REDUCING REGULATION AND LITIGATION WHILE ENHANCING SHAREHOLDER RIGHTS WILL IMPROVE THE COMPETITIVENESS OF U.S. CAPITAL MARKETS

Introduction

- Headed by Glenn Hubbard, Dean of the Columbia School of Business, and John Thornton, Chairman of the Brookings Institution, the Committee on Capital Markets Regulation is an independent, bipartisan and diverse group of 22 experts from the investor community, business, finance, law, accounting and academia. The Committee is dedicated to improving the competitiveness of the U.S. capital markets by reducing regulation and litigation while enhancing the rights of shareholders. Harvard Law School Professor Hal Scott is the Committee's Director. It will continue to explore issues affecting the competitiveness of U.S. capital markets for the next two years.

- Based on research undertaken by some of the best experts available, the report released today represents the first set of findings of the Committee, with recommendations for specific changes in capital markets regulation.

- Maximizing the competitiveness of U.S. capital markets is critical to ensuring economic growth, job creation, low costs of capital, innovation, entrepreneurship and a strong tax base in key areas of the country. Regulation and litigation play central roles in protecting investors and the efficient functioning of our capital markets, particularly in light of recent, highly publicized abuses. Yet excessive regulation, problematic implementation and unwarranted litigation – particularly when occurring simultaneously – make U.S. capital markets less attractive and, therefore, less competitive with other financial centers around the world.

- Enhancing shareholder rights while reducing regulation and litigation that are overly excessive and burdensome are twin pillars of the Committee's recommendations. As shareholders are able to take more control over companies in which they are stakeholders, regulation can be more targeted.

- The Committee believes that its 32 recommendations in four key areas – shareholder rights, Section 404 of Sarbanes-Oxley, the regulatory process and public and private enforcement -- will improve the regulatory system and give U.S. capital markets the competitive boost necessary to respond to the increasingly aggressive efforts of other nations to attract equity capital markets. Regulators and Congress both have roles to play.

Key Findings Regarding the Competitiveness of U.S. Markets

- Historically, U.S. capital markets have been the deepest, most liquid financial markets in the world. As a result, American companies have had access to funding with the lowest cost of capital available globally. The success of venture capital in nurturing small innovative companies – which accounted for 40% of U.S. employment in publicly traded companies in 2002 – depends on strong public markets. Until recently, foreign issuers have come to U.S. public markets for the same reasons, as well as for the quality of U.S. market regulation. Importantly, foreign entities did not have viable public market alternatives elsewhere in the world.

- The world today is vastly different because there are now viable choices. Where there was once only one viable market, there are now several such markets. Companies and investors can now find markets outside the U.S. that are deep and highly liquid. Technology now provides the possibility of easily trading anywhere.

- Because multiple markets have created choices that never used to exist, issuers seeking capital are now using a cost benefit analysis that focuses on the competitive differences between markets, including the potential cost of litigation and the complexity of regulation. U.S. public capital markets must now compete for business in a global marketplace. Access to capital is no longer a competitive advantage.

- Thus, while some erosion of the historically immense U.S. market-share of global equity listings, trading and total equity financing is natural, it cannot fully explain why:

    - 5% of the value of global initial public offerings was raised in the U.S. last year, compared to 50% in 2000.
    - The U.S. share of total equity capital raised in the world's 10 top countries has declined to 27.9% so far this year from 41% in 1995.
    - The decrease in U.S. listing premiums erodes the traditional edge maintained by the U.S. on cheaper cost of capital.
    - Private equity firms, almost non-existent in 1980, sponsored more than $200 billion of capital commitments last year alone.
    - Since 2003, private equity fundraising in the U.S. has even exceeded net cash flows into mutual funds and going private transactions have accounted for more than a quarter of publicly announced takeovers. The increased use of private markets disadvantages the average investor, who typically cannot participate in such markets.
    - The dramatic increase in the use of private U.S. markets is important evidence that regulation and litigation are keeping them out of the public market.

Maintaining Investor Protection and Shareholder Value

- Investor protection is a bedrock principle of U.S. capital markets. The Sarbanes-Oxley Act of 2002 created a new regime of investor protection by enhancing the scope and speed of disclosures. It helped restore market confidence after several high-profile corporate scandals and abuses.

- Investors and companies raising capital participate in markets where they feel safe by reason of effective laws vigorously enforced by knowledgeable, transparent courts and even-handed, vigilant regulators.

- Few would argue that the level of regulatory intensity -- in the form of new laws, outcomes of shareholder litigation and government litigation and the aggressiveness of securities regulators -- has not increased markedly in recent years.

- The question is whether that regulatory intensity has increased to such a degree so as to undermine the competitiveness of U.S. capital markets. Making reduction of regulatory intensity an end in and of itself, however, would be self-defeating. Ultimately, shareholders have the greatest interest in efficient regulation because they pay the price, in reduced share value, when cost of regulation exceeds its benefits.

The Impact of Regulation and Litigation

- The evidence suggests that balance does need to be restored. A substantial portion of the erosion in U.S. markets global and internal competitiveness – and the only factors over which U.S. policymakers have control – relates to insufficiently coordinated, costly and/or excessive market regulation and enforcement, public and private.

- Regulatory requirements for complying with Section 404 of the Sarbanes-Oxley Act cost companies, on average, $4.36 million in the first year – a stiff price for most public companies and a significant burden for small ones, particularly first time market entrants.

- Nearly open-ended responsibility of auditors in complying with Section 404 has made an already consolidation-shriveled profession virtually uninsurable for this work.

- Insufficiently coordinated state and federal enforcement laws and activities have led to state authorities driving matters that are more national in scope.

- Improper criminalization of entire companies has sometimes forced them out of business, eliminating thousands of innocent employees' jobs.

- Private enforcement in the form of securities law class action suits (which do not exist outside the U.S.) resulted in $150 million of liabilities in 1995. By 2004, this had exploded to $3.5 billion – a figure that does not even include an additional $4.74 billion of penalties assessed by US public enforcement bodies.

The Committee's Key Recommendations – Reducing Regulation and Litigation While Enhancing the Rights of Shareholders

- The Committee believes that the competitiveness of U.S. capital markets can be improved by reducing regulation and litigation while enhancing the rights of shareholders.

- The Committee's 32 specific recommendations fall into four areas:

- <u>1. Shareholders Rights</u>: The Committee believes that further expanding shareholder rights will do much to bring about the changes it seeks.

  - ➢ Classified boards should be required to obtain shareholder authorization to adopt a poison pill, and if this is not done within three months, the pill should automatically be redeemed.
  - ➢ The Committee endorsed majority, rather than plurality, voting, which is a cornerstone of shareholder rights, and the Committee will study how it may best operate.
  - ➢ Shareholders should be given the choice to decide how disputes with their companies should be resolved – e.g., through arbitration (with or without class actions), or non-jury trials.
  - ➢ The SEC should resolve issues on ballot access caused by a recent court decision.

- <u>2. Regulatory Process</u>: Effective regulation that creates a hospitable climate for both investors and companies seeking to raise capital depends on the regulatory process that the SEC and other regulators implement to achieve their legislated mandates, as well as on the legislation passed by Congress and the rules created by regulators.

  - ➢ The SEC and self-regulatory organizations (SROs) should move to a more risk-based regulatory process, emphasizing the costs and benefits of new rules. In weighing the costs and benefits of new rules, regulators should rely on empirical evidence to the extent possible. Also to the extent possible, regulations should rely on principles-based rules and guidance.
  - ➢ The SEC should periodically test existing rules to ensure that they still meet reasonable cost/benefit standards.
  - ➢ Public enforcement bodies like the SEC, Justice Department and state securities commissioners and attorneys general need to coordinate their activities, providing for federal precedence where enforcement implications are national in scope. There should be more effective communication and cooperation among federal regulators. The President's Working Group on Financial Markets is one natural venue for ensuring such cooperation.

- <u>3. Public and Private Enforcement</u>: Our enforcement system has many virtues. Most importantly for financial market competitiveness, well-policed markets attract investors and corporations seeking to raise capital. Continued civil and, where justified, criminal enforcement against individual wrongdoers, including CEOs with whom the buck must stop, should be supported. Yet some reform is necessary:

- Greater clarity for private litigation under SEC Rule 10b-5, and from the SEC on materiality, scienter (knowledge of wrongdoing) and reliance is needed. Criminal enforcement against companies should be a last resort, reserved for companies that have become criminal enterprises from top to bottom. We should not hold outside directors responsible for corporate malfeasance that they cannot possibly detect.
- Public enforcement authorities should not be allowed to threaten corporate defendants with denial of their employees' right to due process.
- The SEC should protect outside board members against liability from relying in good faith on the validity of audited financial statements – otherwise, it will be difficult to attract independent directors to boards.
- Congress should explore protecting audit firms against catastrophic loss through the provision of caps or safe harbors, as do some European countries and as the European Union is actively considering. Any use of such protection must be balanced against stiff action against those responsible for misconduct.

- <u>4. Sarbanes-Oxley</u>: The Committee believes that changes in implementation, not statutory change, are necessary. Adjustments in implementation, especially of Section 404, would provide benefits, but at considerably less cost:

  - The SEC should adopt a more reasonable materiality standard both for internal controls and financial statements.
  - The SEC and the PCAOB should adopt enhanced guidance on auditors' role and duties in testing for compliance with Section 404.
  - If a revised Section 404 is too burdensome for small companies ($75 million market cap and less), even after the general reforms outlined above are implemented, the SEC should recommend to Congress that small companies be exempt from auditor attestation and be subject to a more reasonable standard for management certification.