International Finance 10:1, 2007: pp. 91–99
DOI: 10.1111/j.1468-2362.2007.00194.x

COMMENTARY

An Action Plan for US Capital Markets

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Corporate scandals over the past five years have fittingly brought the integrity of US capital markets under scrutiny, provoking a significant legislative and regulatory response. The response was intended to strengthen protections for investors and to improve the laws and regulations that provide the proper incentives for good corporate governance. The events and the responses to them are as great as those underlying the United States' bedrock securities laws of the 1930s.

Among other benefits from the regulatory changes of recent years are improved transparency and accuracy in accounting and financial reporting – traditional advantages of the US market. Yet many participants in the capital markets have raised important questions. What is the effect of regulation on the efficiency of our capital markets? Do changes to the legal underpinnings of capital markets always incorporate evaluation of benefits and costs? Are we taking actions that unintentionally make our capital markets less competitive in the global economy?

On 30 November 2006, the Committee on Capital Markets Regulation issued its first report on regulatory changes needed to maintain and improve the global competitive position of US capital markets for investors.

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The 135-page report offered numerous recommendations and suggestions for areas of further study – principally for regulation, though, in some cases for legislation. The theme is simple: To maintain and enhance the value of US public markets, policy makers must do a better job of assessing and evaluating benefits and costs of our regulatory and legal system and strengthen the rights of shareholders.

The 22-member Committee's initial recommendations should be implemented: They represent the consensus of a diverse group of legal and finance scholars, CEOs, auditors, practising corporate attorneys, institutional investors and investor advocates drawn from both political parties. Taken together, the proposed changes would enhance shareholder value by reducing the cost of capital, increasing expected firm cash flows and reducing excessive risk aversion of corporate managers, auditors and directors.

I. Public Capital Markets Matter

The efficiency and competitiveness of our public capital markets as well as the safeguards for investors in these markets are essential to the vibrancy and resiliency of the US economy. Issuers gain access to a lower cost of capital for growth. Investors benefit from liquidity and efficiency in pricing of securities. And well-developed capital markets are directly related to growth in productivity and greater employment opportunities across the whole of our economic spectrum. More goods and services are available to a larger number of people. It is a virtuous cycle that attracts more capital to the US public capital markets.

Since the 1930s, emphasis on rigorous financial disclosures and robust enforcement has protected investors and promoted confidence that is critical to the efficient functioning of our capital markets. US and many foreign companies have generally concluded that the costs of access to our markets have been offset by the tangible benefits.

Corporate scandals early in this decade, such as Enron and WorldCom, which involved fraud and accounting irregularities, weakened investors' trust in the integrity of US capital markets. Investors responded with lower valuations of securities as these risks were factored in to the cost of capital. There was also a legislative response. In particular, the Sarbanes–Oxley Act of 2002 was the most substantial securities legislation since the Securities Acts of 1933 and 1934. The Act created the Public Company Accounting Oversight Board (PCAOB) to oversee the audit profession; it required corporate leaders to certify personally the firm's financial statements; and it required that auditors certify the firm's internal controls (the statute's now famous Section 404).

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Sarbanes–Oxley offers enhanced benefits of transparency, accountability and investor protection, and thus strengthens our capital markets. But many have asked whether Sarbanes–Oxley reflects an evaluation of benefits and costs. Some critics believe that certain aspects of the legislation may have the unintended effect of making our markets less efficient venues for raising capital.

And questions remain as to whether the conflict-of-interest issues emphasized by the Sarbanes–Oxley Section 404 got at the bigger problems from an economic perspective. There is a need to consider more seriously the role played by takeover mechanisms – and the market – in matters of corporate control and shareholder rights. And Sarbanes–Oxley is not the only matter for debate – and likely not even the most important one – for US capital markets.

Public capital markets play a vital role in any modern economy. They offer the means for growing firms to finance investment. They allow investors' funds to flow to the most promising opportunities. And the risk-sharing, liquidity and information services provided by well-functioning capital markets enhance the value of investors' assets and lower the cost of capital for firms. Legal and regulatory regimes that promote shareholder rights, accountability, disclosure and transparency are an important element in the success of capital markets and the economy as a whole.

US capital markets are losing their competitiveness in global markets, to the detriment of investors. The report concludes that regulatory and legal costs play a leading role in this adverse shift. And the debate over foreign listings in the US is instructive.

Foreign firms still receive a benefit on average from listing in the US according to evidence from economic research. But, that benefit has declined in recent years.

In the universe of global IPOs, the fraction of non-US IPOs listed in the US has fallen to under 10% in 2006 from 37% in 2000. And these figures are not likely to be simply capturing a current shift in the global economic centre of gravity toward Asia. If one removes IPOs from China and Russia, for example, the declines in foreign firms' US listings by number and value are similar. Concerns about listing in the US relate to domestic firms too, as US firms contemplate 'going private' or do not 'go public' for regulatory and legal reasons.

More important, since 2002, the average listing premium has declined 19 percentage points. Of particular interest is the variation across countries. It might be that extra regulation is harmful for firms from countries with poor corporate governance – the cost of meeting the standards is difficult to bear by any measure. On the other hand, the new regulation might be beneficial, even for companies from countries with strong corporate governance – but too costly relative to the benefits. In this case, the decline in listing premiums should be for firms in countries with good corporate governance (that is, who already have the benefit, but now must pay higher costs).

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The report presents evidence to support the latter view. In concert with evidence on global IPOs and private equity transactions, this finding underscores the need to balance costs and benefits of regulation to maintain the global position of US markets. Doing so requires examining all pieces of the puzzle to ensure that regulation enhances shareholder value by improving the incentives of corporate managers, auditors and directors while advancing shareholders' rights in the market for corporate control.

Policy makers should confront the question of whether global economic growth and a welcome trend toward financial reform have put wind in the sails of overseas financial centres, or if the US capital market regulation could also be a factor in their increased competitiveness. There is historical evidence that suggests it could be. In the 1960s, US banks went to London and helped spur the growth of the Eurobond market because of interest-rate ceilings and reserve requirements at home. US regulators subsequently allowed international banking facilities with lower reserve requirements and abolished Regulation Q ceilings on interest rates, but the London market had already taken off. The Eurobond market also drew sustenance from US tax policy in the form of the interest equalization tax. Subsequent tax changes did not slow down the market's development once started. Are we seeing similar market shifts with diminished interest in US listings, the NYSE's overtures to Europe and NASDAQ's interest in London?

The committee's report focused on six areas for action.

II. Sarbanes–Oxley Section 404 Can Be Implemented More Cost-Effectively

Section 404 is aimed at reducing the market impact of accounting 'errors' – whether from fraud, inadvertent misstatements or omissions – by assuring investors that public companies maintain effective controls over financial reporting. The issue is not the statute's underlying objectives, but whether the implementation approach taken by the SEC and the PCAOB strikes the right cost–benefit balance. The evidence about declining listing premiums suggests that it has not. Combined with other evidence presented in the report, this point leads us to conclude that the costs of Section 404 are substantial – many multiples of the SEC's original estimate.

Better implementation of Section 404 can lead to a capture of benefits at a lower cost. First, reform should start by revising the materiality standards in Auditing Standard No. 2 to ensure that reviews are truly risk-based and focus on significant control weaknesses, as the SEC and the PCAOB are now acknowledging. The SEC should define materiality quantitatively and consistently with the definition of materiality in financial reporting.

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Second, the SEC and PCAOB should clarify and permit greater judgement as to the auditor's role in understanding and evaluating management's assessment process. Third, consistent with the objective of focusing control review on higher-risk components of financial processes, the SEC and the PCAOB should give guidance to management and auditors to allow multi-year cycling of testing where appropriate. Fourth, small companies (under $75 million market capitalization) should either be subject to the same (revised) Section 404 requirements as large companies, or Congress should consider reshaping Section 404 for small companies by eliminating auditor attestation while providing for a reasonable form of certification of internal controls by management. Finally, we would not apply Section 404 to non-US companies subject to equivalent home-country requirements.

III. The US Litigation and Enforcement System Requires Reform

Our enforcement system has many virtues. A vigorous system that includes civil and criminal enforcement against individual wrongdoers, including CEOs, makes financial markets safer and more competitively attractive. We do conclude, however, that our private litigation system needs modification in several important ways, and the criminal enforcement system needs better balance.

First, for private enforcement, while claims under Rule 10b-5 account for the bulk of securities litigation, considerable uncertainty exists about many of the elements of 10b-5 liability as a result of conflicting court interpretations over the years. The size and frequency of damage settlements in securities class-action suits, moreover, set the US apart from other major financial centres and is an important factor in the declining competitive position of our securities markets. The SEC should provide more guidance, using a risk-based approach. This review should include materiality, *scienter* (knowledge of wrongdoing) and reliance.

Second, criminal enforcement against entire companies, reflecting the experience with the (now vacated) Arthur Andersen decision, should be truly a last resort, reserved for companies that have become criminal enterprises from top to bottom. In addition, the Justice Department's Thompson Memorandum makes the decision to prosecute a firm turn in part on whether the firm is willing to refuse to advance legal fees to employees who are being prosecuted and waive its attorney–client privilege. A district court has held these restrictions to be unconstitutional. The Justice Department should revise its prosecutorial guidelines to prohibit federal prosecutors from seeking waivers of attorney–client privilege or the denial of legal fees to employees, officers or directors.

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IV. Shareholder Rights Should Be Strengthened

Matters of corporate control are part of the fundamental framework of shareholder rights. And a well-functioning market for corporate control is crucial to an efficient and competitive capital market. The combination of a poison pill and a staggered board raises barriers to hostile bids, impairing the market for corporate control and investors' asset values. Classified boards should be required, as a matter of course, to obtain shareholder authorization before the adoption of a poison pill, unless the firm is the target of a takeover. In that case, the firm should be given no more than three months to obtain shareholder authorization.

Another element of shareholder rights is the need to allow shareholders to devise private alternatives to the present costly litigation system. Such procedures might include the waiver of jury trials (a waiver already commonly made in a variety of circumstances) or arbitration (with or without class actions). This choice should be afforded as part of an initial public offering (IPO) for new companies, provided it is done by shareholder vote after the IPO. Shareholders of companies that are already public should similarly be able to amend their charters and by-laws.

In addition, we applaud the increasing number of companies that have adopted majority-voting requirements. Majority voting is a cornerstone of any effective system of shareholder rights, along with the right of shareholders to vote on poison pills and alternative remedies. In a related area, the SEC should resolve the confusion over the ability of shareholders to place their own director nominees on the company's proxy (confusion created by a recent decision of the Second Circuit Court of Appeals in *AFSCME* v. *AIG*).

Finally, the SEC's new executive compensation disclosure requirements should be rigorously assessed before assessing any policy changes toward the market for executive talent.

V. Excessive Gatekeeper Litigation Is Harmful To Shareholders

Gatekeepers such as auditors and directors play critical roles in monitoring corporate management on behalf of shareholders. Significant increases in potential liability for these gatekeepers in recent years can induce risk-aversion behaviour not in shareholders' long-term interests and possibly reduce the supply of willing and competent professionals to perform these tasks.

Audit firms play the part of ensuring the integrity of financial statements and the effectiveness of internal controls of public companies. Remedies for excessive litigation here will require Congressional action. Like so many of the issues touched on by the committee, this is a complex area. Nevertheless, the Committee recommends that Congress explore alternatives to avoid

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catastrophic loss and its consequences. One approach would be to set a cap on auditor liability (an approach some European countries already pursue, and which Charlie McGreevy, Commissioner for Internal Markets, has recommended for the European Union). An alternative would be to create a safe harbour for certain defined auditing practices. Preventing economic damage awards against audit firms and their employees at a level that would destroy the firm would allow insurers to re-enter this market. Insurance would allow audit firms to conduct prudent oversight with a knowable risk and create an additional source of recovery for shareholders. To ensure that investors are protected against auditor misconduct, such legislation could provide that invocation of a cap or safe harbour by an audit firm would trigger an investigation by federal regulators, who, based on their findings, may impose appropriate sanctions on the firm.

Likewise, we should not hold outside directors responsible for corporate malfeasance they cannot possibly detect. In particular, the SEC should modify Rule 176 to make an outside director's good faith reliance on an audited financial statement or an auditor's comfort letter sufficient for meeting this standard of care.

VI. Effective Regulation Requires Economic Analysis

While there are existing mechanisms at the SEC for applying cost–benefit analysis to proposed rules and regulations, more can be done in this regard to ensure that regulations are achieving the intended effects of investor protection at a cost that is sensible in the context of individual firms, the markets at large and the economy as a whole. The SEC and self-regulatory organizations need to engage in a more risk-based process, focused explicitly on the economic costs and benefits of regulation (as is the case for the FSA in the United Kingdom) for companies and investors, while strengthening shareholder protections. In weighing the costs and benefits of new rules, regulators should assess and rely on empirical evidence to the extent possible.

The SEC should establish explicit principles of effective regulation that will guide its activities to meet its statutory obligations. These principles should include the systematic implementation of a carefully applied cost–benefit analysis of its proposed rules and regulations. Rules should not only be evaluated initially at the front end, but also should be reviewed periodically to ensure they are achieving their intended effect at an acceptable cost.

As a complement to more economic analysis, the committee concludes that the time has come for securities regulators to push with more determination in the direction of principles-based rules, with the consequent reduction in the size of the present, primarily prescriptive rulebooks. And in keeping with the cost–benefit analysis advocated earlier, these rules should

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be risk-based, reflecting anticipated dangers to investors and markets. This process must, of course, start with the enunciation of a set of principles intended to guide proper behaviour. These principles would form the foundation on which the new rules approach would be built.

VII. A Broader Policy Engagement Is Now Required

Compared with the regulatory structure for overseeing financial institutions in other developed countries, the US regulatory system is complex and highly fragmented. Its present form is the consequence of constitutional tensions (federal versus state authority) and a preference for 'functional regulation' that mandates that regulators be created along business-activity lines. Thus, the US financial regulation system has federal, state and private-sector regulatory bodies in securities and banking, but total state jurisdiction in insurance; federal and state law enforcement officials (the Department of Justice, state attorneys-general) and myriad federal financial regulators (the SEC, the Commodity Futures Trading Commission and four banking regulators). Over time, as legislation has permitted and commercial imperatives have encouraged, more business lines have been operated out of single firms. As a consequence, the fragmented US financial regulatory system has become increasingly filled with friction, and even dysfunctional.

There are many inhibitions to rationalization and simplification of this complex system, and change is likely to come slowly. The committee recommends that pending a more thorough revamping of the federal regulatory system, there should be effective communication and cooperation among federal regulators, including self-regulatory organizations. The President's Working Group on Financial Markets is one natural venue for ensuring such coordination takes place.

Because the competitiveness and integrity of US capital markets are central to overall national economic health and investors' well-being, the committee recommends that the President direct his Working Group on Financial Markets to evaluate these key legal and regulatory issues and formalize a process of cost–benefit analysis for capital markets regulation. This opportunity – affecting our nation's wealth and future growth – is one that transcends politics. And it calls for action.

VIII. Additional Steps Can Be Taken

The Committee on Capital Markets Regulation will continue its analysis of the efficiency and competitiveness of US public equity markets and recommendations for regulatory or legislative reforms. Upcoming topics for consideration include an international comparison of overall regulatory

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approaches for equity markets and special analysis of cross-country differences in regulatory treatment of mutual funds and equity derivatives. As with the 2006 report, this work will link underlying economic and legal scholarship to recommendations for public policy.

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