnen und die Verlässlichkeit von Finanzinformationen, die in die Öffentlichkeit kommuniziert werden, zu gewährleisten. Dieses Gesetz beinhaltet strengere rechtliche Anforderungen und verpflichtet das Management ein Internes Kontrollsystem einzurichten. Da SOX auf alle Unternehmen, die auf amerikanischen Börsen notieren und der Securities Exchange Commission unterworfen sind, angewendet wird, sind auch nicht-amerikanische Firmen von diesem Gesetz betroffen.

Diese Arbeit betrachtet den Einfluss des Sarbanes-Oxley Acts auf das Fremdnotierungsverhalten von nicht-amerikanischen Unternehmen. Seit 2002 ist die Anzahl der Notierungen auf amerikanischen Börsen zurück gegangen was aber nicht zwangsläufig allein auf die Implementierung von SOX zurück geführt werden muss. Auf Grund ausgezeichneter Aktionärrechte und Anlegerschutz stellt der britische Börsenmarkt eine ernsthafte Konkurrenz für amerikanische Börsenmärkte dar. Darum habe ich Börsennotierungsanforderungen, Kosten und Nutzen von US und UK Märkten gegenübergestellt um zu vergleichen ob sich Unternehmen von den Regeln des Sarbanes-Oxley Act abschrecken lassen und somit auf einer britischen Börse notieren, oder ob sie ihre Aktien auf Grund der ausgezeichneten Reputation weiterhin an der amerikanischen Börse anbieten.

Die Literatur zeigt dass hauptsächlich kleinere Unternehmen unter der Implementierung von SOX leiden, während größere Unternehmen nicht signifikant beeinflusst werden.

Schlussendlich muss jedes Unternehmen für sich selbst entscheiden ob der Nutzen einer amerikanischen Börsennotierung die Kosten selbst nach des Inkrafttretens des Sarbanes-Oxley Acts noch übersteigt.

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MS Office	Sehr gute Kenntnisse
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SAP R/3	Gute Kenntnisse
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