Today, the Committee on Capital Markets Regulation will issue its first report on regulatory changes needed to maintain and improve the global competitive position of U.S. capital markets for investors. Our 135-page report offers 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 U.S. public markets, we must do a better job of assessing and evaluating the benefits and costs of our regulatory and legal system and strengthen the rights of shareholders.

Our 22-member committee's initial recommendations should be implemented: They represent the consensus of a diverse group of legal and finance scholars, CEOs, auditors, practicing 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.

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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.

In our column on this page late last month, we observed that U.S. capital markets are losing their competitiveness in global markets, to the detriment of investors. Our report concludes that regulatory and legal costs play a leading role in this adverse shift. And the debate over foreign listings in the U.S. is instructive.

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

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 U.S. 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 markets
for corporate control.

-- 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 Public Company Accounting Oversight
Board (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.

Second, the SEC and PCAOB should clarify and permit greater judgment 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 multiyear 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-U.S. companies subject to
equivalent home-country requirements.

-- The U.S. 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, sets the U.S. apart from other major financial centers
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.
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 prior to 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 for IPOs as part of an initial public offering 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 bylaws.

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.

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 behavior not in shareholders’ long-term interests and possibly reduce the supply of willing and competent professionals to perform these tasks.

Mr. Hubbard, dean and professor of finance and economics at Columbia Business School, was chairman of the Council of Economic Advisers under President Bush. Mr. Thornton, chairman of the Brookings Institution, was formerly president of Goldman Sachs.