AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

AMERICA'S CAPITAL MARKETS: MAINTAINING OUR LEAD IN THE 21ST CENTURY

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

APRIL 26, 2006

Printed for the use of the Committee on Financial Services

Serial No. 109–87

U.S. GOVERNMENT PRINTING OFFICE

30–538 PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
RICHARD H. BAKER, Louisiana
DEBORAH PRYCE, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chair*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
CHRISTOPHER SHAYS, Connecticut
VITO FOSSELLA, New York
GARY G. MILLER, California
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona
JIM GERLACH, Pennsylvania
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
MICHAEL G. FITZPATRICK, Pennsylvania
GEOFF DAVIS, Kentucky
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
ARTUR DAVIS, Alabama
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
DEBBIE WASSERMAN SCHULTZ, Florida
GWEN MOORE, Wisconsin,

BERNARD SANDERS, Vermont

Robert U. Foster, III, *Staff Director*

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

RICHARD H. BAKER, Louisiana, *Chairman*

JIM RYUN, Kansas, *Vice Chair*
CHRISTOPHER SHAYS, Connecticut
PAUL E. GILLMOR, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
EDWARD R. ROYCE, California
SUE W. KELLY, New York
ROBERT W. NEY, Ohio
VITO FOSSELLA, New York,
JUDY BIGGERT, Illinois
GARY G. MILLER, California
MARK R. KENNEDY, Minnesota
PATRICK J. TIBERI, Ohio
J. GRESHAM BARRETT, South Carolina
GINNY BROWN-WAITE, Florida
TOM FEENEY, Florida
JIM GERLACH, Pennsylvania
KATHERINE HARRIS, Florida
JEB HENSARLING, Texas
RICK RENZI, Arizona
GEOFF DAVIS, Kentucky
MICHAEL G. FITZPATRICK, Pennsylvania
JOHN CAMPBELL, California
MICHAEL G. OXLEY, Ohio

PAUL E. KANJORSKI, Pennsylvania
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
ARTUR DAVIS, Alabama
MELISSA L. BEAN, Illinois
DEBBIE WASSERMAN SCHULTZ, Florida
BARNEY FRANK, Massachusetts

CONTENTS

	Page
Hearing held on:	
April 26, 2006	1
Appendix:	
April 26, 2006	53

WITNESSES

WEDNESDAY, APRIL 26, 2006

Carter, Marshall N., Chairman of the Board, NYSE Group, Inc.	12
Copland, James R., Director, Center for Legal Policy, The Manhattan Institute	42
Evans, Donald L., Chief Executive Officer, The Financial Services Forum	10
Franko, Lawrence G., Professor of Finance, University of Massachusetts-Boston, College of Management	45
Gingrich, Hon. Newt, former Speaker, U.S. House of Representatives	14
Pinelli, Maria, Americas Strategic Growth Markets Leader, Ernst & Young, LLP	41

APPENDIX

Prepared statements:	
Baker, Hon. Richard H.	54
Brown-Waite, Hon. Ginny	58
Hinojosa, Hon. Ruben	59
Carter, Marshall N.	61
Copland, James R.	77
Evans, Donald L.	90
Franko, Lawrence G.	98
Gingrich, Hon. Newt	102
Pinelli, Maria	130

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Feeney, Hon. Tom:	
The Sarbanes-Oxley Debacle—What We've Learned; How to Fix it	140
Hinojosa, Hon. Ruben:	
HESTEC Documents	277

AMERICA'S CAPITAL MARKETS: MAINTAINING OUR LEAD IN THE 21ST CENTURY

Wednesday, April 26, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:10 a.m., in the Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Gillmor, Lucas, Kelly, Feeney, Hensarling, Fitzpatrick, Campbell, Kanjorski, Hooley, Meeks, Moore, Capuano, Hinojosa, Israel, McCarthy, Baca, Lynch, Miller of North Carolina, Scott, Velazquez, Watt, and Davis.

Chairman BAKER. We have the good fortune of having a distinguished panel with us this morning. I very much look forward to hearing their opinions on the issue of global competitiveness.

The ability to have the world's most efficient capital markets is not an American birthright, but rather a position earned through hard work over the years. If the U.S. capital markets are to retain this distinction, there must be a continual recognition of the principles that enabled our historic success. Further, for those who regulate, and for those of us who legislate, these markets must necessarily undergo reform from time to time, to maintain this position of primacy, or we stand to inherit consequences of our own inaction.

Over the last 5 years, both legislators and regulators have spent a great deal of effort in responding to the identified crises and the consequential erosion of investor confidence. Enron, WorldCom, Global Crossing, and Tyco—all of those related matters—caused the Congress to act as a result of the dotcom bubble bursting.

It also brought home the reality that there were material weaknesses not only in the way the companies operated, but perhaps more importantly, in the manner in which the regulatory structure was organized. As a result, Congress enacted a series of reforms, creating the PCAOB, enabling SEC with new actions, and creating other new courses for business management to follow.

As a result of these actions, investor confidence has improved. And with 95 million American households now invested in the markets, investor confidence has never been more important.

Restoring fairness and enhancing transparency in the markets requires continued vigilance. However, I believe our markets are now facing an even greater challenge in order to retain their supremacy in the form of global competitiveness. If the NYSE/Archipelago and the NASDAQ/Instinet mergers were not enough proof of the changing nature of our markets, NASDAQ has just purchased 14 percent of the London Stock Exchange, while the NYSE has expressed interest in gaining a share of a European exchange as well.

Innovations in technology have had dramatic impact on both trading and capital formation. And such innovation has resulted in great strides in increasing market efficiency. Today, U.S. markets are the most sophisticated and technologically advanced in the entire world. But why are so many companies, therefore, choosing to list abroad, in other exchanges, as well as taking IPO's overseas?

I have come to the conclusion there are three basic areas for us to be concerned about: number one, the irresponsible attitude to litigate, and the cost it imposes on businesses, shareholders, and consequently, consumers; number two, inefficiencies in our current regulatory structure of capital markets; and number three, the historical lack of progress in addressing accounting complexities.

These domestic issues, combined with the increasingly efficient and liquid foreign markets, pose significant challenges to our continued supremacy. If unaddressed, these barriers to attracting capital will continue to put the United States at a growing disadvantage in a very competitive marketplace.

Investor protection and global competitiveness, however, are not necessarily contradictory goals. Congress must ensure that the regulatory system is effective, while enabling innovative and profitable activities in the marketplace.

Responsible tort reform is essential to combat the high cost of frivolous lawsuits. Class action suits oftentimes do little to provide restitution to injured investors, but all too often, only enrich a few legal representatives. There is a need for rebalancing justifiable actions vs. frivolous lawsuits. Such review and reform is essential.

As an aside, I would point to actions taken in Sarbanes-Oxley, with the creation of the fair fund, enabling the SEC, through its own legal counsel, to pursue wrongdoers, and to retain and regain control of ill-gotten gains.

Since the passage of the Act, over $7.5 billion has been identified by the SEC for recovery. This is an effective way to respond to unprofessional conduct.

Also, a comprehensive review of the manner in which securities transactions are regulated is essential. Smart and efficient regulation increases the value of a market for both companies and investors. Duplicative and unnecessary regulation does little other than to raise costs and lower returns. Many of the redundant and outdated regulations are within the authority of regulators to address administratively. However, aggressive oversight is still necessary at the Congressional level, and I intend to do so.

Finally, our current accounting environment is being hindered by a rules-based, retrospective view of financial reporting. As we have heard from witnesses in recent hearings, fostering transparency through technological advance is absolutely a necessity. Projects such as XBRL, known as Extensible Business Reporting Language,

will help provide participants in U.S. markets with relevant data more quickly, enabling all market stakeholders to understand and make more informed decisions, moving away from quarterly earnings statements.

And the time reporting will also help to serve minimizing market volatility, while diminishing the need, or incentives, for management to be creative in managing their earnings. This will also assist toward an international convergence of accounting standards, enabling capital to flow more easily at the international level.

For many years, the capital markets were considered by investors to be, in the United States, alone at the top. However, while we have been tying our own markets down with more regulatory rope, China, Europe, and other foreign markets have been pursuing the risk-based model that made our markets great.

The foreign markets have now gained significant ground in the competition for capital. Of the last and most significant IPO's, 23 out of 25 have been issued in foreign markets. Many large companies now prefer to list in London or Tokyo, as opposed to New York. These facts should serve as a wake-up call to all of us.

While we should be very concerned that capital is leaving, we also have an obligation to American investors. With over half of working Americans now invested in U.S. markets, we have a high standard of responsibility to ensure that markets are efficient, but also transparent to these investors. When necessary, there should be regulatory action taken against those who fail to discharge their fiduciary duties.

This is not really a complicated task. The balancing of equities with investor protection and efficient market function just makes sense. When investors have confidence, capital flows freely. A free flow of capital means innovative products and job creation. This is the essence of a balanced capital market. This is what makes America work. We cannot accept anything less. Mr. Kanjorski?

Mr. KANJORSKI. We meet this morning to examine how we can maintain America's lead in our global capital markets. This is an important issue, and I commend you for convening this hearing.

The United States has the strongest, most liquid capital markets in the world. As one of our witnesses comments in his prepared testimony, "With just 5 percent of the world's population, and 25 percent of its gross domestic product, the United States has captured more then 50 percent of the global capital markets." We need to work in Washington to ensure that we continue to maintain that lead to the maximum extent possible.

In my view, we can preserve our lead by continuing to protect investors. About 1 year ago, then SEC-chairman Donaldson delivered a speech in London. At that time, he noted that efforts to promote transparency for investors and the fiduciary duties of corporate leaders are helping to raise standards throughout the world. He also observed that there are still distinct advantages to listing on the U.S. exchange, and registering with the SEC.

He went on to draw a parallel to the United States Marine Corps. Of all of our military organizations, the Marines are known as the best of the best. Because individuals want to be a part of that elite corps, the Marine Corps has traditionally had few problems in meeting its recruitment goals. We want our U.S. capital

markets to be like the Marines, viewed as the elite, and attracting the best companies and the best investors.

The many requirements of the Sarbanes-Oxley Act demonstrate our commitment to maintaining the highest standards in the world's capital markets. Many existing companies have stepped up to, and met, this challenge. Many emerging companies are doing the same. In fact, according to research by SME Capital Markets in 2005, a record 881 small companies registered with the SEC to raise more than $16.3 billion in capital.

That said, we must do more to ensure that small companies are not discouraged from entering the marketplace. Arthur Levitt, another former SEC chairman, recently wrote in the Wall Street Journal that we need to work within the framework of the Sarbanes-Oxley Act to identify ways to make compliance easier and less expensive. I agree with his assessment.

We must also ensure that investors are protected with access to accurate accounting information, regardless of the size of the public company. While it is somewhat off-the-subject for today's hearing, which deals with publicly-traded companies, we must also remember that there are many smaller private companies seeking access to venture capital.

I would be remiss if I, therefore, did not maintain that we must ensure that these fledgling businesses have access to the money needed to grow and thrive, so that one day they can register as a publicly-traded company on a U.S. exchange.

Additionally, many of the participants in today's hearing will doubtlessly observe that we live in an increasingly global economy. Some others may point to one variable or another, like excessive regulation, frivolous litigation, unwarranted taxation, or lagging education as a reason why the U.S. capital markets may lose their competitive edge.

In reality, we live in a multi-dimensional world, and no one factor alone is likely to contribute to America's continuing success or decline as the world's leading capital market. To ensure that we maintain that dominant role, we need to adhere to the principles of making sure that we have the quality of capital markets with appropriate investor protections.

In closing, Mr. Chairman, today's hearing should help us to better understand what we need to do to make sure that our capital markets continue to lead the world. We should, in my view, remain on the cutting edge of quality regulation, ensure that every corporation plays by the rules, and make certain that all investors have access to reliable information needed to make prudent decisions.

We must also strive to ensure that each party who violates our security laws is held appropriately accountable. I look forward to hearing from our distinguished witnesses on this matter.

Chairman BAKER. I thank the gentleman. Are there further opening statements? Mrs. Kelly?

Mrs. KELLY. Thank you, Chairman Baker, for holding this hearing. I believe that keeping the United States competitive is vitally important. While today's hearing is going to focus on regulatory and legal barriers to competitiveness, the greatest threats to our competitiveness right now are the continuing rise in energy prices

and the threat of terrorism backed by the specter of an Iran that may be building nuclear weapons.

Our financial markets, no matter how well managed and regulated, will not be global centers of excellence if the economy they support is ravaged by declining production from high energy costs, or decimated by terrorist attacks. I look forward to asking each of the witnesses to address what we can do to protect our markets against these twin threats that we currently face.

I appreciate you holding this hearing, and I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady. Ms. Hooley?

Ms. HOOLEY. Thank you, Chairman Baker and Ranking Member Kanjorski. Thank you for scheduling today's timely hearing. I hope it marks just the beginning of a critical debate about what actions should be taken to maintain, and even grow, the competitive advantage that our capital markets have earned in this last century.

As the policymakers, it is critical that we work proactively to avoid losing our dominant role in global capital markets, rather than being forced to play catch-up after our advantage has been significantly diminished.

At the same time, we should not act too hastily, and become engaged in a race to the bottom against our global competitors. Confidence is king, and we should not sacrifice investor confidence for a quick fix. While some will say IPO trends in the past year indicate a down turn in the fortune of our markets, I would note that, after closer examination, many of last year's largest IPO's were a result of emerging capital markets, the listing of state-owned enterprises, geographic barriers, and increased global competition.

In fact, I believe it is somewhat disingenuous to argue that many of these companies would have listed in the United States if only regulations or litigations were lessened. Many simply listed on their more natural markets.

I believe our markets maintain a significant advantage due to their well-earned reputation for transparency, good corporate governance, and appetite for innovation. These pillars of our markets continue to lead to significant valuation of U.S. offerings, valuations that are unmatched throughout the globe.

Our markets remain pre-eminent in effectively raising capital. With leadership in our investment community and among policy makers, we will maintain our status as home to the world's strongest capital markets. In short, the sky is not falling, but we can do better.

I look forward to working with members of this committee and with our investment community in a thoughtful way to facilitate the strongest and most innovative capital markets possible. And I yield back the remainder of my time. Thank you.

Chairman BAKER. I thank the gentlelady. Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman, and thank you for holding this hearing. With the noticeable exception of high gasoline prices, we are clearly enjoying one of the best economies that we have enjoyed in quite a number of years. Over five million new jobs have been created, and in a little less than 3 years we have one of the lowest unemployment rates we have enjoyed in 3 decades. We have the highest rate of home ownership that we have had in

the entire history of the United States of America. Household net wealth is up, income is up. These are the benefits of capitalism.

But you can't have capitalism without capital. And clearly, there are a number of worrisome trends that we see. They may be trends. But I was looking ahead, for example, to Speaker Gingrich's testimony, and learning that recently the London Stock Exchange had recorded 129 new listings by companies from 29 different countries. And in the United States, NASDAQ gained a net 14, and the New York Stock Exchange, net 6.

Clearly, there are some facts out there that should worry us, including 23 of the top 25 largest IPO's being registered outside of the United States.

So, again, as I talk to members of—people who are actually out in the real world, rolling up their sleeves and creating jobs, talking to them about capital markets, I hear the same refrain over and over and over, and that is too much regulation, too much litigation, and too much taxation.

And although it doesn't make a sexy sound bite, it was good that our committee would actually engage in looking into some cost benefit analysis, and looking very carefully—although we know the benefits of much of what we do, and obviously Sarbanes-Oxley was a terribly important law, and needed to restore confidence in the investor marketplace, too often we know, Mr. Chairman, that we, as Members of Congress, collectively do excel in unintended consequences, and it is good that we should look at these unintended consequences, and ensure that we do not imperil our global leadership in the capital markets, and do something that would undermine our great dynamic economy today that is helping to lift so many families and so many members of our Nation out of what would otherwise be low economic circumstances. And with that, I yield back.

Chairman BAKER. I thank the gentleman. Mr. Moore, do you have a statement? Mr. Moore? Mr. Capuano? Are there any further opening statements? Mr. Baca, then we are going to go to Mr. Hinojosa, and then Mr. Scott. Anybody else? Okay, we have one here on the side, too. Mr. Baca, please proceed.

Mr. BACA. Thank you very much, Mr. Chairman, and Ranking Member Kanjorski. I am pleased to be here today to discuss the global competitiveness and how to maintain our lead in the global economy.

While the United States still leads the world in economic power, our percentages are dropping, and we must be on guard to prevent further erosion. A number of factors can explain why our dominance is decreasing.

For starters, corporate abuse continues to harm our economy and erode public confidence. CEO salaries have gone through the roof into hundreds of millions of dollars, where the Federal maximum wages haven't increased since 1997. We must do more to rebuild public trust and protect the American investors, and we must hold executives accountable.

I know that Sarbanes-Oxley has not been popular with business communities. And as a former small businessman, I am sympathetic. For some small businesses, the burden of complying with filing requirements has been very burdensome. Some small busi-

nesses—the small business is the engine that sustains America and creates jobs. So we must make sure that Sarbanes-Oxley is implemented in a way that makes sense.

But if we are serious about keeping America strong, we must put our priorities in order. We must train our workforce for tomorrow's jobs. Today, fewer than 4 in 10 students who graduate high school will go on to college. At this rate, the United States will face a shortage of up to 12 million in the college-educated workforce by the year 2020, and we must close the gap. Closing the gap could add $250 billion to the Nation's GDP, and $85 billion in tax revenue.

We must ensure that the American companies compete in a level playing field, and we must break barriers in corporate America. Hispanics are the largest minority group and the fastest growing consumer segment. Hispanics remain unrepresented in the workforce and corporate boards and investment world.

As chair of a corporate American task force, I have led the fight, along with my colleagues, to ensure that qualified Hispanics are positioned for corporate America; to increase procurement for Hispanic-owned businesses; and to increase diversity in corporate senior management and corporate boardrooms. Removing these barriers will contribute to higher innovation and more productivity, and will enhance the American position in the global economy.

With that, I look forward to hearing what our witnesses have to say about this issue, as well. Thank you very much, Mr. Chairman. I yield back the balance of my time.

Chairman BAKER. I thank the gentleman for yielding. Mr. Feeney?

Mr. FEENEY. Thank you, Mr. Chairman. And I really appreciate our distinguished panel. I will be brief, because I am excited to get to them. I am very interested in, now that we have some history with Sarbanes-Oxley, in the imposition, sometimes unnecessary imposition, that is put on the United States economy.

According to one set of experts from the American Enterprise and the Brookings Institute, Mr. Butler from Chapman University, Larry Ribstein from the University of Illinois, the indirect costs of Sarbanes-Oxley compliance can be estimated at about $1.1 trillion to the United States economy.

Sarbanes-Oxley did an awful lot of good, in terms of providing for accountability and transparency, conflict management, and internal controls. But I am very interested, if the witnesses can, in addressing what is good about Sarbanes-Oxley, what is unnecessary, redundant, and bad about Sarbanes-Oxley, and what fixes they think can be done by the SEC and the accounting oversight board. And then ultimately, is there a legislative fix that is necessary?

So, I am thrilled to have this distinguished panel with us, and very interested—since this committee has direct responsibility for the Sarbanes-Oxley compliance issues—in how we can be helpful in protecting investor confidence, keeping what's good, but reforming what needs to be reformed. And with that, I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman. Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman. I want to thank you and Ranking Member Kanjorski, and to express my sincere appreciation to you for holding this hearing today.

The United States is currently at a crossroads. We can either decide to move toward a more responsible, effective form of government than we presently have, or we can continue down the road that has led to the rise and fall of great nations. Today's hearing is entitled, "America's Capital Markets: Maintaining our Lead in the 21st Century."

I find it an interesting title, since some naysayers contend that we have already lost our lead in the capital markets, or at least are sliding down a slippery slope towards such a loss. I am not going to go into all the ins and outs of arguments that say we are still the lead country, in terms of capital markets, the lead economy, or the true sole superpower in the world. I will leave that to those who will testify here today: Secretary Donald Evans; Mr. Marshall Carter; and the Honorable Newt Gingrich. I look forward to hearing their presentations.

Mr. Chairman, what I am most interested in is ensuring that our markets do remain competitive, and I believe that this requires an intensive and comprehensive investment in our children and their education, particularly in the stem careers of science, technology engineering, and math.

To address this situation, I collaborated with The University of Texas—Pan American to develop Hispanic Engineering, Science, and Technology Week, known as "HESTEC week." It's a year-round leadership program that emphasizes the importance of science literacy to thousands of pre-K to college students and teachers through professional development workshops, presentations by world-class speakers, competitions, and hands-on activities. Participants are encouraged to prepare for studies in math, engineering, technology, and science.

Mr. Chairman, at this point I would ask that all of these documents pertaining to HESTEC be included in the record.

Chairman BAKER. Without objection.

Mr. HINOJOSA. Trying to bring this to a close, I want to say that the importance of HESTEC has never been greater. Statistics show that the United States is falling behind in the number of students excelling in those areas that I mentioned. During HESTEC, we give children and teachers the necessary tools, and encourage them to reach for new heights. HESTEC allows students and educators to interact with some of our country's top CEO's, engineers, scientists, astronauts, and designers.

Events like Educator Day, the Hispanic Science Leadership Round Table, Latinas in Science, Engineering and Technology, Robotics Competitions, and Community Day allow students and educators the opportunities to meet top role models, and learn valuable leadership lessons.

HESTEC is a key ingredient to ensuring that our Nation continues its entrepreneurial spirit, and that our capital markets remain competitive and world class markets. Mr. Chairman, I cannot stress enough how important it is for the United States to produce additional scientists and engineers. We need to do so in order to continue to be able to compete with our overseas counterparts,

much less to remain a superpower. It is my hope that all of those present at today's hearing will review information on the HESTEC program at www.hestec.org. Mr. Chairman, I yield back the remainder of my time.

Chairman BAKER. I thank the gentleman. Mr. Israel, did you have a statement?

Mr. ISRAEL. Thank you, Mr. Chairman. I will be very brief. I just want to point out to everyone that I am particularly pleased to see Mr. Carter here. We had a good meeting yesterday.

And Mr. Carter and Speaker Gingrich may not be aware of this, but they have something in common, other than the fact that they are on the panel today, and that is that they are both Civil War historians. Mr. Carter was in my office yesterday, saw a photograph I have of Joshua Chamberlain, and we debated, Mr. Speaker, whether Little Round Top really was a turning point in the Civil War, or, as some of my friends call it, the War of Northern Aggression.

So, I appreciate you being here. I know this isn't about Civil War history. I just wanted to point that out, and I am looking forward to your respective comments.

Chairman BAKER. I am pleased to have a cessation of hostilities, Mr. Israel. Thank you.

Mr. Miller? Mr. Scott?

Mr. SCOTT. Yes. Thank you very much, Mr. Chairman. I, too, want to congratulate you and Ranking Member Kanjorski for holding this very, very timely and important hearing today on the strength of America's capital system in the global marketplace.

The American financial system remains the vanguard of world markets, without a doubt. And we must maintain that strength. The high standards that we have continue to give respect and status to the companies that list in the United States. And even though we have the best capital system, we must not be too comfortable with our position.

The American markets continue to face strong competition from foreign markets. And I am very concerned with the wide number—as to why a large number of companies are delisting from American exchanges. We have to ask why companies would choose to remove themselves from American exchanges.

I am concerned about the impact of the financial services sector now moving to replace manufacturing as the dominant income-generator and money-maker in our system. What does that portend to the future of our country and our position in capital markets?

I am also concerned about our overwhelming debt, and the deficit, and the impact of having so much of our debt in the hands of foreign nations and foreign institutions. What does that portend for us? The complexity of our tax code, and that is driving many of our foreign partners away from us.

I also want to talk about—a little bit about—the need to invest in human capital, as well as our infrastructure. It has been mentioned before, but our failure to properly address, and give the incentives and encourage our young people to go into math and into sciences, and put the rewards systems there. Further attention and resources are certainly needed for our science and math education. And we must also consider, of course, revisions to our regulatory

and our tax structure so it is consumer-friendly for our foreign friends.

But as we discuss the global marketplace, I just want to take one moment to welcome my good friend from Georgia, former speaker Newt Gingrich, as a witness today. Speaker Gingrich has been a bright and shining light, an illuminating source of fresh and bright ideas on how we can keep our American economy and our economic system at the forefront. And I welcome you here. You continue to be a source of global innovative thinking.

And Speaker, as you may know—I don't know if the rest of America knows—but I am honored and privileged now to soon be representing a great part of your former district in the House of Representatives, in Cobb and Douglas County. So we are glad to have you, as a fellow Georgian, and I am sure you will add so much to our hearing today.

As this subcommittee discusses the future of our markets, we must keep in mind the need to have an efficient system that provides the best prices and information for a wide variety of investors. I look forward to our meeting, and I yield back the balance of my time.

Chairman BAKER. I thank the gentleman. I welcome each of our witnesses here this morning. The committee is particularly excited to have such a distinguished panel on this most important subject. And as you can tell, members' interest is significant, and the expression of concerns about our current posture in international markets is prevalent. And we are not clear as to the steps we should take to enhance our competitiveness, but we are greatly interested in hearing each of your perspectives and your recommendations.

As each of you are quite familiar—I just say it for the purpose of saying it—your entire statement will be made part of the official record. Please feel free to proceed as you would like. We request that you try to keep your remarks to 5 minutes to enable what I believe will be a lengthy question period.

And at this time, I would welcome our first witness, Secretary Donald L. Evans, currently the chief executive office, The Financial Services Forum. A pleasure to have you here, sir.

STATEMENTS OF DONALD L. EVANS, CHIEF EXECUTIVE OFFICER, THE FINANCIAL SERVICES FORUM

Mr. EVANS. Thank you, Mr. Chairman. Let me join the chorus of thanks to you for holding this hearing, and for your focus on America's competitiveness. I have certainly enjoyed our discussions on the subject, as well as discussions with other members of this committee on the subject. It was certainly a focus of the President's State of the Union Address, and I compliment you and the entire committee for staying very, very focused on this most important subject for America's ongoing leadership in the global economy.

Chairman Baker, Vice-Chairman Ryun, and Ranking Member Kanjorski, thank you for the opportunity to participate in today's hearing on ways to preserve the competitive position of the U.S. capital markets. Today's hearing is both important and timely. America stands at a critical crossroads in our history as a Nation.

Faced with the realities of globalization and international competition, will the United States retreat behind a wall of self-delusion and the false protections of tarriffs and trade barriers, pretending the world hasn't changed fundamentally and permanently, or will the United States embrace and meet the challenges of competition, to the betterment of all Americans, and the world?

By calling this hearing today, Mr. Chairman, you have signaled that you understand that America must not turn inward. The financial services industry thanks you for your vision and your leadership. Not only would such a course be very damaging to the U.S. economy, the world at this critical juncture in history continues to need the United States to lead by example.

Mr. Chairman, you are correct when you say that being the world's premier capital market is not our birthright. We earn that distinction by working to make the United States the marketplace of choice. In that regard, I think it's important to emphasize that preserving the international competitiveness of the U.S. capital markets begins with preserving the strength and vitality of the United States economy.

The 20 members, CEO's of the Financial Services Forum, meet twice a year, our most recent meeting occurring earlier this month. At that meeting, for the first time, we conducted a survey of our members regarding their outlook on the U.S. global economies. As part of the survey, we asked our CEO's to rate, in order of seriousness, a dozen potential threats to the U.S. economy.

The four most important threats, according to our CEO's, or the four most serious threats, according to our CEO's, were: one, energy prices; two, health care costs; three, terrorism; and four, U.S. Government's unfunded entitlement liabilities. Rated closely behind were complex regulations and frivolous litigation.

We also asked the CEO's to rate a number of the potential actions taken by Congress to reflect their importance to keeping the United States competitive in a global economy. Our CEO's rated each of the following actions very highly: promote free trade; improve U.S. education; address unfunded entitlement liabilities; address litigation reform; extend tax cuts on capital gains and dividends; and address general tax reform.

Clearly, our financial sector leaders believe that Congress has much important work to do to keep the United States competitive in an increasingly global economy. As you know, capital is the life blood of any economy's strength and well-being, enabling the research and risk-taking that fuels competition, innovation, productivity, and prosperity.

The foundation of any competitive capital market is investor confidence. When investors put their hard-earned capital at risk by purchasing shares in a company or its debt securities, they must have faith that the company is telling the truth about its business and its finances.

We all want an equity listing in the United States to be what it has been for nearly 80 years: the global gold standard. But it is also true that successfully competing for scarce capital is becoming more difficult by the day. Simply stated, the United States is no longer the only game in town. It is entirely in keeping with the principles of our corporate governance standards to re-evaluate

whether the rules and regulations written to implement those principles are effective and appropriate.

Do they impose unnecessarily high and costly burdens on regulated firms, particularly small businesses? Do the costs of meeting the requirements outstrip the acknowledged benefits of listing in the U.S. markets? Are there steps that can be taken to alleviate some of the burden and cost, without undermining investor confidence?

Asked another way, do certain of our securities laws make it easier or harder to compete in the global economy? These are reasonable, prudent questions to ask. And preserving a strong and vital capital marketplace is too important to the future of the United States not to ask them. Thank you very much for the opportunity to appear before your subcommittee, Mr. Chairman.

[The prepared statement of Secretary Evans can be found on page 90 of the appendix.]

Chairman BAKER. Thank you, Mr. Secretary. Our next witness is Mr. Marshall N. Carter, chairman of the board, the New York Stock Exchange Group. Welcome, sir.

STATEMENT OF MARSHALL N. CARTER, CHAIRMAN OF THE BOARD, NYSE GROUP, INC.

Mr. CARTER. Thank you. Chairman Baker, Ranking Member Kanjorski, and members of the committee, thank you for inviting me to testify on this issue of the competitiveness of U.S. financial markets. Chairman Baker and the committee are exercising strong leadership to address this issue at this time.

For the past 50 years, global leadership of U.S. capital markets has been unmatched. Our markets are the most open, honest, liquid, and also the deepest in the world. They have enabled the United States to remain at the center of global capitalism, as the world's leading engine for capital formation, job creation, and economic growth.

U.S. capital markets are still the world's best. However, we are facing stiff challenges. Let me outline the challenges, and discuss the reason why our leadership is being contested. I will conclude with a proposal to strengthen U.S. competitiveness, and enable U.S. markets to regain the initiative.

First, the challenge to U.S. financial markets is real and growing. Despite a welcome resurgence in global IPO's, fewer are listing in the United States. In 2000, 9 of the top 10 IPO's were registered on U.S. exchanges. By 2005, only 1 of the top 25 global IPO's were registered in the United States, and none of the top 10. Even with privatization and mergers, that's a significant drop, as Congresswoman Hooley mentioned.

In addition, more companies qualified to list in the U.S. markets are listing overseas. And some currently listing on U.S. markets are actively delisting. Capital formation, though, is still robust. $86 billion was raised through 224 IPO's for non-U.S. companies last year. However, this capital was raised privately through 144A IPO's, which are not registered.

Unfortunately, when capital is raised privately, millions of U.S. investors cannot participate, and accepted standards for corporate governance and transparency do not apply.

The landscape is changing for four reasons. First, there is a rising perception abroad that litigation in the United States has run amuck. Increasingly, the United States is seen as a place where individual companies can be bankrupted by a single lawsuit, and their executives and directors placed at personal risk. Facing such threats, companies are saying, "No thank you," and opting out.

Second, we lack convergence in international accounting standards at a time when the realities of globalization mandate we need it the most. European companies are moving to a common standard. They wonder why they must meet the U.S. requirement for a separate reconciliation of their accounts, which is costly and redundant. Again, they are saying, "No thank you," and are choosing to raise capital elsewhere.

Third, overseas markets, especially in Europe, are growing deeper and more liquid, and benefitting from the success of the Euro. As foreign markets become better capitalized, and offer a greater choice of products, including the ability to trade across countries, they are taking away U.S. market share. It is happening from London to Hong Kong.

Fourth, while Sarbanes-Oxley has strengthened investor confidence and reformed corporate governance, many companies believe the additional costs of annual section 404 reviews outweigh the benefits. To be sure, some of these costs are coming down, and that's good news.

Nevertheless, when companies who recently listed IPO's on the London Exchange were polled, 90 percent responded that London's rules of corporate governance were more attractive, meaning less costly and burdensome. Section 404 is often cited. However, audit firms are also criticized for requiring a one-size-fits-all approach, and for raising fees for certification.

Mr. Chairman, we are not here to complain, but to propose a course of action. Our solution is not to replace or reopen Sarbanes-Oxley, which we believe has strengthened investor confidence and the integrity of corporate governance. We believe that three common sense reforms can stem the erosion in listings, and re-invigorate U.S. capital raising competitiveness.

First, we would urge Congress to move forward with meaningful tort reform. Second, we would move rapidly to harmonize accounting standards. We strongly support SEC Chairman Cox's drive to eliminate the requirement for foreign issuers to reconcile their internationally accepted accounting standards to U.S. standards.

Third, we would initiate a risk-based approach to annual 404 certification. Companies and their auditors would annually review the internal controls of only the most risky of operations in finances, those that would have a material and significant impact on the company's earnings or operations.

Let me be clear about what I am suggesting. Guidelines for what constitutes risk-based activities would be determined by the accounting oversight board and the SEC. A company would have to pass the annual audit of these risk-based materially significant criteria. Then, and only then, consideration should be given to permitting the company to undergo a full baseline 404 audit every third year. We believe a pilot could easily be done on this concept by the SEC.

I would like to point out that the accreditation of hospitals and audits occurs only every 3 years. Ensuring that our hospitals are safe for patients is arguably more critical to the safety and well-being of the American people.

Should the United States fail to act to reverse the trends we have heard here today, U.S. investors will follow the flight of capital to overseas markets, and we will become more vulnerable. They risk losing the protection of the U.S. regulatory regime, the gold standard, and a regime that offers greater transparency than any other in the world. Our financial markets will become less liquid, and their preeminence and leadership will be in doubt.

The U.S. economy, deprived of precious capital, risks becoming less innovative, dynamic, and prosperous, and we could face substantial job losses in the financial services sector.

So, in conclusion, let me say that, despite the resurgence in global equity financing, the U.S. financial markets are losing the competition for these new listings. We clearly cannot afford to be passive and do nothing. We look forward, Mr. Chairman, to working with our regulators and the members of your committee to bring about that desired result. Thank you.

[The prepared statement of Mr. Carter can be found on page 61 of the appendix.]

Chairman BAKER. Thank you very much, sir. And our next witness is the Honorable Newt Gingrich, former Speaker of the House. Welcome, sir. Please proceed as you like.

STATEMENT OF HON. NEWT GINGRICH, FORMER SPEAKER, U.S. HOUSE OF REPRESENTATIVES

Mr. GINGRICH. Thank you, Mr. Chairman, and I want to thank both you and Ranking Member Kanjorski for hosting us, and allowing us to come and talk about a very, very important topic.

You have heard from the former Secretary of Commerce, and from the chairman of the board of the New York Stock Exchange, that we are concerned about whether or not we will retain our leadership role. And this leadership role is very important, because it divides both the capital for our new businesses, and the opportunity for the kind of wealth creation which has made us, for the last 160 years, the most successful society in the world.

I am not going to repeat the concerns that they had. I just want to start by saying that I do think there are some parts of Sarbanes-Oxley that need to be significantly revisited. The work that has been done by both Alex Pollock and Peter Wallison of the American Enterprise Institute—I outlined some of that, and I submitted that for the record as part of my written testimony.

I would say, in particular, that the Congress should consider making the section 404 voluntary. In recent House subcommittee hearings, Representative Gregory Meeks of New York described the experience of an unidentified 65-employee New York biotech company with a market cap of $99 million, specializing in Multiple Sclerosis and spinal cord injury products. They spend $4 million a year on clinical trials, and $1 million for section 404 compliance.

The entire issue of BioCentury for April 24th is devoted to this problem. And the work that Pollock and Wallison have done, I think, shows overwhelmingly that 404 is clearly very anti-small

business, very anti-entrepreneur, and very anti-start-up in the way it's been exercised. And the easiest way to deal with it would be to make it a voluntary act, and then the market will decide.

If people think it, in fact, is an extra layer that they want to pay for, they will invest more in companies that have that procedure. If, in fact, they think it's not protecting them, they're not going to invest in it, and companies won't do it. But make it a marketplace opportunity, don't make it a government mandate. I think that part of Sarbanes-Oxley was both over-reach, and frankly, has turned out to be something like 50 times more expensive than the original estimates.

So, Congress ought to recognize that this did not work the way people thought it would. It is not the right thing to do. And you have to fix that. You are going to hear from James Copland that the Center for Legal Policy, the Manhattan Institute, and I think that he will give you a strong feeling for this, but Marshall Carter has already testified that—about the problems of litigation. Let me offer you a set of reforms.

One, I think that Congress should hold hearings on the impact of State attorneys general, and the way in which they have been using, frankly, criminal blackmail in which attorneys general in New York and elsewhere say to corporations, you know, "Cut this deal, or you're going to risk going to jail." And very often involving cases they can't possibly win in court, but where the risk of going to jail is so great that they are creating economic havoc.

And attorneys general in the United States are becoming a major problem. As a side part of that, Congress should also look at the degree to which attorneys general who are supposed to be instruments of the State are now hiring private sector trial lawyers to engage in, basically, a form of blackmail in which the private sector lawyer gets a large share of the recovery, the State gets a large amount of money, and companies are basically held hostage, because they're not in an equity fight. They're in a fight where they're going to go to jail if they lose.

And so, it's a total abuse of the power of government. I also would urge Congress to pass a law instructing the Executive Branch that any interstate compact that is not approved by the Congress be filed in court automatically as being a violation of the Constitution.

You have a number of attorneys general around the country who are now routinely cutting deals that have a direct effect on the United States economy. That is a clear violation of the Constitution, which requires that interstate compacts be approved by the Congress, or they be null and void.

In terms of litigation reform, the system needs to be reshaped to favor arbitration over litigation. We should have the British losers pay model, where people who file phony claims would have to pay back not just the cost of litigation, but if it's truly phony, would have to pay 3 times the cost. The caps Congress has tried to bring to bear on malpractice and other kinds of litigation is exactly right.

In addition, I would argue that law firms should be prohibited from bringing class action suits. If a class action is formed, the judge should allow the class to apply to law firms to file, and then pick the law firm which has the lowest bid. What we have created

today is an engine of self-aggrandizement and greed on the part of law firms that are machines for encouraging litigation.

I also would strongly recommend that you explore banning lawyer advertising. I think the rule on that is, frankly, wrong. That's not a First Amendment right, and it strikes me as stunningly destructive to the country.

You should look carefully at the Sarbanes-Oxley litigation time bomb, which is going to presently swamp the courts, because Sarbanes-Oxley sets up two great burdens. In addition to the regulatory burden, which accounting firms, obviously, enjoy and support, it also sets up the burden of many more lawsuits, and it sets up a burden that bond holders may have a cause of action for the simple failure to comply on time. And this is going to lead to a morass of lawsuits and of liability, and further drive businesses outside the United States.

Three last things I just want to mention as it relates to what you're doing. There is a project to create a much more effective business language, and I would strongly—apparently, we have been doing some research on this—it apparently involves about $3.5 million to finish this. It's very important in creating the kind of language—XBRL is the title of it—which enables us to have a very, very sophisticated ability to compare financial data at very, very low cost.

It is absurd that this is sitting out there being worked on, I think currently, by one person, because it's essentially a voluntary project. For $3.5 million, the Congress could bring that online, and enable the United States to have a modern system of transparency.

Chairman Cox, who is certainly very entrepreneurial in his own right, should be encouraged to really transform the Securities and Exchange Commission into a model 21st Century Federal agency.

There is a paper I produced—you can see it at Newt.org—on 21st Century entrepreneurial public management. But the essence of it is very simple. Entrepreneurship focuses on outcomes. Bureaucracies focus on process. Every time we have a scandal, we have a new set of process reforms which add another layer of burden to the next scandal, and we have another layer of process reforms. That is, in fact, a very obsolete model of trying to play catch-up. And I would strongly—I would encourage you to encourage Chairman Cox to look at a very dramatic proposal to rethink the way the SEC operations.

Lastly, I would urge the Congress to revisit the question of stock options. It seems to me that particularly for small companies and for start-ups, there is an alternative model of being able to account for the dilution of stock value by the author of an options in a way which is much less discriminatory against giving options—stock options, historically, were a major method of attracting energetic talent to work very long hours for very small pay, because they had a huge upside.

By requiring the kind of expense accounting we do today, we are dramatically limiting that kind of incentive. And over the next quarter of a century, that is going to substantially lower the amount of innovation and then start-ups that we have.

And I would encourage you, for new businesses and for small capitalization companies, to strongly revisit how we deal with stock

options. So I appreciate very much the chance to offer these observations.

[The prepared statement of Mr. Gingrich can be found on page 102 of the appendix.]

Chairman BAKER. Thank you very much, Mr. Speaker. And I must say, I appreciate each of your thoughts and considerable contribution to our hearing this morning.

I want to maybe take in steps what I believe, based on your comments, may be an advisable process to engage in over the foreseeable future. It was not something that would happen tomorrow.

Starting with Mr. Carter's proposal relative to the 404 pilot, that would be enabled by the SEC administratively, without the necessity of Congressional action. But that should be, I think, a precursor to a more long-term examination of the 404 requirements, if not increasing the requirements that trigger compliance—in other words, get some of the smaller companies now subject to the requirements exempted, or even a longer period of re-examination, as the pilot may demonstrate is feasible to accomplish—and then, over time, move to the Speaker's recommendation as to the advisability of a voluntary compliance.

I think the market has already voted, to some extent. The disclosures you have made today, relative to IPO's and the flow of capital, is already occurring. We need to understand the mechanisms, why this is the case. I think each of the reasons you have outlined are contributors, but we really need to understand the market decision-making process that causes a company to choose to avert our regulatory system.

For example, another step would at least be to require a loser pay mechanism necessary for—to stem the flow of frivolous litigation.

Another step would be to accelerate the pilot already completed at the FDIC on the implementation of XBRL, and make it applicable to all depositories, insurance depositories, within the next year. And assuming the taxonomy can be developed properly, then deploy it to all public operating companies with a view toward a more principles-based real time disclosure, and in my view, eliminating the quarterly earnings report, which I think contributed vitally to the—to managerial interest in creative accounting to beat the Street.

If we couple that with logical tax code revisions to enable people to keep the money they make, maybe we've got a chance. But I will say that I am very concerned about what I see happening not only in India, but soon to come in China, and that unless there are some basic structural changes from where we stand today, vis a vis our foreign competitors, we are going to be the victims of our own ideology.

We have always, as Americans, said, "We are proud to stand up and compete with anybody, because we can outproduce, make a better product at a lower price; just get out of our way." I am afraid that we have created a box, intended for good purposes, to protect investors from manipulative action, and the consequence of that system is to establish a bureaucracy which does not enable efficiencies to be realized in a competitive marketplace.

And I left out a couple of the things that the Speaker brought up that I have footprints on my back to know they're controversial, relative to attorneys general.

In the Clinton Administration, the Congress prevented State legislatures from, in any way, affecting market structure in the securities world. I tried a couple of years ago to provide that same standard for State attorneys general—not to preclude them from pursuing wrongdoing, but where they were to require a market remedy that affected structure that they should at least consult with the SEC before proceeding, and obtain their agreement. It turned out to be more controversial than I first estimated.

And with regard to expensing of options, I have agreed with you, and I have the voting record to prove, that I was not right, either. But I do believe those issues are things we need to return to over time, not precipitously, and lay out an agenda for a competitiveness that I think is highly defensible.

Now, I have made more of a statement than asked a question, but can you add on individually to the list? I know, Mr. Evans, Secretary Evans, that the CEO's have identified their priorities. Would that agenda be responsive to your CEOs' concerns?

Mr. EVANS. Mr. Chairman, I think in great deal it would be. I don't think—let me say this. I have seen some studies that have asked a question as to whether or not Sarbanes-Oxley has been a reason other countries have—other companies have chosen to invest and list outside of the United States, as opposed to in U.S. capital markets.

To me, Sarbanes-Oxley has become kind of a metaphor for all of the various elements that we're talking about here, where Federal Government gets in the way of productivity, gets in the way of corporate boards making good decisions. And one of the most important areas—I don't think you can emphasize it enough—is in frivolous litigation.

I think that is an issue that has been around for many, many, many years. And as I talk to CEO's across the country, I think that is at the top of the list. I mean, some of the issues that we're talking about with respect to Sarbanes-Oxley I think are important to look at and review, particularly 404. I think maybe it's putting too heavy a burden on the small and medium-sized companies, and that needs a serious look. Maybe there are some adjustments that can be made there, and maybe it's a volunteer kind of program, or whatever it might be.

But I don't think you can put enough emphasis on the importance of tort reform, the litigation reform, frivolous lawsuit reform in this country. This is—among the CEO's, among corporations around the country and around the world, they view America as a very litigious society. And so, as they hear more about that, they see more of the disasters of companies being closed or shut down, they say, "I don't want any of that."

And so, I think if I was going to pick an area that I would really put a lot of emphasis on, and a lot of focus on, it would be the whole area of tort reform, litigation reform, and frivolous lawsuit reform. I think that can do more to kind of restore the confidence of companies here in America, and continue to kind of move this

country in a direction that has made it so strong in a global economy, which—we're not afraid to take risks.

When you put kind of—when you have—when you're worried about being sued around every corner, then you become risk-averse. And if you're not taking risks, you're not being innovative. And if you're not being innovative, you're not being productive. And if you're not being productive, the economy is not growing.

So, I just—I think it puts a chilling effect within the board rooms of America, and with small business owners, that they are less likely to take risk, for fear of being sued, fear of having a frivolous lawsuit.

And so, I mean, as I look at all these issues that we're talking about, I think they're all important to address. But if you want me to put one at the top of the list, that's one that I would put at the top of the list.

The other thing I would say that I don't think has been mentioned here, what happens in board rooms and businesses across America, they are spending far too much time dealing with these kind of process issues, and governance issues, and jurisdiction issues, and not near enough time on the strategy of their company, and where to invest, and where to take risk, and where to place capital.

So, it's a big time drain. It's a big energy drain on the leaders of businesses, small, medium, and large, across America. So—and that's something that doesn't get mentioned. Congressman Feeney talked about it costing $1.1 trillion. I'm not sure where that number came from, but the only place I could see it coming from would be all of the time it cost these boards and businesses, in terms of just dealing with this over-regulation, and worrying about lawsuits, etc.

My time is way expired. I will come back in the next round and follow-up on my questions. Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman. I want to make two observations before I start. I am really proud to be—and Mr. Israel pointed out that the Speaker and Mr. Carter are Civil War veterans, and I'm proud to be in your presence.

[Laughter]

Mr. KANJORSKI. But I want to make a second observation regarding my home State of Pennsylvania. We have two characters here, one on the committee, Mr. Scott, who was born in Scranton, Pennsylvania, and had to go south to Georgia to get elected to Congress, and Mr. Gingrich, who was also born in Pennsylvania, Harrisburg, and had to go south to get elected to Congress, which may indicate the flexibility and mobility of the American society. And I would tend to think that maybe that speaks well for our society in the past, coming up to the future, since we sent two of our great sons and bright candles south to help out the—

Chairman BAKER. Careful now, careful.

Mr. KANJORSKI.—and lessen the retardation of the South.

[Laughter]

Mr. KANJORSKI. All that having been said—nastily, but in a friendly spirit—Mr. Gingrich, I appreciate your comments. But you know, it's interesting that you make this observation about Sar-

banes-Oxley at this point in time, when the Enron trial is in process.

And listening to your argument, you would think that we all sat up here a number of years ago, and said, "How can we jab a stick in the eye of American corporations?" And as you recall well, in history, that's not what happened. American corporations became abusive, to huge extents—particularly Enron—costing believing, innocent investors billions of dollars of their savings. And I think there is a responsibility of the government, as a last resort, to step in when there is irresponsible corporate activity.

To listen to your argument, and the Secretary's argument, well by golly, we should just go back to laissez faire, because 4 years is a great time that's past, we no longer need these protections. It's corporate America that caused Sarbanes-Oxley to be enacted, not the reverse. We didn't want to do it.

And I guess I worry about as much the protection, not only of the investor, but also the worker. I didn't hear anything arguing to whether or not we have a fair return to the average worker in American industry, even though we have had this great productivity and all this efficiency that has occurred over the last decade or two. When you look at the numbers, to how that has squared to the average working American, they haven't been too successful.

But let's look at the real facts of Sarbanes-Oxley. The Stanford Law School did a study on security law filings. And they found that they dropped from 213 in 2004 to 176 in 2005, below the average of the 8-year period from—in 1996 to 2004, of 195 cases a year. They attributed that dropping to the success of Sarbanes-Oxley.

And in—the drop that continued even occurred when there were 1,200 restatements in the year 2005, and that the errors found in those restatements wouldn't have been found, except for Sarbanes-Oxley.

Now, we are not dealing with a few errant executives or boards here, we are dealing with a pervasive activity in American corporate life that have forgotten fiduciary responsibility and responsible accounting processes, maybe as a result of competition, or whatever is out there. I can understand that.

But it astounds me to hear you argue that, "Let's go back to laissez faire with corporate life," when we have just come off, and are in the process of a trial now that is horrendous.

I don't even like to listen to that trial, because to hear a CEO sort of give the German alibi that, "It wasn't my responsibility, I didn't know, I was just following orders," and only this one guy out here is responsible, even though the chairman and the CEO ran the corporation, but it was so important and so well run that they didn't know that somebody was stealing money and cooking the books, and that caused the collapse of, I think what, the fifth largest American corporation in the United States. How many other corporations there are, we really don't know.

I would say that I would always favor and would look at—and I think Mr. Carter's suggestion that we evaluate how often we have to review 401 areas and how often we have to go, that's something reasonable to look at. We should understand that if something happens every 365 days isn't necessarily the Golden Rule. Maybe it

could happen every 1,000 days. I don't know. We should examine that.

But we should have some sort of an indictment, it seems to me, of corporate activities in the heydays of the 1990's and the early 2000's, because corporate executives and corporate boards did not carry the fiduciary burden that the American investor expected. And certainly, even today, they don't carry the responsibility to the American worker. And I think anybody who argues against that just is looking with a jaundiced eye toward everything for capital, and nothing for the participants of capital in our system. And I would just hesitate to think that should be our world.

The other point I would like to make is I have heard so much about this litigation. You know, again, I am aware, and I would examine litigious activity in our system. But you know, it's very funny. I didn't hear anybody talk about advertisement of drugs, and the horrendous expenditure of the pharmaceutical industry in selling drugs.

But, Mr. Gingrich, you referred to maybe stopping the advertising of litigation or lawyers. I may indicate to you that that was Chief Justice Warren Burger, who was appointed by Republican President Richard Nixon, who came up with that brilliant idea. I never did support it, and think it was a foolish decision, and I would reverse it tomorrow if we want to get, again, another layer of government into this system.

As far as—as the trial bar and litigation, you know, if somebody comes up with a better system of protection, I would certainly look at it. But doing away with the trial bar, outlawing class actions, putting them aside, that's only going to turn the less responsible in corporate life loose to carry on.

I appreciate your testimony. I think you—certainly, Mr. Speaker, you always give great ideas, and we appreciate them. Mr. Secretary, I know from whence you come, philosophically and politically, and we appreciate your activity now in your new role. Mr. Carter, as a former Marine, we sort of give him special reaction here, the best of the best. And I shouldn't say that, because I don't know what you—you look like a Marine too, so maybe I'm not being a fair guy.

But I think that one of the things I'm proudest about with the chairman of this committee, subcommittee, and this committee as a whole, is it's one of the most bipartisan committees of the Congress. We do not try and politicize these issues. I, for one, have really searched my 20 years here on this committee, to do what is right, and appreciate the magnificence of the American capital system.

But I always understand that there is a tendency—I think Mr. Carter and I talked about it yesterday—sometimes greed occurs. And I don't know how we cut it out, how we contain it. But we have to watch it, because the money, Mr. Secretary, that you are talking about today of investors, is basically pension and 401(k) money of American workers. And we just can't afford to cut irresponsible leadership loose.

So, if you have suggestions of what we can do, and get the same standards that the Stanford study indicates the success of Sar-

banes-Oxley has brought, I am all for it. But unless we find that, I am not for laissez-faire corporate activity. Thank you.

Chairman BAKER. The gentleman's time has expired. Anyone care to make a response?

Mr. CARTER. To your list, I would add two things. We need to set a date starting when we can harmonize accounting standards right now. Something is supposed to happen in 2009, but I do not believe that 3 years from now is going to be sufficient.

And second, I would urge the committee to ask the accounting oversight board and the SEC to determine the feasibility of our proposal, which is to have materially significant risk items put into the 404 requirement.

Chairman BAKER. Thank you. Anyone else? Mr. Speaker?

Mr. GINGRICH. Two things. First of all, since I am not up for re-election, on behalf of Mr. Scott I want to say he is an able representative of Georgia, and should not be viewed in his campaign for re-election as being an export from Pennsylvania. I think you are running a very delicate line there.

I say, although I am proud to have been born in Harrisburg, there is a delicate line in the South, as I am sure the chairman will be glad to share with you in detail.

Second, the only observation I make about Sarbanes-Oxley is if you go back and look at the original estimates of what it would cost small businesses to implement section 404, I believe they are off by a factor of 50. And that is the one section of Sarbanes-Oxley I specifically thought is really worth your looking at, and either finding a carve-out for small businesses below a certain size, or doing something—and then the suggestion of making it optional below a certain size.

And then the market would say to those small businesses either, "I understand I am taking a slightly greater risk because you're not complying with 404, and I will buy the stock," or, "I am not going to buy the stock, so you better comply with 404." But as it currently exists, it's a very anti-entrepreneur, very anti-start-up.

The only other comment I would make, Mr. Kanjorski, is that to the degree we kill jobs, whether it's through litigation or through other devices—you know, France now has, for people under 30, the French have a 24 percent unemployment rate. And if you don't have jobs, you can't help workers.

One of the reasons I so strongly favor your looking at stock options again is because stock options, historically, have been one of the ways that everyday workers suddenly become very successful. And you see this in a number of parts of American life, where over a 10 or 15-year period, they are dramatically rewarded for having invested in a small company. Again, I'm talking about stock options for start-ups, and for relatively small companies, and not for large corporations.

But thank you so much for engaging us today.

Chairman BAKER. I thank the Speaker—

Mr. EVANS. Yes, let me just—I hope in my remarks I didn't suggest that I am ready to go back to a laissez faire kind of attitude. I mean, in terms of Sarbanes-Oxley, I think it accomplished some great things, which—one of the main ones is it put a white hot light on the boards of directors of companies all across the country,

and gave them a clear, clear message as to what their fiduciary responsibility is to the people who own the company, which are the shareholders and the workers, and the people you talk about. I couldn't agree with you more.

I think one of the attitudes that too often gets into the management structure of companies is that they own the company. They don't own the company, the shareholders own the company. The workers own the company. And I want a white hot light on the boards of directors, knowing that they have the responsibility to protect those shareholders' interests who own the company.

So, agreeing with Speaker Gingrich, I couldn't agree more. I mean, what—you know, I am here talking about steps I think we can take to make sure our economy does continue to grow and create jobs for young men and women across this country, because I don't think we have any more important responsibility than to do that.

But in terms of Sarbanes-Oxley, I think it has accomplished some great things. There is this one area of 404. As to what it does to stifle entrepreneurship and small businesses because it puts such a heavy burden on them, I think that's an area that can be looked at.

Chairman BAKER. I thank the gentleman. Mr. Feeney? Excuse me, is it—Mr. Hensarling, I'm sorry, is next.

Mr. HENSARLING. Thank you, Mr. Chairman. Gentlemen, each of you, in your testimony, I believe raise the specter of the loss of global competitiveness of the American capital markets. But I am curious what the implications of that loss of competitiveness is.

If we do not change the way we do business here, what does America look like in—15 years from now. Not unlike Dickens' "Christmas Carol," the Ghost of Christmas Yet to Come, just how healthy is Tiny Tim 10 years from now? What does this mean for job creation, entrepreneurship, creation of family wealth, and our standard of living?

And I believe, starting with you, Mr. Carter, I think you actually raised the specter that we could actually see greater risk and less transparency among investment opportunities for average Americans if they choose to diversify their portfolios with overseas holdings, if I read your testimony right. So why don't we start with you, sir?

Mr. CARTER. That's correct, you would see that because you are not protected with our set of rules and regulations when you invest outside the United States.

This is especially important as we shift the pension burden away from companies to find benefit plans to the individual. We have 93 million Americans who own stocks and bonds, and they must be given a wide choice of flexibility for their investments. As we narrow that, we hurt our ability to have people set aside money for their retirement in adequate investments.

Mr. HENSARLING. Let me turn now to my fellow Texan, Secretary Evans. Do you have a view on this?

Mr. EVANS. Well, you know, I think it is important for us to create the environment here so that the investors of this country have the opportunity—vast opportunities.

One of the trends that does concern me is the one that Marshall referred to. Lately, we are seeing more and more capital go into these private equity funds, and those private equity funds are typically for the larger investors and more sophisticated investors, and it takes away from the opportunity for the average worker to have a wide array of investment opportunities.

So that is another reason I think it is so important that we kind of maintain a friendly kind of environment here for companies to list on our public exchanges. So anything that we can do to accomplish that, I think, is wise.

Mr. HENSARLING. Speaker Gingrich, let me turn to you, and let me first say for a number of us here, that you continue to enlighten and inspire. And for that, we appreciate you, sir. Your views on this question?

Mr. GINGRICH. Well, look, I think you are raising a very important question. And I do think hearings matter. And I would encourage, on a couple of the topics that may not be right for legislation, that this subcommittee look at very aggressive hearings. Because they do set a record that matters.

And let me pick up your observation about 15 or 20 years from now. I believe we are actually entering a period of enormous challenge to this country. And several people mentioned at the beginning of this hearing comments about worker training, comments about education, comments about return to the folks who are working all their life, in terms of their pension funds.

And I think we have to recognize that the system we inherited from the Second World War is not going to carry us through a world in which China and India and Japan are direct and aggressive competitors. When you get to a real-time, worldwide, global financial system, money flees risk. And so, if you have a high-risk litigation system, money is just going to leave. If you have a system in which you have rules that are so burdensome that it's not the right place to build the next factory, the next factory is not going to go there. And one of the tests that Congress should set for itself on a regular basis is, "What are the ground rules?"

And let me give you an example out of today's headlines. We have spent 30 years making it harder to build oil refineries in the United States. And now we are shocked to discover that we don't have refineries. Well, at some point we should have had Congressional hearings that raised your kind of question, which is if we keep doing this, what's the net result going to be on the price of gasoline? Oh, it's going to be a lot higher.

Now, nobody offered the Higher Gasoline Amendment, but they created that by the way in which they established an entire series of energy patterns which have made it harder to produce energy, harder to refine energy, harder to move energy in the United States.

I just want to say what you are doing in this hearing is the forerunner in the financial services world, of the energy mess we're in right now. Because if we continue to assume that the United States is going to continue to inherit the most successful economy in the world, there is going to be a point in the not-too-distant future, when we're going to have our lunch eaten by our competitors.

Mr. HENSARLING. Specifically on page 11 of your testimony, you reference that, "Congress needs to assess how to pre-empt any Sarbanes-Oxley litigation time bomb," which is fairly strong language. Can you add a little more detail to what you see in your crystal ball, as far as this time bomb is concerned?

Mr. GINGRICH. Well—

Chairman BAKER. And let me just add, for process purposes, it's the gentleman's last question, as his time has expired. But please respond.

Mr. GINGRICH. Okay. Since you have cited my testimony, I have to comment. Let me just say again, I want to encourage you to look at Peter Wallison and Alex Pollock's works at the American Enterprise Institute on this topic. And you are presently going to have James Copland talk to you along the same lines.

The point that has been made is, for example, securities class action settlements increased on an inflation-adjusted basis from $150 million in 1997 to $9.6 billion in 2005. Sarbanes-Oxley creates an entire new series of presumptions of sue-ability, and sets an entire new series of benchmarks. And anybody who has watched—and these things become—they are evolutionary. So whatever happens this year is not going to happen the same next year.

There are a set of trial law firms who are engines of litigation, who have strategic sessions that say, "Here is how, over the next 5 years, we will maximize our number of lawsuits."

If you take that track, and then you follow it up with the fact that one of the rules in Sarbanes-Oxley allows the bond holders to go after the equity value of the stock holders for any non-compliance, and that there is an emerging industry of exploiting any technical mistake in filing late in order to exert the ability to basically swap capital from the equity holder to the bond holder. That's going to lead to an entire second round of litigation on top of the current litigation.

So, I do think that it is worth your while to hold some hearings, specifically on the degree to which Congress is about to inadvertently dramatically increase the amount of litigation.

Mr. HENSARLING. Thank you, sir.

Chairman BAKER. All right. The gentleman's time is expired. Mr. Meeks, did you have a question?

Mr. MEEKS. Thank you, Mr. Chairman. I am sorry, I was in another committee, and I didn't get a chance to hear all of the testimony. I am just trying to catch up by reading some real quick now, so I am not repetitive.

So, I guess I will first ask Mr. Carter, being that you are a great New York Stock Exchange, with the recent merger of the New York Stock Exchange and Archipelago, I am wondering—you formed a nice group. Is the company now—do you believe it's well positioned so that you can compete with other international competitors?

Mr. CARTER. It will be, over the next 6 weeks, as we do a secondary offering of stock, and produce the capital that we need to compete in the world market as the stock exchanges around the world consolidate. My answer would be yes, we are positioning ourselves to be a player.

Mr. MEEKS. Right. And let me ask to anyone in particular—to anyone, and maybe to Speaker Gingrich, since you brought up sec-

tion 404—I, along with Congressman Foley, have been running around, and trying to get the word—and hear from businesses in regards to, particularly, section 404.

One of the sections—I think it might have been as NASDAQ—it was an offer with maybe some of the small businesses, of having a random audit, as opposed to everyone being—they thought that that might drive down some of the costs, in a similar style that maybe the IRS does random audits now.

So, I would wonder—I direct the question to you, Speaker Gingrich, but then I would like to hear the comments from Secretary Evans and Mr. Carter, also.

Mr. GINGRICH. Thank you. I think I actually quoted you earlier in this hearing on the—my only observation is that there is a huge difference in public risk between a multi-billion dollar corporation which, if it goes sour, carries enormous risk with it, and a very small—you cited a company whose market cap was $91 million in another subcommittee, and pointed out that they are spending $4 million in trials for drugs, and $1 million in compliance.

When you are at a $91 million risk level, the level for certification—particularly in a setting where, as I said earlier, the original estimates of cost were off by a factor of 50. And so, I would either look for some special carve-out for smaller businesses, or some kind of ability to get to a much more simplified, much less onerous process, or, as has been proposed, making it voluntary for smaller businesses, because the market will then test and say either, "I trust your current level of accounting, and I will invest in your stock," or, "I won't." But there is not a huge risk there.

And so, we have sort of taken a gigantic hammer to a very small business, when in fact, what you may need at that level is a much easier and simpler process.

Mr. EVANS. The only thing I would add to that—and I think those are some excellent ideas—is that I think that we can give some thought to stepping over the accounting firms and going directly into the companies, and telling them what is—what represents appropriate internal accounting controls. There is too much dialogue between the accounting firms and the oversight board, and not enough dialogue between kind of the oversight board and companies.

If the companies are hearing directly from the oversight board as to, "Here is what would encompass internal accounting controls," it seems like, to me, they could get themselves in better position to make sure they have those internal accounting controls, as opposed to the oversight board saying, "Okay, accounting companies, here is what represents internal accounting controls," and then the accounting companies trying to go in and say, "Okay, here is what we understand our internal accounting controls."

Mr. MEEKS. Let me just ask one quick question that—it's off the Sarbanes-Oxley just for a second, just a trend that I am noticing that affects—because I'm trying to make sure that we get as many minority financial companies involved, also.

There seems to be a trend, where there are private equity firms that are taking—that are buying out public firms, and then they are going private again. And there was a period of time where I saw there was a growing trend among smaller minority investment

banking firms, but with this new trend, it seems as though there are less minority firms being able to get involved in the financial markets. I was wondering whether anyone had any comments in regard to that, and how we could fix that, if at all, so that we could have more minority firms that are involved in the financial services.

Mr. CARTER. Well, some of the major minority firms, like Blalock, generally get into most of the underwritings, and most companies now realize that they need to have these firms in their underwritings. But I don't know—I have no solution to the issue of private equity or venture capital excluding those firms.

Chairman BAKER. Unless there is further response, the gentleman's time is expired. Anyone else wish to speak to that issue? If not, Mr. Campbell, did you have a question?

Mr. CAMPBELL. Yes, if I may, Mr. Chairman.

Chairman BAKER. Please proceed.

Mr. CAMPBELL. A brief question. I, at one time, owned dozens of securities. And last year, at one point, I—the post office actually had to call and come by and deliver about a 2-foot stack high of lawsuit things, shareholder lawsuits where I was—and I was looking at all of these, versus the number of securities that I owned, and realized it was something like 60 or 70 percent of every security I had ever owned in that period of time had been sued. Getting to—and obviously, as a—on my behalf, as a shareholder, without my knowledge or consent.

You have all talked about it. And it is clearly an issue. What do you—what specifically do you—and I think you addressed this a little bit, Mr. Speaker, but what do you think will enable shareholders to still redress grievances when they have genuine, legitimate grievances, but will stop all this—where every single company seems to get sued at one point or another for a manipulation, or some other—just simply because there appears to be there is something in it for the trial bar?

Mr. CARTER. My view would be a loser-pays type of tort reform would put a big dent in frivolous lawsuits.

Mr. CAMPBELL. Anyone else?

Mr. EVANS. No, I would support that, too. And I think that's a very good option to consider.

Mr. GINGRICH. And I would just say, first of all, that this is a topic—you should look at what Missouri has done recently, because they passed very extensive litigation reform. One of the things they did that is most important is they do not allow the plaintiff to shop for the right jurisdiction.

Because, as you know, there are some counties in the United States which you could almost guarantee that you are going to lose the case to the plaintiff. And they now require that the case be filed in the county in which the incident occurred, unless both parties agree to move. That, by itself, has begun to change things.

And I couldn't agree more on loser pays. I would simply add that—to go back to—there was an experiment run by a Federal judge in San Francisco, who said to the law firm that brought in the case, the class action suit, that he was going to put it up for bid, because he thought that since the law firm had formed the case, it clearly had a vested interest.

At that point, when they put it up for bid, the entire case disintegrated, because in fact, law firms didn't want to be involved in actually bidding to provide this service on behalf of the people who sue.

I just want to make an observation that is probably obvious to all of you, but I think we make it more complicated than it should be. The Chinese are graduating vastly more engineers than we are, and we are graduating vastly more lawyers. And the reason is, we have designed a system which incentivizes young people to think that if you want to some day own a baseball team, being a trial lawyer is a reasonable road to achieve that.

As long as it is profitable for these firms to behave in a purely commercial manner—this is not about the profession of law anymore; this is about the manufacturing of money by the creation of conflict for the purpose of increasing incomes. Nobody should be surprised that we are going to have a rapidly growing litigation industry in America, and that the cost is going to be killing jobs, diverting money away from workers, and diverting money away from stockholders to lawyers.

And as a result, other companies are going to look and say, "Why would I want to go to the United States and get sued?"

Mr. CAMPBELL. Thank you. I yield back.

Chairman BAKER. I thank the gentleman for yielding back. Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman. I have listened attentively to the information that the panelists have given us, and I want to address one of Secretary Evans' concerns whereas $9 out of every $10 raised by foreign companies through new stock offerings were raised in the United States in the year 2000, the reverse was true by 2005: $9 out of every $10 raised by foreign companies through new company listings occurred outside the United States, principally in Europe.

Also of concern, Secretary Evans points out that in 2005, 23 out of the 25 largest IPO's did not list in the United States. It seems to me that this trend is going to have a negative impact on the stock market.

Mr. Carter, with the recent merger of the New York Stock Exchange and Archipelago to form the New York Stock Exchange Group, is the new company well-positioned to compete with your international competitors? If yes, why? If no, why?

Mr. CARTER. Yes, it is, because prior to our becoming a public company and merging with a company called Archipelago, we only had a single product, which was equities. Today, we will be able to offer derivatives, options, and fixed income instruments through our own floor, or through our electronic crossing network.

So, one of our strategic objectives was to increase our product offerings, which traditionally had not been offered through the New York Stock Exchange.

Mr. HINOJOSA. Thank you. Mr. Evans, you served as the chairman of the board of regents at the University of Texas, and I remember the tremendous leadership that you showed, helping us create more engineers and technicians. So some of your comments seem to lean toward education, which I like.

What do you think we could do to encourage more ventures between the public and private sector? Would you support a line item in the budget to ensure that we invest both in the K–12 programs and then our universities, in order to meet the Administration's goal of an additional 100,000 engineers in the next 5 years. We need your help.

Mr. EVANS. Well, Congressman, you do bring up a very, very important issue. I mean, in my judgement, in terms of America's competitiveness and global leadership in this global economy as we move into the next generations, there is not any issue that is more important than the development of scientists and mathematicians here in our own country. That's where innovation is, that's where problem-solving comes from, that's where creativity is, it's what is driving this economy today, the great focus we put on it in the 1960's and 1970's, and we need to renew that focus.

I have been to your campus, the University of Texas—Pan American, and you have one of the finest engineering facilities, quite frankly, in the country. I compliment you on your HESTEC program. I think that spotlights it well.

This is, I think, a national debate, a national dialogue, that is critical to our economic future and leadership, and it needs to be a dialogue between the public and the private sector. And I think corporations are, indeed, engaged in this dialogue.

When I went to the University of Texas—Pan American, I can remember many, many, many Dell computers that were in the engineering labs there, and so I think you have companies like Dell, and Exxon, and others, that are getting very much involved in what they can do to promote science and engineering all across America.

What we do further? I mean, it's just something we ought to talk about and discuss, because as I look at—you know, another issue that was brought up—I think it was Congressman Feeney, earlier—I mean, the two single most important issues, in my judgement, for our future are the development of scientists and engineers and mathematicians. The most important problem they have to solve is the delivery of affordable available clean-burning energy.

And so, those two issues are the biggest issues in my mind challenging our competitiveness and the future global economy, and it ought to be a joint venture between the public sector and the private sector. Some of that exists today. Can we do more of it? Yes, we can. I would suggest more—I would suggest hearings on it, quite frankly. What are the additional ways we can get the private sector more involved in promoting the education across campuses in America?

Mr. HINOJOSA. I personally want to thank each one of you three presenters, because I think that you bring forth a lot of good information. And I just hope that Congress can take it and do something with it. Thank you, Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentleman. Mr. Feeney?

Mr. FEENEY. Thank you, Mr. Chairman. Earlier I referred to a study entitled, "The Sarbanes-Oxley Debacle: How to Fix it and What We Have Learned." I would ask permission to insert this in the record.

Chairman BAKER. Without objection.

Mr. FEENEY. On page 18—or 11—of that study, by the way, I quote the authors, "A conservative estimate is that the indirect costs of SOX are great than $1.1 trillion, and that is before we have imposed it on a lot of the smaller companies."

I really appreciate all three of your testimonies with respect to litigation abuse, and the competitiveness of America's world markets, and would hope that my Chairman Sensenbrenner would invite all of you to come back to the Judiciary Committee, where we have primary jurisdiction over those issues.

But today, I am interested in the regulatory burdens imposed by Sarbanes-Oxley, in particular. As Congressman Meeks said, I have actually—sometimes with my good colleague—I visited all three of the major exchanges in Chicago. As Mr. Carter knows, I have visited both of the major exchanges in New York. I have come to the conclusion that Sarbanes-Oxley sections 1 through 403 are, on balance, a huge net plus for confidence in American capital markets. It's just 168 words in section 404 that have resulted in the $1.1 trillion indirect cost to our economy.

And I am afraid that, because of those 168 words, we are outsourcing America's world leadership in capital markets. Roughly a century ago, that leadership shifted from London to the United States. I'm afraid it's going to the—in the opposite direction.

Also, private equity is, as Mr. Carter suggested, a very inefficient way to raise equity. I wonder, if 404 had been in place, whether individual American investors would have ever had an opportunity to invest in a company like Dell, or Microsoft, or any of these others that have grown so exponentially, in large part, because of their access to competitive markets.

And when I look at the fact that pre-Sarbanes-Oxley, 90 percent of money raised by foreign entrepreneurs in the public forum was raised in America, and now 90 percent is being raised overseas, when I look at the London stock market that is advertising itself throughout the globe, including in America, as a Sarbanes-Oxley-free zone, I met with Mr. Tsang, the chief financial officer in Hong Kong, and asked him whether a Hong Kong entrepreneur would consider listing, as he went public, on the American stock exchange.

He actually laughed at me. Not in an impolite way, but he said, "Congressman, there is no way." And I said, "Is that because their lawyer or accountant would advise them not to do so?" He said, "Nobody would have to talk to their lawyer or accountant to know that the burdens of Sarbanes-Oxley would preclude consideration of America as a place to raise capital."

That being said, section 404 is 168 words. Mr. Carter, do you know whether Standard & Poors, or Moody's, the most important rating services in the country, avail themselves, or use 404 on a regular basis?

Mr. CARTER. You mean for their own operations?

Mr. FEENEY. Yes.

Mr. CARTER. I am—

Mr. FEENEY. No, no, I'm talking about—evaluate the health of a company. Do they rely on 404 in a big way?

Mr. CARTER. Well, only to the extent, in the annual proxy or the annual report, if they saw that the company failed to meet 404

standards, as reported by their auditor, I think it would certainly impact their—

Mr. FEENEY. But they don't actually pull the 404 report, to your knowledge? Actually, I have talked to them, and they say they don't—they have never looked at a 404 report.

Mr. CARTER. I don't believe that would even be accessed by them.

Mr. FEENEY. Another question I have about the burdens that have been imposed. Last year, I am told, we had roughly 1,200 restatements of—by corporations in the public arena in America. The standard for restatements is that if it's something that would affect investor confidence, there ought to be a restatement, which, of course, is expensive, requires a new auditing procedure.

My understanding is that less than five of those restatements had any impact on investor behavior in the markets. And is the restatement proliferation that we're seeing, in part, imposed because of 404 and Sarbanes-Oxley requirements? Really, for any of the panelists, if you know. I don't know.

Mr. CARTER. I would think it would be more in line with the companies and the CEO's and CFO's are concerned about litigation if they failed to describe some change in accounting procedures, even though it was below the materiality standard, which might be 5 percent.

Mr. FEENEY. And finally, Mr. Speaker, you talked about the litigation explosion that's about to occur, in part, because of Sarbanes-Oxley.

Do you think it's not just public companies that are threatened, but because of a—trial lawyers will assert that even privately-held companies, and even charities—I have them in my office all the time—they are terrified that they are going to be the next victims, once we set these impossible-to-meet accounting standards that privately held firms and, indeed, charities may be subject to some of the same litigation abuses we now see in the public markets?

Mr. GINGRICH. I think we have managed, over the last 30 years, to create a culture in which there—you have to think of it as an organic growth. There is a system evolving in which there is a permanent need to find new reasons to sue. Because, otherwise, you can't expand the pool of money flowing into the litigation industry.

Just think of it as an industry. This is an industry that is in a growth curve, designed to find more and more—they've got very bright, new lawyers that show up at their law firm, and they say, "Find the next four reasons to sue." And every year, there is a slight expansion of that.

And part of the reason that I suggested that this subcommittee hold hearings on the impact of State attorneys general is the combination of State attorneys general who have criminal power, working with private law firms to, in effect, hunt down and blackmail companies, is a very chilling long-term prospect in this company, and is an intervention in the national economy by lawyers usurping Congress's role.

And I think it's a—for big corporations, whether public or privately held, for big corporations and for fairly successful people, that is a very serious long-term threat if it continues to metastasize into a sort of a cancerous assault on the system at large. And it has grown dramatically in the last 10 or 12 years.

Chairman BAKER. The gentleman's time has expired. I do understand that some of our panelists may have time constraints. We—don't let the committee arbitrarily hold you if there is a time obligation, but just let us know, as appropriate. Mr. Speaker has to leave at noon, or a little after noon? Mr. Israel, we will go with him, then.

Mr. ISRAEL. Thank you, Mr. Chairman. I would like to follow up with Mr. Carter on Mr. Feeney's concerns about section 404. I understand the notion of trying to exempt small firms from the—what some would argue are the onerous burdens of section 404.

One of the concerns I have is that if you look at the tech boom several years ago, small firms became big firms. And I wonder whether your suggestion of applying a risk-based review to all firms is the answer, and would provide for more consistency and reliability.

As I understood your testimony, this will provide for a 3-year benchmark with intensified annual reviews on specific criteria in the interim. And I noted from your testimony that you have a very good analogy. You talk about the joint counsel on the accreditation of hospitals, auditing hospitals every 3 years. Their work is vitally important to the protection of U.S. citizens, and their very survival, and yet hospitals don't get audited on an annual basis.

So, I wondered if you could just help us kind of flesh out the details of the proposal as you—

Mr. CARTER. Well, I am also—one of my other retired duties is that I am the chairman of the Boston City Hospital, which is the old St. Elsewhere, from TV days.

If, in fact, the hospital has some serious lapses in treatment, patient deaths and things like that, then they do get audited, absolutely, every year.

The proposal that we make, or the suggestion, is that if a company could establish the materiality criteria—that is, something in their operating environment, or their business model that produces serious risk—those particular items—and it might be anywhere from 10 percent for a small company, to 25 percent for a big, multinational company, would be audited every year.

If, in fact, that audit produced a satisfactory result of internal controls, then there would be no 404 baseline audit done that year. So that would be year one. Year two, you would do the same thing. If, in fact, on year two they flunked that test, they would do a baseline 404. If they passed it, they would still do, at the third year, the baseline 404.

But these are very specific criteria. For example, in a commercial bank you might look at the loan losses. And if the company was providing less loan losses than their loss experience told them to do over 10 years, that would be a materially significant risk, which is if loan losses go up, it will impact the revenue.

The advantage of this, of course, is that it can be done by the SEC and the Oversight Accounting Board; it does not require reopening the legislation.

Mr. ISRAEL. Thank you. And before I yield my time, Mr. Chairman, let me just say that I have an interest in running the traps on this with you, and seeing if we can create a dialogue with some

of my constituents in New York, who have complained to me consistently about the straight-jacket approach of section 404.

Mr. SCOTT. Would the gentleman yield?

Mr. ISRAEL. Yes, I yield to my colleague.

Mr. SCOTT. Thank you very much, Mr. Israel. I wanted to get this question in, and I appreciate your courtesies before the Speaker has to leave.

I am very, very much concerned about our debt and its implications on our capital markets for the future. And as you know, I would like all of your opinions on this, but I certainly want to get to the Speaker before he has to leave.

As an historian, Mr. Speaker, you fully realize that history is replete with those civilizations and great nations who have gone down, and have collapsed for three basic reasons: one, global overreach; the other one is because of a loss of resources at home; but the most glaring one is a ballooning debt, especially in the hands of foreign governments and institutions.

On all three of those criterion, it points to that the United States is in serious, serious trouble. But nowhere are we in as great a trouble as with our ballooning debt, and with that debt, nearly 50 percent of our debt in the hands of foreign countries and foreign capital markets.

And I want to try to put our hands around this, especially given the fact that in the—in this last 5-year period, under the President, this present Administration, and under this Congress—couldn't have been without the collaboration of both—we have borrowed, in the last 5 years, more money from foreign governments and foreign institutions, than all of the preceding 41 Presidents and Administrations in the history of the United States.

Chairman BAKER. Mr. Scott, you are going to need to give him a chance to respond, because he is going to have to get out the door here in just a—

Mr. SCOTT. Right. Would you please give me your response on—in terms of the significance of this debt, and the peculiar perilous position it is placing our country in?

Mr. GINGRICH. Well, you picked a heck of a question to close out my opportunity here. But it's an important question, and it's worth taking a minute on.

First of all, I believe, both as a practical long-term matter, and as a moral matter, that governments ought to balance their budget. And I was very proud of the fact that, in the late 1990's, we did get 4 straight years of a balanced budget, and we paid off $405 billion in debt. And I think that's a useful—strategically, the Congress should try to get back to that.

And to do that, frankly, you have to transform the health system, because health is 26 percent of all Federal spending, and the fastest growing section. So if you're serious about getting to a balanced budget, you have to really think through transforming health.

Second, I worry a fair amount about the international debt and the degree to which we are spending more overseas than we are selling. There are some technical reasons, but that's partly a function of our strength, because a lot of people around the world want to send money here because we're the best place to invest in the world.

But I would say this reinforces Secretary Evans' point that there is no single topic, other than transforming health, that Congress could take up that would be more important than the energy issue, because a substantial portion of our total balance of trade problem is the degree to which we now borrow—buy huge quantities of oil overseas, and basically ship the money out.

So, if you had—if you were back to where we were 30 years ago on energy, and if you had transformed the health system, you would be very close both to balancing the Federal budget, and having a dramatically healthier—long-term balance—so it is an important topic, and it's one worth—certainly worth pursuing.

Chairman BAKER. The gentleman's time is expired. And let me express appreciation to you, Mr. Speaker, for your time and appreciation here today. It has been most helpful. And we will be calling on you as we go forward. Thank you very much, sir. Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank the ranking member as well, for holding this hearing.

One of the hats that I wear on another subcommittee is on the Committee on Government Reform, Subcommittee on Regulatory Affairs. And while this committee is looking at a whole set of issues, that subcommittee is looking specifically at 404. And I appreciate the Secretary and also Mr. Carter, with their suggestions earlier in the hearing.

It seems like we're in general agreement on the fact that the effect of 404, generally, is negative upon small and medium-sized businesses, which are principally the source of our innovation and competitive edge.

However, being mindful of what the Speaker said earlier about the pendulum of scandal, and then the pendulum of reform, it comes back the other way. And sometimes it overswings, if you will.

I would like to talk about what our subcommittee thinks might be a consensus view. We're concerned about exemption, and that the idea of exempting companies from filing under 404 may be overswinging the pendulum a little bit. And we are also concerned about what might happen on the voluntary compliance, or random auditing scenarios, not that those have been dismissed—I think we have an open mind toward it—it's just that there is some concern that we may be eliminating some of the benefits of Sarbanes-Oxley, and eliminating some of the transparency and the accountability, by going that route.

But one thing that I think we are hearing from both the panel and some members up here is that, first of all, the idea that right-sizing this section 404 so that we perhaps go to the materiality standard, and we're not asking for a full-blown—what I call the full employment act for accountants approach, which we have right now. If we went to a materiality standard, and went to a biannual compliance, rather than every year—and I know, Mr. Carter, you suggested every third year; I'm a little worried about that, about having 36 months go. Would we be losing some of the accountability and some of the transparency that we're getting right now from Sarbanes-Oxley by moving the reporting out 3 years?

But if you take those two initiatives in conjunction, one, adopting a materiality standard, instead of the everything out of the sun

standard, and you make it every other year, it would seem that that step alone would reduce the cost by 50 percent, roughly speaking. Would those two steps, in your mind, be enough to have a significant impact on the cost right now, and the burdens on small and medium-sized businesses?

Mr. CARTER. Well, we would not support exemptions, nor would we support voluntary compliance. I think the—don't be confused about the biannual nature and the third year. In each of the years, if the materiality criteria were met, you would not have to do the in-depth 404 audit. If they weren't met, you would. And these materiality criteria would be the ones that would impact more than, say, 5 percent of the revenue.

So you certainly could start it on a biannual basis. You get a free year, and then you do the 404. I don't think that would relieve the burden as much as the third year approach would.

Mr. LYNCH. And what about your concerns regarding transparency or accountability? You think it's still there with—

Mr. CARTER. Well, it would still be there for those material items. We're talking about material items that are going to significantly impact investor confidence, because they would impact the expenses and the revenue.

Mr. LYNCH. I guess what we're concerned about is that if something were to slip through the cracks on the materiality standard—something is at 4 percent, not 5 percent, it falls through, and then over 3 years it balloons into something that, a couple of years ago, would have been material but you don't catch it because you're waiting every third year. We're concerned about things percolating up over that 3-year interim, I guess.

Mr. CARTER. Well, if they didn't meet the materiality criteria in the intervening years, you would, of course, do the full 404 audit. This is why a pilot program would be nice, to look at—you could sort of crank that up in 6 or 8 months.

Mr. LYNCH. Yes, okay. Mr. Secretary, your thoughts?

Mr. EVANS. Well, I don't have a lot of the facts as to how much it would save or wouldn't save. But let me just say this. I mean, the benefits of Sarbanes-Oxley, to me, have been enormous. And they have been enormous because the one thing that was lost in 2001 was trust in the markets.

Mr. LYNCH. Right.

Mr. EVANS. I mean, as I travel around the world, people ask me all the time, "How has America been so successful?" And I always tell them, "Well, it's our freedoms, it's our democratic, capitalistic system that creates this incredible environment for competition, it leads to innovation, our productivity, and all of that."

And third, I tell them, it's "the American people are good people. They're honest people, they're decent people, they tell the truth." And so, when that last tenet is violated, it hurts the character of the country, and it shakes the trust and confidence of the investors. And that's what happened.

And so, Sarbanes-Oxley stepped in, and however many pages it is, and however many items it is, the main thing it did is it restored trust in the markets. And so, now what we have to do—but it also, at the same time, created a lot of uncertainty. And that's what I am sure caused a lot of other companies angst as to, "Do

I want to really get into the middle of that, not knowing really what it means to me yet," as a company or as a CEO? "So maybe I will just go to some other exchange until I more clearly understand the impact of Sarbanes-Oxley on my company if I wind up listing there."

So, you have to—you know, you have the trust that I think it restored, and I think that's evidenced by the remarkable results of the stock market over the last 3 or 4 years since then—not all attributable, of course, to Sarbanes-Oxley. We have a strong economy, but the market is up about $5 trillion in value.

But at the same time, it created some uncertainty, and we have got to work through these various areas of it that seem to be somewhat troublesome, like 404. And I don't have enough of the facts to tell you, Congressman, you know, how I would do it, whether I would have, you know, every other year review, or make it voluntary, or what I would do with it, but it seems to me that is an area that is stifling innovation, it's stifling entrepreneurs, it's draining energy away from where we ought to be directing energy in this country for innovation, and creativity, et cetera.

So, you know, without the facts, I have a hard time, you know, telling you exactly what I would do with it. But I would look at it hard, and probably do something with it. But don't, by any means, underestimate the power of Sarbanes-Oxley and what it did to restore trust in our markets at a very, very important time.

Chairman BAKER. The gentleman's time is expired.

Mr. LYNCH. I just want to thank both of the gentleman for helping the committee out with its work. Thank you.

Chairman BAKER. I thank the gentleman. And Mr. Scott is going to be recognized now on his own time for other members. He was yielded time by Mr. Israel, so he is entitled to his own time. Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. I appreciate your courtesies. I would like to ask both of you a question. First, let me start with you, Mr. Carter, in terms of the health of the New York Stock Exchange.

Have any New York Stock Exchange-listed companies left the Exchange this year? And if so, what were the reasons that the cited for leaving?

Mr. CARTER. There have been a number of foreign countries, non-U.S. companies, companies like Vivendi and Kohl, a company in Australia, who left. And they left because of those four reasons: the litigation; atmosphere; 404; the depth of their own markets allowed them to raise plenty of capital.

Mr. SCOTT. How would you describe this problem? Do you see this as a trend? Do you see this as just a blip on the radar, or do you see this as presenting some serious problems for the future of the Stock Exchange?

Mr. CARTER. We don't view it as an anomaly just for 1 year, we view it as a trend, starting in 2000, where we had 9 out of 10 IPO's registered here in the United States, and last year we had 1 out of 25. This year I think we need a few more months in the year before we see what's going to happen.

Mr. SCOTT. Now, have any New York Stock Exchange-qualified companies that might, in the past, have listed on the market decided to list elsewhere?

Mr. CARTER. Yes, they have. I think the most significant is the fact that about—almost 200 offerings, raising about $80 million, listed—raised the money here, but did not list on a U.S. Stock Exchange. They raised the money through the so-called 144A offerings, which are not available to the average investor. So this is all part of a trend.

Mr. SCOTT. What were the reasons that they decided for that decision, for their decision?

Mr. CARTER. It was the same—

Mr. SCOTT. The same?

Mr. CARTER. Yes.

Mr. SCOTT. Going to our tax code, outside of the regulations and the four reasons you've cited, do you believe that our current tax code is too complex and cumbersome for foreign companies to navigate? And did the President's commission on tax reform provide any helpful ideas on improving the system? And do you have any ideas on how to have a more fair tax decision? One, is it a factor in making it more difficult for foreign companies—

Mr. CARTER. The complexity is a factor, but it doesn't measure up to the top four that we have talked about here today.

Mr. SCOTT. Okay. Mr. Evans, let me turn to you, please. You recommend that we evaluate whether rules and regulations are effective and appropriate. Can you evaluate the current regulatory structure, including Sarbanes-Oxley, on whether they are achieving their intended objectives?

Mr. EVANS. Well, Congressman, I think probably some are, many are, and probably many are not. Much of the regulatory structure was put in place in the 1930's. Our economy, obviously, has changed dramatically since the 1930's. So I think there is a variety of regulations that do need to be reviewed and thought through.

We have a tremendous amount of duplication, in terms of jurisdiction, a lot of jurisdictional overlap that I know a number of our members have to deal with. We have members that—in the financial services forum—that would have to deal with the OCC and the FDIC and the Federal Reserve Board, and the SEC. Others would have to deal with the Federal Reserve and the SEC, and then State regulatory bodies.

And so, there can be a tremendous amount of overlap. And in some instances, just conflicting regulations. So, you know, I just—I think it is a regulatory structure that was, as I said, put in place back in the 1930's, and there are elements of it that probably need some serious review. Do we need four or five different agencies regulating the same institution?

Mr. SCOTT. Do you feel that they impose unnecessarily high cost burdens on the regulated firms?

Mr. EVANS. Indeed I do. Now, I can't tell you—you know, I don't have any specific studies. I can just tell you that, indeed, they create inefficiencies in the marketplace.

Mr. SCOTT. And you would agree especially on smaller businesses?

Mr. EVANS. Indeed I would.

Chairman BAKER. And the gentleman's time has expired, if I may, Mr. Scott.

Mr. SCOTT. All right, thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman. Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Carter, I heard your answer to the question raised by Mr. Meeks and Mr. Hinojosa regarding the merger of the New York Stock Exchange with Archipelago, and how you feel that you are in a better position today to compete in the ever changing global capital markets.

The second part of that question is, do you believe, giving as an example, the bid that was put out by NASDAQ to purchase the London Exchange, do you believe that for U.S. exchanges to remain competitive globally, it is necessary to pursue mergers with foreign exchanges?

Mr. CARTER. Well, a merger applies—two companies come together, and a single company is the result. It could very well be that some of the strategic advantage could be done by a minority participation. And we certainly want to participate in that on a global basis.

Many of the markets in Asia are owned by the government, so they are probably not going to allow a merger. But we still have plenty of opportunity in this country, too.

Ms. VELAZQUEZ. Okay. In order, Mr. Carter, to go public today, small companies must be more sophisticated and more mature than ever before, and they must employ a sizable administrative work force to comply with the many regulations they face.

In addition, other factors have increased the challenges that these firms face in accessing the public markets, such as the liquidity demands of institutional investors, as well as consolidation within the underwriting industry. Do you believe it is harder for small firms to go public today than it has been in the past?

Mr. CARTER. It certainly is harder, administratively. But any increased difficulty that causes smaller companies to not go public has been more than replaced by the large amount of cash available through private equity, hedge funds, and venture capital that will allow our smaller company to develop the capital resources they need in order to expand.

So, we do see, though, a reluctance of the venture capital people to take a company public, and sometimes there is no need for it, because they can generate plenty of capital for that company to expand.

Ms. VELAZQUEZ. Okay. Thank you, Mr. Chairman.

Chairman BAKER. The gentlelady yields back. Mr. Davis?

Mr. DAVIS. Thank you, Mr. Chairman. Let me thank the gentleman for being so indulgent with us. Mr. Secretary, as you recall from your days in the cabinet, the way these hearings typically work is that the people you're really responding to have long left by the time you get to ask your questions.

So I regret the Speaker is not here, the former Speaker, and that Mr. Feeney is not here. And in a sense, my questions would probably be better directed to them. But I do want to get your response.

Mr. Gingrich and Mr. Feeney talked a good deal about the litigation climate and the securities world in the past several years, and they painted a rather dire picture of companies having to spend

enormous amounts of money on legal resources. They painted a rather dire picture of our competitiveness being diminished because of rising lawsuit and tort presence in the world of securities.

Every now and then I think it's always helpful to let facts sometimes get in the way of a good rhetorical argument. If I understand the data correctly, we had fewer lawsuits last year for securities-related claims than we did in the average in 1996 to 2004, around 190-some suits a year to as many, in some years, as 215 or 216, down to apparently 175 last year.

As I think both of you are aware, the Supreme Court issued a ruling, I think several years ago, which made it dramatically harder, if not impossible, for litigants to go into State court in securities fraud cases. The Supreme Court recently issued a ruling tightening the standard of proof in a fraud case by strengthening the causality requirement.

As I understand it, empirically, the damages awarded in these cases are less than they were during the period 1996 to 2000. And of course all of you are aware of the Securities Litigation Reform Act, or something similar to that, was passed in 1995, which made its own substantive changes limiting executive liability, and limiting large accountant liability.

So, the facts do seem to get in the way of an argument. I have no doubt whatsoever that every company in America spends a lot of its resources on litigation. I practice plaintiff side and civil defense side, so I am certain of that.

But let me—I should just ask you, Mr. Carter. As you talked to investors in the market, as you talked to large companies in the market, what's your response to what I just said, the fact that, in many ways, the litigation climate has dramatically improved in the last several years?

Mr. CARTER. I think most people would not agree with you on that. They would not feel that the litigation climate has improved. The statistics I see show that more institutional investors are suing, as opposed to individuals, and second, that the settlements have been larger over the last few years. But I would say the average investor would not necessarily agree that the litigation situation has gotten better.

Mr. DAVIS. Put it in some perspective for me, though, because I'm trying to get a sense of exactly what those individuals would have Congress do, and what they would have the courts do.

Congress and the courts have made it harder to bring these kinds of cases, from a substantive standpoint and from an interpretive standpoint, by the court. So, what dramatic acceptable direction is there for Congress and the courts to go, given all the things I have described earlier, and all the reductions in the scope of liability?

Mr. CARTER. Well, I would say two things. I think the chairman's idea about loser pays will certainly decrease the number of individual lawsuits. I go back about 20 years to when Senator Dole and Senator Kassebaum got tort reform for aircraft manufacturers that put a 19-year limit on the fact that you could sue somebody that made an airplane that you crashed in. And they tied that litigation reform to jobs. I—

Mr. DAVIS. Let me ask you—and I cut you off simply because I'm last, and my time is limited. The only problem I have with that, Mr. Carter, those of us who have been in the litigation world, there are meritorious cases that sometimes lose. And I assume you would agree with me, that there are meritorious cases that, for whatever reason, still sometimes are not successful. Do you agree with that, Mr. Secretary?

Mr. EVANS. I do—to a certain degree I agree with that. I think—

Mr. DAVIS. Mr. Carter, I assume you also would agree there are certainly meritorious cases that sometimes end up being unsuccessful.

The reason that I make that point is the notion of losers pay sounds attractive to people. But that presumes that a losing claim is a frivolous claim and a non-meritorious claim. We know that's not always the case. And we know that a losers pay scenario makes it very, very difficult for all but the most well-heeled investors.

And Mr. Carter, I think you made this point. Claims arising by large classes of investors, but smaller classes of investors, the ones who would be particularly deterred, it would seem, would be the real victims of this losers claim scenario.

Mr. EVANS. Yes, but the other side of that, Congressman, is many, many, many suits are filed that companies are obliged to go ahead and settle before they really go through the process, because they can't afford to destroy their image—

Mr. DAVIS. I agree, it's a balancing act, and I am just trying to—

Mr. EVANS. And that's the other side of it.

Mr. DAVIS. Right.

Mr. EVANS. I mean, there are many who say, "Look, I can win this case, there is no question about it."

Mr. DAVIS. Right.

Mr. EVANS. "But I can't afford to have my company's name on the front page of the New York Times."

Mr. DAVIS. Yes. I make my last 5 seconds' observation. I don't dispute that the other side exists, I am simply making that point, in the interest of balance. The job of this institution is to realize that there is no perfect world, there are legitimate interests on both sides of that argument. Mr. Chairman, I think my time is up.

Chairman BAKER. The defense counsel's arguments have been most educational, but I hesitate to admit that they were not totally persuasive as of the moment. I thank the gentleman for yielding.

Let me express to each of you the committee's appreciation for your participation. I have not had occasion to visit with Mr. Kanjorski, but it comes clearly into view that over the coming months we would be well served by a task force of folks of your stature, working with the committee on identifying the top 8, 10, 12 items on which we might be able to reach agreement—as, for example, pursuit of the pilot program that you have suggested here today.

And so, at a later time, subject to consultation with Mr. Kanjorski, we may get a letter out to you indicating a desire to meet more informally. We have done this on the subject of insurance reform in the nature of roundtables, and we found them very helpful for our members to be able to get thoroughly engaged in understanding the need and justification for some of the things you have

suggested doing here, with an eye toward perhaps some sort of legislative program for perhaps early next year.

But we look forward to working with you, we appreciate your contributions, and thank you for your time. And when appropriate, we will get our second panel of witnesses forward.

Let me welcome you, and express appreciation for your patience. Our hearing has gone much longer than we had anticipated. As you know, we will make your full statement part of the official record. We ask that you try to keep your remarks to the 5 minutes customary.

And with that, I would call on Ms. Maria Pinelli, representing the Americas Strategic Growth Markets Leader of Ernst & Young. Welcome.

STATEMENT OF MARIA PINELLI, AMERICAS STRATEGIC GROWTH MARKETS LEADER, ERNST & YOUNG, LLP

Ms. PINELLI. Good afternoon, Mr. Chairman. My name is Maria Pinelli, and I am the Americas Strategic Growth Market leader for Ernst & Young. I am here today to present the key findings from Ernst & Young's third annual global IPO report. I have submitted our full report, along with my written testimony.

Today, I will highlight the major global IPO trends that we found. Trend number one: globalization of the capital markets continues. 2005 was a very strong year for the global IPO markets. The total capital raised increased by over one-third, from $124 billion in 2004, to $167 billion in 2005, the largest amount raised since 2000.

Although the United States is the dominant player in the global capital markets, there are over 50 exchanges competing for $46.8 trillion of capital around the world. Six exchanges dominate the exchange market: The New York Stock Exchange; NASDAQ; London; Euronext; Tokyo; and Hong Kong. But the United States maintains the lead in both the amount raised, and number of IPO's.

The New York Stock Exchange and NASDAQ alone represent 38 percent of the total global market cap. For the 10-year period 1995 to 2005, the New York Stock Exchange grew almost 200 percent, and NASDAQ grew almost 250 percent. In spite of this U.S. growth, there is legitimate attention focused on the growth of other exchanges, such as the Hong Kong stock exchange, which increased 135 percent in the same 10-year period.

There are many reasons for the recent growth of non-U.S. exchanges. For one thing, many exchanges are engaging in highly aggressive marketing campaigns to attract new listings. We have to remember that these exchanges are businesses, competing for a share of a $46.8 trillion market.

Trend number two: state-owned enterprises tend to list on local exchanges. Only one of the top 10 global IPO's of 2005 listed in the United States. The five largest IPO's were state-owned enterprises from China and France. They listed on regional exchanges close to their home markets. We predict this trend will continue in the future, driven by emerging capital markets such as China and Russia.

The largest global IPO in 2005—and ever—was China Construction Bank's $9.2 billion offering on the Hong Kong stock exchange.

A large investment by Bank of America for $3 billion represents the largest single foreign investment into a Chinese company. This demonstrates that global and U.S. investors are comfortable investing on less regulated foreign stock exchange, which is an emerging trend in the global capital markets.

Trend number three: America's reputation as a safe, transparent economy results in a higher valuation premium for listed companies. Issuers and investors recognize that U.S. capital markets demand compliance with a gold standard of corporate governance regulations, which result in higher valuations than on foreign markets.

The New York Stock Exchange states in our report that motivation for most companies listing in the United States is the valuation premium. On average, 30 percent. That accrues as a result of adhering to high standards of governance. Foreign companies will continue to list in the United States due to this valuation premium, and also because of unparalleled investor sophistication.

This is one of our strategic competitive advantages over other capital markets. And any temptation to lower these standards in competition with foreign exchanges needs careful consideration.

Let me give you an example that says it all. Baidu.com, a Chinese search engine company much like Google, cited market maturity, investor understanding of their business, regulation requirements, and the ability to achieve a corporate identity as an international company as the most notable criteria in deciding to list in the United States.

Our future reports will continue to monitor the trends and activities of IPO's around the world, and Ernst & Young will share these reports with the committee in the future. Thank you for this opportunity to testify, and I look forward to your questions.

[The prepared statement of Ms. Pinelli can be found on page 130 of the appendix.]

Chairman BAKER. Thank you, Ms. Pinelli. Mr. James R. Copland, Director, Center for Legal Policy, The Manhattan Institute. Welcome, sir.

STATEMENT OF JAMES R. COPLAND, DIRECTOR, CENTER FOR LEGAL POLICY, THE MANHATTAN INSTITUTE

Mr. COPLAND. Thank you, Chairman Baker. And it's my pleasure to speak before your committee today. It's an honor for me to follow the distinguished panel we just heard from. And I would like to say that I would echo many of the sentiments expressed by all three of the panelists, and the suggestions that were there raised, in terms of litigation reform being a priority by Secretary Evans, the schema for obstacles that were raised by Mr. Carter, and the multitude of ideas suggested by Speaker Gingrich for improving our litigation system. I would, with one or two slight exceptions, I would agree with every one that was raised.

I direct the Center for Legal Policy at the Manhattan Institute. We have been working on civil litigation reform for about 30 years now. And last night we had our annual Hamilton Awards dinner, where we honor people who are—who have made a long, significant, lasting contribution to New York. It's named after our first Treasury Secretary. So I think it's appropriate, in the spirit of Al-

exander Hamilton, to consider what's going on with the U.S. capital markets today.

And we definitely see some disturbing trends. I certainly would say that the United States has been and probably, for the immediate future, will continue to be the leader in this area. But in terms of initial public offerings, as has been alluded to, there has been a precipitous decline in recent times, in terms of overseas offerings here in the United States.

In Europe last year, the IPO's were double those of the United States, in terms of float, three times those of the United Staes, in terms of total offerings, and five times those of the United Staes, in terms of the number of overseas offerings, i.e. offerings out of the area actually being listed there. So this is a disturbing trend.

And I think a number of the points made by Mr. Carter are valid in looking at the reasons here, particularly new reporting standards here in the United States under Sarbanes-Oxley, and especially the prosecutorial environment involving many of the State attorneys general offices.

But I also don't want us to neglect the area of litigation. It has been highlighted consistently today as an important area. Specifically, from the bankers' perspective, if you look at figure three on page eight of my written testimony, you will see the long-term trend lines of filings in securities class actions. There is a large uptick in 2001, with the collapse of the dot-com bubble. What is driving that is a lot of IPO allocation suits. So bankers themselves are finding themselves much more in the hook in the U.S. market than they used to be.

And then, secondly, the so-called litigation time bomb that Speaker Gingrich alluded to was referenced in the report by Henry Butler and Larry Ribstein that was entered into the evidence by Mr. Feeney. There certainly are a lot of new avenues for suit that have been entered into the risk factor for being listed on an American exchange in the last year.

I would like to just briefly run over some of the broad tort statistics and securities statistics before I run into the few specific ideas I raise in my written comments for consideration by the committee.

The tort tax in the United States is $260 billion, annually. That's 2.2 percent of GDP. You can see the trend lines on figure one on page three of my written testimony. And basically, you see that since 1950, there has been a four-fold increase relative to GDP, and the percentage of our economy consumed by tort from 0.6 percent to 2.22 percent. And this is the equivalent of a 5 percent wage tax on the economy, bigger than the entire corporate income tax. So it's a very sizable tax burden that we place on businesses and individuals in our society.

Internationally, if you look at the comparison on page four of my written testimony, figure two, Germany, we have about twice the tort tax of Germany, three times that of France or the UK. So it's a serious competitive disadvantage.

Now, in terms of securities filings, as was raised in the previous panel, there has been an effort—many of you were, doubtless, involved. If you were here in 1995 in the Private Securities Litigation Reform Act, it's been partly successful, but it certainly hasn't lived up to its full promise for reasons I will explain as I go into the

ideas, I think, that we could really focus on, particularly in the securities area, in getting ourselves improved, in terms of our competitive environment.

First of all, I would reiterate the notion that a loser pays system could be a useful reform. I think many of the concerns raised about that system, in terms of access to the courts, are simply not applicable in the securities context, because these involve large litigation industry shops that Speaker Gingrich was alluding to that are well financed and diversified.

I would also add that I think it would be even more useful in a mass torts context than in a securities context. I know that's outside the scope of this committee, but that's where you really see the proliferation of large numbers of individual weak claims overwhelming defendants' ability to defend against those claims.

The second thing I wanted to bring up is the failure of the lead plaintiff provision of the PSLRA to control abuse. In particular, I focus in my comments on the potential that we have seen for public State employee pension funds to use those provisions and act as lead plaintiffs.

And because these are often controlled by political actors who are influenced by or receiving money from the trial bar, the potential for mischief that I outline in my report is great. We have seen it in New York. The Louisiana Fund that I mention in my report has been notorious, as has been CalPERS, and several others.

So, I think we need to look at keeping employee pension funds out of the lead plaintiff business and/or secondly, doing what Speaker Gingrich alluded to. This is the practice formerly employed by Vaughn Walker, district judge in San Francisco, and that is having auctions for class counsel in securities class action cases.

I can discuss this more under questioning, but I think it's an idea that deserves a lot of attention. It was ruled not in compliance with the PSLRA by the ninth circuit. Judge Alice Kazinsky wrote that opinion. So I think he has probably got a pretty good case, in terms of the language of the statute of the PSLRA, but I think an auction process deserves serious scrutiny.

And then, finally, the pleading standard that was heightened under the PSLRA has been adopted inconsistently across the circuits. We have seen the higher standard that was used in the ninth circuit being effective in weeding out frivolous suits, and conversely—and adding a higher percentage of strong suits.

Unfortunately, a lot of the securities cases have started moving into other jurisdictions, as you would expect. So adopting that heightened pleading standard specifically in the statute could go a long way, I think, to deterring some of the weaker securities suits. Thank you, Mr. Chairman.

[The prepared statement of Mr. Copland can be found on page 77 of the appendix.]

Chairman BAKER. Thank you very much, sir. I appreciate your comment. Our next witness is Mr. Lawrence G. Franko, professor of finance, University of Massachusetts, Boston College of Management. Welcome, sir.

STATEMENT OF LAWRENCE G. FRANKO, PROFESSOR OF FINANCE, UNIVERSITY OF MASSACHUSETTS-BOSTON, COLLEGE OF MANAGEMENT

Mr. FRANKO. Thank you very much, Chairman Baker and committee members, for the opportunity to testify. My name is Lawrence Franko. I am the author of a recent study on U.S. competitiveness in the global financial services industry, which is referenced in my written testimony, and is available on the worldwide web under that title.

We have heard today discussion of many threats and concerns about U.S. competitiveness in global financial services. I don't think we should forget about these threats and concerns, but my view is that we should also not forget our strengths, and the remarkable position from which we start.

As Representative Kanjorski mentioned earlier, the importance of American firms in the world financial services industry is really quite remarkable. Indeed, the U.S. position in the most dynamic and rapidly growing segments of the industry is even more so.

There have been many references to IPO's, and how some of those—many of those recent ones—have taken place outside of the United States. But it is worth noting that U.S. investment banks and brokerage houses dominate not just U.S., but international capital market transactions, globally. U.S. investment banks easily account for two-thirds of the worldwide underwriting of these IPO's.

Our money management institutions and mutual funds manage well over half of the world's pension fund and personal financial assets. Far more than half of the world's hedge fund—indeed, 85 percent or so of the world's hedge fund, venture capital, private equity, derivatives, and risk management activities are conducted by American-owned and managed firms.

And again, even when these activities occur overseas, as in London, frequently they are conducted by American enterprise.

The numbers would be even greater were one to count not just U.S.-owned institutions, but the major U.S. activities, some of which are of global scope in their own right, owned by foreign, predominantly European, banks and insurance companies. The United States has global leaders in traditional banking and insurance, but it is noteworthy that U.S. global dominance and capital markets has arisen and accelerated as a result of the move toward new modes of financial intermediation, asset gathering, and risk management in our domestic markets.

I list a number of driving forces of this development in my testimony. Let me just highlight a few of them. First, we should not forget the post-World War II development of the prominence of the U.S. dollar in international transactions. Part of the development of trust in the United States and U.S. capital markets is the brand, the U.S. dollar, and the fact that people have confidence in the U.S. dollar that they do not have in other currencies.

Is it not somewhat ironic that when Saddam Hussein was pulled out of his spider hole, he was carrying a briefcase filled with pieces of paper that had the picture of Benjamin Franklin on them? Franklin is probably the most viewed American of all time, well

ahead of even Colonel Sanders, even in places like Japan and China.

Second, I think we should note the early U.S. encouragement given to funded pension plans, as opposed to relying primarily on government pay-as-you-go transfers. There was much mention of U.S. debt earlier. But by far the largest elements of U.S. debt are the unfunded liabilities of programs like social security and Medicare. And I would hope that, at some point before my children and grandchildren have to start paying much higher taxes, that Congress would revisit how private pension plans might be given even more encouragement.

Third, we had an early development of the securities culture here, where regulation and competition interacted to produce a large domestic market in which publicly quoted, professionally-governed, transparency-oriented firms are the norm, rather than the exception.

I have lived and worked in many countries around the world. And one of the major differences between the United States and many other countries is that we do not have large numbers of family firms, State firms, who are entrenched and secretive, and who do not provide the kind of transparency that our markets do. I think it makes a big difference, in terms of why we have been so successful as an economy, as opposed to other countries.

I will mention the public policy implications, the regulatory implications. Other people have stressed this. We should do nothing that moves us back and away from the confidence of the publicly quoted transparent, professionally governed business model, which we have more than any other country in the world.

I might also mention the declining protection given to incumbent banks and insurance companies from capital markets competition, compared to other countries, another element of our business environment that makes us rather distinctive. And I also want to mention skills, knowledge, which has been mentioned earlier.

There is a good deal of talk about people training for science and engineering and mathematics. As a professor of finance who is all too aware that some of my brighter colleagues came out of much more mathematically-rigorous traditions and training than I did, just because one has studied physics doesn't mean one can't make a contribution to risk management. Quite the contrary. And that matters a lot for our position.

The United States has often been the first market for financial innovations ranging from mutual funds, to hedge funds, to big bangs, to public security offerings on a large scale, to providing rights for minority shareholders and many others. Other countries gradually realized that they needed those capital markets, and their capital markets developed in a way that was similar to a pattern that the United States had experienced earlier. One of the reasons for the dominance of U.S. investment banks and securities firms is that by the time other countries realized they needed a capital markets culture, our companies had already developed unassailable strengths.

What does this mean for regulation? Well, I would echo many of the conclusions and recommendations that have been made earlier today. We should not get bogged down by the complaints about

Sarbanes-Oxley. Perhaps there are parts that need to be refined, but we should remember goals, even when we are preoccupied by details.

Congress makes laws, and many laws are highly detailed and complex. Ultimately, however, maintaining and strengthening the U.S. global capital market position means maintaining our reputation. Our brand is not just transactions, efficiency, knowledge, and skill, it is also honesty, transparency, and good corporate and capital market governance. We cannot gain the benefits of this reputation without incurring some costs.

Secondly, though this item hasn't been mentioned explicitly today so far, I would argue that regulations should look out for the interests of consumers and share and bond stakeholders, not for those of managers and firms who may wish to entrench themselves against competition.

Had our big bang not occurred first, or had our banks been able to continue to shut out out-of-State or non-bank competition, we would not have the thriving capital market actors we do today. Firms hone their global competitive skills by first competing at home. Regulation that protects today weakens firms in the long run. We should promote the future, not the past. Thank you for your interest and attention.

[The prepared statement of Mr. Franko can be found on page 98 of the appendix.]

Chairman BAKER. Thank you very much for each of your testimonies. I want to start with you, Mr. Franko, relative to your closing comment, and that is the competition is what breeds a domestic company's skills to compete internationally.

I come at this issue believing that much of our regulatory constraints preclude that type of head-up competitiveness, and to some extent, discourages entry into the market by smaller and start-up companies.

Now, I am not expressing the view—an outright repeal of Sarbanes-Oxley. That's not where I am going. What I am suggesting is that the government should never be the determinant of winners and losers. That has to come from market-driven forces. Where we can identify areas where government rule is, to a great extent, precluding that competitive opportunity, we need to get out of the way.

Not on this topic, but on a related matter, insurance sales. There is no reason on earth why a life insurance policy sold in Florida can't be sold in Maine without going through 50 different State approval processes. A clear case where regulatory barriers preclude product development which precludes competition, and the result is very abhorrently high insurance rates in some States because of their local jurisdictional constrictions.

I think the same can be said of our securities environment. Much of the body of law that governs activities was written in the 1930's. I don't care how bright they were. They couldn't possibly have predicted a derivatives transaction, or understood counterparty risk in 1934.

Going forward, what I am hopeful for is an ability to have an arms-length examination of every component of market function, determining what regulatory aspect is perhaps not working as in-

tended, or worse yet, a regulation which only adds to cost, therefore taking it out of the shareholder pocket, ultimately, and serves no public benefit.

Am I in territory that you agree with, or is that a view that you find inconsistent with what you have testified to here today?

Mr. FRANKO. You are more than in territory that I agree with. I completely agree with your sentiments. I empathize with Members of Congress who wish to maintain our competitive system in the face of lobbying for privileges and exemptions. Many people in the banking and insurance world are surely eagerly lobbying to use regulation as a means of maintaining or raising barriers to entry. I think the more that we can promote competition, the better.

Speaker Gingrich mentioned work by Peter Wallison. Peter and I were college classmates, and I keep track of Peter's articles and comments regularly. In an op ed about 2 days ago in the Wall Street Journal, in which he argued that Wal-mart should not be prevented from offering banking services, he came up with the wonderful sentence, "People who think they are building walls are, in the long run, building coffins."

One of the reasons I think we do not have more major leaders in global banking and global insurance is that for far too long our banks and insurance companies were much more interested in building walls than they were in innovation and dynamism, and I think it has come back to haunt them, because they have lost major ground, both to domestic capital market firms and to foreign competitors.

Chairman BAKER. Well, it seems to me rather rudimentary capital markets philosophy that if you have money and you wish to deploy it and create a product or a service and sell it at whatever price you may choose, your success is determined by the consumer's willingness to pay that price for that product or service. And if they don't, you are not going to prevail very successfully. And if somebody figures out a better way to make your product at a lower price, you are still in trouble.

Anything that skews that market function from occurring is not ultimately healthy for your long-term economy. And Ms. Pinelli, in your prepared statement, I was noting that you indicate that the U.S. markets represent about 30 percent of market cap, while Asia Pacific is at 28 and Europe is at 27. I don't find great comfort in that lead. That's—in polling terms in a political world, that's within the margin of error.

I was taken by—the tone of your testimony seems to indicate that things aren't really that bad, that if you take out the state-owned enterprises that were made private, and take that out of the IPO offerings, that really it's not that big a deal, and that you place great value in the regulatory seal of approval on U.S. businesses that you believe enables the flow of capital to come into our marketplace. Is that a correct characterization of your testimony?

Ms. PINELLI. Mr. Chairman, I think, if I can summarize what you're trying to ask me, is we are seeing growth in foreign capital markets. That is of concern to us. Yes, it is.

Keep in mind, the United States, we have capitalized the financial services industry: resources, utilities, and transport industries. These organizations in China: the banking system, the energy sys-

tem, they are coming to market for the very first time. If you take out the state-owned enterprises in China in the last year, their IPO activity is not as compelling as we might think.

And I believe the question that you are asking is what about the traditional businesses, non-state-owned products and services that a willing consumer would pay for, how do we stand competitively in that area, in that market segment?

I can tell you that Suntech, for example, the largest entrepreneurial Chinese company, chose to list on the New York Stock Exchange this past year, in 2005, with a $500 million offering. I gave you the example of Baidu.

And I support your comments that that area does need further examination, and it's a trend that we continue to monitor.

Chairman BAKER. So your—to wrap up your summary of my question, that although we should be concerned about market dominance, that we are not in a death fight quite yet, that if we're attentive, maintaining appropriate regulatory oversight, do this examination and reduce those things which don't have public value, enabling the free flow of capital to where it can be most efficiently deployed, those outside U.S. markets will list in U.S. markets principally because that gives them credibility in the worldwide market that they are able to meet our listing standards.

Ms. PINELLI. And, of course, there is valuation premium.

Chairman BAKER. Yes.

Ms. PINELLI. They will come to market and immediately—if, you know, we understand the New York Stock Exchange—have a 30 percent premium.

But I don't have the answers, and I share your concerns, and I congratulate you on this special committee. The question for me is how many more state-owned enterprises, how large will they be? Bank of China is coming to market in 2006. It will be massive. It will be bigger than the $9.2 billion China Construction Bank. The Hong Kong Stock Exchange will then have a large pool of capital. They will strengthen their capital market.

Then the question becomes will traditional businesses outpace—will that growth outpace that of the United States, and when they choose to go to market in the public arena, will they choose the United States? Well, today we do have a valuation premium standard. We are seeing signs of very good companies coming to the United States because of our investor sophistication, valuation premium, very good corporate governance—

Chairman BAKER. So the observation would then be as the Asia Pacific exchanges grow, and they become perhaps even larger than the U.S. capital markets, does an individual need to come to the United States to get the valuation premium, or can they list in their own marketplace and achieve the same end?

Ms. PINELLI. Well said.

Chairman BAKER. Thanks. Last thing, Mr. Copland. I don't want to ignore the observations about litigation reform. I share your view, so I don't necessarily want to replow that ground.

I want to perhaps discuss with you just a little bit accounting generally, and the concerns about the foreign-owned company coming to the United States, and in order to become GAAP-compliant,

having to spend an inordinate amount of time and resources—and that's another weight in making the decision not to come.

I am an advocate of Extensible Business Reporting Language, XBRL, which has now undergone a pilot at the FDIC, and has been a successful pilot, and hope to encourage the deployment of that to all insured depositories in the near term.

Assuming we can develop the appropriate taxonomy for private operating companies to utilize this—and I understand the SEC has encouraged data tagging in its reporting methodologies—that that could be a very good way to slide into an international standard where you have more real time disclosure of things which are not required now by the SEC to be disclosed, but which are of value to the investor.

And secondly, it enables the Mom and Pop investor to be able to do comparisons so we don't get Mr. Campbell's 14 pages of documents, 14 feet of documents, but rather what you wish to get to compare with another entity you wish to compare it with.

So, it's, I think, a very helpful tool, not only for the knowledge of the investor, but also, ultimately, to enable us to do away with quarterly reporting so that you don't have this internal pressure on management to beat the Street every 90 days, which I think has been an insidious force in why we got into all these accounting manipulations in the first place.

Do you have a view of that set of issues? And how do you feel we can move, as a committee, in going forward, not necessarily just to reach a single international standard, but to enable that capital to flow more freely to us, by reducing the accounting concerns?

Mr. COPLAND. I agree with you, Mr. Chairman. I think the accounting compliance issues are very important, and the ability to—you know, the extra cost of following the different accounting standards is high.

I also agree with you that the artificiality of the 10Q, 10K sort of process is—creates perverse incentives for management that aren't necessarily aligned with shareholders. And—

Chairman BAKER. Well, for my purposes, we now have a rules-based retrospective system. And as long as you play by the rule, you're going to be okay.

Mr. COPLAND. Right.

Chairman BAKER. I learned that a telecommunications company booked its revenue in a current operating quarter the sale of broadband capacity on a broadband system which had not yet been built. And that was legal. And I knew we were in deep trouble.

At the same time, if I knew that a company was selling widgets, and 9 out of 10 were being returned, or customer satisfactions surveys said I would never walk in your door again, I know which information I would rather have about a company's performance. The old rules-based retrospective, or the customer satisfaction survey?

I think getting that kind of disclosure to the markets—we seem to requite disclosure of an inordinate amount of detail which the market has no interest in reading. And I don't know how we got mismatched so badly, but—

Mr. COPLAND. Yes. I agree with you. I think, frankly, the litigation climate is a large reason why the—this kind of information

comes out there for protective reasons, as well as just excessive regulatory compliance.

In terms of Mom and Pop Investor, I think it's very difficult for the mom and pop investor. You know, I have investments as well. I get the piles of statements. You can't read them, you can't make anything of them, you just try to have a diversified portfolio, and hope that the system itself is sound.

I do think that, you know, that big hedge fund managers, mutual fund managers, etc., do read these. And I do think that, therefore, you know, there is definitely value there. There is informational value, and you want to maximize the ability to get that out on the market at the minimal cost.

And you know, I don't think we have the equation quite right yet, so I think, you know, some of these substantial reforms, over time, the real-time ability to disclose information could be very useful. You know, I think we do have to have concerns about what the litigation implications might be for companies that are doing that, and that's something I think that we always ought to keep in mind in this environment.

But I do think that, you know, a lot of what you're saying makes a lot of sense to explore further—

Chairman BAKER. Well, we don't want to encourage forward-looking statements that encourage litigation. We need to have disclosure without liability.

Mr. COPLAND. Right.

Chairman BAKER. For making what is intended to be a good faith projection of business direction. But as we go forward, I indicated earlier that—to the other panel—that it is my intention, over the next several months, to investigate what the agenda ought to be, to identify those half-dozen or dozen issues that really need to be focused on that would make a significant difference in our future competitiveness, because I do have concerns that, despite the fact that we are still at 30 percent, we need to be widening the gap, not watching it shrink.

And to that end, we certainly are going to be calling on you for your professional insights to help create that agenda. It's not something that—you know, I'm not going to run out and suggest repealing Sarbanes-Oxley, I don't want to get folks all excited, but we need to look at every aspect, and make an informed judgement about, you know, what is warranted and what is justified, in light of our current market conditions.

Mr. Campbell, I didn't mean to exclude you from our discussion, but I want to express appreciation to each of you for your contribution. We will be back to you in writing over the coming weeks. And thank you for your participation here today. Our meeting is adjourned.

[Whereupon, at 1:08 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 26, 2006

Opening Statement
Rep. Richard H. Baker
Subcommittee on Capital Markets
Hearing entitled "America's Capital Markets: Maintaining Our Lead in the 21st Century."
April 26, 2006

Good Morning, today the Capital Market's Subcommittee meets to hear from our distinguished witnesses their views on the global competitive outlook of our nation's capital markets.

Having the world's most efficient capital markets is not America's birthright, rather it is a position earned through hard work and ingenuity. If the U.S. Capital Markets are to retain this distinction, there must be recognition and restoration of the principles that enabled such success. Further, those who regulate and legislate for these markets must institute necessary reforms to maintain our primacy, or inherit the consequences of our inaction. Over the last five years, both legislators and regulators have spent a great deal of effort in responding to a crisis in investor and market confidence. The Enron, WorldCom, Global Crossing, and Tyco revelations (to name a few), in conjunction with the DotCom bubble bursting, brought home a sobering reality; there were material weaknesses not only in the way these companies operated, but perhaps more importantly, in the manner in which they were regulated. Through the efforts of the Congress, the PCAOB, SEC, and others, investor confidence has been significantly improved. This confidence has never been more important as now over 95 million Americans call themselves investors, or stated another way, over half of all American households are marketplace investors.

Restoring fairness and enhancing transparency in our markets requires continued vigilance on the part of both regulators and legislators. However, I believe our markets are now facing an even greater challenge; retaining supremacy in an increasingly competitive global market. If the NYSE/Archipelago and NASDAQ/Instinet mergers were not enough proof of the changing nature of our markets, NASDAQ has also just purchased 14% of the London Stock Exchange, while the NYSE has expressed interest in gaining a share of a European exchange as

well. Innovations in technology have had a dramatic impact on both trading and capital formation, and innovators have made great strides in increasing the efficiency of our markets. Today, U.S. markets are the most sophisticated and technologically advanced in the world. So why are so many companies choosing to list abroad at exchanges such as the London Stock Exchange instead of on U.S. Exchanges? I believe there are three significant areas of concern:

(1) irresponsible litigation and the costs it imposes on businesses, shareholders, and consumers;

(2) inefficiencies in the regulation of our capital markets;

(3) the historic lack of progress in addressing accounting complexities and international convergence of accounting standards.

These domestic issues, combined with increasingly efficient and liquid foreign markets, pose a significant challenge to the supremacy of U.S. capital markets. If unaddressed, these barriers to attracting capital to our markets will continue to put the U.S. at a growing disadvantage in the global market. Investor protection and global competitiveness are not necessarily mutually exclusive. Congress must insure the regulatory system is effective, while enabling innovative and profitable activities.

First, responsible tort reform is essential to combat the high cost of frivolous lawsuits that plague our markets. Class action suits often times do little to provide restitution to injured investors and all too often only enrich those attorneys who handle them. There is a need for re-balancing, between justifiable actions against frivolous filings. Such review and reform is essential to maintain market dominance in a global market. As an aside, I am proud that the Fair Fund, created in Sarbanes-Oxley, has now designated over 7.5 billion dollars for return to investors without the need of class action litigation. There are effective ways to react to unprofessional conduct.

Secondly, we must undertake a comprehensive review of the manner in which securities transactions are regulated. Smart and efficient regulation increases the value of a market for both companies and investors. Duplicative and unnecessary regulation does little else than to raise costs and lower returns, thus making a market less attractive

for all participants. Many of these redundant and outdated regulations are within the authority of regulators to address on their own, and several have begun such evaluation. However, aggressive oversight is still necessary at the Congressional level to ensure that regulatory constraints that provide little or no benefit to investors are eliminated. Much of our regulatory standards were proposed in 1933 & 1934. There has to be room for considerable improvement.

Finally, our current accounting environment is hindered by being a rules-based, retrospective looking system of financial reporting. As we heard from witnesses at our recent subcommittee hearing, (Fostering Transparency in Financial Reporting) technological advances are allowing companies instantaneously determine their financial condition and therefore able to provide that information to the markets in virtually a real time manner. Projects such as XBRL, or eXtensible Business Reporting Language, being undertaken in by the FDIC & SEC will help provide participants in U.S. markets relevant data more quickly, enabling more informed investment decisions. Moving away from quarterly earnings forecasting toward real time reporting will also serve to help minimize the market volatility, while diminishing the need for "creative" earnings management by corporate executives. This will also assist progressing toward an international convergence of accounting standards. A global market requires the free flow of capital across international boundaries, and this requires a seamless and uniform method of accounting.

For many years, U.S. capital markets were considered by investors to be "alone at the top" with regard to opportunity and efficiency. However, while we have been tying our own markets down with regulatory rope, China, Europe and other foreign markets have been following the risk taking model that made our markets great. These foreign markets have gained significant ground in the global competition for capital. This fact drives the point home, 20 out of 24, of the largest most recent IPOs were brought public, not in the U.S., but overseas. Many large companies now prefer to list in London or Tokyo, instead of New York. These events should serve as a wake-up call for Congress and the regulators. While we should be very concerned that capital is leaving our markets,

we also have an obligation to American investors. Over half of working Americans now invest in U.S. markets in a very significant way. Smart and efficient regulation is both beneficial and necessary to a properly functioning capital market, but it is also necessary to insure investors have clear disclosure and timely information to make their investment decisions. And when necessary, there should be regulatory action taken against those who fail to discharge their fiduciary duties. This is not a complicated task. Balancing investor protection with efficient market function just makes sense. When investors have confidence, capital flows freely. A free flow of capital enables markets to grow, enabling product development, and job creation. This is the essence of properly balanced capital markets. This is what makes America work. We cannot accept anything less.

U.S. Congresswoman
Ginny Brown-Waite

Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing, Wednesday, April 26, 2006
"America's Capital Markets: Maintaining our lead in the 21st Century"

Statement for the record

I want to thank you Mr. Chairman for holding this hearing today. And thank you to the witnesses that have joined us.

Some figures I was recently made aware of trouble me. In 2000, 9 out of the 10 largest IPOs were in the United States. Last year, only *one* out of the 24 IPOs that raised a billion dollars or more was in the United States. And according to a recent Wall Street Journal article, global stock and bond issuance rose by $1.86 trillion in the past year, with non-U.S. companies driving the activity. While the U.S. still leads the world in IPO volume and U.S. securities companies are still in high-demand, if Congress doesn't take a good look at the policies surrounding our capital markets, the U.S. will go from a world leader to a mere player in no time.

One this is certain: the United States must to get a handle on its litigation costs if we are going to continue to be a market leader. Congress has passed several pieces of legislation over the past decade; yet settlements increased to almost $10 billion last year. With this type of lawsuit abuse, the United States will lose its ability to compete with global markets.

Additionally, we have some of the strictest accounting practices in the United States thanks to Sarbanes-Oxley that protect consumers. However, the International Organization of Securities Commission and SEC Chairman Cox continue to advocate for compatible security and accounting laws globally. Accordingly, I look forward to hearing from our witnesses to learn what Congress can do to bring these other countries up to our standards. I want to ensure that U.S. accounting standards and securities laws do not discourage foreign companies from trading in New York and on other exchanges.

Thank you again Mr. Chairman for holding this hearing.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
"AMERICA'S CAPITAL MARKETS: MAINTAINING OUR LEAD IN THE 21ST CENTURY"
APRIL 26, 2006

Chairman Baker and Ranking Member Kanjorski,

I want to express my sincere appreciation for you holding this hearing today.

The United States is currently at a crossroad.

We can either decide to move towards a more responsible, effective form of government than we presently have or we can continue down the road that has led to the rise and fall of great nations.

Today's hearing is entitled "America's Capital Markets: Maintaining our lead in the 21st Century." I find it an interesting title since some naysayers contend that we have already lost our lead in the capital markets, or at the least, are sliding down a slippery slope towards such a loss.

I am not going to go into all the ins and outs of arguments that say we are still the lead country in terms of capital markets, the lead economy or the truly sole superpower in the world.

I will leave that to those who will testify here today: 1) Secretary Donald Evans, 2) Mr. Marshall Carter, and 3) the Honorable Newt Gingrich. I look forward to hearing their presentations.

What I am most interested in is ensuring that our markets do remain competitive, and I believe that this requires an intensive and comprehensive investment in our children and their education, particularly in science, math and technology.

To address this situation, I collaborated with the University of Texas-Pan American to develop Hispanic Engineering, Science & Technology (HESTEC) Week. It is a year-round leadership program that emphasizes the importance of science literacy to thousands of Pre-K to college students and teachers.

Through professional development workshops, presentations by world class speakers, competitions and hands-on activities, participants are encouraged to prepare for studies in math, engineering, technology and science.

Mr. Chairman, at this point, I would ask that all of these documents pertaining to HESTEC be included in the record.

The importance of HESTEC has never been greater-statistics show that the United States is falling behind in the numbers of students excelling in the areas of science, math and engineering and these figures are even more alarming among Hispanics and other minority groups.

During HESTEC, we give children and teachers the necessary tools and encourage them to reach for new heights. Students and educators interact with some of our country's top CEO's, engineers, scientists, astronauts and designers. Events like Educator Day, the Hispanic Science Literary Roundtable, Latinas in Science, Engineering and Technology, Robotics Competitions and Community Day allow students and educators the opportunities to meet top role models and learn valuable leadership lessons. In addition, more than $1.4 million has been raised for student scholarships.

HESTEC is a key ingredient to ensuring that our nation continues its entrepreneurial spirit and that our capital markets remain competitive and world class markets.

Mr. Chairman, I cannot stress enough how important it is for the United States to produce additional scientists and engineers. We need to do so in order to continue to be able to compete with our overseas counterparts, much less to remain a superpower. I would hope that all of those present at today's hearing review information on the HESTEC program at www.HESTEC.org and focus increased commitment and dollars on science, math and engineering in the United States.

Mr. Chairman, I yield back the remainder of my time.

Testimony

New York Stock Exchange, Inc. 11 Wall Street New York, NY 10005 www.nyse.com

Marshall N. Carter

Chairman of the Board

NYSE Group, Inc.

On

"America's Capital Markets: Maintaining Our Lead in the 21st Century"

Financials Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

United States House of Representatives

Washington, DC

April 26, 2006

Chairman Baker, Ranking Member Kanjorski, Chairman Oxley, Ranking Member Frank and members of the Committee. I am Marsh Carter, Chairman of the NYSE Group, Inc.

Thank you for inviting me to testify before your committee today.

I am grateful for this opportunity to discuss an issue of rising national importance, which is the loss of U.S. competitiveness in the capital formation process. Chairman Baker, your leadership on this issue could not come at a more significant time to our markets and our economy. Thank you for taking the initiative of holding this hearing to preserve the preeminence of the U.S. markets.

Today I am going to divide my testimony into four parts:

First, I will present evidence detailing this loss of competitiveness.
Second, I will offer some explanations as to why it is occurring.
Third, I will discuss some ideas for improving our competitive position.
Finally, I will conclude with the implications of losing our leadership position for American investors, our capital markets and the broader economy

Let me begin with the good news. That is, our economy is strong, and the U.S. market remains the market of choice. In 2005, the U.S. again achieved the highest amount of capital raised in IPOs by any single country in the world. The U.S. provides unrivaled

access to a very deep and broad pool of investors and enables companies to extend their own visibility on a global stage. At the NYSE, we had record trading volumes in 2005.

But there is a very troubling trend emerging among foreign companies seeking access to capital, particularly the largest foreign companies. From every vantage point, evidence of the loss of U.S. competitiveness in the capital formation process in the increasingly global marketplace is real and growing. In 2000, nearly half, 46.8%, of the global IPO equity was raised on U.S. exchanges. However, in 2005 only 5.7% of the dollars raised by non-U.S. company IPOs was raised through shares listed on U.S. stock markets subject to U.S. regulatory rules and oversight. Unfortunately, we do not believe this is a one-year phenomenon.

In terms of sheer numbers, global foreign IPOs that are SEC-registered and listed on a U.S. exchange declined from 100 in 2000 to 35 in 2005.

In addition, of the top 24 global IPOs in 2005:

- Only one was registered in the U.S.
- All of the top 10 were outside the U.S. public markets.
- Eight of the top 10 raised capital in the U.S. via private placements and therefore not accessible to the average investor.
- Vivendi, one of the five most active French stocks on U.S. exchanges, has announced its intention to delist.
- Coles Myer Ltd., Australia's leading retailer, will also delist.

- Cable & Wireless Plc., Britain's second leading telephone company, delisted last December.
- The number of companies with American depositary receipts on U.S. exchanges has declined 8.8 percent since 2002.
- Twelve companies from China qualified to list on the New York Stock Exchange listed in Hong Kong instead. One of these companies, China Construction Bank, was the world's biggest IPO in five years – nearly $10 billion – and elected to go to market in Hong Kong rather than the U.S.

These statistics are in stark contrast to the situation in 2000, when 9 of the top ten worldwide IPOs registered on U.S. markets. All told, there were fewer IPOs in 2005 than in the peak year 2000. However, the proportion of the value of all IPOs that were global – i.e. that were raised in markets outside their home country – actually increased from 48.1% to 55.8%. More IPOs are global -- and fewer are listed in the U.S. This highlights quite dramatically the U.S. loss of global market share.

In 2005, $86 billion was raised through 224 IPOs for non-U.S. companies in the U.S. capital markets. This illustrates that non-U.S. companies still want to access the unparallelled depth and liquidity of the U.S. capital markets.

However, they are no longer doing so through the public markets, to the degree that they once did. Of the 224 IPOs for non-U.S. companies that came to the U.S. in 2005, 94% of those offerings, 189 of them representing $80.5 billion, were not registered in the U.S. or

listed on any U.S. exchange. Instead, they were offered privately, to qualified institutional investors, under Regulation 144A. These 144A IPOs are less liquid, and are not subject to the rigorous regulatory oversight and disclosure that apply to registered offerings. Individual investors, for the most part, cannot participate directly, but can only access these 144A offerings through pension funds, mutual funds, and other institutional investment vehicles. These 144A offerings completely circumvent the corporate governance and transparency requirements that are the hallmarks of the registration process. This means less investment opportunity, and less protection by corporate governance and other rules, for the nation's individual investors.

Let me turn to the possible explanations for this disturbing trend. We see at least four.

First, the U.S. is losing listings because of the persistent concerns surrounding the U.S. trial bar and the litigious environment in the U.S. We need to recognize that the United States today has the reputation, both at home and globally, as an increasingly difficult place to do business. The possibility of being sued for huge sums, while also bearing high costs of legal defense has brought many companies to a moment of reckoning that mitigates against registering their securities in the United States. The total value of settlements in securities litigation class action lawsuits has continued to increase from $150 million in 1997 to $9.6 billion in 2005. Given the risks and threats to their bottom line, regrettably, foreign companies are simply concluding that it's not worth it to come to our market.

A second reason for the loss of listings on U.S. financial markets is the lack of convergence in international accounting standards. This divergence becomes all the more important in this period when European companies and countries are moving toward a common standard. When companies today are required to reconcile their accounts with U.S. GAAP when they list in the U.S., many balk at what they consider needless and costly redundancies in reporting.

While the FASB and IASB have made significant progress towards reconciling U.S. GAAP with international accounting standards, to date, the progress has been mostly incremental and failed to reduce costs significantly. While the SEC, IASB and FASB have established a goal to eliminate burdensome reconciliation requirements for the financial statements of non-U.S. issuers by 2009, there is no target date yet for true convergence of U.S. and international accounting standards.

A third explanation to which we can point is the improving quality and depth of equities markets abroad. European markets in particular are being helped by the success of the Euro, their relatively new, single European currency. Broad acceptance of the Euro makes it now possible, for example, for a Spanish investor to purchase a German security easily and with no foreign currency risk exposure.

Europe has also developed robust homegrown sources of capital. Europe today is served by three principal exchange operators, the Deutsche Borse, Euronext and the London Stock Exchange. Each of these exchanges is a well–capitalized, publicly-held entity that

offers broad product mixes, that can absorb significant offerings, and all are competing aggressively to expand globally and to take away U.S. market share.

The London Stock Exchange's small-cap growth market, known as AIM, saw a tripling of the number of overseas listings in the past two years, with more than 220 foreign companies listing. They saw increasing interest in 2005 not only from companies in Australia, Israel and China, but also from companies here in North America.

Other markets, especially in Asia, the Hong Kong and Tokyo Stock Markets representing two excellent examples, are stepping up the pace to compete for listings and global capital, usually at the expense of the U.S. As reported in the April 6, 2006 edition of The Wall Street Journal, the Tokyo Stock Exchange is in the middle of a campaign to become the exchange of choice for Asian companies. As part of their effort, "the TSE is trying to persuade Japanese regulators to accept (financial) statements that follow international standards."

Finally, foreign companies are unquestionably concerned about the costs and added regulatory burdens associated with the U.S. regulation, including Sarbanes-Oxley.

U.S. regulatory costs in general are high because of the overlapping, multiple regulatory enforcement bodies to which public companies are subject. The Securities and Exchange Commission and the 50 states (and U.S. territories), in particular New York and California, in the wake of the scandals that began with Enron and Worldcom, have been

outdoing each other in their efforts to demonstrate that they are tough cops. This regulatory zeal is a real concern for international companies.

With respect to Sarbanes-Oxley, we have stated and we believe that the law as a whole strengthened investor confidence by reforming corporate governance and financial disclosure. As noted in a recent opinion piece in The Wall Street Journal, Sarbanes-Oxley did two important things: it established the PCAOB to provide private-sector regulation of the accounting profession, and it mandated that public companies and their outside auditors attest to the quality of their internal controls. Sarbanes-Oxley has changed the tone at the top of organizations, revitalized the engagement of boards, provided for better disclosure, and is largely responsible for the compliance culture that now exists at companies.

Indeed, one of the underlying motivations for companies listing in the U.S. is the increase in value – which averages about 30 percent -- that accrues as a result of adhering to the high standards of governance that the U.S. markets demand. But companies are increasingly viewing the costs associated with these regulatory requirements, as well as their impact on the speed with which they can reach the market, as outweighing the valuation premium they offer. The way that the requirements of Section 404 were implemented is perceived to have resulted in substantial cost and duplication of effort that has caused international companies to conclude that the additional costs of our regulatory structure outweigh the benefits.

While we are heartened by the recent report that Section 404 compliance costs are decreasing, the costs continue to be a significant factor in international companies' decision to list, or not to list, on a U.S. market.

When the London Stock Exchange surveyed 80 international companies that conduced IPOs on its market, it reported that 90 percent of the companies that had listed on the LSE felt that the demands of U.S. corporate governance rules made listing in London more attractive. The Wall Street Journal recently reported that small U.S. companies are turning to London's small-cap market, AIM, for a variety of reasons, including the regulatory costs of going public. The article noted that "one of the reasons most commonly cited is the strain of Sarbanes-Oxley regulations in the [United S]tates."

These added costs and regulatory risk are seen as disincentives that are dissuading more and more non-U.S. companies and even U.S. companies from listing on U.S. exchanges. According to the National Venture Capital Association, the venture-backed IPO market declined from $11 billion in 2004 to $4.4 billion in 2005. While this cannot be entirely attributed to the added costs of regulation, it is a real factor.

With that said, let me turn now to possible ideas for improving our competitive position. We are encouraged that your hearing today, Chairman Baker and Ranking Member Kanjorski, signals a recognition on the part of our Congressional leaders of these realities and a demonstration of the leadership needed to find solutions. We also recognize the work of the SEC, PCAOB, accounting firms and others to address these issues.

For our part, the New York Stock Exchange has worked over the last two years, both nationally and internationally, to bring together interested parties – regulators, accountants, CEOs and others – to discuss the issues facing the U.S. capital markets. The purpose of these efforts has been to find common ground and strive for a better balance between regulatory costs and benefits, as well as to accelerate convergence of international accounting standards.

We believe that these efforts are bearing fruit, and we applaud the willingness of U.S. regulators to demonstrate greater flexibility. At the same time we strongly believe that more needs to be done. Understanding that there will be no shortage of proposed solutions, permit me to suggest three possible areas of focus for strengthening competitiveness of U.S. markets:

First, continue to work to reduce the risks and costs of meritless litigation;
Second, seek to accelerate harmonization of accounting standards; and
Third, work with the SEC and PCAOB to streamline the regulatory requirements attendant to securities registration, including the requirements under Section 404, and ensure that these regulators have adequate flexibility to implement the law's requirements in a cost-effective manner.

With respect to the costs of meritless litigation: tort reform is a difficult objective that many have worked hard for many years to achieve. Some of you here today, as well as

SEC Chairman Cox are owed a great debt of gratitude for the success ten years ago of the Private Securities Litigation Reform Act, which has helped to curb meritless securities lawsuits against public companies. But more needs to be done to control the costs of the country's appetite for litigation, so I urge the Congress to continue to press for meaningful tort reform.

With respect to harmonization of accounting standards, we applaud the efforts of SEC Chairman Cox to achieve this goal. Just this February, he welcomed the announcement by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) of a memorandum of understanding about their plans for measurable progress on improved and converged standards in a number of areas. Chairman Cox has endorsed the "roadmap" for elimination of the requirement that foreign private issuers reconcile financial statements prepared using international financial reporting standards to the U.S. system of Generally Accepted Accounting Principles (GAAP).

As I noted above, while the FASB and IASB have made significant progress towards reconciling U.S. GAAP with international accounting standards, we need to accelerate efforts to achieve true convergence of accounting standards for U.S.and non-U.S. issuers. Every year we delay it will become more difficult for us to regain market share that is lost to other countries.

With respect to reducing the regulatory costs of U.S. registration, we believe that much of what needs to be done can be done within the current system via the SEC and the PCAOB. We suggest that those organizations consider emphasizing and supporting risk-based reviews under Section 404. For example, each year, a company and its auditors review the internal controls surrounding the most material, significant income statement and the balance sheet assertions where the risk of material misstatement would prove harmful to investors. This approach ties into the current SEC focus on "materiality" aspects of risk. Such reviews would catch the most egregious risks to the organization without the costs associated with some of the reviews currently being conducted. Of course, in order to provide some comfort to auditors and companies, explicit guidelines and criteria for such risk-based reviews would need to be provided by the PCAOB.

Within a risk-based review framework established by the SEC and PCAOB, they could use their rulemaking authority to reduce the frequency of annual baseline Section 404 reviews to every third year. Once the controls are in place, it is more a matter of maintaining and updating them, especially with respect to low materiality, low risk areas. For the intervening two years, auditors would still review all of the high materiality, high risk areas while performing high level testing on the areas of low risk and low materiality, working from a baseline Section 404 audit. Every third year, the audit firm would conduct another baseline Section 404 review. This would preserve the investor protections provided under Section 404 without the unnecessary burden of annual baseline reviews.

Let me be clear: we advocate that the SEC and PCAOB establish specific risk-based materiality criteria. A company must pass the annual audit of these materiality criteria. Only then would consideration be given to permitting the company to undergo a full baseline audit every third year.

Just this week, The Economist recommended a risk-based approach under Section 404, suggesting that the SEC "narrow the scope of the internal-control review carried out by auditors so that they examine only the larger risks, not the size of people's lunch expenses."[1]

It is worth considering the approaches to periodic review that are taken in another industry where risks to consumers are considerable. For example, the Joint Council on the Accreditation of Hospitals (JCAHO) audits hospitals every three years. The work of the JCAHO is vitally important to the protection of U.S. citizens and yet it does not conduct audits on an annual basis.

Now let me turn to the consequences of losing global listings – for U.S. investors, our financial markets and the broader economy. Let me be clear that the NYSE Group believes in competition, in free and open markets, and in the right of investors to manage their risks and invest wherever they choose. In fact, it is our commitment to these core principles that led to our historic decision to become a public, for-profit company, merging with Archipelago and transforming the New York Stock Exchange into a far

[1] "In search of better SOX," The Economist (April 22nd-28th, 2006) at 11.

more competitive and innovative marketplace offering a broader portfolio of products and platforms.

At the same time, we understand that investing outside the U.S. is an important, and growing, means for American investors to manage risks and potentially to increase returns, as well. Therefore, even when companies do not list in the United States, American households can own their stock indirectly through mutual funds, pensions or savings plans, insurance contracts, or other institutionally managed accounts.

However, when U.S. investors send their capital to overseas markets in this manner, they risk losing the protection of strong, well-established and designed U.S. standards including the federal and state securities laws and the rules and oversight of SROs like the NYSE. These protections are the highest in the world. Ironically, the factors that are causing more non-U.S. companies to raise capital overseas instead of in the U.S. are denying U.S. investors the benefits of transparency and investor protection that are the hallmarks of U.S. registered offerings.

While robust private placement and overseas listings markets are important to both local and international markets, we do not believe that reducing transparency, limiting access, and leaving U.S. investors more exposed and more vulnerable is a good thing. And this is unfortunately the impact of companies being less willing to participate in the U.S. public markets.

In addition, independent research also shows that when non-U.S. companies meet the high bar of U.S. listing standards, the global value of their brand is enhanced, and they can sell their stock at a higher price. These gains are also increasingly at risk.

As for the impact of the forces that are causing foreign issuers not to list on U.S. markets on our economy, the financial services industry has long been one of the most dynamic in the U.S. and, as such, a vital U.S. export, and a strong and reliable engine for growth and prosperity. Capital is the lifeblood of our economy, however, nothing is written in stone that decrees American capital will stay here or that global capital will continue to come here. If the volume of the listings business continues to trade away from U.S. exchanges, the ability of the U.S. to remain the leading financial center in a world of rapid globalization will be in doubt. And, should the United States no longer be viewed as the investment capital of the world, we will risk losing our leadership in innovation, job-creation and growth as well.

* * *

In conclusion, despite a welcome resurgence in global equity financing, the United States is losing the competition for these new listings. While capital markets abroad become steadily more developed, liquid and open, the United States has created barriers to our own success in the form of our propensity for litigation and the costs of our own regulatory system.

We stand at the fork in the road. One road continues along the direction that we are headed today. It leads, unfortunately, to a further weakening of U.S. competitiveness, an increasing loss of global capital, and the flight of U.S. investors toward the possibility of uncertain, regulatory regimes.

There is another road that we believe is a better road. It is the road that builds on the beneficial effects of Sarbanes-Oxley with a risk-management based approach and common-sense regulation, so that we can meet the competitive challenge; maintain the leadership of U.S. financial markets, and America's position as the investment capital of the world.

For the sake of our markets and the good of our country, we believe that this is the road upon which we can and, hopefully, will make our journey together.

Thank you again Mr. Chairman for holding this hearing today and for giving me the opportunity to testify before your committee.

James R. Copland
Written Testimony

U.S. House of Representatives Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"America's Capital Markets: Maintaining Our Lead in the 21st Century"

April 26, 2006

Good morning. My name is Jim Copland, and I am the director of the Center for Legal Policy at the Manhattan Institute. The Center for Legal Policy has been studying the civil justice system for 20 years, led throughout that period by my colleagues Peter Huber and Walter Olson, both senior fellows at the Institute. I took over directorial duties at the Center in February 2003 after having been a management consultant at McKinsey and Company. I have a background in law, which I studied at Yale Law School; finance, in which I concentrated my studies at Yale School of Management; and economics, which I studied at the undergraduate and masters level. Since joining the Manhattan Institute, I have led the Center for Legal Policy in new and continuing initiatives, including:

- Publishing a series of reports, entitled *Trial Lawyers, Inc.*, that assess the legal industry as a business. After publishing an initial report in Fall 2003, we have subsequently published industry- and state-focused reports and shorter updates.[1]
- Launching a web magazine, *PointOfLaw.com*, that brings together information and opinion on the U.S. legal system. *Point of Law* publishes columns, sponsors regular discussions, and has ongoing "weblog" commentary from many of the nation's top legal scholars in the field of tort law.
- Continuing efforts to assess empirically the U.S. tort system. Among the Center's works in recent years were a series of 4 reports assessing the problem of forum shopping in class action litigation, the problem that was the focus of the recently enacted Class Action Fairness Act. The Center has also been active in analyzing various specific types of litigation, including medical malpractice, asbestos, and "toxic" mold.[2]
- Formulating policy solutions to the problem of overlitigation. Last fall, we convened a policy working group with some of the nation's leading academics and practitioners to consider ideas for reform that deserve special emphasis. One item of particular interest to emerge from that conference is "loser pays"—the rule in other developed countries whereby the losing party in litigation pays the other's expenses. We are currently developing an in-depth look at how a loser pays mechanism might work in the U.S.; that idea and others to come out of last year's conference will inform the policy portion of my comments.

---

[1] All published *Trial Lawyers, Inc.* reports and updates are available at www.triallawyersinc.com.
[2] For a complete listing of Manhattan Institute publications on civil justice, see http://www.manhattan-institute.org/tools/pubs.php.

Introduction

My charge before you today is to discuss my views on how regulation, litigation, and financial reporting are affecting the global competitiveness of U.S. capital markets. I will focus my comments on **litigation**, since that is my area of expertise.

I do note at the outset, however, that the tendency to criminalize corporate conduct in the wake of the collapses of Enron and WorldCom adds substantial new risks to directorship and basic business judgment. Particularly pernicious in my view is the tendency of state attorneys general, often aspiring to higher office, using their broad prosecutorial powers to regulate interstate commerce in the financial arena. Such prosecutorial overreaching tends to interfere with proper federal regulatory authority vested in the Securities and Exchange Commission and Commodity Futures Trading Commission, and, inevitably, tends to make the United States a less attractive business venue. I would urge the committee to consider investigating to what extent the broad scope of federal regulation under the SEC, CFTC, and other pertinent federal agencies should be clarified to preempt the prosecutorial authorities of state attorneys general in certain respects.[3]

I also note briefly that new financial disclosure requirements in the United States have been criticized by some leading academic scholars in the field, notably Larry Ribstein of the University of Illinois and Stephen Bainbridge of UCLA. Professor Ribstein has suggested that certain reporting requirements, if not modified, could drive capital out of the U.S. and into Europe. I would urge the committee to consider the views of Professors Ribstein, Bainbridge, and others in some depth, with a view toward amending the well-meaning Sarbanes-Oxley reforms to ameliorate unintended side effects of the new regulations.[4]

The U.S. Tort Tax

When it comes to litigation,[5] the American "tort tax"—the percentage of the gross domestic product consumed by tort law costs—is 2.22 percent. As Figure 1 shows, the percentage of our economy devoted to tort litigation has grown astronomically over the last 50 years. In 1950, torts cost $1.8 billion; in 2004, torts cost $260.1 billion. Over that span, the inflation-adjusted tort tax per capita grew almost tenfold. Tort costs grew almost four times as fast as GDP.[6] The American tort tax is estimated to be the equivalent of a 5 percent wage tax, well higher than the corporate income tax, and "far more than enough money to solve Social Security's long-term financing crisis."[7]

---

[3] Additional commentary on this topic can be found on the Manhattan Institute's web magazine *PointOfLaw.com*. *See, e.g.*, http://www.pointoflaw.com/cgi-bin/mt-search.cgi?search=spitzer.

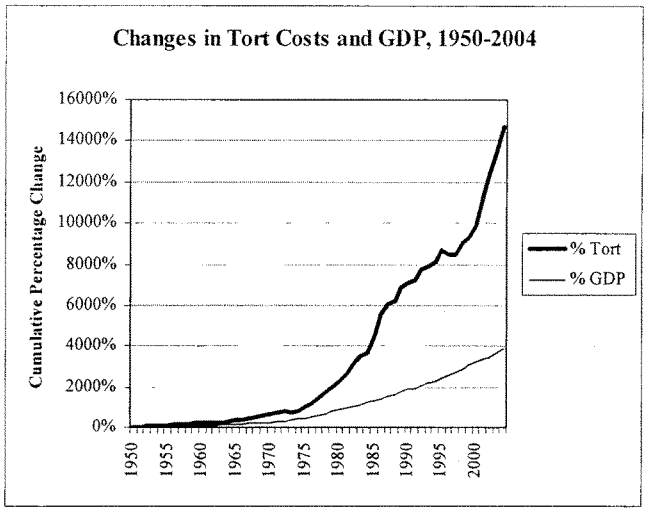
[4] The viewpoints of Professors Bainbridge, Ribstein, and others can also be accessed through *PointOfLaw.com*, at http://www.pointoflaw.com/cgi-bin/mt-search.cgi?search=sox.

[5] The comments that follow are adapted in part, in some cases directly, from earlier of my writings, available at http://www.manhattan-institute.org/html/copland.htm.

[6] Tort tax statistics are taken from estimates derived by the actuarial firm Towers Perrin Tillinghast, *U.S. Tort Costs and Cross-Border Perspectives: 2005 Update*, available at http://www.towersperrin.com/tillinghast/publications/reports/2005_Tort_Cost/2005_Tort.pdf.

[7] *See* Steven Hantler, *The Seven Myths of Highly Effective Plaintiffs' Lawyers*, Manhattan Institute Civil Justice Forum 42, at 6 (April 2004)(citing Council of Economic Advisers, *Who Pays For Tort Liability Claims? An Economic Analysis of the U.S. Tort Liability System* 12, 13 (Apr. 2002)).

Figure 1.



Source: Towers Perrin Tillinghast, supra *note 6.*

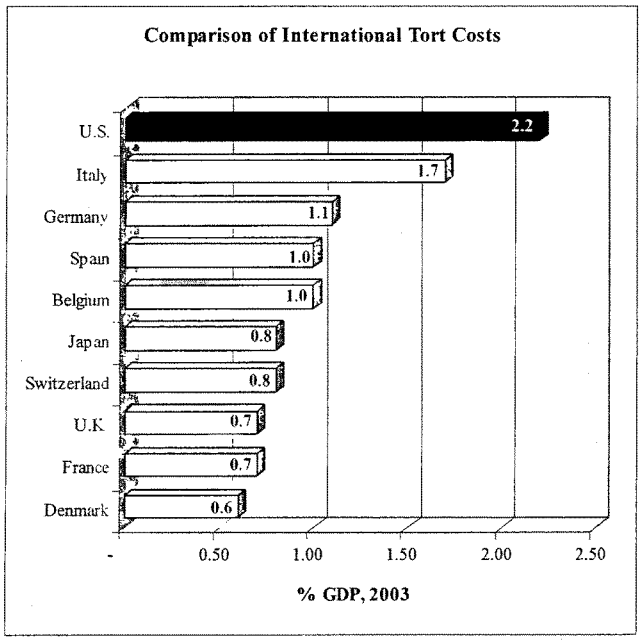
These tort tax estimates come from the actuarial firm Towers Perrin Tillinghast, which has been assessing the costs of tort litigation for several years. A few points are in order. First, the estimates are top-down, derived from insurance company data. "Bottom-up" estimates of tort costs are essentially impossible to construct given the paucity of data; most cases settle, and settlements are typically sealed and protected by attorney-client privilege. Second, the tort tax measured by Tillinghast involves direct transfer payments between parties to litigation, including attorneys, as well as the administrative costs incurred by insurance companies. The tort cost estimates do not reflect the full cost of tort litigation, any more than marginal tax rates reflect the full dynamic effect of taxes on the economy. Reduced research, innovation, and investment are not measured, nor are wasteful nonproductive behavioral responses—such as defensive medicine—that are intended solely to lower litigation risk. Third, even on its own terms, the Tillinghast study does not include all forms of tort litigation. Significantly, the estimates omit punitive damages, most securities litigation, and the multi-state tobacco settlement.

I note that trial lawyers and their allied advocates typically criticize the Tillinghast numbers, in no small part because they include insurance company administrative expenses for handling tort claims. Since the primary purview of this committee involves insurance as well as capital markets, the insurance cost of litigation is a critical component of the equation. The scope and unpredictability of litigation is destabilizing to insurance markets, with adverse consequences for the American economy and consumer. For example, in medical malpractice cases, the median jury verdict rose from $500,000 in

1997 to $712,000 in 1999 to $1 million in 2000,[8] which precipitated a well-publicized crisis in the medical malpractice insurance industry. In 2001, the medical malpractice insurance industry suffered $3 billion in underwriting losses, including almost $1 billion from the St. Paul Companies, the then-largest malpractice insurer. St. Paul exited the market, as did the Farmers Insurance Group, and physician-owned Pennsylvania insurer PHICO declared bankruptcy.[9] In any event, whether or not insurers' administrative costs should be included in tort tax estimates is really a red herring. Such costs constitute 22.2 percent of tort cost estimates today, as compared with 32.2 percent in the 1950s. In other words, the relative expense of insuring against tort losses, though sizable, has not risen as quickly as tort costs overall.

In assessing the impact of litigation on American competitiveness, it is perhaps most useful to look at how our tort costs compare with those of other nations. The tort tax in the United States is far higher than that in other developed countries. The percentage of its economy that America devotes to tort law is almost twice that of Germany and three times that of France or Britain. Figure 2 shows direct tort law costs as a percentage of GDP in the United States and other industrialized nations.

Figure 2.



Source: Towers Perrin Tillinghast, supra *note 6.*

[8] Based on statistics from Jury Verdict Research, *see* http://www.juryverdictresearch.com/Press_Room/Press_releases/Verdict_study/verdict_study8.html.
[9] For more details, see http://www.pointoflaw.com/columns/archives/001347.php.

A Cost-Benefit Analysis?

In assessing the American tort tax, we must of course not merely look at the costs of the system. While America may not be appreciably safer than the other industrialized countries, perhaps our tort system is achieving other goals, in terms of safety or equity, that other nation's regulatory systems or welfare states provide. In other words, are we getting bang for our buck? The answer to this question is almost certainly no.

Safety and Deterrence

Let's first consider safety. America is a much safer place, in terms of accidents, than it was fifty years ago, but the evidence shows that the decline in accident rates "has been steady and consistent both before and after the initial expansion of products liability law," with "little, if any, correlation between the decline in accident rates and the expansion in tort liability."[10] A recent study by Professors Paul Rubin and Joanna Shepherd at Emory that looked at rates of accidental death in states from 1981 through 2000 showed that tort reform—including caps on noneconomic damages, a higher evidence standard for punitive damages, product liability reform, and prejudgment interest reform—*saved lives*, to the tune of 22,000 prevented accidental deaths over the time period.[11] In addition, extensive cross-sectional studies of punitive damages for a variety of risk measures (including "toxic chemical accidents, toxic chemical accidents causing injury or death, toxic chemical discharges, surface water discharges, total toxic releases, medical misadventure mortality rates, total accidental mortality rates, and a variety of liability insurance premium measures") have found that "[s]tates with punitive damages exhibit no safer risk performance than states without punitive damages," so that "there is no deterrence benefit that justifies the chaos and economic disruption inflicted by punitive damages."[12]

What explains these results? In the modern American tort system, most people who are injured are not compensated and many who are compensated are uninjured. For example, in asbestos litigation, many of those suffering from mesothelioma, the deadly cancer linked to asbestos exposure, go undercompensated, while those with no cognizable medical injury receive payouts from bankrupt firms and their successor trusts.[13] In medical malpractice litigation, the famous 1991 Harvard Medical Practice Group Study

---

[10] *See* George Priest, "Products Liability Law and the Accident Rate," in *Liability: Perspectives and Policy* (Robert Litan and C. Winston, eds. 1988).

[11] *See* "Tort Reform and Accidental Deaths," available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=781424.

[12] W. Kip Viscusi, "The Social Costs of Punitive Damages Against Corporations," 87 *Geo. L.J.* 285, 297-98 (1998); W. Kip Viscusi, "Why There Is No Defense of Punitive Damages," 87 *Geo. L.J.* 381 (1998).

[13] *See* Lester Brickman, "Asbestos Litigation," transcript of comments to the Manhattan Institute, Mar. 10, 2004, available at http://www.manhattan-institute.org/html/clp03-10-04.htm ("[Plaintiffs' lawyers] assert claims on behalf of each client in their inventories who are recruited by screenings, against each of the bankruptcy trusts and a few dozen or more of the solvent defendants. Even if they only collect a few hundred to a few thousand dollars per claim, it adds up. For a single claimant, one without any asbestos-related illness recognized by medical science, this can amount $60,000, even as high as $100,000."); *see also* Lester Brickman, "On the Theory Class's Theories of Asbestos Litigation: The Disconnect Between Scholarship and Reality," 31 *Pepperdine L. Rev.* 33 (2004).

emerged with "two striking findings: most persons with potentially legitimate claims appeared not to file them, but most claims that were filed had no evident basis." [14]

These outcomes are unsurprising. Mass tort cases, like asbestos, tend to overwhelm courts and are subject to abuse, even fraud, as Judge Janis Jack has discovered in looking at silicosis claims and Judge Harvey Bartle has discovered in handling the Fen-Phen settlement trust.[15] In these product liability and medical malpractice cases, lay jurors are unsophisticated even though we count on them to act as final arbiters; jurors' duties today include "redesign[ing] airplane engines and high-lift loaders, rewrit[ing] herbicide warnings, determin[ing] whether Bendectin causes birth defects, plac[ing] a suitable price on sorrow and anguish, and administer[ing] an open-ended system of punitive fines."[16] Moroever, jurors "face accidents up close" without the "broader vision, dominated by the individual case."[17] Little wonder, then, that asbestos dockets are flooded with illegitimate claims[18] and that the medical malpractice bar is dominated by extreme but unlikely cases, such as the claim that an infant's cerebral palsy was caused by asphyxiation in delivery.[19] "When all is said and done, the modern rules do not deter risk: they deter behavior that gets people sued, which is not at all the same thing."[20]

---

[14] *See, e.g.*, Troyen A. Brennan, *et al.*, "Incidence of Adverse Events and Negligence in Hospitalized Patients: Results of the Harvard Medical Practice Study I," *New Engl. J. Med.* 324, 370-6 (1991); "The Nature of Adverse Events in Hospitalized Patients: Results of the Harvard Medical Practice Study II," *New Engl. J. Med.* 324, 377-84 (1991). The study reviewed "a weighted sample of 31,429 records" of "nonpsychiatric patients discharged from nonfederal acute care hospitals in New York in 1984." Richard Anderson, "An 'Epidemic' of Medical Malpractice? A Commentary on the Harvard Medical Practice Study," *Manhattan Institute Civil Justice Memo* No. 27 (July 1996), *available at* http://www.manhattan-institute.org/html/cjm_27.htm.

[15] *See* Lester Brickman, "What Did Those Asbestos X-Rays Really Show?", at http://www.pointoflaw.com/columns/archives/002092.php; James Copland, "Fen-Phen Follies," at http://www.pointoflaw.com/archives/000990.php.

[16] Peter Huber, *Liability: The Legal Revolution and Its Consequences* 185 (Basic Books 1988).

[17] *Id.* The juror's closeness to the case is compounded by the cognitive inclination known as "hindsight bias," *i.e.*, "the natural human tendency after an accident to see the outcome as predictable – and therefore, easy to affix blame," Hantler, *supra* note 7, at 3, which "'makes the defendant[s] appear more culpable than they really are.'" *Id.* at 3 (quoting Jeffrey J. Rachlinski, "A Positive Psychological Theory of Judging in Hindsight," 65 *U. Chi. L. Rev.* 571, 572 (1998)).

[18] A study by Johns Hopkins radiologists published last August in *Academic Radiology* found that initial "B" readers contracted by plaintiffs' attorneys to identify lung changes had identified abnormalities in 95.9% of 492 cases; independent readers hired by the radiologists who examined the same x-rays, without knowing their origins, found abnormalities in only 4.5% of cases. *See* Joseph N. Gitlin, *et al.*, "Comparison of 'B' Readers' Interpretations of Chest Radiographs for Asbestos Related Changes," 11 *Acad. Radiol.* 243 (2004).

[19] A January 2003 report issued by the American College of Obstetricians and Gynecologists and American Academy of Pediatrics found that "that use of nonreassuring fetal heart rate patterns to predict subsequent cerebral palsy had a 99% false-positive rate." *Neonatal Encephalopathy and Cerebral Palsy: Defining the Pathogenesis and Pathophysiology* (American College of Obstetricians and Gynecologists and American Academy of Pediatrics Jan. 31, 2003), available at http://www.acog.org/from_home/Misc/neonatalEncephalopathy.cfm (executive summary). Presumably, juries assessing dueling experts, after witnessing a child born with a tragic defect, are particularly ill-equipped to determine whether the case before them falls into the rare category of cases in which a lack of oxygen in delivery was responsible for the cerebral palsy.

[20] Huber, *supra* note 16, at 164.

Equity and Administrative Cost

The basic inability of our tort system to deliver accurate results also, in and of itself, throws into question how well the law in this arena is fulfilling its equitable function. Moreover, by any measure, the administrative costs of the tort system are astronomical:

> If viewed as a mechanism for compensating victims for their economic losses, the tort system is extremely inefficient, returning only 22 cents of the tort cost dollar for that purpose. . . . Of course, the tort system also provides compensation for victims' pain and suffering and other noneconomic losses. Even including these benefits, the system is less than 50% efficient. [21]

In short, tort awards are random, slow, and inequitable. The tort law system shows no evidence of deterring specific risky behavior such that actors economically internalize the cost of accidents, deters instead innovation and products and behaviors that are useful but novel with unknown risk profiles, and is incredibly expensive to administer.

Securities Litigation: The Post-PSLRA Picture

How such costly litigation affects the competitiveness of American *capital markets*, however, is a more complex question. As already noted, insurance companies bear a significant burden from unpredictable litigation exposure, a burden that should not be disregarded. To that extent, reforming our tort law should shore up insurance company stability and competitiveness. But beyond the insurance component, many of the perverse effects I have previously mentioned are specifically relevant to the competitiveness of American manufacturers, and to the health and safety of American consumers, more than to capital markets competitiveness *per se*.

To understand capital markets competitiveness, we should look specifically to the field of securities litigation. When Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA), there was substantial concern that securities lawsuits were adversely affecting U.S. capital markets. Academics who studied securities litigation found that the value at which securities lawsuits settled was not related to the merits of the underlying suit.[22] Securities lawyers were deemed to be filing "strike suits" whenever a stock price declined. Such stock price drops were regular occurrences in the high-technology sector, since high-tech stocks naturally trade at high multiples of current earnings, if any, and are priced based on speculative assumptions about future earnings growth. Also, securities lawyers were observed often "rushing to the courthouse door" to file a suit and gain control of litigation, since they merely had to find a named plaintiff on behalf of a prospective class.[23] The excessive cost of discovery in securities class action litigation

---

[21] *See* Towers Perrin Tillinghast, *U.S. Tort Costs: 2003 Update, Trends and Findings on the Cost of the U.S. Tort System*, at 17 (2003).

[22] *See, e.g.*, Janet Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions," 43 *Stan. L. Rev.* 497 (1991).

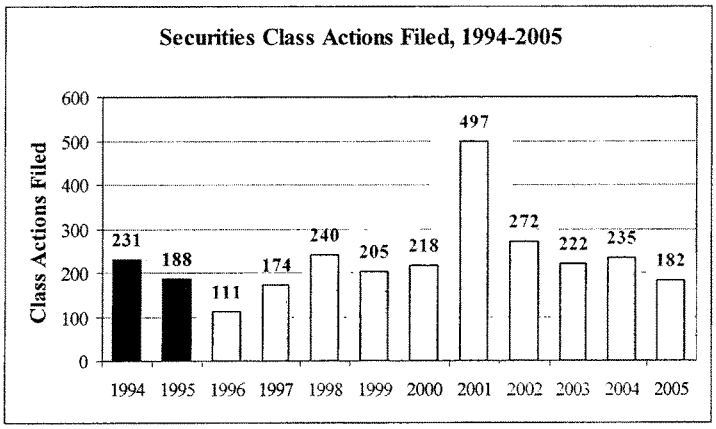
[23] Such behaviors were not only unseemly, but perhaps even fraudulent. The Department of Justice is reported to be investigating whether one of the nation's top securities litigation firms made "payments to a

combined with minimal pleading standards to enable plaintiffs' attorneys to extract substantial settlement values from defendant firms, regardless of case merits.

The PSRLA tried to solve the *in terrorem* effect of discovery compelled by strike suits by requiring more in-depth pleading standards to support a securities claim and by automatically staying discovery while a motion to dismiss is pending. The Act provided a safe harbor provision for forward-looking statements. Finally, the PSLRA forced judges to select as the lead plaintiff in securities cases the investor most likely to protect the class of claimants' interests, typically the largest investor, rather than merely permitting the first plaintiff filing suit to control the litigation. This approach was intended to remedy what legal scholars call the "agency cost" problem inherent in any class action litigation. To understand agency costs, consider that by definition, individual claims are small for class litigation, so no individual plaintiff typically has sufficient interest to monitor or control the class attorneys. Securities class action king Bill Lerach once boasted to *Forbes* magazine, "I have the greatest practice in the world. I have no clients."

Did the PSLRA work as intended? On first glance, no. As Figure 3 makes clear, after an initial one-year decline in securities lawsuit filings, the number of lawsuits filed annually essentially returned to the pre-PSRLA level, and indeed increased slightly.[24]

Figure 3.



Source: Stanford Law School Securities Class Action Clearinghouse.

former client and lead plaintiff in several class actions." *See* http://www.pointoflaw.com/archives/002319.php.

[24] The one-year spike in filings in 2001 corresponds to the collapse of the "dot-com" stock market bubble. According to the Stanford Securities Class Action Clearinghouse, "Calendar year 2001 differs from prior experience because of the proliferation of 'IPO Allocation' lawsuits. These complaints generally allege that underwriters engaged in undisclosed practices in connection with the distribution of certain IPO shares. These complaints do not allege that issuers have engaged in fraud when describing their own business or financial circumstances."

Studies have shown that since the adoption of the PSLRA, the rate of *dismissals* of cases has roughly doubled, but the *value of monetary settlements* has increased.[25] "High technology issuers remain at significantly greater risk than issuers in other industries. . . . [and] Congress did not achieve its goal of increasing the filing delay in class actions. Actions are filed as quickly now as they were before passage of the Act."[26] An empirical study has shown, however, "a closer relationship between factors relating to fraud and securities class actions after the passage of the PSLRA, suggesting that Congress achieved at least part of its objective in enacting the law."[27]

Two main problems have prevented the PSLRA from living up to its promise. First, not all federal circuits have interpreted the PSLRA's heightened pleading standard in the same way. The Ninth Circuit, encompassing California, adopted a more rigorous pleadings standard in *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970, 974 (9th Cir. 1999), requiring a showing of "deliberate recklessness" and requiring that "a complaint include a list of all relevant circumstances in great detail." Studies have shown that filings in the Ninth Circuit tend to have a higher percentage of facially strong cases and a lower percentage of facially weak cases.[28] Unfortunately, but predictably, the Ninth Circuit has also seen a relative drop in case filings, as plaintiffs' attorneys seek out more lenient jurisdictions.

A second major problem with the PSLRA in practice has been the trial bar's ability to work around the lead plaintiff provision. Presumptively under the PSLRA, such plaintiffs are the shareholders with "the largest financial interest in the relief sought by the class." Plaintiffs' firms quickly realized that the largest shareholders in our economy are typically state employee pension funds, such the California Public Employees' Retirement System and the New York State Common Retirement Fund, and that such state funds are politically directed and thus subject to political influence. According to a study by PricewaterhouseCoopers, securities cases with public pension funds as lead plaintiffs rose steadily from four in 1996 to 56 in 2002.[29]

For an example of how pernicious the connection between political interests and public pension funds' serving as class plaintiffs can become, consider that two law firms that represented a class of plaintiffs suing Citigroup on behalf of WorldCom shareholders and bondholders had, directly and indirectly, been responsible for $121,800 in donations to New York State Comptroller Alan Hevesi. By virtue of his office, Hevesi controlled the lead plaintiff in the suit, the New York State Common Retirement Fund. The firms who had donated to Hevesi stand to gain $144.5 million from Citigroup. Incredibly, the New York Fund that led the suit against Citigroup, on behalf of WorldCom shareholders, owns almost $1 *billion* in Citigroup stock.

---

[25] *See* Adam C. Pritchard, "Should Congress Repeal Securities Class Action Reform?", *Cato Policy Analysis* No. 471, at 9 (2003).
[26] Michael A. Perino, "Did the Private Securities Litigation Reform Act Work?", 2003 *U. Ill. L. Rev.* 913 (2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=346840.
[27] *See* Pritchard, *supra* note 25, at 11.
[28] *See* Perino, *supra* note 26, at 916.
[29] *See* Steven Skalak & Daniel Dooley, Pricewaterhousecoopers, *Securities Litigation Update: The Pension Fund Factor* 2 (2003).

Some smaller state retirement funds have also become notorious as repeat plaintiffs for the securities bar. An Ohio judge found that the Teachers' Retirement System of Louisiana was a "professional plaintiff" and that it wastefully sought to appoint four separate firms as counsel for a case. As of 2004, the Louisiana pension fund had been involved in no fewer than 60 class-action suits in the preceding eight years.

Options for Reform

Reform options for the tort system as a whole are many and complex. Moreover, given that so much of tort law is at the state level, federal options are complicated.[30] I will thus limit these suggestions to those that might be appropriately adopted in the context of securities law, and therefore appropriate for this committee's consideration.

1. *Embrace a "Loser Pays"-Style Fee Shifting Principle.* Central to the filing of weak claims in American law is our nation's refusal—essentially unique among developed countries—to hold the loser of lawsuits financially accountable for the costs imposed on the other side. In regular litigation, minimal "notice" pleading standards enable plaintiffs to file lawsuits at very low cost; defendants then assume the very expensive burden of discovery. Even for meritless claims, defendants have a significant incentive to settle, since their costs are substantial, win or lose. Other countries strongly deter weak lawsuits by forcing plaintiffs to internalize the cost they impose on defendants in the event of loss.

   The PSLRA does reduce these problems, in theory, for securities claims, by heightening pleading standards and staying discovery. Nevertheless, the evidence on filings suggests strongly that weak claims continue to be filed.

   A clear mechanism exists for deterring weak lawsuits in federal courts. Federal Rule of Civil Procedure 68 provides an offer-of-judgment provision as follows:

   > At any time more than 10 days before the trial begins, a party defending against a claim may serve upon the adverse party an offer to allow judgment to be taken against the defending party for the money or property or to the effect specified in the offer, with costs then accrued. If within 10 days after the service of the offer the adverse party serves written notice that the offer is accepted, either party may

[30] Lawyers among you will know well that there is no federal common law, under the Supreme Court's long-standing, seminal decision in *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). Cross-state and state-federal forum shopping remains a significant problem for tort law overall, particularly in products liability cases—although the Class Action Fairness Act of 2005 should reduce the "magnet court" problem for class action suits. Notwithstanding *Erie*, Congress could reduce forum shopping, constructively align tort law with federalist principles, and improve the quality of litigation overall through changes to federal diversity jurisdiction and adoption of appropriate federal choice of law rules. *See, e.g.*, Michael Krauss, "Product Liability and Game Theory: One More Trip to the Choice-of-Law Well," 2002 *B.Y.U. L. Rev.* 759; *see also* Doug Laycock, "Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law," 92 *Columbia L. Rev.* 249 (1992).

> then file the offer and notice of acceptance together with proof of service thereof and thereupon the clerk shall enter judgment. An offer not accepted shall be deemed withdrawn and evidence thereof is not admissible except in a proceeding to determine costs. If the judgment finally obtained by the offeree is not more favorable than the offer, the offeree must pay the costs incurred after the making of the offer. The fact that an offer is made but not accepted does not preclude a subsequent offer. When the liability of one party to another has been determined by verdict or order or judgment, but the amount or extent of the liability remains to be determined by further proceedings, the party adjudged liable may make an offer of judgment, which shall have the same effect as an offer made before trial if it is served within a reasonable time not less than 10 days prior to the commencement of hearings to determine the amount or extent of liability.

On its face, FRCP 68 reads like a loser pays provision; however, the "costs" covered by the Rule are only "statutory costs" and do not typically include attorneys' fees and expenses—the bulk of costs in most litigation. Amending FRCP 68 to shift all attorneys' fees and expenses if a plaintiff proceeds with a claim and receives less than the defendant's offer should sharply discourage weak claims and promote reasonable settlement. Based on other countries' experience, the value in such an approach would likely outweigh the administrative costs to determine fees—particularly given that most cases settle. The calculus for filing (and settling) claims would be substantially shifted were plaintiffs required to internalize defendants' costs.[31]

The typical reaction against loser pays systems is that they are alleged to "shut the courthouse door" on less-well-heeled plaintiffs, who would be unable to bear the risk of bearing the defendants' costs. Such concerns are generally overblown; other countries have insurance systems, including legal expenses insurance and "after-the-event" insurance, to defray such risks.[32]

Regardless, such concerns are wholly inapplicable to securities litigation, in which plaintiffs are dispersed. Securities litigation is dominated by large, well-financed, diversified law firms with broad access to capital. Moreover, under the PSLRA, the lead plaintiff is presumptively a large, often institutional investor. It is hard to imagine that a large institutional investor and large diversified law firm could not, at arms' length, negotiate a reasonable strategy to assume the risk of paying defendants' costs in the event of loss. Securities law thus provides a compelling template for experimenting with a strong-form Rule 68.

---

[31] According to Tillinghast, an estimated 19 percent of all litigation costs/fees are consumed by plaintiffs' attorneys, and 14 percent by defendants' counsel. *See 2003 Update*, *supra* note 21.
[32] *See* Walter K. Olson, "Loser Pays," at http://www.pointoflaw.com/loserpays/overview.php.

2. *Reform the PSLRA's Lead Plaintiff Provisions.* As previously noted, a significant problem with the PSLRA in practice has been the ability of the plaintiffs' bar to co-opt public pension funds as their new professional plaintiffs. Unlike institutional investors whose sole fiduciary duty is to maximize fund-holder return—e.g., mutual funds such as those operated by Fidelity or Vanguard—public employee pension funds are typically led or influenced by politicians who may be in political alliance with the trial bar and/or recipients of trial bar campaign contributions. In short, whereas the incentives of private institutional investors are largely aligned with their fund-holders, public employee pension funds are managed by actors who have diverse interests that may or may not coincide with their investors' returns. As such, the risk for mischief, observed in practice, is inherent in public employee pension funds. A simple solution to this problem would be to amend the PSLRA to clarify that public employee pension funds cannot be the lead plaintiff in a federal securities suit.

   An alternative approach to rooting out class counsel mischief would be to embrace by statute broad acceptance of the practice originated by District Judge Vaughn R. Walker, who auctioned off the rights to class counsel to the plaintiffs' firm willing to accept the lowest fee. Walker's auction practice both reduced contingency fees and resulted in higher average recovery for plaintiffs. Clearly, auctioning the right to serve as class counsel worked better than designating a "large plaintiff" to eliminate the "captive plaintiff" problem. The Ninth Circuit stopped Walker's practice in *In re Cavanaugh*, 306 F.3d 726 (9th Cir. 2002), in which it interpreted the PSLRA's language to "provide[] no occasion for comparing plaintiffs with each other on any basis other than their financial stake in the case." Clarifying the PSLRA to permit and even encourage class counsel auctions would reduce superfluous litigation driven by non-competitive contingency fee arrangements and ensure fuller recovery for legitimate claimants.

3. *Amend the PSLRA to Endorse the Ninth Circuit's Rigorous Pleading Standard.* As discussed above, the Ninth Circuit's rigorous pleading standard has worked to root out bad claims and increase the percentage of strong claims in that circuit. As long as plaintiffs' lawyers are able to shop their cases to alternative fora, however, the national effectiveness of the PSLRA will be largely unrealized. A simple amendment to the PSLRA could clarify that the statute requires, as the Ninth Circuit determined in *Silicon Graphics*, that a complaint "include a list of all relevant circumstances in great detail" and a demonstration of "deliberate recklessness" to survive on the pleadings.

Conclusion

Litigation in America is extremely costly, relative to our history and to other developed nations. Our tort law system fails to justify this cost by meeting its safety-enhancing or equity-producing mandates. As such, the system's distorting effects on economic activity, enormous insurance burden, and high administrative costs are hard to defend.

Securities litigation, despite the PSLRA, remains a significant competitive disadvantage for American capital markets. While private securities lawsuits, rightly conceived, can complement the SEC's regulatory authority, our system continues to permit too many meritless suits, often filed against our highest-growth companies.

Reforms could help align our private law system of enforcement with its object, namely, to encourage open disclosure of information to investors to facilitate accurate market pricing. I propose three simple reforms to this effect: (1) adopting a loser pays' system through the offer of judgment rule; (1) refining the PSLRA's lead plaintiff provision by forbidding lead plaintiff status for public pension funds or by allowing counsel rights to be auctioned off; and (3) amending the PSLRA to strengthen its pleading requirements consistent with the Ninth Circuit's *Silicon Graphics* standard.

Although the United States continues to enjoy the world's most competitive capital markets, such status is not a foregone conclusion. In the early nineteenth century, New Jersey was the locus of business incorporation, until then-Governor Woodrow Wilson drove companies away by trying to use the state's incorporation law as an antitrust law. Just as Delaware took New Jersey's corporate law business, markets in Europe or Asia, likewise, could take U.S. capital markets business.[33] Indeed, PricewaterhouseCoopers released a report last week showing that in 2005, Europe passed the United States on initial public offerings—almost doubling the American float, attracting almost three times the number of listings, and attracting more than five times the number of overseas IPOs.[34] Regulation and reporting rules may be the dominant forces explaining the short-run shift away from American capital markets, but the importance of litigation should not be ignored.

---

[33] For this argument, I am indebted to Larry Ribstein. *See* http://www.pointoflaw.com/archives/002292.php.
[34] *See* http://www.primezone.com/newsroom/news.html?d=96661; *see also* http://observer.guardian.co.uk/business/story/0,,1744628,00.html.

Statement of the Honorable Donald L. Evans
Chief Executive Officer, Financial Services Forum

Testimony Before the
Subcommittee on Capital Markets, Insurance and GSEs
of the
House Financial Services Committee

April 26, 2006

Introduction

Chairman Baker, Vice Chairman Ryun, and Ranking Member Kanjorski, thank you for the opportunity to participate in today's hearing on ways to preserve the competitive position of the U.S. capital markets.

As you know, I am here as the Chief Executive Officer of the Financial Services Forum. The Forum is a financial and economic policy organization comprising the chief executive officers of 20 of the largest and most diversified financial institutions with operations in the United States. The Forum works to promote policies that enhance savings and investment, and that ensure an open, competitive and sound global financial services marketplace. As a group, the Forum's member institutions employ more than 1.5 million people in 165 nations, and hold combined assets of more than $12 trillion.

Today's hearing is both important and timely. America stands at a critical crossroads in our history as a nation. Faced with the twin realities of globalization and international competition, will the United States retreat behind a wall of self-delusion and the false protections of tariffs and trade barriers, pretending that the world hasn't changed, fundamentally and permanently? Or will the United States embrace and meet the challenges of competition – to the betterment of all Americans and the world?

By calling this hearing today, Mr. Chairman, you have signaled that you understand that America must not turn inward. The financial services industry thanks you for your vision and your leadership. Not only would such a course be very damaging to the U.S. economy, the world at this critical juncture in history continues to need the United States to lead by example.

Preserving the Strength and Vitality of the U.S. Economy

Mr. Chairman, you are correct when you say that being the world's premier capital market is not our birth right. We earned that distinction by working hard to make the United States the marketplace of choice. In that regard, I think it's important to emphasize that any effort to preserve the international competitiveness of the U.S. capital markets must begin with preserving the strength and vitality of the U.S. economy more broadly. In many ways, our world-class

capital marketplace is both a source of tremendous strength for, and a reflection of, our enormously productive, complex, and dynamic U.S. economy.

With that in mind, I'd like to share with you some new information that I'm sure you'll find of interest. The 20 member CEOs of the Financial Services Forum meet twice a year, our most recent meeting occurring earlier this month. At that meeting, for the first time, we conducted a survey of our members regarding their outlook on the U.S. and global economies.

The answers we collected are of particular value because our members are the CEOs of the largest financial institutions. As you know, Mr. Chairman, the financial sector is unique in that it is the enabling sector of our economy, fueling the activities and risk-taking of every other sector. Our members make decisions every day about which ventures to finance and where to put their capital at risk, both here in the United States and around the world. In that way, they have a unique vantage point – a "commanding heights" perspective – on the U.S. and global economies. I've attached the full results of our survey to my written testimony for the record.

As part of the survey, we asked our CEOs to rate in order of seriousness a dozen potential threats to the global economy. The top three threats – rated far more serious than other selections – were: 1) energy prices, 2) terrorism, and 3) anti-globalization and protectionism.

We then asked the same question about potential threats to the U.S. economy. The four most serious threats, according to our CEOs, were: 1) energy prices, 2) rising healthcare costs, 3) terrorism, and 4) the U.S. government's unfunded entitlement liabilities. Rated closely behind were complex regulations and frivolous litigation.

In our final question, we asked the CEOs: "On a scale of 1 to 5 (with 1 being 'not important' and 5 being 'the most important') please rate the following potential actions taken by Congress to reflect their importance to making the United States more competitive in the global economy." Our CEOs gave each of the following Congressional priorities a better-than-3 rating, again with 5 being "the most important":

- Promote free trade;
- Improve U.S. education;
- Address unfunded entitlement liabilities;
- Address litigation reform;
- Extend the tax cuts on capital gains and dividends; and,
- Address general tax reform.

Clearly, our financial sector leaders believe that Congress has much important work to do to keep the United States competitive in an increasingly global economy.

The Unique Role and Strength of the U.S. Capital Market

Let me turn now the specific topic of keeping our capital market competitive.

Capital is the lifeblood of any economy's strength and well-being. Investment capital enables the research and risk-taking that fuels competition, innovation, productivity, and prosperity. Successfully competing for global capital, therefore, will always be a national priority – which is why a strong, dynamic, and competitive capital marketplace is so important.

At present, the U.S. capital market is the largest in the world, accounting for 45 percent of global equities and more than half of world's corporate debt securities. The U.S. market is also the deepest, most sophisticated, most efficient, and most stable capital market in the world.

These aspects of the U.S. market provide substantial benefits for issuers of securities and investors alike. For investors, benefits include a wider range of investment alternatives, highly efficient pricing, and greater liquidity. For issuers of securities, benefits include a cheaper cost of capital, an increased shareholder base, and enhanced corporate prestige.

For foreign firms that list on U.S. stock exchanges, these benefits translate into a so-called "listing premium." Academic studies have consistently shown that foreign firms listed in the United States have a higher valuation than foreign firms listed elsewhere. Indeed, a study released by Ohio State University in the fall of last year concluded that cross-listed foreign firms enjoy a valuation premium of 14 percent on average, and as high as 31 percent.[1]

Having the world's premier capital market within our borders has conferred many benefits and advantages to the United States. It is no coincidence that the world's largest, most liquid, and competitive capital market is part of the world's largest, most productive and innovative economy.

Critical Importance of Investor Confidence

Mr. Chairman, the foundation of any competitive capital market is investor confidence. When investors put their hard-earned capital at risk, by purchasing shares in a company or its debt securities, they must have faith that the company is telling the truth about its business and its finances. They must be sure that the company's financial statements have been prepared using high-quality accounting standards designed to accurately reflect the company's financial condition.

If investors don't have that faith – or if their faith is ever undermined – investors will insist on a risk premium on their investment. The net effect of this "uncertainty" or "anxiety" premium is to raise the cost of capital, with clearly negative implications for business investment, risk-taking, innovation, productivity, and, therefore, job creation.

[1] Study by Andrew Karolyi, Professor of Finance, Ohio State University.

As it becomes more difficult, more expensive, and more time-consuming to distinguish the good from the bad, investors might well abandon questionable markets for others around the world. Even worse, they may choose not to invest at all.

This scenario is of particular concern at a time when more than half of U.S. households own equities, and when investment decisions regarding the deployment of retirement funds are increasingly being delegated to the individual beneficiaries. The number of America shareholders has risen from 30 million in 1980 to more than 84 million in 2002. And those individual investors – putting money into 401(k) pensions, mutual funds, and brokerage accounts – account for up to 80 percent of the new money flowing into U.S. stock markets.

Since the 1930s, the United States has required some of the most extensive financial disclosures, backed up by one of the most robust enforcement regimes in the world. Companies wishing to list on U.S. exchanges must register with the SEC, which regulates listed companies to protect investors and creditors. The SEC requires companies to produce financial statements that demonstrate their financial status. Theses statements must meet standards established in US GAAP (Generally Accepted Accounting Principles). Independent auditors must audit companies' financial statements to attest to their validity and compliance with GAAP.

Such requirements entail substantial costs, particularly for foreign firms who must reconcile their financial statements to U.S. standards. But such costs are more than offset by the reduced cost of capital, the prestige, and other benefits that come with listing in the United States.

Educated investors understand that investing by its very nature entails risk, but the U.S. government has built a rigorous framework of investor protections to ensure an open, fair, and transparent marketplace, and a level playing field for all investors, large or small. And the results are clear – nearly half of all equity shares in the world, by market capitalization, trade in the United States, and foreign investors have entrusted more than $4.5 trillion to our equity markets.

Late '90s Scandals Undermine Investor Confidence

Unfortunately, in the boom years of the late 1990s, with equity prices climbing ever higher, new companies in a mad rush to go public, and the markets under the spell of what Alan Greenspan famously called "irrational exuberance," too many forgot the critical importance of maintaining the confidence and trust of investors.

As the dot.com bubble burst, a parade of corporate scandals began. Enron, WorldCom, Adelphia, Health South, Tyco, Global Crossing, Cedant, and others were accused of managerial fraud, accounting irregularities and other governance abuses. While the vast majority of corporate officers are honest people who discharge their responsibilities with the highest ethical standards, it became apparent that an erosion of general standards had occurred, with questionable practices becoming accepted by too many and ethical corners too often being cut.

The unfortunate effect of this deterioration in corporate governance was to undermine investors' faith in the integrity and basic fairness of the world's greatest capital market. The subsequent drop in equity prices and the reluctance of investors to return to the markets once prices

stabilized led to the loss of more than $7 trillion of equity value – nearly half of the markets' total capitalization.

Sarbanes-Oxley

The government's response came in 2002 when Congress passed and President Bush signed into law the Sarbanes-Oxley Act – the most significant piece of securities legislation passed since the Securities Acts of 1933 and 1934, the latter of which created the Securities and Exchange Commission.

Sarbanes-Oxley created the Public Company Accounting Oversight Board to oversee the audit profession, and created new rules to protect auditor independence. It addressed conflicts of interest faced by securities analysts, increased the penalties for financial fraud, and gave the SEC additional resources. The Act also instituted other important safeguards, such as requiring the chief executive and chief financial officers of issuing companies to personally certify the company's financial statements, and mandated that auditors certify the adequacy of the issuer's internal controls – the so-called Section 404 provision of the statute.

As you know, Mr. Chairman, in the nearly 4 years since its passage, Sarbanes-Oxley has become a topic of spirited debate. Some observers argue that the Act went too far, imposing heavy compliance and legal burdens, especially on smaller businesses, and that Congress should take corrective action. Others argue that any roll-back of Sarbanes-Oxley would damage the critically important investor confidence the Act was intended to shore up.

In assessing the effect of Sarbanes-Oxley, we first must acknowledge what has happened since its passage. Investors – including millions of individual investors – have returned to the markets, pushing the Nasdaq, the S&P 500 Index, and Dow Jones Industrial Average to 5-year highs and creating more than $5 trillion in additional equity value.

Now, it's important to remember that association does not necessarily imply causation. Indeed, another major event that occurred not long after the passage of Sarbanes-Oxley that also boosted investor confidence was the reduction in tax rates on capital gains and dividends. Such cuts have powered equity markets by rewarding risk-taking and encouraging the flow of new capital into the markets. Congress must not allow these cuts to expire.

Having said that, it's my view that one cannot credibly argue that the confidence-boosting aspects of Sarbanes-Oxley have had nothing to do with the impressive performance of U.S. equity markets since 2002.

At the same time, however, other developments have established a pattern that should be deeply concerning to all of us:

- In 2005, the United States accounted for 20 percent of worldwide IPO proceeds, down from 35 percent in 2001.

- In 2005, 23 of the 25 largest IPOs did not list in the United States.

- In 2005, the top 10 IPOs, measured by global market cap, were not registered in the United States.

- In 2005, the largest IPO in five years listed in Hong Kong.

- In 2000, nine out of every 10 dollars raised by foreign companies through new stock offerings were raised in the United States. In 2005, the reverse was true – nine out of every 10 dollars raised by foreign companies through new company listings occurred outside the Unites States, principally in Europe.

- In 2005, 41 start-ups backed by venture-capital investors went public, down from 67 in 2004 and 250 in 1999.

- A recent London Stock Exchange survey of 80 international companies that went public on its market found that of those that contemplated a U.S. listing, 90 percent decided that Sarbanes-Oxley made London more attractive.

- In an attempt to capitalize on the reluctance of foreign firms to list in the United States, the LSE has launched promotional initiatives to give companies more listing options, including a special listing discount for smaller companies.

- Korean retailer Lotte Shopping recently conducted the largest IPO in Korean history, choosing to list its shares in Seoul and London.

- In February, I met with Charlie McCreevy, Commissioner of the European Union for the Internal Market. While in Washington, Mr. McCreevy was also scheduled to meet with SEC Chairman Cox, with whom he wanted to talk about easing U.S. requirements for foreign companies to *de*-list from U.S. exchanges.

Our public company corporate governance standards are not uniquely responsible for this troubling trend. Other contributing factors surely include the rising costs associated with frivolous litigation, rising healthcare costs in the United States, and the costs associated with foreign companies having to reconcile their financial statements to meet GAAP standards. But given the evidence, Mr. Chairman, it seems clear that, in addition to the acknowledged benefits of our corporate governance laws, unintended consequences have undermined the attractiveness of the U.S. capital market for many foreign companies.

On the topic of keeping our capital markets competitive, I would be remiss if I didn't point out that the apparatus of financial supervision in the United States is badly in need of reform. Our system remains a patchwork of legal entity-focused regulatory fiefdoms with overlapping jurisdictions, varying statutory responsibilities and powers and, too often, inconsistent supervisory postures and priorities. These circumstances have increasingly led to needless duplication, regulatory arbitrage, structural imbalances, inefficiency, and waste – with assuredly negative consequences for the competitiveness of our markets.

As Chairman Oxley has rightly observed: "The clear inefficiencies in the current system and the increasingly competitive nature of the international market are going to eventually collide and put U.S. financial services firms at a potentially serious disadvantage."

Supervisory and regulatory reform is a topic for another discussion – one which the Financial Services Forum has many ideas that we'd be delighted to share with this subcommittee.

Conclusion

Mr. Chairman, as we consider appropriate steps to take to preserve the current status of the U.S. capital market as the envy of the world, we cannot lose sight of the critical importance of investor confidence. Having the deepest, most liquid and stable market requires the capital that only investors can provide.

The overwhelming majority of investors – regardless of national origin or where they are placing their capital – want the same thing: honesty and integrity. They want to be sure that boards of directors take their fiduciary responsibilities seriously. They want to know that the financial information companies provide is authentic and reliable. They want to know that companies in which they invest have internal controls and governance standards adequate to properly and profitably manage their operations into the future. And when fraud is uncovered or securities laws are violated, investors rightly expect regulatory authorities to aggressively protect their interests through enforcement action.

We all want an equity listing in the United States to be what it has been for nearly 80 years – the global gold standard. We want listing and registration in the United States, with all its extensive requirements, to signal to issuers and investors alike that an issuing company is committed to, and has demonstrated its ability to meet, the highest standards of corporate governance and accountability.

But it is also true that successfully competing for scarce capital is becoming more difficult by the day. Simply stated, the United States is no longer the only game in town. Europe-based global exchanges such as the London Stock Exchange, the Deutsche Borse, and Euronext are well-capitalized, public, for-profit markets that are well positioned to aggressively compete for global market share. European-listed IPOs raised over $61 billion in 2005 – double the amount raised in 2004.

In Asia, the Tokyo, Hong Kong, Singapore, Seoul, and Malaysian markets continue to develop, and with the Chinese and Indian economies growing at 9 and 6 percent respectively, it's only a matter of time before the Shanghai and Bombay exchanges become formidable competitors.

Mr. Chairman, it is entirely in keeping with the principles of our corporate governance standards to re-evaluate whether the rules and regulations written to implement those principles are effective and appropriate:

- Do the rules and regulations achieve the intended objectives?

- Do they impose an unnecessarily high or costly burden on regulated firms, particularly smaller businesses?

- Do the costs of meeting the requirements outstrip the acknowledged benefits of listing in the U.S. markets?

- Are there steps that can be taken to alleviate some of the burden and costs without undermining investor confidence?

In other words, do our securities laws make it easier or harder to compete in the global marketplace? These are reasonable, prudent questions to ask. And preserving a strong and vital capital market is too important to the future of the United States not to ask them.

The United States has an historic opportunity to engage head-on the challenges of globalization and international competition, and thereby help create a more prosperous, peaceful, and democratic world. We can and must properly balance the twin priorities of defending the highest standards of corporate disclosure and accountability, while keeping the United States the world's capital market of choice.

Thank you very much for the opportunity to appear before the subcommittee.

STATEMENT OF
DR. LAWRENCE G. FRANKO
Professor of Finance, College of Management, University of Massachusetts Boston, and Senior Investment Advisor, International Value Equity Group, Delaware Investments

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

ON

UNITED STATES COMPETITIVENESS IN THE GLOBAL FINANCIAL SERVICES INDUSTRY

Wednesday, April 26, 2006

Thank you, Mr. Chairman and Committee Members for the opportunity to testify today on "America's Capital Markets: Maintaining Our Lead in the 21st Century." It is an honor and a privilege to be able to address the Committee.

My name is Lawrence Franko. I am the author of a recent study on U.S. Competitiveness in the Global Financial Services Industry, which was prepared for the Financial Services Forum of the College of Management at the University of Massachusetts Boston. The complete paper can be found on the Worldwide Web at www.financialforum.umb.edu/documents/franko .

This work is the latest in a series of articles and books I have written on Global Corporate Competition which go back to the 1970s and to my affiliation at that time with the Harvard Business School's Multinational Enterprise Project.

U.S. Pre-eminence in Financial Services

The importance of American firms in the world's financial services industry is remarkable, and the position of U.S. enterprise in the most dynamic and rapidly growing segments of the industry is even more so.

With five percent of the world's population, and a quarter of its GDP, the United States has more than half of the capitalization and trading of the world's stock and bond markets. U.S. investment banks and brokerage houses dominate not just U.S., but international capital market transactions. Our money-management institutions and mutual funds manage well over half of the world's pension and personal financial assets. Consumer credit transactions are dominated worldwide by American brands. Far more than half of the world's hedge-fund, venture capital and private equity, and derivatives and risk management activities are conducted by American owned and managed firms.

These proportions would be yet higher were one to count not just U.S. owned institutions, but the major U.S. activities – some of which are of global scope in their own right – owned by foreign, predominantly European, financial firms.

While less impressive in the aggregate, the U.S. also has global leaders in traditional banking and insurance activities, several of whom spread internationally by piggy-backing on the historical expansion of U.S. multinational manufacturing and service firms. However, the regulatory balkanization and fragmentation of banking and insurance in the U.S. long inhibited the honing of competitive advantages that could translate into global dominance. U.S. global dominance in capital markets has arisen and accelerated after, and as a result of, the move toward new modes of financial intermediation, asset-gathering, and risk management in our domestic market.

Driving Forces

The driving forces of U.S. global pre-eminence in financial services and especially in capital markets activities are many, but several stand out:

1. The post-World War II prominence of the U.S. dollar in international transactions, and the development of trust in the U.S. dollar "brand."
2. The early U.S. recognition that encouragement should be given to funded pension plans, as opposed to relying primarily on government pay-as-you-go transfers.
3. The early development of a "securities culture," where regulation and competition interacted to produce a large domestic market in which publicly-quoted, professionally governed, transparency-oriented firms are the norm, rather than the exception.
4. Declining protection given to incumbent banks and insurance companies from capital markets competition, compared to other countries where dis-

intermediation was long inhibited and barriers to financial market alternatives remained high.

5. Institutions of higher education geared to producing the people with the knowledge and skills for capital market management positions.
6. The U.S. position as "first market" and others as "follower markets" for financial innovations from mutual funds, to hedge funds, to "big bangs," to public securities offerings on a large scale (floatations of previously family-owned or state firms), to providing rights for minority shareholders, and many others.

In broad summary, other countries eventually grew to have needs for capital market activities similar to those the U.S. had experienced earlier. They realized that they could not have economic growth and efficient capital allocation without importing competitive and regulatory practices developed first here. And, by the time they did so, many U.S. firms had developed unassailable strengths.

These strengths meant that even in non-U.S. locations where financial services may be concentrated – due to combinations of historical and customer agglomeration, or lighter or more deft regulation-- such as in the City of London, U.S. institutions would take the lead.

Likely Futures

There are many reasons why American financial, and especially capital markets institutions are likely to continue to expand their role in the world's financial services industry.

U.S. institutions have wide and deep first-mover advantages compared to their non-U.S. competitors. Not only have they pioneered the vast majority of the "alternatives to traditional banks," they have developed the technological, marketing, managerial, and worldwide network infrastructure to exploit those advantages.

Dis-intermediation has much further to go outside the U.S. The U.S. "past" of the replacement of banking by capital market and asset management institutions – at least in commercial, as opposed to retail financing – is Europe and Asia's future. Merge defensively as they might, nationally or across borders, traditional banks whose strengths are based on close ties to local and regional relationships are going to remain vulnerable to the competitive winds blowing from less-expensive capital market transactions. Retail customers may remain because of inertia and the psychic benefits of personalized hand-holding, but large and even small businesses who must compete in wider and wider economic spaces like the European Union and the Pacific Rim, will go to the most experienced midwives of low-cost capital market sources of funds.

The "securities culture" also has much further to go outside the United States. Significant reliance on "pay-as-you-go," un-funded government pension plans is simply not viable in the 21st century. Alternatives must be found, and no one has yet found a better one than the funding and investing of savings for retirement as pioneered in the U.S. There are abundant opportunities for U.S. asset managers.

Regulatory and Competitive Implications

The great global success of U.S. capital markets institutions rests on at least four domestic pillars. Our home market is unique in the world because of:

- The intensity of competition, within and especially across financial services industry segments.
- The depth and size of our markets, with multitudinous varieties of securities and instruments.
- Innovation and skills, and perhaps especially,
- The reputation, transparency, and probity of the leading firms and actors in the market, including the reliability of the U.S. dollar and institutional "brand."

Translated into the mission of this Committee, I would suggest two overarching guidelines for the future.

We should remember goals, even when preoccupied by details. Congress makes laws, and many laws are highly detailed and complex. Day-to-day petitions pertaining to those laws seem largely to center on arguments over whether and how S.E.C., Sarbanes-Oxley, Patriot Act and other rules and regulations might be lightened, changed, or strengthened. Ultimately, however, maintaining and strengthening the U.S. global capital market position means maintaining our reputation. Our "brand" is not just transactions efficiency, knowledge and skill. It is also honesty, transparency, and good corporate and capital market governance. We cannot gain the benefits of this reputation without incurring some costs.

Regulation should also look out for the interests of consumers, and share and bond-stakeholders, not for those of firms and managers who may wish to entrench themselves against competition. Had our "big bang" not occurred first, or had our banks been able to continue to shut out out-of-state or non-bank competition, we would not have the thriving capital-market actors we do today. Firms hone their global competitive skills by first competing at home. Regulation that protects today weakens firms in the long run. We should promote the future, not the past.

Thank you for your interest and attention.

STATEMENT OF

FORMER SPEAKER OF THE HOUSE NEWT GINGRICH

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND

GOVERNMENT SPONSORED ENTERPRISES

WEDNESDAY, APRIL 26, 2006

Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee:

Thank you for inviting me to appear before you today to testify on the global competitiveness of America's capital markets.

America's ability to win -- and not just compete -- in the global economy depends in part on our having the world's most efficient capital markets. Substantial reforms in this area will be required for America to continue to be the most successful economy in the world and the best source of high paying jobs and enough economic growth to sustain the Baby Boomers and their children when they retire.

Last year, the London Stock Exchange recorded 129 new listings by companies from 29 different countries. In the United States, NASDAQ gained a net of fourteen and the New York Stock Exchange a net of six. In a press report by the London Stock Exchange on the reasons for its success, it cited that "about 38 percent of the international companies surveyed said they had considered floating in the United States. Of those, 90 percent said the onerous demands of the new Sarbanes-Oxley corporate governance law had made London listing more attractive."

Recently, New York Stock Exchange CEO John Thain told the Senate that last year that not a single top ten initial public offering (IPO) (by size of

DRAFT 4/26/2006
© 2006 Gingrich Communications

market capitalization) was registered in the U.S., and that 23 out of the top 25 largest IPOs in the world were registered outside the U.S. last year. This is contrast to the year 2000, when nine out of every ten dollars raised by foreign companies was raised in the U.S.

These are only a few indications that the very nature of our times will give the United States no choice but to transform or decay. We must make the bold changes required to enable our capital markets to flourish and our economy to win in the global marketplace or we will cede our leadership position to others.

For over a century, the pace of progress in America has been driven by the discoveries of scientists and technologists, brought to the marketplace by entrepreneurs in the form of products and services. We have flourished and lead the world because we have adapted to the opportunities created by science and technology. Countries that have ignored these opportunities have fallen behind in standards of living and quality of life.

America is facing a serious challenge to our economic superiority for the first time since we surpassed Great Britain around 1840. Over the last 150 years we have been the most dynamic economy in the world. While Germany and Japan could challenge us in some areas, they were simply not big enough to compete with America in everything.

Now we are faced with the economic rise of China and India, countries whose populations are larger than our own. Americans will have to be four times as productive just to match them in overall economic activity (since there will be four times as many Chinese and over three times as many Indians as Americans). Historically, we have achieved far more than this level of productivity advantage. But as other countries study us and learn what we do, they will learn to be better competitors.

In scientific knowledge and advancement, we are experiencing today a rate of change that is four times greater than what we did during the last 25 years—making the scale of change we will experience in the 25 year period 2006-2031 at least equivalent to what we experienced in the 100 year period 1906-2006.

DRAFT 4/26/2006
© 2006 Gingrich Communications

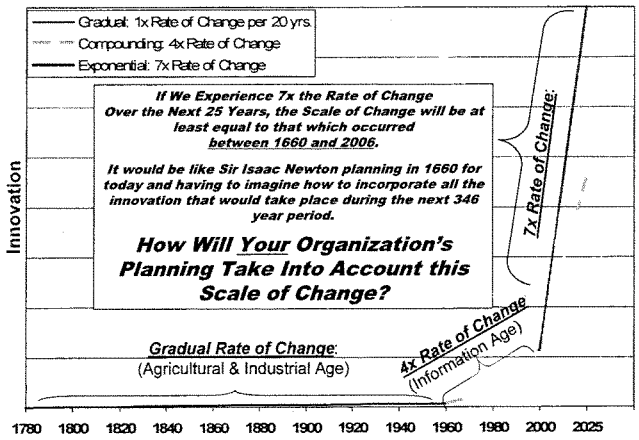
More scientists are alive today than in all of previous human history combined. Furthermore, instead of sharing knowledge at the rate of the printing press and mail delivery, scientists are sharing knowledge through the Internet and the cell phone. This explosion of knowledge is moved from laboratory to market by a venture capital-licensing-royalty system of unprecedented power and ability.

Drivers of change fueled by Moore's Law will increase knowledge and productivity on a world wide basis—virtually guaranteeing continuous down-ward pricing pressures: information technology; communications; nano-scale science and technology; quantum mechanics; and biology.

In terms of productivity improvement, this is much like the period of 1873 to 1896 when there were advancements in steel, electricity, electric light, steam ships and the telephone. For example, the introduction of commercial refrigerator cars for railroad and ships meant that you could deliver Texas beef anywhere—collapsing food prices. The constant and steady explosion of productivity will continue to drive prices downward.

The scale of scientific change we will experience in the next 25 years is suggested by the following diagram.

The Scale of Scientific Change 2006 - 2031



DRAFT 4/26/2006
© 2006 Gingrich Communications

We are in the early stages of a revolution in knowledge that will transform the way we live, learn, and do business.

This scale of change means that there are enormous economic opportunities for the United States in the coming years.

Having strong capital markets is a key to continuing the entrepreneurial creativity that has made us the most successful and prosperous economy in the world for over 160 years. Strong U.S. capital markets will also ensure that America can capture the rewards of a rapidly innovating scientific and entrepreneurially based economy.

When you examine this scale of change and combine it with the rise of massive new centers of low cost production in China, India, and elsewhere, you are in a transformed world. Yet, our government has not adapted nearly fast enough, in its function and policies, to this changing world.

The following are a set of recommendations for this subcommittee to consider as it continues its important work of ensuring that the United States has the most efficient and productive capital markets in the world:

1. **Fundamental Overhaul of Sarbanes-Oxley**. With three years experience of the Sarbanes-Oxley regulatory regime, it has become plainly evident that this law requires a fundamental overhaul. The good intentions of Congress have met with the law of unintended consequences. The explicit and implicit costs of Sarbanes-Oxley compliance are staggeringly high and far exceed the benefits. The costs are disproportionately large for small businesses, which on a percentage of revenue basis are estimated to be 11 times that of larger companies. Congress clearly did not intend this. The Securities and Exchange Commission's (SEC) original estimate of $91,000 per company on average was wildly optimistic and probably undercounts compliance costs by a factor of 40 to 50. There is also the future cost associated with the litigation "time bomb" set in motion by Sarbanes-Oxley. This refers to the onslaught of lawsuits that can be expected in any future market or industry downturn owing to the new causes of action created by Sarbanes-Oxley and also by the apparent ease in which liability can be shown by tracing decline in market price to a shortcoming in internal financial controls. With such compliance costs, it is little wonder that so

DRAFT 4/26/2006
© 2006 Gingrich Communications

many new listings chose the London Stock Exchange over a U.S. exchange. Moreover, judging from what we have learned from the Rudman Report on Fannie Mae, it appears that the reliance that Sarbanes-Oxley puts on audit committees and boards of directors were insufficient to prevent the financial deception by management in this high profile case. It is examples like this one that makes it possible to question whether the cost associated with Sarbanes-Oxley compliance is not simply a deadweight loss to the economy.

Alex Pollock and Peter Wallison of the American Enterprise Institute are two of the most thoughtful observers I know on Sarbanes-Oxley. I am attaching to this statement as **Appendix A** recent Congressional testimony by Pollock on the unintended burdens of the Act. In particular, Pollock sets forth a number of recommendations that this subcommittee should consider, which I reproduce here:

a. Enact the provisions of HR 1641, introduced last year by Congressman Jeff Flake of Arizona. HR 1641 would make Section 404 of Sarbanes-Oxley voluntary, as opposed to mandatory. This approach would be well suited to a market economy and a free society.

   If investors actually want the kind of heavy internal control documentation 404 demands, then the companies will do it because investors will demand it. Investors will punish those companies which opt out.

   If, on the other hand, investors conclude that resources would be better spent elsewhere-- on research, or introducing new products, or customer service, for example-- then companies will do that and the investors will react accordingly.

b. If a totally voluntary approach be viewed as politically impossible, at a minimum make Section 404 voluntary for smaller public companies. Exemption from these requirements for these companies is recommended by the SEC's Advisory Committee on Smaller Public Companies.

DRAFT 4/26/2006
© 2006 Gingrich Communications

[Pollock] believe[s] that "voluntary with disclosure and explanation" would be a better concept than simple "exemption." The company should decide what approach it will take to internal control certification and explain to its investors why it has so chosen. Investors can consider the company's logic and make up their own mind.

c. Instruct the Public Company Accounting Oversight Board (PCAOB) to change its review standard from "other than a remote likelihood" to "a material risk of loss or fraud." [Pollock] think[s] this is essential to improve the implementation behavior of the accounting firms.

d. State clearly that Congress does not have the naïve belief that accounting is something objective, but rather understands, as every financial professional does, that accounting is full of more or less subjective judgments, estimates of the unknowable future, and debatable competing theories. As the saying goes, it is art, and by no means science.

   Therefore the express instruction of Congress should be that consultation, judgment and professional advice on the application of accounting standards is expected and demanded of accounting firms.

e. Instruct the PCAOB to require a Section 404 regime for the public accounting firms themselves, as a condition of their public trust, on the same standards as apply to public companies.

f. Mandate a report from the SEC and the GAO comparing the British principles-based Turnbull Guidance on corporate risk controls to the approach taken by Sarbanes-Oxley implementation.

g. Bring the PCAOB under Congressional authority as a regulatory agency should be, subject to appropriations, oversight and a normal appointments process, and move PCAOB assessments, as they are for any other regulator, to the regulated entities.

DRAFT 4/26/2006
© 2006 Gingrich Communications

h. Finally, enact a sunset or reauthorization requirement for Section 404 of Sarbanes-Oxley five years from now. That would be 2011, a decade after the scandals which gave it birth, with correspondingly greater experience, knowledge and perspective for all concerned.

2. **Reign in State Attorneys-General**. We must have a uniform national set of securities regulations. To the extent that state Attorneys-General are encroaching in this rule-making area, then the Congress should direct the SEC to preempt such state action.

   In recent years, the actions of some state Attorneys-General are eliciting serious questions about the fair treatment of corporations and threatening the rule of law. A competitive environment has evolved in which "activism" is the norm and generating media headlines an ever present goal as Attorneys-General crusade against one industry after another. Further, Attorneys-General have reaped publicity and political advantages through their pursuit of multi-state litigation targeting the tobacco, pharmaceutical, software and financial services industries. A few Attorneys-General have gained national attention by speaking to the media during the pendency of investigations.

   Also disconcerting is the alliance between Attorneys-General and members of the plaintiffs' bar, who are often awarded contingency fee contracts for state work. These attorneys are also major campaign contributors of the elected Attorneys-General, raising significant concerns about conflict of interest and fairness in prosecutions and civil litigation.

   As trial lawyers ratchet-up their shopping of litigation concepts to state Attorneys-General, there needs to be legislation to address the problem of Attorneys-General hiring plaintiffs' attorneys on a contingency fee basis. The Private Attorney Retention Sunshine Act calls for increased government oversight and greater transparency when Attorneys-General seek to forge contingency fee deals with outside counsel. The Sunshine bill has already been enacted in seven states, and its adoption is being championed in others this year, including West Virginia and Florida.

DRAFT 4/26/2006
© 2006 Gingrich Communications

Christopher DeMuth of the American Enterprise Institute has written about the dangers of unchecked interference by state Attorneys-General:

Even more striking are the new coast-to-coast regimes being constructed by state officials like New York Attorney General Eliot Spitzer. He candidly admits that his mission is the wholesale restructuring of entire industries on a nationwide scale. The agreements he has imposed on Merrill Lynch and other financial services firms make detailed requirements of how the firms are to be managed in the future. This has created, thanks to collaboration with officials in other states, new national regulatory programs established entirely outside the legislative process and outside the public rule-making procedures of regulatory agencies. Instead, the deals are cut in lawyers' offices. The results are policy cartels with no exit for any firm or customer, no policy competition or experimentation, no federalism.

The emerging phenomenon is one of multiplying special-purpose national governments operating in parallel with the official national government and without any coterminous political accountability. This has come to pass because of the desuetude of several Constitutional provisions, none more important than the Compact Clause, which provides that "no State shall, without the Consent of Congress, enter into any Agreement...with another State." The requirement of Congressional approval is unqualified and it is fundamental. For a gang of states to go off on their own and set up independent governing regimes is, politically, a form of partial secession. Yet this protection has lapsed through judicial neglect.

Here the big innovation was the 1998 settlement agreement among most of the states and the leading tobacco companies. The agreement established a national regime for the marketing of tobacco products, including a de facto national excise tax on cigarettes designed to raise $246 billion over 25 years, a range of spending programs funded by the revenues, entry controls to limit competition from new manufacturers, and a host of other regulatory requirements. The states have become so addicted to the tobacco revenue windfall that the decline in cigarette smoking is now a serious fiscal worry.

DRAFT 4/26/2006
© 2006 Gingrich Communications

The tobacco program was followed by the Spitzer-led initiatives for regulating investment firms. The pharmaceutical industry—already heavily regulated by the official federal government—is next. Attorney General activists are already closely coordinating a variety of cases in courts across the nation.[1]

This blackmail model of Attorneys-General championed by New York's Eliot Spitzer, which mugs companies without going to court, is a job killer. These practices must be stopped.

The Congress should also take decisive action to halt any inter State agreements that are being made in violation of the Compact Clause. The Constitution is clear that the federal government sets the framework for the national economy. Congress and the Executive Branch have a constitutional duty to protect that role from encroachment by states.

3. **Litigation Reform**. Edwards Deming once warned that litigation was one of the greatest threats to the American economy. Prior to 1963, civil justice suits were a reasonable part of making America work. Only in the last forty years has the prospect of litigation emerged as a self-enriching industry for a narrow group of lawyers—the personal injury attorneys. Today, entire law firms exist solely to file such lawsuits. The scale of lawyer enrichment has grown to a point that some of the wealthiest persons in America are personal injury lawyers who participated in the tobacco settlement. Money that should have gone to those injured by smoking instead went to lawyers who now fly their own private airplanes and buy baseball teams.

   There are other major consequences of this explosion of litigation. Laws are being changed from an instrument of justice into an instrument of revenge and redistribution. Americans are learning to treat litigation as a lottery, to sue rather than settle, and to turn American civil life into one of conflict and suspicion.

   Investment decisions about creating new drugs, jobs, and trying new services are being made riskier by defense lawyers who warn about the litigation that has unpredictable and possibly bankrupting costs. This endangers the entrepreneurial character of our economy.

[1] Christopher DeMuth, "Unlimited Government," *The American Enterprise*, Jan-Feb, 2006

DRAFT 4/26/2006
© 2006 Gingrich Communications

Such an environment makes America a less and less desirable place to do business for companies that increasingly have choices of where to locate in a global economy. Securities litigation also affects where new companies decide to seek capital financing.

Potential investors, looking at the litigation risks in America compared to the rest of the world, are beginning to shift investments to less risky countries.

We need to fix this. The following are a set of recommendations to reform our litigation system:

a. Arbitration Preferable to Litigation. Everyone should know that rapid, inexpensive arbitration is preferable to litigation. Cases involving technical knowledge should go first to panels of experts (health courts in the case of medical malpractice), but plaintiffs should be able to appeal to a court if they feel cheated. They should, however, have to carry the result of the expert panel with them into the litigation.

b. Losers Pay. Losers should be at risk for costs, and if the judge finds that the loser filed a case without substance, triple damages should be payable by the loser, and the personal injury lawyer should be required to pay court costs for having willfully brought a case without merit.

c. Fixing Percentage of Recovery for Injured Party. The injured party should be guaranteed 85 percent of the settlement while the personal injury lawyers should be limited to no more than 15 percent.

d. Prohibit Law Firms from Bringing Class Action Lawsuits. It should be illegal for a law firm to form a class action lawsuit for its own enrichment. The injured parties should originate the lawsuits and hire the law firm. The judge should have the option of opening the class action lawsuit to competitive bidding to find the least expensive law firm for the injured parties.

DRAFT 4/26/2006
© 2006 Gingrich Communications

e. Ban Lawyer Advertising. We should return to a world in which lawyers do not advertise. There are profound reasons why society has historically held that lawyers should not publicly seek cases. The damage done by constant thirty-second reminders of the right to sue and the right to feel injured and trespassed upon is incalculable. It actively harms American society, the American economy, and the stature and prestige of the legal profession. The profession-enhancing rationale behind anti– ambulance chasing laws was right. The reduction of the law into a commercial venture is wrong. It is time to reverse that decision and make the law once again above the profit motive.

f. Securities Litigation Reform. Despite enactment in 1995 of the Private Securities Litigation Reform Act, claims are growing larger and cases are frequently settled for massive amounts of money. Securities class action settlements have increased on an inflation–adjusted basis from $150 million in 1997 to $9.6 billion in 2005. There needs to be reform of the system to ensure that companies are not burdened by excessive, costly litigation which fails to compensate truly injured parties. The Congress should also assess how to preempt any Sarbanes-Oxley litigation "time bomb" from swamping the courts and harming investors. In October 2005, the U.S. Chamber Institute for Legal Reform released an economic study directed by a world-renowned securities scholar and companion research paper that provide a detailed overview of who benefits most from securities class actions and how these cases impact the business community and the U.S. economy. The study is the first of its kind and reveals that most institutional investors don't simply break even from securities class action settlements; many of them benefit, accumulating the gains of stock prices inflated by alleged fraud and also receiving compensation for losses suffered as a result of allegations of fraud. The companion research paper draws significant conclusions about the economic consequences of securities lawsuits, including the alarming conjecture that the mere filing of a securities class action lawsuit on average results in a 3.5 percent drop in the defendant company's equity value.

DRAFT 4/26/2006
© 2006 Gingrich Communications

The current system is not working as intended and it was created in a very different environment. The SEC has now increased its enforcement resources and is able to bring more cases. For example, in 1986 the SEC's annual budget was $106.4 million and in 2005 its annual budget was $961.3 million. We need fundamental reform of this system given the new regulatory environment and given that the current system clearly does not work well as the economic studies reveal.

g. Fixing the Fraud and Abuse in Mass Tort Litigation. The crux of the trial lawyers' mass tort business model is the medical screening process in which lawyers, doctors and screening companies ally to mass produce claims. This assembly-line process has enabled trial lawyers to quickly and inexpensively generate such a high volume of plaintiffs that most defendants opt to settle, rather than risk time and money on a trial. The end result is a multi-million dollar payday for plaintiffs' lawyers, who leverage their windfall to finance more mass screening operations that will yield more questionable claims to serve as the basis for more litigation against American employers.

To clean up the screening process once and for all, there needs to be significant legislative and regulatory reforms of the system. Possible solutions include:

- Legislation at the federal or state level that would set standards for diagnoses, requiring that diagnoses state the disease is caused by exposure to the product in question and rule out alternative causes; proof of a doctor-patient relationship; and a medical indication that a test is needed before it is prescribed.

- Creation of uniform procedures for medical and legal personnel involved in medical screening.

- Furthermore, National Institute of Organizational Safety and Health (NIOSH) needs to be urged to strengthen a proposed code of ethics for B-Readers, physicians specially certified to diagnose diseases like silicosis and asbestosis by reading x-

DRAFT 4/26/2006
© 2006 Gingrich Communications

rays. To make sure these doctors are held accountable, NIOSH needs to audit and decertify B-Readers who depart dramatically from industry best practices in making their diagnoses.

4. **Fully Fund the XBRL Project**. The Congress should fully fund the development of the XBRL project championed by SEC Chairman Cox so that U.S. companies can take advantage of this financial reporting system that allows investors and analysts to compare company performance. I understand that this project is estimated to cost approximately $3.5 million to complete. Given the dramatic economic benefits that will accrue to the U.S. from the comparatively small cost of this project as well as the long term enhancement of the competitiveness of our capital markets, supporting this effort with federal dollars is well justified. Set forth as **Appendix B** is an essay by Peter Wallison that describes what is at stake.

5. **Transform the SEC into the Model Federal Agency of 21st Century Entrepreneurial Government**. It is an objective fact that government today is incapable of moving at the speed of the Information age.

   There is a practical reason government cannot function at the speed of the information age. Modern government as we know it is an intellectual product of the civil service reform movement of the 1880s.

   Think of the implications of that reality.

   A movement that matured over 120 years ago was a movement developed in a period when male clerks used quill pens and dipped them into ink bottles.

   The processes, checklists, and speed appropriate to a pre-telephone, pre-typewriter era of government bureaucracy are clearly hopelessly obsolete.

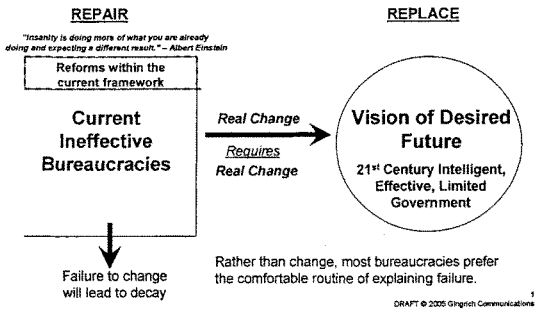
   Yet the unseen mental assumptions of modern bureaucracy are fully as out of date and obsolete, fully as hopeless at keeping up with the modern world as that office would be.

DRAFT 4/26/2006
© 2006 Gingrich Communications

It is simply impossible for the SEC to meet the challenges of the 21st century with the industrial era regulatory paperwork and process focused system. The SEC must become a real time, transparent, self policing market focused system.

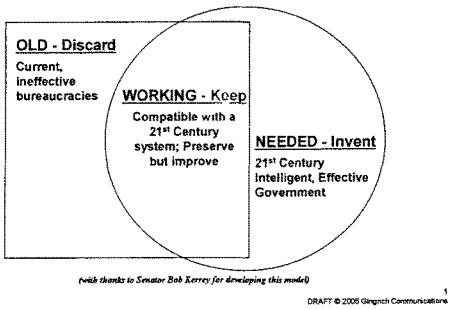
The difference in orientation between what we are currently focused on and where we should be going can be illustrated vividly.

Building a 21st Century Intelligent, Effective, Limited Government Versus Marginally Reforming Current Ineffective Bureaucracies



Of course, it is not possible to reach the desired future in one step. It will involve a series of transitions, which can also be illustrated.

Transitioning to a 21st Century Intelligent, Effective, Limited Government Will Necessarily Mix the Old and the New



DRAFT 4/26/2006
© 2006 Gingrich Communications

Congress can help speed this transformation of the SEC by helping to define the metrics by which it will measure whether the SEC is meeting its goals.

A good place to start looking for ideas on how to reform the SEC is a paper by Peter Wallison and Cameron Smith dated October 5, 2005 and entitled "The Responsibility of the Securities and Exchange Commission for Efficiency, Competition and Capital Formation: Reforms for the First 1000 Days." It is a wealth of ideas for guiding the improvement of the SEC.

6. **Examine Stock Options**. The Congress should revisit the decision by the Federal Accounting Standards Board (FASB) to require the expensing of employee stock options (ESOs) by firms that issue options to their employees. A way should be found for startups and small companies to revert to the older model of stock options. The subcommittee should consider the approach outlined by Charles Calomiris in an August 5, 2005 AEI Working Paper entitled "Expensing Employee Stock Options". In it, Calomiris states:

   It would be better to require that firms estimate expected dilution from existing ESOs on an ongoing basis, and include those estimates in the denominator of a constantly updated calculation of earnings per share. That statistic could be given a prominent place in the public reports of the firm, and would be available as an important source of information for investors.

   The computation of expected dilution (that is, the estimate of the number of shares granted that are expected to be converted in the future) would, of course, be subject to the same measurement errors noted in Sections 6-10 [of this paper]. But the consequences of those errors would not be the same. First, there would be no double counting of dilution costs. Second, there would not be any potential for confusion on the part of investors about the actual expenses of the firm, or the warranted value of the firm. Third, avoiding expensing would eliminate the incorporation of unreliable and misleading measures of "cost" in the firms accounting earnings. Fourth, expected dilution costs could be updated on an ongoing basis, so that

DRAFT 4/26/2006
© 2006 Gingrich Communications

changes in stock prices and volatility could be reflected in forward looking estimates of dilution.

This forward-looking approach to measuring dilution would allow stockholders to take account of dilution before it occurs (an improvement on the current system of measuring earnings per share), and would provide a more accurate measure of future dilution than expensing, since FASB's proposal would fix the magnitude of expensing at the grant date and not update it.

7. **Transform Math and Science Learning**. Winning the challenge of China and India will require profound domestic transformations, especially in math and science education, for America to continue to be the most successful economy in the world. The collapse of math and science education in the United States and the relative decline of investment in basic research is an enormous strategic threat to American national security. This is a strategically disappearing advantage. There is a grave danger that the United States will find itself collapsing in scientific and technological capabilities in our lifetime. In fact, the 14 bipartisan members of the Hart-Rudman Commission on national security unanimously agreed that the failure of math and science education is a greater threat than any conceivable conventional war in the next 25 years. The Commission went on to assert that only a nuclear or biological weapon going off in an American city was a greater threat.

   Improving math and science education is the single greatest challenge to our continued economic and national security leadership. Without a profound improvement in math and science learning, America will simply not be able to sustain its national security nor compete for high value jobs in the world market.

   This is among the most important decisions our generation will make about our country's future and our children's future. For the last twenty years, we have tried to improve education while accepting the fundamental principles of a failed system, guarded by the education bureaucrats and teachers unions. We must now transform math and science education or fall behind. It really is that simple.

DRAFT 4/26/2006
© 2006 Gingrich Communications

Senator Alexander has shown tremendous leadership on this issue and has recently put forward an education reform bill that this subcommittee should review.

Set forth below are an additional set of ideas:

a. Getting students to study math and science may be done through incentives. We should experiment with paying students for taking difficult subjects in math and science. In this world of immediate gratification, many young people in poorer neighborhoods look to athletes and musicians as their future and drugs and violence become their reality when their hopes inevitably most often fail. The long and difficult road to becoming a PhD. in math or chemistry has virtually no support in these neighborhoods nor is it presented as an attractive way out. But, if as early as seventh grade there were some economic reward for learning math and science, which competes head to head with McDonalds, the signal sent would be immediate and dramatic. If the rewards went up as the classes grew more difficult we would have students pouring into math and science instead of fleeing it.

   We should therefore conduct a pilot project to see if this approach can be successful. And we should begin by targeting a poor inner city district where the potential for sending a strong signal is perhaps strongest.

   As a Congressman, I invented a program called "Earning by Learning." I gave my speech money to pay poor children in public housing $2 a book for every book they read in the summer. The first year, a young girl in Villa Rica, Georgia read eighty-three books and earned $166. That was big money for a fourth grader in Villa Rica public housing. That fall, she got into trouble when she went back to school because she was too used to reading and kept doing more than the curriculum permitted. She wanted to learn so much that she was considered a troublemaker. Everywhere we tried "Earning by Learning" it worked.

b. We should set a goal of eliminating fifty percent of the education bureaucracy outside the classroom and the laboratory and

DRAFT 4/26/2006
© 2006 Gingrich Communications

dedicate the savings to financing the improvements in math and science education.

There has been a steady growth in the amount of money spent on red tape, bureaucracy, and supervision. We now have curriculum specialists who consult with curriculum consultants, who work with curriculum supervisors, who manage curriculum department heads, who occasionally meet with teachers. The more we seem to spend on education, the smaller the share we spend on inspiring and rewarding those actually doing the educating.

c. Students must have informed, enthusiastic, and confident teachers guiding them in difficult subjects. We therefore need to foster and encourage teacher specialists who have mastered a subject matter, such as engineers and mathematicians. They should be allowed to teach after taking only one course on the fundamentals of teaching. They should be allowed to teach part-time so that more professionals can have the opportunity to share their knowledge and experience in the classroom. Moreover, every state should pass a law establishing an absolute preference for part-time specialists with real knowledge over full-time teachers who do not know the subject. Finally, by the 2008 school year, no one should be allowed to teach math and science that is not competent in the subject matter.

d. We should apply the free enterprise system to our education system by introducing competition among schools, administrators, and teachers. Our educators should be paid based on their performance and held accountable based on clear standards with real consequences.

e. Graduates willing to stay in math and science fields should pay zero interest on their student loans until their incomes reach four times the national average income. This would encourage students to stay in these needed fields and continue to pursue knowledge.

f. We should reward the best and brightest high school graduates and fully fund their further education. Norman Augustine, the

DRAFT 4/26/2006
© 2006 Gingrich Communications

former Chairman and CEO of Lockheed Martin and former Undersecretary of the Army, recently testified before the Hose Committee on Education and the Workforce. He recommended an America's Scholars Program to fully find the undergraduate and graduate education on the physical sciences, math, biosciences, or engineering of the top 1,000 high school seniors each year. These scholarships would be based on academic success and ability to maintain the highest degree of excellence throughout the remainder of their education.

g. We should reward and encourage private sector participation in math and science education. We should provide a tax credit to corporations that fund basic research in science and technology at our nation's universities.

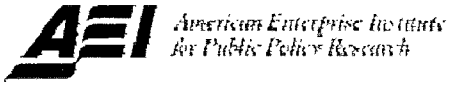
h. Congressman Frank Wolf was exactly right in a letter he sent to President Bush last May in which he cited the urgent national security need to triple the federal budget allocation for innovation -- basic science research and development -- over the next decade. America must act to rebuild our core strength in basic science research and development so that America can maintain its global position long into the 21st Century.

Our past achievements in science, technology, and economic growth will disappear if we fail to transform our system of math and science education and make more investments in basic research. The ability to provide jobs and the American way of life in the 21st century depends on our competitiveness with China and India, which in turn, depends on our success in leading the world in math and science education and continuing to be the world leader in innovation.

These ideas are designed to stimulate thinking beyond the timid "let's do more of the same" that has greeted every call for rethinking math and science education. If the future and safety of our country really are at stake in the areas of math, science, and engineering (and I believe they are), then we can do no less than respond with an appropriate intensity and scale.

DRAFT 4/26/2006
© 2006 Gingrich Communications

Appendix A



Addressing the Unintended Burdens of the Sarbanes-Oxley Act

By Alex J. Pollock
Posted: Monday, April 3, 2006

TESTIMONY
Committee on Government Reform (United States House of Representatives)
Publication Date: April 5, 2006

Implementation Bureaucracy

This hearing is important and timely. With more than three years of national experience with Sarbanes-Oxley implementation to consider, Congress can now easily see that its good intentions have resulted in notable adverse consequences. I am sure you have heard a lot about this from the businesses in your own districts.

Let us start with the most obvious unintended results. Sarbanes-Oxley implementation activities, particularly the Section 404 certifications which have become notorious, have created a tremendously expensive amount of paperwork and bureaucracy.

The explicit costs alone are extremely high and disproportionately high for smaller companies. The implicit costs of employee and management time and effort are high. In addition, there are the opportunity costs of diversion of management focus from playing offense to playing defense.

The total costs far outweigh the benefits which are likely to arise from them, especially for smaller companies.

This is especially true because the testimony of history is quite clear on the reliable regularity with which frauds and scandals accompany investment booms and bubbles. In my opinion, the detailed rules, bureaucratic overhead, and mechanical requirements which characterize Sarbanes-Oxley implementation will not prevent fraud and scandal during the next boom when it comes.

In a typical view of its Sarbanes-Oxley experience, frankly expressed, one smaller company's letter to the SEC describes the following: "concentration on minutia...redundant and inefficient...adversarial

relationship with audit firm...form over function...unrealistic requirements on small and developing companies." It further points out that the cost of all this, which far exceeded the estimates, is of course money taken away from its shareholders.

A letter from the British Confederation of Industry correctly observes that "Dealing with risks on the basis of a remote likelihood," which is the Sarbanes-Oxley implementation approach, "not only imposes huge costs but also makes this a nitpicking process."

An American trade association letter describes, "An atmosphere of near paranoia...the public accounting firms have increased their aversion to risk to an extreme degree."

On the disproportionate negative impact on smaller companies, the SEC's Advisory Committee on Smaller Public Companies has recently concluded: "The result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete.... We believe Section 404 represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed."

Another commentator, Eliot Spitzer, has described Sarbanes-Oxley implementation as an "unbelievable burden on small companies."

Congress clearly did not intend all this. The SEC did not intend it either, nor did it know what the effects of its regulation would be. This is apparent from the initial SEC estimate of a cost of $91,000 per company on average, an estimate which appears to be low by a factor of 50 or so. Either the SEC staff had very little understanding of what their regulation actually required, or interpretation of the regulation morphed in ways never imagined. Indeed, the SEC and the PCAOB subsequently criticized the accounting firms quite sharply for what Sarbanes-Oxley implementation has become.

In short, no one intended the outcome we've got. I believe it's time to fix it.

Effects on Accounting Firms

The flip side of the enormous expense and distraction for companies is that for the large public accounting firms, Sarbanes-Oxley implementation has been a revenue and profit bonanza. One journalist called it the greatest wealth transfer of modern times, from shareholders of companies to partners of accounting firms.

This is especially ironic since Congress was quite clear that this was not its intent. The Senate Committee Report on Section 404 was specific: "The Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees"! (emphasis added). Nevertheless, virtually every audit committee in the country has helplessly watched its audit fees escalate dramatically, unable to exercise any judgment about whether the expensive routines make sense for their shareholders. A second irony is that the implementation of an act dedicated to controlling conflicts of interest has created an obvious

conflict of interest for the accounting firms themselves. The more massive the Sarbanes-Oxley routines, the more memos, procedures and risk control descriptions which are generated, the more often they are reviewed and revised, the more meetings, the more interviews of managers, the more time it all takes, the more profitable the accounting firms become. No wonder they take out advertisements praising Sarbanes-Oxley!

In response to these developments, the "Pollock Proposal" is to expand Sarbanes-Oxley internal control requirements to cover the accounting firms themselves. Since they impose huge costs and nitpicking procedures on everybody else, they should have to go through the same Section 404 routines as a prerequisite to practicing on other people. I expect that, first, they would fail the reviews, and second, their views and reviews of others would become more reasonable.

Another perverse effect of Sarbanes-Oxley implementation is that, as another company wrote to the SEC, "External auditors are reluctant to give advice with regard to interpretation and application of complex accounting rules to avoid possible criticism from the PCAOB in regards to their independence." A related comment: "Almost every significant audit-related decision is now being referred to the firm's national offices rather than being addressed at the practice level."

In other words, the PCAOB environment has made public accountants afraid to carry out the core function which defines a profession: exercising judgment. I consider this the reduction to absurdity of the effects of Sarbanes-Oxley implementation on accounting behavior--and a striking disservice to the companies trying to cope with the ever more convoluted accounting rules propounded by the FASB. Note that this issue suggests that we also need to review the PCAOB.

Reform of Sarbanes-Oxley Implementation

Learning from unambiguous experience, Congress now has the

opportunity to correct the expensive morass of problems resulting from the implementation of Sarbanes-Oxley in ways neither it nor anyone else ever intended, and to bring the costs to shareholders and the benefit to shareholders into balance.

Here's what I believe Congress should do:

1. Enact the provisions of HR 1641, introduced last year by Congressman Jeff Flake of Arizona. HR 1641 would make Section 404 of Sarbanes-Oxley voluntary, as opposed to mandatory. This approach would be well suited to a market economy and a free society.

If investors actually want the kind of heavy internal control documentation 404 demands, then the companies will do it because investors will demand it. Investors will punish those companies which opt out.

If, on the other hand, investors conclude that resources would be better spent elsewhere-- on research, or introducing new products, or customer service, for example-- then companies will do that and the investors will react accordingly.

2. If a totally voluntary approach be viewed as politically impossible, at a minimum make Section 404 voluntary for smaller public companies. Exemption from these requirements for these companies is recommended by the SEC's Advisory Committee on Smaller Public Companies.

I believe that "voluntary with disclosure and explanation" would be a better concept than simple "exemption." The company should decide what approach it will take to internal control certification and explain to its investors why it has so chosen. Investors can consider the company's logic and make up their own mind.

3. Instruct the PCAOB to change its review standard from "other than a remote likelihood" to "a material risk of loss or fraud." I think this is essential to improve the implementation behavior of the accounting firms.

4. State clearly that Congress does not have the naïve belief that accounting is something objective, but rather understands, as every financial professional does, that accounting is full of more or less subjective judgments, estimates of the unknowable future, and debatable competing theories. As the saying goes, it is art, and by no means science.

Therefore the express instruction of Congress should be that

consultation, judgment and professional advice on the application of accounting standards is expected and demanded of accounting firms.

5. Instruct the PCAOB to require a Section 404 regime for the public accounting firms themselves, as a condition of their public trust, on the same standards as apply to public companies.

6. Mandate a report from the SEC and the GAO comparing the British principles-based Turnbull Guidance on corporate risk controls to the approach taken by Sarbanes-Oxley implementation.

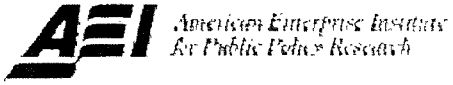
7. Bring the PCAOB under Congressional authority as a regulatory agency should be, subject to appropriations, oversight and a normal appointments process, and move PCAOB assessments, as they are for any other regulator, to the regulated entities.

8. Finally, enact a sunset or reauthorization requirement for Section 404 of Sarbanes-Oxley five years from now. That would be 2011, a decade after the scandals which gave it birth, with correspondingly greater experience, knowledge and perspective for all concerned.

I believe these steps would bring under control the unintended effects, which have proved so remarkably costly, bureaucratic and inefficient, caused by the way Sarbanes-Oxley has been implemented.

Thank you again for the chance to be here today.

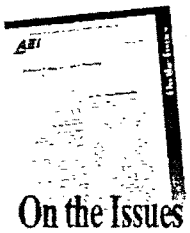
Appendix B



XBRL and U.S. Financial Market Leadership

By Peter J. Wallison
Posted: Monday, March 13, 2006

ON THE ISSUES
AEI Online
Publication Date March 13, 2006



This essay is available here as an Adobe Acrobat PDF.

March 2006

A version of this article originally appeared in Washington and Wall Street *(published by Institutional Risk Analytics) on February 21, 2006.*

To remain competitive internationally, U.S. companies need to accelerate the development and use of XBRL, a financial reporting system that enables investors and analysts to compare company performance.

In December, the London Stock Exchange celebrated a record year for foreign company new issues, with 129 new listings by companies from twenty-nine different countries. In contrast, the New York Stock Exchange registered a net gain of six foreign listings (a gain of nineteen and a loss of thirteen) in 2005, and NASDAQ gained a net of fourteen. According to a press report by the London Stock Exchange on its success, "about 38 per cent of the international companies surveyed said they had considered floating in the United States. Of those, 90 per cent said the onerous demands of the new Sarbanes-Oxley corporate governance law had made London listing more attractive." By now, it is well-known what harm Sarbanes-Oxley has done to the attractiveness of the U.S. securities markets, but what is not well-known is that the lack of resources available to a relatively obscure accounting group--engaged in the development of a technical-sounding disclosure system called XBRL--may also threaten not only the current primacy of the U.S. financial markets, but also the future competitiveness of U.S. companies.

Since 1998, the American Institute of Certified Public Accountants (AICPA) and a few other organizations have sponsored the

development of a taxonomy for extensible business reporting language (XBRL), a derivation of the computer language XML that has the ability to tag individual words and numbers so that they can be understood in a particular context. The tagging facility permits financial statements, and even text such as footnotes, to be translated into a common language that can be read by computer applications. Thus, an analyst or investor who is interested in comparing, for example, the oil reserves of all publicly reporting energy companies would be able--using XBRL--to search a database containing the financial statements or 10K reports of these companies and pull out the relevant data in seconds. Because XBRL tags each term with contextual meaning, it allows the search engine to ignore "reserves" for bad debts or other purposes and to extract only the data on oil reserves. Without this facility, the same information would have to be developed through a time-consuming page-by-page search through the disclosure materials filed with the Securities and Exchange Commission (SEC).

XBRL represents a huge advance in the information potentially available to investors and analysts, and its significance has not been lost on the new chairman of the SEC, Christopher Cox. Since taking office, Cox has made the implementation of XBRL--which he calls "interactive data" in order to avoid the techie connotation of XBRL--one of his key priorities, devoting attention to it in almost a third of all his public speeches. Under his prodding, the SEC is doing what it can to encourage the use of XBRL by public companies, most recently offering expedited review of securities registrations for those companies that file in the interactive data format.

But there is a problem. The development of the XBRL taxonomy--the definitions and classifications that enable contextual tags to be applied to every item in a company's financial statements--is going slowly. As Cox explains, "the development of taxonomies lacks resources. Believe it or not, the awesome global challenge of fashioning a new way for billions of people to exchange financial data is currently dependent on the success of one solitary man who labors in anonymity at XBRL-US," the coalition of U.S. firms that has overall responsibility for developing the XBRL taxonomy. Indeed, it's true: only one person is currently employed full time on this task; the others are volunteers who believe in the value of XBRL but are employed elsewhere and help out when they can. This bizarre situation--in which the chairman of the SEC sees great value in a technological advance that is limping along in a state of resource privation--is the result of the traditional American view that the private sector, and not the government, ought to lead in the development of market innovations. But this approach, ordinarily so successful, does not work when no private sector company or group sees an immediate economic benefit from an

investment. Up to now, the AICPA has mostly been footing the bill, and the organization deserves applause for doing so, but even the accounting industry cannot afford to devote substantial resources to the development of a disclosure system that will mostly be of use to analysts. It is likely, in fact, that the XBRL project will separate from the AICPA this year.

And why is this a problem? For the same reason that the growth of the London Stock Exchange is a problem. The EU is also aware of the power and significance of XBRL, but its officials have not relegated it to a private, voluntary initiative. In typical European fashion, the governments have funded and pushed XBRL through to completion. Now, the EU's new common financial reporting system, known as International Financial Reporting Standards (IFRS), can be stated fully in XBRL. The United States lags behind. Before Chairman Cox, the SEC would not even acknowledge the significance of XBRL, and its development has been slow and uneven. Now that the value of the system has been officially recognized, it is far behind in its development.

Here, then, we come to the crux of the issue: in the future, companies that want their financial statements to be more accessible to investors and analysts will have another reason, apart from Sarbanes-Oxley, to offer their securities in the EU, particularly London, and to report their financial results in IFRS. And, even worse, in the globalized capital market of today, capital will flow to the companies whose financial statements are most easily analyzed and understood, giving those companies that state their financials in IFRS an important competitive advantage over the U.S. companies that use generally accepted accounting principles (U.S.-GAAP).

To be sure, at the moment, the U.S. financial reporting system is the preferred financial reporting system for most businesses, but IFRS is not far behind. According to the latest data available, U.S.-GAAP is used by companies comprising 53 percent of the capitalization of all markets, while IFRS is used by 35 percent. The balance, 12 percent, use other financial reporting systems but will likely convert to either U.S.-GAAP or IFRS as the capital markets continue to globalize. As shown by the growth of the London stock market, however, and the corresponding decline in foreign listings on the U.S. markets, IFRS is closing the gap and will continue to do so.

So what we have is a competition in two distinct areas, all revolving around the development of XBRL. The first is competition between the U.S. and EU securities markets for dominance in the global financial markets of the future. The EU, which has now put in place the XBRL

taxonomies that are necessary to make financial reports stated in IFRS more accessible to investors and analysts than those stated in U.S.-GAAP, is in a position to take advantage of this resource in attracting new listings and encouraging the use of IFRS. But the second area of competition may be even more important in the long run. Unless the XBRL taxonomies can be completed soon, U.S. companies that report in U.S.-GAAP may find themselves at a disadvantage in attracting capital vis-à-vis foreign competitors that use IFRS. The long-run consequences for the competitiveness of the U.S. economy as a whole could thus be adversely affected.

What to do? Now that XBRL has the full endorsement of the SEC, there can be no reason for U.S. companies to hold back. XBRL is coming--the only question is whether it will be sooner or later. The competition between the United States and the EU for financial dominance and the competition among companies for scarce capital argue strongly for the U.S. financial and industrial communities to get behind the XBRL effort. This means providing the financial resources to increase the personnel available to the XBRL-US consortium. It does not take much to join (www.xbrl.org/us), and there is a lot at stake.

Peter J. Wallison is a resident fellow at AEI.

Testimony before the House Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Americas Capital Markets: Maintaining a Lead in the 21st Century"

Testimony by Maria T. Pinelli
Partner and
Americas Strategic Growth Markets Leader, Ernst & Young LLP

April 26, 2006

Good Morning Mr. Chairman and members of the subcommittee. My name is Maria Pinelli and I am the Americas Strategic Growth Market Leader for Ernst & Young LLP, a global leader in professional services with over 107,000 people in 140 countries.

I am here today to present the key findings from Ernst & Young's 3rd Annual Global IPO Report, prepared from Thompson Financial data and with the input of 22 Ernst & Young Partners and their teams around the world. This report entitled, "*Accelerating Growth: Global IPO Trends 2006*" reviews IPO activity and trends in 2005 and offers insights for companies planning to IPO in markets around the world.

Our report highlights three key trends, which I will discuss in further detail:

1. Globalization of the capital markets continues. Although the US is the dominant player in the global capital markets, there are 50 exchanges around the world, thereby increasing global IPO competition.

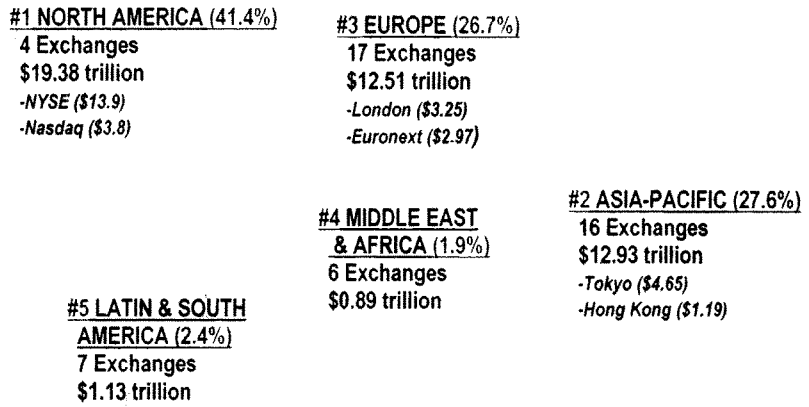
2. The five largest IPOs in 2005 were the result of large State Owned Enterprises ("SOEs") being privatized. We will see this trend continue in the future, driven by emerging capital markets such as China and Russia.

3. The US maintains its reputation as a safe, transparent economy—a factor which results in a higher valuation premium for listing companies.

Globalization of the Capital Markets Today

The global capital markets consist of over 50 exchanges worldwide with a total market capitalization of $46.8 trillion.[1] To put it in perspective, this is almost 4 times the $12.4 trillion GDP of the US.[2]

Stock Exchanges* by Region & Market Capitalization



*World Federation of Exchanges members
Source: World Federation of Exchanges, 22 March 2006.

6 exchanges dominate the global capital markets - NYSE, Nasdaq, London, Euronext, Tokyo & Hong Kong, which collectively represent 64% of the total global market capitalization.

The US maintains the leading market share for 2005. The NYSE and Nasdaq represent 38% of the global market capitalization. Of the 50 global exchanges, the NYSE alone

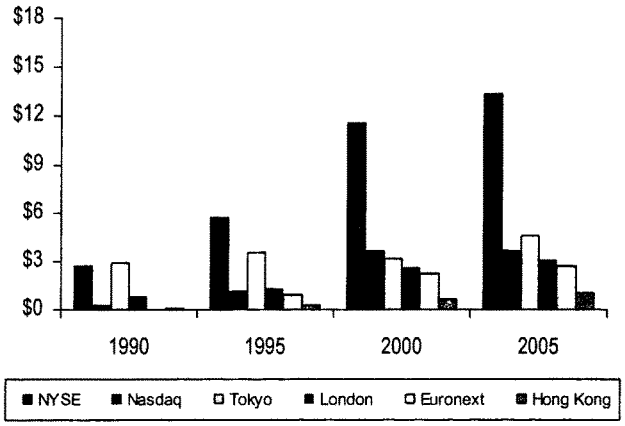
---

[1] See Appendix A

[2] The World Factbook. 20 April 2006. www.cia.gov/cia/publication/factbook/rankorder/2001rank.html

remains the single largest exchange, representing 30% of the total market capitalization. This compares to the market capitalization of 28% in the entire Asia-Pacific region and 27% in Europe. In addition to the US claiming a dominant share of total market capitalization, US exchanges also experienced significant growth. For the ten year period from 1995 to 2005, the NYSE grew almost 200% and Nasdaq grew almost 250%.

Stock Market Capitalizations by Exchange ($trillion)



Source: World Federation of Exchanges

In spite of this US growth, much attention and focus has been generated from the growth of the local exchanges such as the Hong Kong Stock Exchange, which has increased 135% in the same period.

% Change in Market Capitalization 1995 – 2005		
1	Nasdaq	247.1%
2	Tokyo	210.7%
3	NYSE	198.6%
4	Hong Kong	135.4%
5	London	127.1%
6	Euronext	29.0%

IPO Activity in 2005: US Maintains the Lead

2005 was a very strong year for the global IPO markets. The total capital raised in global IPOs rose by over one third from $124 billion in 2004 to $167 billion in 2005, which is the largest amount raised in one year since 2000.

US domiciled companies raised $33.1 billion, $32.6 billion of which was on US exchanges, maintaining its global lead. The US also had the largest total number of IPOs, with 210 listings.

2005 By Number of Listings		
1	United States	210
2	Australia	169
3	Japan	157
4	United Kingdom	117
5	China	114

2005 By Total Amount Raised ($B)		
1	United States	$33.1
2	China	$22.3
3	France	$18.3
4	Australia	$10.1
5	United Kingdom	$8.1

Competition for IPOs among exchanges is accelerating and non-US exchanges are engaging in highly aggressive marketing campaigns to attract new listings. These local exchanges are businesses competing for a share of a $46.8 trillion market. For example, the London Stock Exchange has a sales office in Hong Kong dedicated to attracting Asian companies. In addition, the Alternative Investment Market (AIM)[3] is aggressively marketing to international companies, including those in the US. They highlight the cost, litigation and compliance differences between AIM and Nasdaq.

[3]The Alternative Investment Market (AIM) is a sub-market of the London Stock Exchange, specifically tailored to smaller, growing companies. AIM was launched in 1995 and more than £24 bn ($42 bn) has been raised for over 2,200 companies since then. Smaller companies can float shares on AIM, which has less regulation and no requirements for capitalization or number of shares issued. International companies are beginning to list on AIM. As of December 2005 over 270 foreign companies were admitted to the AIM, making up 12.3% of its listed companies.

Large IPOs in 2005 Driven by State Owned Enterprises

While the US maintained the lead among all nations, only one US listed company was represented in the top 10 global IPOs of 2005. This company was Huntsman Corp, a US chemicals company that raised $1.6 billion on the NYSE. The five largest IPOs of 2005 were SOEs from China and France and they were listed on regional exchanges close to their home market. As the study indicates, this phenomenon is caused by the increased privatization of SOEs, a trend that we believe will continue as emerging markets and countries develop.

	NAME	DOMICILE NATION	INDUSTRY	FORMERLY STATE-OWNED?	CAPITAL RAISED ($B)	EXCHANGE
1	China Construction Bank Corp	China	Banks	Yes	$9.2	Hong Kong
2	Electricitéde France	France	Energy/Power	Yes	$8.2	Euronext
3	Gaz de France	France	Energy/Power	Yes	$4.2	Euronext
4	China Shenhua Energy Co Ltd	China	Mining	Yes	$3.3	Hong Kong
5	Bank of Communications	China	Banks	Yes	$2.2	Hong Kong
6	Tele Atlas N.V.	Netherlands	Technology	No	$1.9	Euronext
7	PartyGaming	Gibraltar	Professional Services	No	$1.7	London
8	Goodman Fielder Ltd	Australia	Consumer Staples	No	$1.6	Australia
9	AFK Sistema	Russia	Technology	No	$1.6	London
10	Huntsman Corp	United States	Materials	No	$1.6	New York

The top 5 global IPOs in 2005, all former SOEs, raised an aggregate of $27 billion and 16% of total IPO capital. These included three Chinese companies listed on the Hong Kong Stock Exchange, and two French utility companies listed on Euronext.

The largest global IPO in 2005 was China Construction Bank's $9.2 billion offering on the Hong Kong Stock Exchange. This IPO included a large investment by Bank of America - $3 billion through $2.5 billion pre-IPO purchase of existing shares and a further $500 million at IPO - the largest single investment by any foreign company into a Chinese company. This demonstrates that global and US investors are comfortable investing in non-US companies on foreign stock exchanges, which is an emerging trend in the global capital markets.

We expect to see this trend of large SOEs privatizing through IPOs on local exchanges continue, primarily in the emerging economies of China, India, Russia and Eastern Europe. Bank of China (BOC), the largest of the four major Chinese banks, is expected to go public on the Hong Kong Stock Exchange in 2006. There is considerable political support for SOEs to list on a local exchange. When paired with the fact that foreign investors' show continued confidence in the global economy, we should anticipate that such former SOEs will list on a local or regional exchange with geopolitical ties.

In contrast to this global trend of state-owned enterprises being privatized in emerging economies, the financial services, utilities and resources sectors in the United States have already capitalized their companies through the public markets. The US Capital Markets are further along in this economic cycle, but emerging markets are now beginning the process of capitalizing these industries on their local public markets and this will be represented by increasing IPOs of SOEs on local markets.

The impact of SOEs on the IPO market is illustrated by looking at China. Chinese companies raised over $24 billion in proceeds with 114 IPOs in 2005, placing second in the global markets in terms of capital raised. But if you exclude China's top three IPOs, which were all State-Owned Enterprises, only $9.6 billion in proceeds were raised, which would result in China dropping 60% to 4th place in the global capital markets for amount raised by country. Without their 2 large SOE IPOs, the amount raised for French companies drops from $18.3 billion to $5.9 billion (67.7%) to place 7th in the global capital markets for amount raised by country.

Valuation Premiums Result from Corporate Governance Regulations

US capital markets are perceived by issuers and investors as maintaining a "gold standard" of corporate governance regulations, which results in a valuation premium.

Noreen Culhane, EVP Global Client Group for the New York Stock Exchange states in our IPO report that "motivation for most companies listing in the US is the valuation

premium (average 30%) that accrues as a result of adhering to high standards of governance."[4]

Foreign companies will continue to list in the US due to this valuation premium and also because of unparalleled investor sophistication. This is one of our strategic competitive advantages, over other capital markets, and any temptation to lower these standards in competition with foreign exchanges needs careful consideration.

With the recent scandals experienced in the capital markets – Japan, London, and recently the US - investor protection is top of mind.

The US Still Leads in Available Capital and Liquidity

Even with the globalization of the capital markets, the US still leads in available capital and liquidity, with strong capital markets supported by an infrastructure and a regulatory model developed over many decades. The influence of large state owned transactions in emerging countries will continue to impact our view of what should be the traditional US dominance in the global capital markets.

The real question remains whether or not the foreign markets can sustain growth at such a rate that they will outpace the US over the long run and whether the US can do anything about it. Trends we will continue to examine in future Ernst & Young global IPO reports include:

1. Will US and global investors continue to demonstrate confidence in investing in foreign capital markets?

---

[4] Culhane, Noreen. "Exchange Perspectives – A View from the New York Stock Exchange." *Accelerating Growth: Global IPO Trends 2006.* Page 26. A recent academic study from the University of Toronto / Ohio State University confirms this valuation premium, found that cross-listed non-US companies listing on the NYSE enjoyed an average valuation premium of 31%. From Doidge, Craig *et al. The Valuation Premium for Non-US Stocks Listed in US Markets.* September 2005

2. What will be the impact of future large IPO activity for State Owned Enterprises the global capital markets? Are they one time or recurring events?

3. Will China's growth in non state-owned enterprises outpace that of the US in the long run?

4. How do corporate governance, litigation and listing requirements impact decisions with respect to global IPO activity from a corporate and investor perspective?

As economies around the globe strengthen, their domestic stock exchanges will likely follow suit. Differentiation of the US markets in terms of valuation, governance, transparency, investor confidence and investor sophistication, all current attributes of the US markets, will continue to attract capital to the US. From a policy perspective, differences between markets that create risk, costs or inefficiencies without a compensating valuation premium, should be challenged in a competitive environment.

Our future global IPO reports will continue to monitor the trends and activities of IPOs around the world, and Ernst & Young will share these reports with this committee in the future.

Thank you for the opportunity to testify today and I look forward to your questions.

Appendix A: Global Stock Exchanges ($trillion)

Grand Total	$46.83

1. NORTH AMERICA (41.4%)	
NYSE	$13.90
Nasdaq	$3.80
TSX	$1.60
AMEX	$0.08
total	**$19.38**

2. ASIA PACIFIC (27.6%)	
Tokyo	$4.65
Osaka	$3.06
Hong Kong	$1.19
Australia	$0.85
Korea	$0.76
Bombay	$0.61
India	$0.57
Shanghai	$0.32
Singapore	$0.28
Malaysia	$0.19
Thailand	$0.14
Shenzhen	$0.13
Jakarta	$0.09
Philippines	$0.04
New Zealand	$0.04
Colombo	$0.01
total	**$12.93**

3. EUROPE (26.7%)	
London	$3.25
Euronext	$2.97
German	$1.38
Spain	$1.09
Switzerland	$0.99
Italy	$0.88
Den/Fin/Swed	$0.86
Oslo	$0.22
Istanbul	$0.20
Athens	$0.17
Wiener Borse	$0.15
Ireland	$0.12
Warsaw	$0.11
Luxembourg	$0.06
Budapest	$0.04
Cyprus	$0.01
Ljubljana	$0.01
total	**$12.51**

4. LATIN & SOUTH AMERICA (2.4%)	
Sao Paulo	$0.60
Mexico	$0.25
Santiago	$0.14
Colombia	$0.06
Buenos Aires	$0.05
Lima	$0.03
Bermuda	$0.00
total	**$1.13**

5. MIDDLE EAST & AFRICA (1.9%)	
Johannesburg	$0.62
Tel Aviv	$0.13
Cairo & Alexandria	$0.09
Tehran	$0.04
Malta	$0.004
Maritius	$0.003
total	**$0.89**

Source: World Federation of Exchanges, www.world-exchanges.org, accessed 22 March 2006.

Note: When total Japan market capitalization is calculated, Osaka Stock Exchange is excluded to avoid double counting due to multiple dual listings on Tokyo and Osaka.

Maria Pinelli
Partner and Strategic Growth Markets Leader
Ernst & Young LLP

As Strategic Growth Markets Leader for the Americas, Maria is responsible for driving Ernst & Young's market leadership in Strategic "Growth" Markets, including IPOs, market share of venture/private equity backed enterprises, entrepreneurial mid-market and corporate mid-cap companies who will become future market leaders.

Maria is responsible for the Ernst & Young's Entrepreneur of the Year Program in the Americas, as well as the annual IPO Retreat for CEOs and CFOs of future public companies. She also oversees the Venture Capital Advisory Group.

Maria was an audit Partner until January 2006, with over 20 years of experience servicing entrepreneurial growth clients. This included providing business advisory services, accounting and strategic financing advice.

She has an intimate knowledge of US and Canadian GAAP and is well-versed in US/SEC/Canadian regulatory accounting matters. Maria has served both publicly listed entrepreneurial companies and private companies. She has led 18 IPOs over the course of her career in both Canada and the US.

Previously, Maria served as the Canadian Technology Industry Leader for Ernst & Young, where she advised companies on acquisitions, due diligence, financing and initial public offerings in Canada and the U.S.

Maria graduated from McMaster University, Hamilton, Canada with a Bachelor of Commerce, and became a Chartered Accountant in 1989, on the Ontario Honor Roll. She completed both the Harvard Business School and Kellogg School of Business programs through Ernst & Young.

The Sarbanes-Oxley Debacle

What We've Learned; How to Fix It

Henry N. Butler and
Larry E. Ribstein

The AEI Press
Publisher for the American Enterprise Institute
WASHINGTON, D.C.
2006

AEI LIABILITY STUDIES

Michael S. Greve
Series Editor

The AEI Liability Studies examine aspects of the U.S. civil liability system central to the political debates over liability reform. Individual studies analyze the consequences of important liability doctrines for consumer welfare and productive efficiency, assess the effectiveness of recently enacted liability reforms, examine intricate jurisdictional and institutional dilemmas, and propound original proposals for improvement. The goal of the series is to contribute new empirical evidence and promising reform ideas that are commensurate to the seriousness of America's liability problems.

TWO CHEERS FOR CONTINGENT FEES
Alexander Tabarrok and
Eric Helland

HARM-LESS LAWSUITS?
WHAT'S WRONG WITH CONSUMER CLASS ACTIONS
Michael S. Greve

Contents

FOREWORD, *Christopher DeMuth* ix

INTRODUCTION 1

1. FROM ENRON TO SOX: SHOOT FIRST, ASK QUESTIONS LATER 7
   - Enron *7*
     - *The Post-Enron Regulatory Panic* 8
     - *Mounting Reports of Corporate Wrongdoing* 9
     - *The Stock Market Decline* 10
     - *The News Media's Role* 10
     - *The Lack of Effective Political Opposition by Probusiness Interests* 11
     - *The Role of Policy Entrepreneurs* 16
     - *Populism and Political Entrepreneurs* 18
     - *The Boom-Bust Regulatory Cycle* 19
     - *All Action, No Talk* 20
   - The Sarbanes-Oxley Act *20*
     - *Increased Internal Monitoring* 21
     - *Gatekeeper Regulation* 21
     - *More Disclosure* 21
     - *Regulation of Insider Misconduct* 22
     - *Regulating Securities Analysts* 22

2. WHAT SHAREHOLDERS WANT—THE OPTIMAL AMOUNT OF FRAUD 23

3. IMAGINING A WORLD WITHOUT SOX 26
   - Capital Market Forces *27*

Market Monitoring 28
Reputations and Signaling 30
Shareholder Monitoring *32*
State and International Competition *33*
Regulation by Stock Exchanges and Other Private Institutions *35*

4. THE COSTS OF SOX 37
Direct Compliance Costs *38*
Section 404 Internal Controls Disclosures and Attestation 38
Audit Committee Independence 42
Managing in the Shadow of SOX *43*
Section 404 Internal Controls 44
Impact on Managerial Risk-Taking: Independent Directors 45
Constraining Executive Compensation: Insider Loan Prohibitions 46
Lawyer Monitoring 47
Monitoring by Corporate Executives 49
Building the Paper Trail 49
Whistleblowing 49
Opportunity Costs of SOX *50*
Diversion of Managerial Talent 50
From Entrepreneurs to Hall Monitors 51
Reducing Smaller Firms' Access to Public Capital Markets 53
Cutting Off Information *55*
Taking the Informed Out of the Loop 55
Reducing Trust 56
Inducing Cover-Ups 57
Perverse Incentives and Undoing Efficient Risk-Bearing *58*
Criminalization of Corporate Agency Costs *60*
The Folly of Criminalizing Corporate Agency Costs 60
Weakening the Moral Force of the Criminal Law 61
SOX in the Context of Current Prosecutor Practices 62
Auditor Regulation *63*

Regulation of Analyst Conflicts *64*
Crippling the "Genius" of American Corporate Law *65*
Chasing Away Foreign Firms *71*

5. THE LITIGATION TIME BOMB 75
A Review of Liability Threats under SOX *75*
Using 20/20 Hindsight to Assess Risk *77*
Litigators' Incentives *79*
The Potential for Blackmail *79*
What Can Shareholders Do about the Time Bomb? *81*

6. THE BOTTOM LINE: HAS SOX BEEN WORTH IT? 82

7. IMMEDIATE POLICY IMPLICATIONS 86
Defuse the Litigation Time Bomb *87*
Allow Opt-Outs or Opt-Ins *88*
Foreign Firms *90*
Exempt Small Corporations *91*
Remove Criminal Penalties *92*
Limit Internet Controls Reporting *93*
Leave Internal Governance to State Law *93*

8. THE FUTURE: REGULATORY HUBRIS OR GREATER HUMILITY? 94
Periodic Review and Sunset Provisions *96*
Certification and Opt-Out Approaches *97*
Nuanced Regulation *97*
Investor Education *98*
Deregulation *98*

CONCLUSION 100

NOTES 103

ABOUT THE AUTHORS 129

INDEX

Distributed to the Trade by National Book Network, 15200 NBN Way, Blue Ridge Summit, PA 17214. To order call toll free 1-800-462-6420 or 1-717-794-3800. For all other inquiries please contact the AEI Press, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 or call 1-800-862-5801.

Library of Congress Cataloging-in-Publication Data
Butler, Henry N.
The Sarbanes-Oxley debacle: what we've learned; how to fix it / Henry N. Butler and Larry E. Ribstein.
p. cm.
Includes index.
ISBN-13: 978-0-8447-7194-6 (pbk : alk. paper)
ISBN-10: 0-8447-7194-5
1. Corporations—Auditing—Law and legislation—United States.
2. Financial disclosure—Law and legislation—United States.
3. Corporate governance—Law and legislation—United States.
4. Securities fraud—United States—Prevention. 5. United States. Sarbanes-Oxley Act of 2002. I. Ribstein, Larry E. II. Title.

KF1446.B88 2006
346.73'0666—dc22

2006013205

11 10 09 08 07 06 1 2 3 4 5 6

© 2006 by the American Enterprise Institute for Public Policy Research, Washington, D.C. All rights reserved. No part of this publication may be used or reproduced in any manner whatsoever without permission in writing from the American Enterprise Institute except in the case of brief quotations embodied in news articles, critical articles, or reviews. The views expressed in the publications of the American Enterprise Institute are those of the authors and do not necessarily reflect the views of the staff, advisory panels, officers, or trustees of AEI.

Printed in the United States of America

Foreword

The "liability explosion" would be much easier to address if it were in fact, as the term implies, a sudden event with a specific cause. But the expansion of legal liability beyond its traditional common-law boundaries has been a gradual, evolutionary process, with numerous interwoven causes. For example, until a century ago tort cases were, for the most part, disputes between citizens of the same political jurisdiction, decided by local judges and juries. With the emergence of large corporations and the growth of interstate commerce, tort cases increasingly pitted local plaintiffs against out-of-state citizens or corporations with highly diffused ownership—but were still decided by judges and juries of the plaintiffs' states or communities, whose tendency to dispense justice with more attentive sympathy for neighbor-plaintiffs than for foreigner-defendants was strong and systematic. Beneficial economic developments produced an unfortunate byproduct: the transformation of a system of dispute resolution into the unconstrained imposition of a tort tax.

The progressive expansion of liability had many political, intellectual, and even cultural causes in addition to economic ones. Although many changes in legal doctrines and procedures were reasonable adaptations to social change, by the end of the twentieth century the system as a whole was producing many results that were manifestly unjust, socially harmful, and economically counterproductive. Still, the movement for legal reform was as slow and complex as the phenomena it responded to. Not only had free-wheeling liability produced a politically powerful interest group adamantly opposed to reform—the trial lawyers—but the liability system itself was highly decentralized, with many subtle features

and interdependent parts. Many proposals to improve it by revising one or another legal rule foundered on the problem of top-down regulation: Revising a single feature of a complex system leads the other features to respond in kind, which may leave matters even worse than they were before. Only in recent years, a quarter-century after the liability explosion first attracted political notice, have state and federal reforms begun to appear with serious evidence or prospects of yielding tangible improvements.

The problems of excessive legal liability have been a longstanding concern of the American Enterprise Institute. In this monograph series, AEI aims to inform the growing political debates with original, intellectually rigorous research and scholarship by some of America's leading students of law and economics. Series editor Michael S. Greve, who is John G. Searle Scholar at AEI, is himself a leading thinker and writer as well as an activist in liability-reform circles. The studies presented here aim to be attuned to the strengths as well as deficiencies of our civil liability system, and to address the most serious issues in the policy debates. Some contributions supply much-needed empirical data and analysis, while others tackle the intricate institutional problems of the civil justice system. Above all, the studies aim to contribute fresh ideas and practical reform proposals that are commensurate to the depth and gravity of the problem of unbounded liability.

CHRISTOPHER DEMUTH
President
American Enterprise Institute
for Public Policy Research

Introduction

The Sarbanes-Oxley Act of 2002 (SOX) emerged from the spectacular crashes of Enron, WorldCom, and other corporations after the bursting of the dot.com stock market bubble. Enron and WorldCom became poster children for the supposed "separation of ownership and control" problems first publicized seventy years earlier by Adolf Berle and Gardiner Means and echoed by generations of corporate scholars ever since.[1] After the millennial frauds, the usual proponents of reform argued for regulation that would restore "investor confidence" in the securities markets. Congress responded with the most sweeping federal securities legislation since the original laws in 1933 and 1934.

Since 2003, the direct costs of SOX have become evident. Despite, or perhaps because of, the significant indications of costs and problems related to SOX, many journalists in prominent magazines have rushed to the act's defense in its fourth year of life.[2] Their argument goes something like this: There was fraud; SOX was designed to reduce fraud by requiring more honesty and disclosure; therefore, SOX is good. For example, *The New Yorker*'s James Surowiecki acknowledges SOX's significant costs, but emphasizes the social costs of fraud—that WorldCom made its rivals look less efficient than they were, resulting in misallocation of resources. Joe Nocera of the *New York Times* stresses that accountants now have a regulator, the U.S. Securities and Exchange Commission (SEC) has more money, CEOs must vouch for their firms' financial statements, corporate loans are outlawed, directors must be more independent, and the internal controls disclosures are revealing useful information.[3] Nocera also acknowledges the

expenses under SOX, but says the costs are starting to drop, and that the SEC is working to reduce the burden on smaller companies. *Business Week* has blithely asserted that SOX "is enabling businesses to cut costs and boosts productivity." Perhaps Congress should apply its managerial prowess more broadly.[4]

Praise for SOX is also pouring in from those who participated in its creation. Representative Michael Oxley, who shepherded the House version of SOX and provided its surname, says, "The system is much better now. . . . We have come a long way since the economic dark days that are only a couple of years behind us." Investors once were "losing confidence in the American markets." Now, he says,

> boards are working harder, playing more of the role that they were designed for. They are responding to shareholders and increasing dividends and buybacks. Audit committees are more active and more independent. They are using their authority to engage independent counsel. The PCAOB [Public Company Accounting Oversight Board] is up and running and is actively reviewing auditing firms.[5]

As a result, he says, corporate profits, jobs, stock prices, venture capital, and research and development spending are up, and bankruptcies are down. In other words, Oxley attributes to SOX the turn in the business cycle. Next, like Lear, he will be crediting it with atmospheric phenomena. While it is understandable that Oxley would overstate the benefits of his namesake, one should be skeptical of his self-serving assessment.

Former SEC chairman Arthur Levitt, a key proponent of several of SOX's provisions, wrote in the *Wall Street Journal* to oppose SOX exemptions for small public firms proposed in December by an SEC advisory committee.[6] Levitt insists, remarkably, that "the small-business lobby" is seeking changes that "would make it more difficult for smaller companies to attract capital needed for growth and undermine confidence in the markets." In other words, he is so sure

of the wisdom of the changes he helped adopt that he is willing to assume that the "small-business lobby" is lobbying against its own interests. Levitt ignores the fact that this supposedly powerful lobby was too weak to prevent passage of the act.[7] Moreover, it is hard to accept that exempting firms constituting only 7 percent of the capitalization of the market would undermine investor confidence in the entire market.

No one can deny that there have been some benefits from SOX, including the increased information revealed by the internal controls disclosures. Moreover, the business world is clearly performing better now than in the chaotic days before SOX. The relevant policy questions are whether the benefits exceed the costs, and whether the business world is better now *because* of SOX.

While proponents in Congress and the media have been creative in finding social benefits deriving from SOX, they have not been equally thorough in understanding its full costs. SOX defenders focus on direct costs, such as increased audit fees. But while these are substantial (approximately $6 billion per year), they are only the tip of the iceberg—with much larger but less obvious costs accruing beneath the surface. Indeed, the best evidence indicates that SOX imposes additional net losses of $1.1 trillion. This monograph demonstrates that its supporters are utterly misguided in their assessment: Both logic and evidence make it clear that SOX was a costly mistake.

As we will discuss in chapter 1, SOX's problems are unsurprising, given the circumstances of its birth. Enron may or may not have helped set off a market panic, but what ensued was clearly a Code Red regulatory panic. When one combines the efforts of proregulatory interest groups with the avid news media reports of corporate fraud, it is not surprising either that SOX was enacted, or that it still has many defenders. Although there were significant ambiguities about precisely what, if any, problems needed fixing, Congress was in no mood for ambiguities. The prevailing regulatory philosophy was "shoot first and ask questions later." We are only now asking the right questions and getting the correct, if depressing, answers.

Chapter 2 provides a good starting point for asking these questions by considering what investors—the putative beneficiaries of SOX—desire in antifraud regulations. Clearly, investors do not like to be defrauded. To the extent government regulation can prevent fraud, shareholders benefit. But shareholders will find such regulation valuable only if the benefit from reduced fraud is greater than the cost of regulatory compliance. SOX's attempt to create a perfect world with zero fraud goes too far. Moreover, it is well-accepted in the financial economics literature that the costs and benefits of securities regulation should be evaluated from the perspective of typical shareholders who can avoid some costs of fraud by investing in diversified portfolios of shares. By imposing the costs of eliminating fraud on all firms in investors' portfolios, the SOX mandates are a terrible deal for the ordinary investors it purports to protect.

Although the act's defenders assert that the business world is better off now than before SOX, chapter 3 makes it clear that the relevant question is whether the business world is better *because* of SOX. The American corporate governance system is incredibly dynamic—for over a hundred years, it has demonstrated its resilience and ability to evolve in response to dramatic structural changes and external shocks. Even if there were a problem that needed solving, it is likely that existing institutions and the market could have solved it without a massive new dose of one-size-fits-all regulation from the federal government. Moreover, given the dynamism and success of our system, the proponents of massive new regulation logically should bear the burden of justifying it. To frame the question of whether SOX was necessary, we consider what would have happened if there had been no SOX. American markets would not simply have turned into a costly casino with careful investors stuffing their money in mattresses. Existing market devices and regulation have already worked to punish the pre-SOX frauds and, thus, to deter future fraud. If new rules had been necessary, capital-hungry companies, stock exchanges, states, and professional groups would have had ample incentive to provide them, and thereby to demonstrate their integrity to investors. They also had better information than politicians and regulators about

what to do. It is highly unlikely that Congress could outthink this dynamic system, particularly during the frenzied regulatory panic of 2002.

The costs of SOX are described in chapters 4 and 5. In general, defenders have limited their calculations to the act's most direct compliance costs. They, like Congress in 2002, ignore indirect and possibly hidden—but still quite substantial—costs. Chapter 4 surveys the mounting evidence on the direct costs of SOX—particularly those of complying with the notorious section 404 internal controls—that have triggered so much interest in the media, and then discusses in detail some of the less obvious costs, including interference with business management, distraction of managers, risk aversion by independent directors, over-criminalization of agency costs, reduced access to capital markets, and the crippling of the dynamic federalism that has created the best corporate governance structure in the world.

Chapter 5 describes the ticking litigation time bomb SOX has created. The first major market correction will be painful for investors, but it will be a gigantic litigation festival for trial lawyers. SOX gives litigators the benefit of 20/20 hindsight to identify minor or technical reporting mistakes as the basis for lawsuits against corporations, officers, and directors. The threat of litigation on this scale should in no way be construed as investor protection.

Chapter 6 compares the small benefits of SOX discussed in chapter 3 with the large costs discussed in chapters 4 and 5. Based upon the best available evidence, it concludes that SOX has imposed a net loss on the American economy of $1.4 trillion. A widely cited study of the annual direct costs of complying with SOX indicates that firms will spend a total of $6 billion in 2006.[8] Even if annual direct costs of this magnitude were going to continue in perpetuity, the present value of those costs would amount to only a small fraction of $1.4 trillion net loss. A conservative estimate is that the indirect costs of SOX are greater than $1.1 trillion.[9]

Chapter 7 considers the potential policy implications of our conclusion that SOX is a colossal mistake. A favorable court decision in a recently filed lawsuit could provide the leverage to enact

some major changes in SOX. On February 8, 2006, the Free Enterprise Fund filed a lawsuit alleging that the accounting oversight board SOX created violates the appointments clause of the Constitution because its members should be appointed by the president or heads of executive branch departments rather than by the SEC. This suit has the potential to overturn all of SOX, which lacks a severability clause. However, if the Free Enterprise Fund prevails, the courts are likely to give Congress a window of opportunity to fix it. Although political reality makes it unlikely that Congress will repeal SOX, it may have the incentive to respond to the increasing criticism of SOX and fix its most egregious flaws.

Several relatively minor changes in the statute could greatly reduce the burden that SOX imposes on the American economy. First, SOX should be amended to prohibit private lawsuits. Second, it should be amended to exempt securities of foreign corporations. Third, it should be amended to exempt all but the largest corporations. Fourth, it should be amended to allow shareholder opt-out of at least some provisions through shareholder proxy proposals. Finally, the criminal sanctions in SOX should be removed.

Chapter 8 takes a longer view. The post-SOX era offers real opportunities to assess what we have learned about policymaking from the Sarbanes-Oxley fiasco. Given policymakers' tendency to overreact in market panics, doubts about the efficacy and costs of federal regulation, and the availability of other mechanisms for controlling corporate fraud, there is much to be said for a careful approach to federal regulation that, among other things, allows for alternatives and limits the scope of regulation. Perhaps something can be salvaged from the SOX fiasco.

1

From Enron to SOX: Shoot First, Ask Questions Later

An assessment of SOX should begin with its passage. What did we know about the costs and benefits of regulation, and when did we know it? If Congress had known that the costs of SOX were going to be as high as they turned out to be, would it nonetheless have passed the act? This chapter shows that Congress knew very little when it acted precipitously, in the midst of a regulatory panic. An understanding of the defects of this process may help us prevent a similar mistake the next time the conditions are ripe for such a panic.

Enron

The long millennial bull market, which had peaked in March 2000, dropped even before September 11, 2001. By late September, trillions in shareholder wealth had evaporated. So the market was in an ugly mood when Enron Corporation disclosed on October 16, 2001, that it was taking a half-billion-dollar after-tax charge against earnings and a $1.2 billion reduction of shareholders' equity because it was revising its accounting for transactions with one of its so-called "special-purpose entities." Thus began Enron's collapse into litigation and bankruptcy.

It was a spectacular fall. Enron had been a model for the new economy, pioneering a way to create markets that heralded drastically reduced transaction costs. Enron showed, for example, that utility companies did not have to own energy sources to ensure fuel sources—they could buy the energy through Enron's energy market.

Fortune had ranked Enron the most innovative company in America for six straight years, and its chief executive, Jeff Skilling, now known mainly as a criminal defendant, had been named the nation's second-best executive (after Microsoft's Steve Ballmer) as recently as six months before the collapse. Business school classes had admired Enron's business model. After October, 2001, they rapidly turned to studying Enron as a classic example of business failure.[1]

As first detailed in the so-called Powers Report, issued in February 2002, Enron executives had created earnings for the company and its insiders by disguising speculation as hedging, making murky deals with hazy special-purpose entities, and claiming as revenues predictions of years of sales and prepayments on commodities contracts.[2] The report spread the blame widely. Senior officers were either involved in the transactions or oddly ignorant of what was going on. The Enron board, including its fully independent audit committee, knew of problems, but it put its faith in representations by senior officers that they would police the insider deals and in assurances by the company's accounting firm, Arthur Andersen. Andersen, in turn, and its partner in charge of the Enron account, failed adequately to scrutinize their major customer of both audit and nonaudit services. Meanwhile, despite indications that all was not well at Enron, securities analysts continued to give buy recommendations, and the major debt-rating agencies rated Enron's debt as investment grade until shortly before the crash.

The Post-Enron Regulatory Panic. Something had happened to Enron, but it was not clear what. Clearly some corporate executives had been dishonest, but they were being found out and punished under existing law. Companies already had plenty of watchdogs. Enron and WorldCom had independent directors and auditors. Securities analysts seemingly had ample incentives to watch them closely.

As detailed in Roberta Romano's exhaustive study of SOX's legislative history, Congress acted precipitously, without anything resembling a balanced consideration of the issues.[3] The House

passed a relatively mild bill in April 2002, after the stock market had recovered somewhat and the public had become calmer. It focused on increased criminal penalties to exact the vengeance against executives the public was demanding, and provided for an accounting industry watchdog. However, by the end of July the Senate had passed, and the House and Senate had agreed to in conference, a much stricter law. The Senate version included several more consequential corporate governance measures, among them a prohibition on executive loans, and requirements of audit committee independence and executive certification of financial statements. This bill was reported out of the conference committee on July 23 and quickly passed and signed into law July 30, 2002, by President George W. Bush, who described the law as putting into effect "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[4]

What happened to propel this law from a modest bill to a far-reaching law through a divided Congress in only three months? The answer to this question reveals much about the source of the problems discussed in this monograph. The following are some of the relevant factors. Many are interrelated. Some grew out of unique events in 2002, while others reflect long-term historical trends. The main question is what they tell us about how we might avoid future SOXes.

Mounting Reports of Corporate Wrongdoing. Between April and July there were reports of numerous additional cases of corporate fraud or bad accounting. Xerox had improperly accelerated revenues from long-term equipment leases, Qwest and Global Crossing had manipulated revenues and expenses on fiber optic deals, cable firm Adelphia had apparently been looted by its controlling shareholders, and there were reports of excessive spending by Tyco CEO Dennis Kozlowski. Most spectacularly of all, WorldCom collapsed into bankruptcy after disclosing that it had falsely claimed as assets billions of dollars it had paid as ordinary business expenses to use its transmission networks.

But what did all this mean? The media suggested that all of it was connected, and that it indicated a drastic increase in the total

amount of fraud. Was this was the reality? Were the stories actually connected in a way that called for coherent government action? Looting by executives is a different problem from accounting errors, not least because the former is already well-covered by existing law. Moreover, connecting looting, a real problem, with accounting errors, may tend to make the latter look worse than it is.

The Stock Market Decline. The stock market had been declining since early March 2002—possibly as the direct result of investor concerns over the growing threat of war in Iraq. This decline created political pressure to do something about mounting corporate fraud in order to "restore confidence" in the market.[5] The market reached a temporary low in late July, around the time of the vote on the conference committee bill. In fact, the Dow Jones Industrial Average dropped a thousand points in July alone. Just as investors' judgment errors may have played a role in the run-up in stock prices prior to 2001, so they may have figured in the post-boom panic. Ironically, SOX itself may have been responsible for that decline, since stock prices plunged around the time that it became evident Congress would pass a stringent version of SOX.[6]

The News Media's Role. During the first half of 2002 the news media were unrelentingly negative on business: 77 percent of the 613 major network evening news stories between January and July concerned corporate scandals, of which 195 connected corporations to Congress and 188 to the Bush administration, compared to 11 percent of 489 business stories about scandals in the same period the prior year.

This suggests that corporate crime was quite salient in the public mind during deliberations on SOX.[7] Salience tends to drive the political agenda; people think more about corporate crime than about the potential costs of laws intended to deal with it. Moreover, the news media undoubtedly play a role in creating this salience by deciding which stories are featured prominently, and how they are portrayed.

Because the media are obviously important players in the political process, it is important to examine their incentives. Evidence

indicates that news media bias toward the left produces more regulation.[8] Moreover, noted financial economist Michael Jensen has characterized the press as producers of entertainment rather than information. Jensen says that readers want simple answers delivered in an entertaining way.[9] This suggests that the press will tend to exaggerate market excesses colorfully and support simple regulatory solutions that ignore the complexity of the underlying problems. To be sure, readers also demand correct information. But a recent study testing these alternative hypotheses shows significant evidence of sensationalism in coverage of executive compensation.[10]

Applying these insights to SOX, it is clear that the millennial stock market crash created a market for entertaining stories about bad businesspeople. The media saw gains in a continuing saga of corporate fraud that readers or viewers would follow avidly day by day. This conveniently meshed with the media's proregulatory bias. All of this negative coverage interacted with the public's anxiety about the economy and the market, its tendency to stress recent prominent news, and general populist sentiments about business, discussed further below.

The Lack of Effective Political Opposition by Probusiness Interests. Several factors usually serve as inherent brakes on enactment of business legislation, particularly laws as sweeping and multifarious as SOX. While there are always reformers and business groups in favor of regulation that may be socially harmful, for instance, the social costs are often felt by firms and interest groups who are in a position to bear the costs of lobbying against the reform effort.[11] The political process provides ample opportunity for firms and groups to express and organize opposition and slow down legislation. Laws like SOX must wend their way through both houses of Congress, beginning in committee and finally working their way to the floor. Even if a single party dominates both houses, this apparent unity may mask significant disagreement among the relevant business groups. That is particularly so with most business legislation, which rarely pushes galvanizing hot buttons.

In the case of SOX, the houses were controlled by different parties—Republicans had the House, while Democrats had the Senate. This created the conditions for disagreement not only within parties and within legislative bodies, but between the houses of Congress. We have already noted that, true to the differing party alignments, the House initially passed a significantly weaker version of the law that became SOX than did the Senate. Yet it was the Senate's version that eventually became law, and quickly at that. Why did the usual "brakes" of interest groups and the political process apparently fail here? One possible reason, of course, is that the conditions outlined above, as well as others still to be discussed, created significant public pressure for action. Another is that the Bush administration needed to demonstrate its disapproval of its former political ally, Kenneth Lay of Enron, who was now a notorious symbol of corporate malfeasance.

Despite these politics, business groups might have stopped the SOX juggernaut if they had been united.[12] The U.S. Chamber of Commerce did give battle. Its members included smaller firms that were more sensitive to sharp increases in monitoring costs, were not susceptible to blame for the most public corporate frauds, and did not have to worry as much about a backlash from public shareholders or customers who might be incensed by their opposition to corporate reform. The Business Roundtable did not, however, oppose SOX. It represented big business, which in the summer of 2002 was concerned less about regulatory costs than about avoiding the public's ire. These companies might have concluded that supporting the government's moves against fraud would provide them with cheap public relations—or at least that it would be costly in terms of public relations to oppose them. Moreover, no one seemed to be representing the interests of foreign issuers, not even the U.S. securities industry that derived significant revenues from trading these shares. And, of course, there was no one to defend the interests of potential future firms stillborn because of high regulatory costs.

There were deeper reasons business interests supported SOX even after its high costs became apparent. Firms might have been

particularly willing to support legislation that imposed regulatory costs if those that bore the most costs were their competitors. For example, Henry Manne argued that the original federal securities laws helped leading securities firms that underwrote relatively low-risk, high-disclosure securities to compete against firms that served a higher-risk clientele.[13] With respect to the costs of SOX, it was significant that bigger companies might have smaller rivals. The biggest worry for all big companies was the next big thing, which would come bubbling up from the venture capital incubator—unless SOX prevented it.

Some of the more vocal business supporters of SOX were the accountants and others in the monitoring and consulting industry who audit, investigate, prosecute and defend fraud, as well as prepare disclosure documents.[14] It is ironic that some of the biggest winners from SOX have been those whose gatekeeping failures triggered the law in the first place. Joseph Nocera of the *New York Times* views this as

> one of the unintended consequences—that Sarbanes-Oxley has been a financial boon to the profession, since all the big accounting firms have to audit a company's financial controls as well as its books. "In effect, the law is giving the auditors business," Senator Sarbanes said with a chuckle. But so what? Better that they make money doing actual auditing work than by selling themselves as consultants.[15]

Public choice economics suggests, however, that the intent of SOX should be inferred from its consequences. In this view, the accounting lobby—who Nocera says was the "primary opponent of Sarbanes-Oxley"—was pleased with the passage of SOX.[16] As Yale law professor Jonathan Macey has said,

> The politicalization of the process of corporate governance has produced massively perverse results. Specifically, those corporate governance institutions

> that have performed the worst have been rewarded, while those institutions that have performed the best have been hampered by legal rules designed to impede the ability to operate. Rather than producing genuine reform, the wave of corporate governance, accounting and capital markets scandals of the 1990s have generated political responses that benefit narrow interest groups and harm investors. Politics, not economics, determines which corporate governance devices are favored and which are not. As a consequence, the most effective corporate governance devices tend to be disfavored, while the ineffective mechanisms are rewarded in the regulatory process.[17]

Some firms may have supported SOX because it appeased public passion for reform as cheaply as possible. Indeed, firms may continue to believe that the act's main importance is symbolic. Roberta Romano notes that this may explain the increased criminal sanctions, at least, as indicated by the extent to which these were emphasized by legislators in their debates and by opinion polls on the public's view of SOX.[18] But this does not account for the act's governance reforms, which were not featured in the debates. Romano believes the symbolism explanation is inconsistent with the high actual costs of governance reforms.

The failure of business to stop the SOX juggernaut also owes something to the Republicans, who normally could be expected to defend business interests. Although the Republicans did slow down the train in the House in April, by the summer they could no longer provide effective opposition. Facing midterm elections in November, the party controlling the White House and identified with business stood to lose much more than the Democrats as the result of any public ire about the economy and corporate misconduct. Corporate fraud helped the Democrats discredit Republican deregulatory and antitax policies. Republicans therefore risked damaging their agenda by siding with opponents of regulation. The choice between keeping or increasing control and temporarily

abandoning some of their constituents might have seemed easy, particularly since those constituents were divided and had their own reasons for wanting the Republicans in power.

Moreover, the Republicans had a more significant problem. On July 4, the press had revived a story from twelve years earlier about President Bush's failure to file an appropriate notice of his 1990 sale of the stock of Harken Energy while he was a director of that company.[19] Bush held a news conference on July 8, looking like he had been caught with his hand in the cookie jar. The next day he announced a set of corporate governance reforms, including executive certification of financial statements, stiffer criminal sentences, and restrictions on nonaudit services by accounting firms. The reforms also condemned insider loans, though the president did not suggest dealing with them by federal or other law.

The political picture was therefore darkening rapidly for the Republicans. They needed corporate reform legislation quickly, or at least could not afford to be seen as obstructing it. This helps explain why they consented to a cloture motion in the Senate.[20] Cloture effectively prevented amendments on the Senate floor, the main exception being Senator Charles E. Schumer's executive loan provision, discussed below.

The Republicans still might have hoped to avoid a disastrous law through negotiations in conference. But things rapidly got worse for them when, on July 10, a story appeared about the president's below-market-rate loan from Harken, also while he was a director.[21] By July 11, the story was all over the media.[22] Again, politics was shaped by a combination of actual events and deliberate news media decisions concerning what stories to feature—in this case, a decision to investigate President Bush's twelve-year-old conduct in the business world just as other corporate fraud stories were emerging.

So, as the Senate and House proceeded to conference July 16 over their very different versions of corporate reform—a conference in which Republicans had hoped to modify the more drastic Senate version of the act that had emerged from the cloture vote—the Republicans were in a political corner. The president pressured the House Republicans for a quick compromise with the Senate, saying

that "the two [chambers] need to get together as quickly as possible and get me a bill that I can sign before the August recess."[23] Among Republicans there was "a mad dash to embrace the Sarbanes bill,"[24] which left lobbyists little room to make last-minute adjustments. By July 25, 2002, the deal had been made, and the consensus bill passed the House 422-3 and the Senate 99-0.

The Role of Policy Entrepreneurs. Roberta Romano stresses the role of "policy entrepreneurs" in shaping SOX provisions on executive loans, independent audit committees, executive certification of financial statements, and provision of nonaudit services.[25] These influential participants in Congress's deliberations saw a new opportunity to press proposals they had long favored without success. While the witnesses may have been sincere, the one-sidedness of their testimony clearly contributed to Congress's flawed policymaking.

For example, in the Senate committee hearings on the bill that became SOX, former SEC chairman Arthur Levitt Jr. and chief accountant Lynn Turner pushed their agendas on independent audit committees and restrictions on nonaudit services by auditors. The latter was an initiative Levitt had pushed two years earlier, only to be defeated by the efforts of Harvey Pitt on behalf of the big auditing firms. At the time of the SOX deliberations, Pitt was the SEC chairman, but he was unpopular among congressional Democrats. Other policy entrepreneurs who testified in the Senate included corporate lawyer and prominent governance reform advocate Ira Milstein, who advocated fully independent audit committees. The witness list in the Senate was shaped by the proregulatory committee chair, Senator Paul Sarbanes.

As proreform witnesses ignored evidence of which they were aware, doubt was cast on the wisdom and effectiveness of these proposals. For example, Romano recounts the testimony of witnesses, including Levitt, on the need to restrict auditors from providing nonaudit services. The witnesses failed to mention that the Panel on Audit Effectiveness, whose creation Levitt himself had suggested, had found no evidence that the performance of nonaudit services

had actually impaired audit quality.[26] Referring to the report in 2000 of this panel and to a 1978 report reaching the same conclusion, Romano says,

> It should be noted that . . . witnesses who advocated a prohibition, such as Levitt, were, without question, fully aware of both reports, but one would not have known that from their testimony. The lack of candor is embarrassing.[27]

One wonders how Levitt would have treated a comparable lack of candor in SEC disclosure documents.

The opinions expressed at the committee hearings by prominent policy entrepreneurs resonated with the views of academic reformers who, since the 1930s, had urged increased federal regulation of corporate governance. Moreover, they meshed with the interests of trial lawyers, who had chafed against the restrictions on securities class remedies and lawsuits that were in the Private Securities Litigation Reform Act of 1995 (PSLRA) and imposed by the Supreme Court. In particular, the trial lawyers supported Senator Patrick Leahy's effort to lengthen the statute of limitations on securities actions. This gave Democrats a negotiating tool to get the Republicans to agree to cloture.[28] Since lawyers, particularly transactional lawyers who advised on corporate governance, had an interest in tightening governance requirements, an American Bar Association task force representing their interests made recommendations dealing not only with lawyers but with corporate governance generally, including an endorsement of increased director independence.[29]

The question is what influence these policy entrepreneurs may have had on the final legislation. Romano points out that the corporate governance proposals they championed could not be dismissed as symbolic politics—that is, something to wave in front of a gullible public to show that the politicians were doing something.[30] In fact, the politicians did not do much waving—the proposals were hardly discussed in floor debates. These were the

sort of "inside-the-beltway" proposals about which the general public cares little, particularly compared with more salient issues like increased criminal penalties for misconduct, which everybody can understand.

The role of the policy entrepreneurs may have been to provide grist for the political mill. Although the political environment may have been conducive to regulation, politicians need specific proposals to enact. The policy entrepreneurs put their weight behind some. The proposals may not have been symbols in themselves, but they at least served to lend substance to the final legislation—in itself a potent symbol that Congress had done something about corporate malfeasance.

The result of the hodgepodge of proposals that came out of the woodwork was legislation that extended far beyond the problems that triggered the regulatory panic, including strict new regulation of the auditor-client relationship and the imposition of a large additional bureaucracy on the accounting profession.

Populism and Political Entrepreneurs. Like other products, legislation needs to be sold to its consumers—in this case, the voters. Legislators sometimes have a special ability to match opportunistically specific legislative proposals with the public mood. Jayne Barnard has detailed how Senator Schumer was able to do this with respect to what may be one of the most intrusive and costly SOX provisions—the outlawing of certain loans to insiders.[31]

As discussed above, President Bush's political problems over his Harken loans were an important factor in putting pressure on Republicans to support SOX. More specifically, Bush had decried executive loans in a July 9 speech shortly after the first Harken story, which Schumer had attended, though he had not proposed any legislation to deal with them. The *Wall Street Journal* nevertheless noted that day that the loans were "too popular to disappear anytime soon."[32]

"Soon" had a special meaning in this fast-moving political context. When Bush's own inside loan was reported shortly thereafter, Schumer realized that the time was ripe for a move. So, on July 12,

2002, after obtaining White House support, he introduced an amendment in the Senate outlawing insider loans. This was one of only three amendments that were made after cloture, and got special consideration because of Bush's Harken problem.[33] In his statements supporting the amendment, Schumer explicitly played the populism card, asking, "Why can't these super rich corporate executives go to the corner bank, the SunTrust's or Bank of America's, like everyone else to take loans?"[34] The amendment passed without discussion by voice vote.[35]

The Boom-Bust Regulatory Cycle. SOX was arguably just one example of the "Sudden Acute Regulatory Syndrome"[36] that usually follows a market panic—like the Bubble Act passed in England in the midst of the South Sea Bubble, and the federal securities laws in the United States that followed the 1929 stock market crash.[37] When the economy is booming or stable, significant new financial or corporate governance regulation will not help any particular interest group enough so that they will be willing or able to apply pressure for it—or at least enough pressure to overcome opposition by antiregulatory groups. The proregulatory groups cannot enlist the support of consumers or investors who are riding a rising market, or who are simply indifferent to a dull one.

The political dynamic changes, however, when fraud becomes a hot media story. People are susceptible to claims that regulation is needed to "restore confidence" in the market. Moreover, there is a deep-seated distrust of financial markets and an envy of rich capitalists that awakens when these markets are going down and not providing goodies. These public attitudes can be seized by policy entrepreneurs, political opportunists, and proregulatory interest groups.

This "regulatory panic" account of financial regulation suggests that laws like SOX are enacted precisely when lawmakers are least able to evaluate them properly. Lawmakers regulating in a crash are likely to underestimate the gains that a vibrant business and capital market environment can provide and ignore the regulatory costs of their actions. Such times are ripe for regulation that

penalizes useful practices and generally discourages risk-taking by punishing negative results and reducing the rewards for success.

All Action, No Talk. We have shown that, for several reasons, lawmakers and voters did not seem willing to debate the costs and benefits of SOX calmly. Deliberations in Congress were sparse.[38] There was only one day of debate in the House, with hardly anyone speaking on some of the major proposals in the House bill, such as officer loans and audit committee independence. In the Senate committee, the witnesses were heavily skewed in their views of regulation, and their testimony did not attempt to balance costs and benefits, nor to present evidence that was inconsistent with their conclusions. The Senate debated the resulting bill hurriedly and under cloture, and it was passed swiftly with little revision.

Some of the factors that led to this result, such as the political environment, were specific to SOX and are unlikely to recur. But many of the factors that produce a regulatory panic have recurred over time and are likely to arise again. We are doomed to relive the SOX experience unless we can better understand the costs of this type of regulation and the excesses inherent in SOX. Congressmen and interest groups might have resisted the populism and the panic if they had better realized the havoc this type of law might cause. Since the most invasive corporate governance provisions did not, in any event, particularly resonate with the public—that is, they likely were simply pulled off the shelf to fill out the legislation—a better understanding of the costs of governance "reform" may reduce the likelihood of a future SOX. We provide those insights below.

The Sarbanes-Oxley Act

At this point it is useful to provide a quick roadmap of what Congress did in the dog days of summer 2002. The provisions will be grouped according to their general objectives.

Increased Internal Monitoring. SOX has several provisions intended to ensure better monitoring for potential fraud by a corporation's own agents. The act

- mandates that the board audit committee consist solely of independent members and be responsible for hiring and overseeing auditors;
- requires executives to certify reports, with criminal penalties for reckless certification;
- penalizes executives who fraudulently influence or mislead auditors;
- mandates disclosures concerning the firm's internal controls structure;
- mandates a code of ethics for financial officers;
- provides for protection of whistleblowers.

Gatekeeper Regulation. SOX includes provisions intended to ensure better and more disinterested performance by professionals who are supposed to scrutinize corporate transactions. The act

- requires attorney reporting of evidence of fraud;
- reduces financial ties between auditors and audited companies;
- provides for the independent Public Company Accounting Oversight Board (PCAOB).

More Disclosure. The act provides for new categories of disclosure relating to

- the firm's internal controls structure and code of ethics;
- off-balance-sheet transactions;
- pro forma earnings.

The act also provides for SEC rules requiring more rapid disclosure of material changes in financial condition.

Regulation of Insider Misconduct. Beyond disclosure and monitoring, SOX includes some direct regulation of suspect categories of insider conduct. The act

- prohibits loans to insiders;
- requires return of incentive-based compensation following accounting restatements.

Regulating Securities Analysts. The act includes provisions intended to ensure that securities analysts operate independently of their firms' investment banking activities.

2

What Shareholders Want—The Optimal Amount of Fraud

The "separation of ownership and control"—the notion that managers of publicly traded corporations may not have incentives to act in their shareholders' best interests—has been the overriding concern of corporation law and corporate governance since before Berle and Means coined the phrase in 1932.[1] Officers and directors may take advantage of shareholders by not working hard, consuming excessive perquisites, paying themselves exorbitant salaries, hoarding cash, building empires, diversifying the corporation for their personal risk preferences, not taking enough risks, and so forth. Managers use their dominance of the director selection process to promote the election of directors who will defer to them. Shareholders let managers get away with this because it is not worth their time to be active participants in corporate monitoring—they are rationally ignorant and follow the Wall Street rule of selling their shares rather than complaining about poor performance.

The economic approach to the corporation builds on this tradition and refers to the "separation of ownership and control" as an agency problem—the managerial agents do not always have the incentives to act in the shareholders' best interests. Agency theory characterizes the corporation as a "nexus of contracts" among shareholders, managers, directors, creditors, and employees who voluntarily join together in mutually beneficial transactions.[2] In this economic model, agency costs are the sum, first, of the costs of managers pursuing their own interests at the expense of shareholder value and, second, of the costs of resources devoted to

dealing with this problem. It is irrational and wastes shareholder value to attempt to align managerial interests perfectly with shareholder interests because the costs of perfect control exceed the benefits. In other words, the optimal amount of self-interested conduct by managers, both for shareholders and for society as a whole, is more than zero.

Agency theory provides a useful framework for thinking about the role of SOX in protecting shareholder value from managerial malfeasance. In the extreme, we can stop all such malfeasance only by outlawing the corporation and forcing businesspeople to stop hiring agents.

How do we determine the optimal amount of fraud? In other words, how much fraud should shareholders be expected to tolerate? One approach is to put it in the context of efficient markets and risk-bearing by shareholders. Efficient securities markets discount the known risk of fraud in the price of securities based on factors such as the nature of the industry and the track records of key executives. This forces firms to deal with these risks if they want to raise new capital. To be sure, some of the risk of fraud cannot be quantified. But shareholders are assumed to own a portfolio of stocks through which they diversify many different risks, including the risks of managerial ineptitude, managerial entrenchment, accounting and other fraud, self-dealing, and lawsuits. Thus, through diversification, shareholders can minimize their costs of bearing the risk of fraud. A corollary is that attempting to eliminate all managerial malfeasance would actually hurt diversified shareholders by requiring managers to devote resources to reducing risks that shareholders can deal with cheaply on their own.

Consistent with this market structure, our corporate governance system allows managers to take reasonable business risks on behalf of shareholders. These risks would include strategic decisions in entering markets, mergers and acquisitions, research and development, and organizational control issues—for instance, how much to invest in internal controls such as monitoring employee performance. All of these business decisions are protected from state law fiduciary liability by the business judgment rule, which allows

managers to take reasonably informed risks without fear of second-guessing by litigious shareholders with 20/20 hindsight.[3]

SOX section 404, which is discussed in detail in chapter 4, is a good example of a misguided attempt to eliminate all agency costs. This section requires executives to certify the adequacy of their internal controls. The discussion below will demonstrate that the internal controls requirement does not reflect a tradeoff of costs and benefits that is in the best interests of shareholders. Shareholders are not interested in perfect internal controls for the sake of control. They are only interested in improving internal controls if the improvement will increase share value. Yet the early results from the section 404 internal controls attestations indicate that, although less than 8 percent of the largest 2,500 corporations found deficiencies, all firms were required to invest millions of dollars to identify these problems. This suggests that diversified investors would be better off without section 404. In the absence of SOX, corporate boards and executives would have been guided by rational cost-benefit analysis in determining the extent of controls and the appropriate amount of documentation.

3

Imagining a World without SOX

Defenders do not mince words in claiming that SOX is a tremendous success. For example, Harvey Goldschmidt, a former SEC commissioner and strong proponent of the reforms, states, "I think that Sarbanes-Oxley has been a great success in terms of the effect it has had on improved corporate governance. There is no question it has been a great piece of legislation, and anybody who says otherwise is talking like a darn fool."[1] And Representative Michael Oxley—not a "darn fool"—suggests that the issue of benefits transcends data:

> No one can know with any accuracy . . . where we would be today had Sarbanes-Oxley not been created. . . . How can you measure the value of knowing that company books are sounder than they were before? Of no more overnight bankruptcies with the employees and retirees left holding the bag? No more disruption to entire sectors of the economy? I think that's a valuable return for the investment, when the outlays now are a small fraction of the losses that were sustained.[2]

This sort of thinking obviously puts a strong burden of proof on opponents of regulation. Indeed, to the extent Oxley suggests that the value of the legislation cannot be measured, the burden is impossible to bear.

The burden should, instead, be on proponents of massive new regulation. The overwhelming success and strength of our capital markets, and the dominance of private contracting, suggest that the

market works without new regulation, and that regulations should thus be required to pass a cost-benefit test. And, contrary to Oxley's assertion, there are ways to measure both costs and benefits, as demonstrated by the finance studies summarized below in chapter 4. Although these metrics are imperfect, they can, cumulatively, provide some guidance to regulators if carefully done and understood.

The analysis should begin with a realistic appraisal of the benefits that have flowed from SOX. It is important to understand that much of what SOX sought to accomplish might have been done at much lower cost by markets alone or under state law without the need for a broad and burdensome new federal regime.

To frame this analysis, assume for the moment that there is less fraud in the post-SOX world. This chapter asks if there would have been more fraud over the past three and a half years in the absence of the act. Some of the improvement may have nothing to do with SOX. But even if some market improvement can be traced to it, it is far from clear that it would not have been provided by the markets or the states, perhaps more efficiently, if SOX had not been adopted. If Congress had not acted, others might have, and there were already ample mechanisms in place to protect against further frauds. Issuers, securities firms, and other market actors had even stronger incentives than Congress to restore "confidence in the market" if, as Congress believed, lack of confidence were driving away their customers and sources of capital.[3]

This chapter shows that there are many things corporations, private organizations, and states might have done if Congress had not passed SOX. It also shows that these alternatives might have been at least as effective as SOX in reducing managerial malfeasance and fraud, and concludes that the act has interfered with the operation of these important corporate governance devices.

Capital Market Forces

Even without SOX or any other law, the capital market would continue monitoring corporations, backed by the extensive mandatory disclosure laws already on the books. Even in the absence of private

or public regulation, markets had the capacity to address the problems that surfaced in Enron and related scandals. Here we discuss some of the available alternatives.

Market Monitoring. SOX was Congress's response to the particular frauds revealed in Enron, WorldCom, and other cases. For example, auditors and lawyers failed to spot or report fraud, so Congress passed provisions mandating reporting and greater independence of these gatekeepers. Bernie Ebbers and WorldCom demonstrated the problems that loans to insiders could cause when not carefully monitored, so Congress decided to ban them.

Securities analysts, investment managers, and others have a strong financial motive to ferret out information. How can the market spot fraud, which by definition is hidden? The same information about past frauds and disclosure lapses that Congress relied on in passing SOX now can inform market actors as to what to look for in the firms they watch. Analysts now know, for example, to look more closely at the fine print in financial statement footnotes and to rely more on "hard" numbers, such as free cash flow, rather than "soft" numbers affected by firms' decisions on capitalizing and amortizing expenses, unusually high rates of growth, and arrogant managers.[4]

Companies also provide information in the form of the mechanisms they adopt, or fail to adopt, to monitor for fraud. Financial economists are doing significant theoretical modeling and empirical research to determine which corporate practices and characteristics are correlated with financial risk. For example, researchers showed that the more nonaudit services corporations bought from their audit firms, the more they were likely to "manage" earnings. The market evidently caught on to this, because the same study showed that investors tended to devalue firms that disclosed unexpected purchases of nonaudit services.[5] There is also evidence that firms subject to SEC enforcement actions from 1978 to 2002 incurred total market penalties, as measured by expected loss in the present value of future cash flows due to higher contracting and financing costs, that were twelve times the total of SEC and private litigation penalties imposed on these firms.[6] These penalties were

visited not only on firms, but also on their managers. Another study has shown increased management turnover following earnings restatements, and indicated that the employment prospects of the displaced managers of restatement firms are poorer than those of the displaced managers of firms that have not issued restatements.[7]

In the post-Enron environment, firms would similarly put investors on alert if they gave large loans to executives, had executives on the board audit committee, or used other governance mechanisms that the market has condemned. The firms could decide whether the benefits they obtain from these devices outweigh the increase in capital costs. They also would have incentives to adopt market-favored devices, and to signal in other ways that they are well-managed, as discussed later in this chapter.

To be sure, market monitoring may not work without mandatory disclosure. But a well-developed mandatory disclosure system already exists. The question for federal regulators and Congress should have been whether this system ought to have been tweaked to give the market the information it needs. This approach would have preserved the traditional distinction, entrenched for seventy years, between the federal emphasis on disclosure and the state emphasis on internal governance.

In fact, even before Enron's collapse and the advent of SOX, analysts had a lot of the information they needed to be able to spot fraud. For example, in February 2001, eight months before the disclosures that brought Enron down, a hedge fund manager figured out that Enron had been using derivatives to speculate rather than to hedge.[8] The footnotes to Enron's financial statements disclosed the basic facts concerning the company's potential exposure to debts incurred by special-purpose entities.[9]

If all these facts were available, why did it take so long for the market to catch on? The answer is that the market was in a boom cycle. "New-economy" firms were exploring methods of doing business for which evaluation metrics had not been developed. Analysts and executives were arguing that the established guidelines for price-earnings multiples did not apply to novel business methods. Optimistic day-traders, flush with cash, were inclined to agree.

So was SOX necessary to prevent future market vulnerability to fraud? The existence of a repetitive cycle of periods of boom, bust, and regulation strongly suggests not. As noted above, the market disregarded information that was actually in the disclosure documents of firms like Enron. To be sure, this was not clear disclosure—it had to be ferreted out by analysts. But once that had been done, the warning signs were in the open, inviting more careful investigation and evaluation. Perhaps curious analysts would have hit stone walls within the companies, but the absence of information (and a company's unwillingness to provide it) suggests the presence of risk which, in turn, is reflected in the market price.

Moreover, even if more disclosure, or perhaps the barring of suspect practices, would have prevented Enron and other frauds, it is not clear that such regulations will prevent the next fraud—which will not be about special-purpose entities or derivatives, but probably about some other practices that neither the markets nor Congress can now anticipate. With or without SOX, the possibility of another major Enron-like corporate fraud would inevitably persist.

Reputations and Signaling. The primary political argument for the passage of SOX was the political need to "restore investor confidence." Although there is good reason to doubt the economic validity of this argument, an underlying theoretical argument supports regulation if the post-fraud securities market is a market for "lemons" that investors will avoid because all investments, like the inventory on a shady used car lot, look like potential losers. This refers to the theory of George Akerlof, the 2001 Nobel laureate in economics.[10] It follows from this insight that regulation like SOX is not so much for the benefit of investors, who will avoid future risk, but for that of reputable sellers who will lose business unless they can persuade buyers that the sharks are gone and it is safe to swim.

The question is whether regulation is necessary to reassure investors. Akerlof shared his Nobel Prize with Michael Spence and Joseph Stiglitz for their work on market responses to the lemons problem.[11] In the present context, these would include

firms' maintaining good reputations for honesty and signaling to investors and others that they are not like Enron or WorldCom.

Firms' reputations provide an important way to protect investors. Firms invest significant sums in advertising and in behavior that induces investors to trust them and thereby reduce their cost of capital.[12] Firms that cheat incur a significant penalty by devaluing the reputation they spent so much to build. This effect was observed recently in mutual funds that suffered significant outflow of funds after news reports of misbehavior.[13]

Signals include maintaining a high level of voluntary formal disclosure, voluntarily joining organizations or obtaining certifications from reputational intermediaries, having candid meetings with securities analysts and the media, or voluntarily adopting mechanisms suggested by governance reformers, such as expensing stock options, separating audit and nonaudit services, or hiring auditing firms that follow this practice.

Firms also can signal by buying insurance, since the size of the premium indicates the extent of the insured risk. This is a fairly reliable signal, since insurance firms have strong incentives to set the price accurately, and firms' incentives to insure minimize the risk of false signals. There is evidence that the liability insurance premiums of firms' directors and officers accurately indicate the quality of their governance arrangements.[14] Firms also might signal honesty by buying "financial statement insurance," in which the insurance carrier hires the auditor and provides the signal.[15]

An advantage of signaling over mandatory regulation is that each firm can decide whether the benefits of signaling integrity outweigh the costs. For example, some firms may derive substantial benefits from having their auditors do nonaudit services, and they may have in place alternative monitoring systems that reduce the need for this extra assurance of disinterested auditing. One-size-fits-all regulation precludes this sort of tailoring.

Moreover, mandatory regulation may carry the extra cost of discouraging or disabling potentially valuable signaling. Once the law requires all firms to adhere to the same standard, they have less incentive to signal their integrity. This reduces market incentives to

develop and adopt alternative signaling mechanisms. For example, in the absence of SOX, a market in financial statement insurance might have developed that would permit more precise and cost-effective measurement of fraud risk.

Given the potential for signaling to restore confidence in the market on a firm-by-firm basis, the main theoretical defense of SOX is as a subsidy for firms that have relatively high costs of using these mechanisms. One might argue that, without SOX, newer and smaller issuers, which are riskier because the market has less information about them, might have struggled in a risk-sensitive post-Enron market as compared to their bigger and more reputable rivals. But this would be an ironic defense of SOX, given the outcry concerning the problems the act—particularly its internal controls provisions—creates for smaller firms (see chapter 4). If SOX-type regulation is, indeed, better for smaller firms, then it should be designed with the needs and characteristics of these firms in mind. Clearly, SOX did not meet this alleged need.

Shareholder Monitoring

Even if SOX had never become law, firms would be subject to scrutiny not only by the capital markets, but also by their own shareholders. Highly visible institutional shareholders like TIAA-CREF have the clout to press for changes by directly communicating with managers and by enlisting support from other shareholders through shareholder proposals that the firm must subsidize under current SEC rules.[16] Managers would risk market penalties by not responding favorably to proposals that receive significant support. The proposals also could provide information to the SEC as to the extent to which shareholders—whose money is on the line—favor particular reform initiatives.

To be sure, institutional investors such as state pension funds may have their own political agendas, and individual investors lack incentives to spearhead governance reform. But there are also very motivated investors who can institute reform by buying large or controlling interests. The active takeover market of the 1980s was

killed by the combination of federal prosecutions of the key players, the Williams Act, and state anti-takeover laws. Indeed, the weakened market for corporate control that resulted from this regulation may partly account for the recent corporate frauds. However, a new market for control has been revived through hedge and private equity funds. These buyers have much more high-powered monitoring incentives than the independent directors, auditors, and lawyers on whom SOX relies so heavily.

The more general lesson from the recent history of takeovers concerns the efficacy of regulation. Takeover regulation was supposed to be the solution to the last problem of excessive job insecurity for managers and workers. It did little to address this problem, while helping to weaken governance and thereby create conditions for the next crisis of corporate fraud. The lesson is that additional market regulation may have unforeseeable perverse effects and should be approached with caution rather than embraced in panic.

State and International Competition

Even without SOX, there would still have been the substantial body of state corporate law, which historically, and even after SOX, has been the principal mechanism for regulating corporate governance. SOX, however, represented a significant shift away from state law in its provisions prescribing the composition of board audit committees, prohibiting certain officer loans, and requiring reimbursement of bonuses and stock profits. Even SOX's disclosure provisions, particularly including the internal controls disclosures, may have indirectly invaded state regulation of corporate governance by establishing a de facto governance standard.

The state-based system of regulating corporate governance has been hailed as one of the main strengths of the U.S. capital markets.[17] Although William Cary, a former SEC chairman, famously decried the competition for corporate charters as a "race to the bottom," Ralph Winter quickly pointed out that Cary had ignored the fact that efficient capital markets ensure that firms' incorporation

decisions are capitalized into the value of their shares.[18] There is significant evidence based on stock returns indicating that firms' incorporation decisions are, in fact, efficient.[19]

There are also strong advantages inherent to adjudication of corporate issues in state courts. As two prominent Delaware judges remarked recently:

> In our experience, the effective adjudication of corporate law disputes requires a great deal of direct involvement by the trial judge. The factual records in such cases are often large and make for demanding reading. Moreover, many of these matters are time-sensitive and involve the application of complex legal doctrines to the evidence in a very short timeframe—a reality that limits the capacity of judges to delegate very much of the work to law clerks. As we understand it, the federal courts already face a stiff challenge in addressing their already formidable caseloads. . . . In view of that reality, it seems unlikely that the federal courts are well-positioned to absorb the burden of adjudicating corporate governance disputes now handled by state courts.[20]

Some might argue that Enron and other frauds indicated a failure of state corporate law. But it is interesting that two of the main culprits, Enron and WorldCom, were not incorporated in the leading jurisdiction of Delaware, but rather in Oregon and Georgia, respectively. These firms' choice of state law may have been based on an expectation of favorable regulatory treatment or better protection against takeovers than in Delaware.[21] In the wake of Enron, firms might have been more careful in eschewing these considerations and focusing on whether the chosen regime protects shareholders against managerial agency costs. This would also encourage Delaware to respond to the heightened concern with agent misconduct.[22]

Moreover, before blaming state law and turning to more federal law, we should consider that a regulatory landscape already increasingly dominated by federal law was ineffective in preventing Enron.

It is not obvious that even more federal law is the answer. Mark Roe has argued persuasively that the ever-present threat of federalization necessarily constrains states in regulating corporate governance.[23] As discussed below, SOX may have tightened this noose and further disabled the states from responding to corporate governance problems.

Relying on state law would better enable firms to tailor their governance to their particular circumstances. For example, the evidence indicates that more board independence is not correlated with firm value.[24] A review of state laws on executive loans, which were supplanted by SOX's prohibition of many such loans, indicates significant variation, from prescribing procedures for approval to requiring the board to identify a corporate benefit, or providing for no default regulation at all.[25]

Theoretically, the advantages of state competition might be extended to the international scene, with international jurisdictional competition as to disclosure rules.[26] Foreign firms already can choose to "bond" their integrity by cross-listing in the United States or other jurisdictions, thereby subjecting themselves to these legal regimes in addition to those in their home countries. Substantial evidence supports this bonding explanation of cross-listing.[27] Full-fledged international competition currently is hobbled by the fact that the United States insists on regulating all trading within its borders regardless of where the firms are based. Thus, if international competition is not as successful as state competition, it is because of the overreaching of federal law. Piling on more federal law through SOX aggravates rather than reduces this problem.

Regulation by Stock Exchanges and Other Private Institutions

Finally, it is worth wondering whether private organizations might have picked up any regulatory slack that existed in the absence of SOX. Firms can supplement market discipline by subjecting themselves to regulation by nongovernmental bodies. In a manner similar to the signaling discussed above, a firm's decision to be

regulated would be evaluated by the capital markets and reflected in its stock price.

Firms already are subject to governance provisions in stock exchange listing agreements. Exchanges theoretically have an incentive to compete for listings by offering rules that reduce listed firms' cost of capital.[28] Thus, shortly after SOX was passed, the New York Stock Exchange Board of Directors adopted listing standards relating to director independence that went beyond the act's regulation of audit committee membership.[29] The NYSE, for example, has an incentive in competing with NASDAQ and other exchanges to encourage firms to pay higher listing fees in exchange for a lower cost of capital by assuring investors in those firms that the NYSE is actively monitoring them.[30]

Other types of self-regulatory organizations might also play a significant role in monitoring firms. There is evidence, for example, that peer review and competition among professional auditing associations can provide effective monitoring of auditing firms.[31]

The upshot of the analysis and evidence presented in this chapter is that the American corporate governance system has numerous self-correcting forces that are likely to be more focused and more measured than an economy-wide regulatory intervention such as SOX. Neither Congress nor SOX's defenders give credit to the historical, institutional strengths of our corporate governance system. A greater appreciation of the market forces and institutional incentives leads to the inevitable conclusion that there was little opportunity for Congress to add much value. In short, the benefits of SOX necessarily have been slight. Unfortunately, as detailed below, SOX's costs have been enormous.

4

The Costs of SOX

Many defenders focus on these direct compliance costs and reassure us that they are temporary, will decline as firms figure out how to comply, and, in any event, are worth it if the result is reducing fraud. Their assessments, however, are based on an overly sanguine view of what SOX compliance actually entails, and a failure to realize what a heavy weight it ties around the legs of U.S. firms. Among other things, SOX has diverted attention from the hard work of maximizing shareholder value and distorted executives' incentives and investment decisions. As discussed in chapter 6, the most extensive and persuasive study of SOX's financial costs estimates the loss in total market value of firms around legislative events leading to its passage at $1.4 trillion.[1] This astronomical amount suggests that the stock markets implicitly estimated the net costs of SOX to be much greater than simply the present value of the future direct costs of compliance. The lesson from chapter 2 was that the risk of corporate fraud and agent misconduct does not necessarily justify regulation if the costs of the regulation exceed the costs of the fraud and misconduct that would occur in the absence of regulation. Although SOX was ostensibly passed to protect investors, it hurts them if it forces corporations to spend more on protection than they are gaining in fraud reduction. It is useful to recall the 1976 swine flu scare, in which one person died from the disease and thirty-two from the vaccine.

This chapter considers some sources of SOX's direct and indirect costs.

Direct Compliance Costs

First we discuss the direct compliance costs imposed by SOX that have attracted the most media attention.

Section 404 Internal Controls Disclosures and Attestation. Consistent with the philosophy of the original 1933 and 1934 federal securities acts, SOX increases mandated disclosure in several areas. Perhaps the most troublesome new provision has been section 404, which imposes a brand-new and extensive obligation on managers to assess the quality of their internal controls. Little discussed or debated in Congress, and little noticed during the whirlwind of July 2002, it provides for SEC rules requiring that firms' annual reports

> contain an internal control report, which shall—(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Section 404 acquires extra importance because of two other sections of the law requiring senior executives to take personal responsibility for these new annual report disclosures. Section 302 provides for SEC rules requiring senior officers to certify in each annual or quarterly report not only that they know of no material misstatements or omissions in the report, but that they

> (A) are responsible for establishing and maintaining internal controls; (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly

> during the period in which the periodic reports are being prepared; (C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and (D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.

The officers must certify that they have disclosed to the firm's auditors and board audit committee

> significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and . . . any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

Finally, the signing officers must indicate "significant changes in internal controls or in other factors that could significantly affect internal controls" since the last evaluation.

Section 906 requires the issuer's CEO and CFO to certify that

> the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

These requirements include, of course, the internal controls disclosures under section 404.

The SEC has, in fact, issued voluminous rules implementing and interpreting these provisions.[2] To give a taste of the rules, they clarify

that the officers must sign off on, among other things, whether transactions are recorded as necessary, and provide assurances regarding unauthorized acquisition, use, or sale of assets.[3] Changes potentially affecting internal controls that the officers must evaluate include significant corporate transactions, expansion into new regions, and changes in management or organizational structure.[4] The SEC has also made clear that management must follow methodologies that recognized bodies have established after public comment.[5]

SOX also requires external auditors to opine on both managers' assessments and their own evaluations of control effectiveness.[6] The provision was implemented by Auditing Standard No. 2, promulgated by the Public Company Accounting Oversight Board (PCAOB), the auditor regulator that SOX created (and whose appointment is the basis of the Free Enterprise Fund lawsuit mentioned in chapter 1). Section 404 created a new standard of what potential problems needed to be disclosed—specifically, "significance" rather than the traditional test of "materiality." This standard will have to be developed through many years of case law and SEC rulemaking. In the meantime, firms and auditors have to guess how the test will be applied.

The SEC initially estimated that its proposed rules implementing SOX section 404 "would impose an additional 5 burden hours per issuer in connection with each quarterly and annual report."[7] This estimate was sharply rebuked in comments on the proposed rule.[8] The SEC's final rule revised the estimate up to "around . . . $91,000 per company," not including "additional cost burdens that a company will incur as a result of having to obtain an auditor's attestation."[9] Moreover, the SEC was way off the mark even after it revised its cost estimates. For example, Financial Executives International estimated compliance costs at $4.36 million per company as of mid-2005, and AMR Research has estimated that companies will spend $6 billion to comply with SOX in 2006.[10] One can only wonder how the SEC (or plaintiffs' attorneys) would react to errors and restatements of similar magnitude by a publicly traded corporation.

There was an outcry from firms as the internal controls rule kicked in for financial statements due after November 15, 2004—an outcry so intense that it may have accounted in part for the

early departure of SEC chairman William Donaldson. The SEC responded in several ways to the concerns about internal controls reporting—by delaying reporting by small and foreign companies; by convening an advisory committee on smaller public companies, which has recommended exemptions of, or at least modified requirements for, smaller companies; and by a roundtable in April 2005.[11] These were followed by a May 16 policy statement and joined by a policy statement from the PCAOB on implementing the internal controls audits. The policy statement observed:

> Although it is not surprising that first-year implementation of Section 404 was challenging, almost all of the significant complaints we heard related not to the Sarbanes-Oxley Act or to the rules and auditing standards implementing Section 404, but rather to a mechanical, and even overly cautious, way in which those rules and standards apparently have been applied in many cases. Both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.[12]

The upshot of these initiatives, as described in a speech last November by SEC commissioner Cynthia Glassman, is that Glassman was "still hearing stories of auditors identifying over 40,000 key controls and, while significant reductions in auditors' fees were projected at the time of the roundtable, recent anecdotal reports suggest that such fee reductions have not yet materialized."[13]

It should not be surprising that the SEC's and PCAOB's jawboning were not enough to "bring reasoned judgment and a risk-based approach" to the process.[14] As will be discussed further, the problem is that auditors, corporate executives who also sign off on

financial statements, and corporations must fear not only regulatory sanctions if they understate risks and the need for controls, but also civil litigation and criminal prosecutions the next time inherent business uncertainty drives a firm's price down.

One striking thing about the controversy over the costs of compliance with section 404 is that, even though they are much higher than anyone in the government predicted, no one in Congress or the SEC is advocating reconsidering the propriety of section 404—although there is some concern about its adverse impact on smaller firms. SOX's defenders dismiss the problem as one of startup costs that will be amortized over time. But many of the costs are ongoing and are likely to remain high, even if lower than during the initial period.[15]

Another striking thing about the controversy is that it was so predictable. Precisely the same thing happened when Congress adopted the first major set of internal controls in 1977 in the Foreign Corrupt Practices Act. The controversy was quelled only when the SEC adopted an interpretation and policy statement.[16] If Congress had done its homework, it would have foreseen the problems that would result from SOX's much broader internal controls provision.

Audit Committee Independence. Corporate reformers long have loved the idea that directors who are not employed full-time by the company and who are otherwise independent of the company and its insiders will aggressively monitor executives' performance on behalf of shareholders. They have ignored theoretical questions, such as why it is logical to assume that one who is employed full-time elsewhere would have adequate time, incentives, and information to be effective, or why any problems with nonindependent directors would not be reflected in share price. They have also ignored the ample data showing that corporate profitability is generally unrelated to the number of independent directors on the board.[17]

The specific SOX contribution to board structure was to ensure that a company's auditors are chosen and overseen by a fully independent audit committee. This focus was not surprising, given the lapses in oversight by Enron's auditor, Arthur Andersen. But as

Congress rushed to act in the headlong process discussed in chapter 1, nobody asked the right questions about whether any of this could have been prevented by requiring more independence. Remarkably, nobody seems to have cared that the Enron audit committee was independent. Nobody inquired as to the difficulty directors faced in overseeing auditors. Nobody wondered whether this fix was necessary or effective in addition to SOX's provisions applying directly to audit firms. Nobody asked, is it worth the cost for firms to pay both the increased audit costs under the act and the increased costs of audit committees? Nor did anyone ask whether any but the largest companies could afford the stringent new audit committee requirements, or what these requirements would mean to foreign issuers subject to SOX with board structures very different from those of U.S. companies.

The data before and after SOX lend little support to the notion that the benefits of increased audit committee independence are worth the costs. Roberta Romano reviews sixteen studies attempting to relate audit committee independence to various performance measures and finds that ten fail to show that audit committee independence improves performance, one reports inconsistent results for different models, and three of the remaining studies suffer from methodological flaws.[18] The factor that seems to matter more in the studies than independence is whether the audit committee members are financially sophisticated.

Rules requiring independent directors may be much more burdensome for small than for large firms. One study found that small firms paid $5.91 to nonemployee directors per $1,000 in sales before SOX, compared with $9.76 per $1,000 in sales after SOX, while large firms' costs increased only from $.13 to $.15 per $1,000 in sales.[19] This disproportionate impact on small firms stifles entrepreneurial incentives and, in effect, denies access to public capital markets.

Managing in the Shadow of SOX

SOX is a burdensome intrusion into the internal affairs of public companies. This could be justified by regulators if it corrected a market

failure and resulted in benefits greater than costs. However, as discussed above, the benefits are likely small, and the costs are very high.

Section 404 Internal Controls. As we have seen, section 404 of SOX, its so-called "internal controls" provision, involves serious direct compliance costs. SOX defenders argue that these costs are worth the deterrence to fraud that internal controls reporting and certification provide. But it is harder to justify the significant long-term effects such reporting has on business.[20]

First, modern firms, unlike the small shops of the early nineteenth century, rely on specialization of functions, automation, delegation of authority, and complex hierarchies. Managers have to be able to trust their subordinates. SOX raises a serious question whether this sort of trust is consistent with the need to have adequate "controls." SOX will surely provoke redundancies that detract from bureaucratic efficiency.

Second, SOX clearly penalizes change and innovation. Any upgrades, new software, or acquisitions would have to be evaluated as "significant changes in internal controls or in other factors that could significantly affect internal controls." The safer course, when in doubt, is to do nothing.

Third, SOX requires firms to devote significant resources not only to tracking information, but to providing a costly and unnecessary paper trail. For example, the SEC's rule defining executives' certification obligations says that

> an assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes. This evidential matter should provide reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered.[21]

Of course, firms need to find and discipline fraud. But, as we have repeatedly emphasized, they will be less profitable if they have to spend more on preventing fraud than the fraud was costing them.

The risks imposed by the internal controls provision fall directly on auditors or executives who sign off on the internal controls reports. Since auditors and executives are less able to bear risk than the shareholders of publicly held firms who hold diversified portfolios, the auditors and executives may respond by either demanding greater compensation or adjusting their behavior to reduce the risk. Indeed, one study finds a post-SOX decline in the ratio of incentive compensation to salary after the passage of SOX, and in firms' research and development expenses and capital expenditures.[22] These results indirectly indicate reduced manager incentives to invest in, and be compensated based upon, the riskier long term. Ultimately, the shareholders bear most of this risk.

Impact on Managerial Risk-Taking: Independent Directors. SOX requires audit committees to be made up entirely of independent directors. This seemed like a reasonable response to the accounting scandals because it appeared that senior executives had been able to dominate the auditors and audit committees of Enron, WorldCom, and others. As mentioned above, board independence has long been a favorite panacea of corporate governance reformers, despite questions about its cost-effectiveness. Those questions aside, Peter Wallison has offered an argument that independence can actually be harmful:

> The independent directors of a company are part-timers. No matter how astute in the ways of business and finance, they know much less about the business of the companies they are charged with overseeing than the CEOs and other professional managers who run these enterprises day to day. Unfamiliarity in turn breeds caution and conservatism. When asked to choose between a risky course that could result in substantial

> increases in company profits or a more cautious approach that has a greater chance to produce the steady gains of the past, independent directors are very likely to choose the safe and sure. They have little incentive to take risk and multiple reasons to avoid it.[23]

Constraining Executive Compensation: Insider Loan Prohibitions. Executive compensation is a perennial hot button issue in corporate governance, yet SOX did not directly address the area. Perhaps Congress was mindful of the perverse incentives created by its last foray into executive compensation, in 1993, when it limited the tax deductibility of executive pay to $1 million annually unless it was "performance-based."[24] This law naturally encouraged more reliance on stock options which, in turn, increased managers' incentives to manage earnings and focus on short-term results.[25] Moreover, a predictable result of this reform is that executives increasingly will be rewarded based on "random" components of company performance rather than the results of their own efforts.[26] Now concern about excessive managerial compensation has spurred a massive SEC effort to overhaul executive compensation disclosure.[27] This is likely to be only the beginning of more executive compensation "reform," as the cycle of misguided tinkering continues.

SOX's contribution to the executive compensation reform party was section 402, prohibiting insider loans. The problem with this regulation is that such loans have the potential benefit of encouraging insider ownership of company stock, which tends to align executives' interests with those of the shareholders.[28] To be sure, insider loans may have costs.[29] But Jayne Barnard suggests that Congress might have better balanced costs against benefits by examining the terms, purpose, and size of the loan, the company's expectations for repayment, the manner of approval, and the existence and extent of disclosure to investors. In other words, there is a vast difference between the mammoth questionable loans from WorldCom to CEO Bernie Ebbers and many of the other insider loans that SOX outlawed. Even if some regulation were efficient, it would have been better left to the states, which have a variety of strategies for

dealing with these loans. Moreover, federal regulation might have taken several less intrusive forms, including enforcing existing disclosure laws, increasing disclosure, mandating particular approval or collection procedures, and prohibiting certain types of loans.[30]

Instead of this careful balancing of costs and benefits, Congress precipitously responded to the Republicans' need to reduce the damage from disclosures concerning the president's loans many years before, and to pressure from Senator Schumer's populist opportunism.[31]

Congress's action left many questions unanswered concerning the relationship between the loan prohibition and corporate practices currently authorized by state law, including advancement of attorneys' fees and expenses in litigation, agreements facilitating executives' exercise of stock options, and corporate payment of life insurance premiums for executives.[32] Even Sarbanes and Oxley expressed disagreement about whether clarification was necessary.[33] In desperation, after receiving little official clarification, lawyers from twenty-five large law firms drafted their own guidance, only to leave themselves open to a charge that they had violated the antitrust laws.[34] The SEC's Advisory Committee on Smaller Public Companies has recommended that the SEC clarify various aspects of this provision, noting that it has not yet done so.[35] Such confusion and waste of legal talent are additional indirect costs of SOX.

Lawyer Monitoring. SOX section 307 calls for the SEC to promulgate a rule "requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" to the chief legal counsel or chief executive officer, and, if they do not respond, to the audit committee, other independent directors, or the board. This provision was a response to well-publicized reports that Enron's outside lawyers had failed adequately to act on information they had concerning misdeeds within the company.

After SOX, the SEC had to figure out how lawyers could fulfill their reporting obligation. An important part of the SEC's rule was

to permit corporations to set up something called a Qualified Legal Compliance Committee (QLCC) as a reporting mechanism. Two commentators criticized this innovation as "likely to increase the cost to issuers of obtaining and retaining high-quality directors, increase the demands on scarce director time, and . . . interfere with board collegiality and board-management relations."[36]

An empirical study of how the QLCC rule has actually functioned showed that, while the SEC had predicted 3,620 issuers would form QLCCs, the number by mid-September 2005 was only 556, about 3 percent of eligible firms.[37] The main problem, the author found, was that lawyers and directors believed this structure inappropriately shifted responsibility for legal compliance decisions away from the managers, where it had traditionally been, and onto the board, which is not equipped to determine how to handle legal risk. This, of course, means that the board may have to bear legal liability for not acting on risks that are identified by reports to their QLCCs. On the other hand, investment funds and trusts have been more willing to form QLCCs, since those firms do not have separate managerial employees, and they welcome this opportunity for dealing with potential conflicts of interest by their investment advisors. This study sheds light on the main problem with SOX section 307 and, indirectly, on a central problem with SOX: Even if some adjustment in relationships between corporations and their lawyers is justified, by regulating the details of the relationships, SOX risks interfering with structures that are firmly entrenched under state law and current practice, with unpredictable and potentially costly results.

Another potential problem with section 307 is that removing relationships with lawyers from operating management and putting them into the hands of independent directors erects a barrier between firms' managers and the professional advisors these managers must deal with every day.[38] If changes in lawyer monitoring are necessary, there are ways to make them cost-effectively through the structure of professional firms and ethical rules. Clearly, lawyer monitoring not only is a waste of legal talent but also unnecessarily disrupts candid communications and traditional hierarchical relationships.

Monitoring by Corporate Executives. SOX increases monitoring duties of corporate executives by requiring them to certify reports and internal controls. This forces them to immerse themselves in the minutiae of their firms which, as will be discussed, may not be an efficient use of valuable managerial resources. Also, imposing litigation risk on individual managers is likely to make them insist on precautions and paperwork that diversified shareholders would find excessively costly. Thus, the executive certification requirements add to the costs of the internal controls requirements. Moreover, as discussed below in chapter 5, the litigation risk inherent in the certification requirements may contribute to excessive timidity in corporate management. With potentially billions of dollars in liability at stake, the most profitable corporations subject to SOX will be the ones whose executives are well-trained to anticipate litigation difficulties rather than deal with business issues.

Building the Paper Trail. SOX imposes complex new record-keeping obligations on corporations. On the one hand, they have to document everything they do, creating a paper trail of explanations. On the other hand, if there is a fraud and an investigation, some email or other document that was innocuous at the time it was created might be crucial evidence for the plaintiff if, in hindsight, it indicates a problem that should have been pursued. SOX will necessitate the development of a new field of expertise in corporate paper-shuffling. As will be discussed later in this chapter, the need for such expertise will divert managerial resources from more productive skills and tasks.

Whistleblowing. SOX section 806 subjects corporate executives to heightened scrutiny by protecting whistleblowing employees from reprisals. It was created in response to reports of attempts to squelch employee reports of the fraud at WorldCom, and to address the likelihood that many employees eventually will learn about aspects of any massive fraud.

Congress did not, however, sufficiently consider the potential costs of this provision. Most importantly, section 806 essentially

creates a new subtopic in employment law that hinders employers from efficiently monitoring their employees. Workers who "cause information to be provided" concerning a securities violation to the SEC, Congress, or "a person with supervisory authority over the employee," now have job protection under SOX. Given the open-ended language of the provision, an employee can threaten the firm with embarrassment even if his information is less than damning. Firms are likely to be litigating over, for example, when an employee "reasonably believes" that information shows a securities law violation and whether the job action was due to the whistleblowing.

Congress also obviously did not think long and hard over who should administer this new employment law. As it happens, it delegated enforcement to safety and health regulators, who have enough problems handling their main jobs without getting into the brave new world of financial fraud.[39]

Opportunity Costs of SOX

We have catalogued the various problems managers face in the wake of SOX, but we have not yet considered how much all this is going to cost. SOX's drafters and defenders seem to think that managers have plenty of time and energy, and that, as long as they do not have much else to do, they may as well spend time on the tasks SOX assigns to them. In fact, management energy and resources are scarce. What is spent on SOX compliance is not spent on other activities that may be more valuable to the firm and to society. This recalls Milton Friedman's admonition memorialized as "TANSTAAFL"—"There ain't no such thing as a free lunch."[40]

Diversion of Managerial Talent. SOX has demanded the attention of all board members and senior officers of every publicly traded company in America. It is very difficult to measure the opportunity cost of the time devoted to complying with SOX. For example, if a CEO whose annual salary is $1 million estimates that one-quarter of his time is devoted to complying with SOX, an accountant might calculate that the requirements cost the company

$250,000 in the CEO's time. However, the costs are surely much higher. The CEO is paid to add value—much more value than his salary.[41] The SOX mandates mean that the most talented American businesspeople must devote less time to increasing shareholder value than they otherwise would have been able to do, draining precious managerial resources at a time when U.S. businesses are subject to increasing competition from countries that are not saddled with SOX.

SOX not only diverts executive time from important managerial matters, but may be instrumental in diverting the executives themselves. Many executives are leaving public corporations, with their greatly increased risk of SOX liability, for the greener pastures of private equity.[42] The allocation of executive talent should depend on market opportunities, not federal regulation.

From Entrepreneurs to Hall Monitors. SOX is a problem not just for the firms that must incur high costs to comply, but because of the social costs from the business that does not get done and the firms that are not formed. SOX, in effect, represents a political judgment that less risk of fraud or bad business outcomes is necessarily good for society. Some social costs are attributable to the disproportionately high costs SOX imposes on smaller companies, discussed in the next section. The problem can arise, however, because of burdens imposed on larger firms as well.

First, the disproportionate compliance costs per dollar of capitalization for smaller firms impose social costs by discouraging startup ventures. The venture capital market is built on the assumption that successful startups financed by venture capital ultimately will exit from the venture phase into the public securities markets. To the extent that SOX is a tax on smaller public firms, it is therefore also a tax on entrepreneurial ventures.

Second, SOX imposes social costs by causing firms that have already been formed either to go private or to stay privately held. In this situation the owners, at least as a group, take the course of action that maximizes their wealth, given legal costs. However, there may be a social cost to the extent that public ownership of a

firm offers gains to society as well as to the firm's owners. For one thing, public ownership enables diversification of risk, and thereby encourages entrepreneurial activity. Firms need to balance the higher agency costs of separating ownership and control against the advantages of risk diversification. A problem with SOX in this respect is that it forces at least some firms to accept a tax on public ownership for which they would not contract as a way of reducing agency costs. Society also may gain from public or community ownership of certain types of firms. For example, many firms going private in 2004 were community financial institutions, a type of firm for which public ownership may confer a social benefit.[43]

Third, SOX may reduce the flow of resources to riskier firms. Firms whose earnings are relatively variable, that engage in novel or more complex types of business for which the accounting standards are more uncertain, or that use novel business practices such as hedging and derivatives, are all subject to increased liability risk under SOX, particularly because of the greater need for disclosures about internal controls. This is supported by evidence that certain types of firms tend to find internal control problems—younger, smaller firms, and larger firms that are relatively complex and undergoing rapid change.[44] These additional risks may make it harder for them to find high-quality executives, auditors, and outside directors. Top executives may be attracted by more stable firms with lower liability risk, firms in less risky industries, or nonpublic companies not subject to SOX. They also might find jobs with better risk-reward profiles in consulting or auditing, given the need for these services under SOX. In other words, SOX may have the effect of shifting business from innovation and invention to simply looking for fraud.

Fourth, SOX may exact social costs by deterring acquisitions of smaller firms by larger ones. The SOX internal controls disclosure and certification requirements impose substantial burdens on firms acquiring new lines of business. These acquisitions, like going public, may be an important mechanism for financing entrepreneurial activity. They also may have the effect of moving assets to firms that are better able to minimize regulatory risks, or they may help reduce this risk by giving buyers an incentive to investigate risk and sellers

an incentive to reduce it.[45] To be sure, SOX may also increase acquisitions because it increases the advantages firms derive from being big. But this happy circumstance of achieving economies of scale in SOX compliance would likely only occur with the merger of firms that had similar internal controls systems prior to the acquisition. Otherwise, the acquiring firm would have to invest considerable resources in harmonizing the control systems. Moreover, the economics of scale in compliance does not subtract from the costs of deterring acquisitions. Rather, it adds to social costs by encouraging acquisitions that would not be efficient without SOX.

Reducing Smaller Firms' Access to Public Capital Markets. The internal controls rule also places a particularly heavy burden on smaller firms with significantly less benefit to investors. Evidence indicates that smaller and less actively traded firms react more unfavorably to events that increased the likelihood of SOX's passage.[46] In particular, smaller firms have higher overhead costs than larger ones, and therefore must struggle to compete with them. Any increase in overhead imposes an extra burden. Smaller firms compete, in part, through flexibility—the ability to change business plans rapidly to meet customer needs, and to combine functions in single individuals.

SOX delivers a dual hit to these firms by both imposing rigid and inflexible rules and increasing overhead costs. Moreover, these are not merely startup costs of compliance, but ongoing. Thus, it is not surprising to see that internal-controls reporting costs small firms more per dollar of capitalization or revenues than larger firms.[47] This effect is compounded for small firms in the startup phase, for which the risk assessment required by section 404 is likely to be more difficult. This may, in turn, reduce socially beneficial entrepreneurial activity.

Conversely, SOX's provisions, particularly its internal controls reporting, are inherently less beneficial for small than for large companies. The risks posed by small business failure to the economy are lower, since they represent only a small fraction of total market capitalization. Internal controls structures are less useful in small

firms, which rely on top managers for control, and where these managers can, in any event, override internal controls. Given the lower benefits, it is not surprising that smaller firms have been more likely than larger ones to find weaknesses in internal controls when they set up these systems.[48]

The heavy burden SOX imposes on small firms has had the significant side effect of causing these firms to reduce their public ownership to avoid SOX. They can do this by becoming privately held or by "going dark"—that is, reducing the number of nominal public shareholders to below three hundred, which is the threshold for application of the Securities and Exchange Act of 1934, of which SOX is a part.[49]

SOX has clearly caused some firms to go private. This is indicated indirectly by evidence of post-SOX declines in small firms' share prices, and of share-price reactions to going private becoming more positive after enactment of SOX.[50] More directly, a recent paper compares the post-SOX rate of going private among American firms with the rate among foreign firms not subject to the act, thus controlling for non-SOX factors that could have caused firms to go private. It produces evidence consistent with the hypothesis that SOX induced small firms to become private during the first year following enactment.[51]

Why should we care if firms are going private?[52] The liquidity, risk-bearing, and informational advantages of public ownership potentially make them more valuable than they would be if they were closely held. To be sure, this does not mean that all firms should be public, but it does suggest it may be socially costly to, in effect, put a tax on public ownership. The whole point of SOX is supposedly to encourage public ownership by building "investor confidence." Unfortunately, the firms most in need of this "confidence," and therefore the ones SOX is purportedly helping the most, are the smaller, less-established firms that are, in fact, most disadvantaged by it.

Studies also have shown that 200 firms went dark in 2003, the year after SOX was enacted, that more firms went private after SOX, and that 44 of 114 firms that went private in 2004 cited SOX

compliance costs as a reason. There is evidence that firms with higher audit fees were more likely to go dark, further linking going private with the costs of complying with SOX.[53]

Going dark means that firms stay public, since the three-hundred-shareholder minimum for registration includes shares held in "street name" on behalf of multiple beneficial holders. These firms lose disclosure transparency, which may help insiders but hurt outside shareholders who remain in the firm. Two studies show that firms lose share value when they announce they are going dark, and that, especially after SOX, going-dark transactions are positively correlated with insider ownership.[54] Firms might lose value from going dark because this transaction signals that they have fewer opportunities for growth, and therefore less need to make disclosures that would aid in raising capital. Indeed, the studies show that these firms do tend to have weaker growth potential.

But there is also evidence that firms that go dark have characteristics such as lower accounting quality and more free cash, indicating greater likelihood of insider misconduct.[55] In other words, they may have perverse reasons for wanting to avoid disclosure. Even before SOX, insiders could try to avoid disclosure obligations by going private and dark. But SOX's higher disclosure costs now give them a legitimate explanation. Even if this is the real explanation, SOX would be indirectly causing a loss of securities law protection for precisely those shareholders who need it most.

These effects of SOX's requirements on small firms, particularly the internal controls rule, mean that SOX is serving as an entry barrier to public ownership of business firms.

Cutting Off Information

SOX may not only increase firms' disclosure costs, but may also actually reduce the quantity and quality of disclosure in some respects.

Taking the Informed Out of the Loop. By reducing potential conflicts of interest, SOX also severs links that could provide

high-quality information. Most importantly, prohibitions on consulting work by auditors and the required periodic change of auditors reduce potential "knowledge spillovers" between auditing and consulting and truncate the learning process in auditor-client relationships.[56] Similarly, at the director level, directors who have other links with the firm might do a better job recognizing concerns that might arise in audits and the tricks insiders might be playing, and therefore may be more effective members of audit committees, than directors who have "Caesar's wife" independence.

The SOX provision requiring lawyers to "report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" obviously inhibits conversations between lawyers and the firm's agents, as discussed above. Indeed, this issue was thoroughly debated in drafting rule 1.13(b)–(c) of the American Bar Association's Model Rules of Professional Conduct, which rejected a SOX-type approach. Rule 1.13(b) requires the lawyer to "proceed as is reasonably necessary in the best interest of the organization," giving consideration to a variety of factors. This language requires lawyers to exercise professional judgment about reporting facts, and to consider a variety of different actions. With SOX, however, Congress did not hesitate to change radically the relationship between lawyers and their corporate clients.

The question in these situations is whether the benefits of higher-quality information outweigh the costs of potential bad incentives. The answer may vary from one situation to another, which suggests that the one-size-fits-all SOX answer is inappropriate. For example, the amount of information directors or auditors get from their other links with the firm may depend on the complexity or unique properties of the firm's business. Also, the costs of potential incentive problems may depend on the quality of monitoring the firm is getting from other sources. A fully independent audit committee may be enough to ensure that the auditor is doing its job without also prohibiting the auditor from performing nonaudit services.

Reducing Trust. SOX also may reduce information flow between employees by reducing trust and creating adversarial relationships

within the firm.[57] For example, a worker whose conduct was at least arguably innocent or defensible in the light of applicable rules, but did nevertheless hurt the firm, might reasonably fear punishment by overly zealous monitors or whistleblowers and therefore may be reluctant to communicate with them.

Insiders who are closely monitored may become less trustworthy. Some scholars think that legal sanctions "crowd out" the motivations people have to be trustworthy when they are not subject to these sanctions.[58] Also, the widespread dislike of what many corporate employees view as wasted effort and paperwork under SOX might make compliance a kind of game or adversarial process, and thereby discourage cooperation.

The trick, then, is to find the precise balance between sanctions that help ensure that insiders will not rely excessively on underlings, and sanctions that encourage underlings to be more untrustworthy. Again, this is best done on a firm-by-firm basis rather than by one-size-fits-all regulation. And it certainly cannot be done by the sort of rush to judgment that happened in the summer of 2002.

Inducing Cover-Ups. After insiders have committed acts for which they can be held liable, their interests may change from serving the firm's interest in protecting its reputation to serving their own interest in staying out of jail. Although a cover-up also may increase potential penalties, the insider may decide that he has a better chance of avoiding detection. Also, insiders who are facing jail may become less risk-averse and gamble everything on even a small chance of not getting caught.[59]

SOX increases these problems by imposing liability, including criminal liability, even on those who have not themselves engaged in self-aggrandizing conduct, but have certified reports where they had knowledge of internal controls lapses or failed to disclose information to auditors and the audit committee.

Although there is often a correlation between this conduct and more culpable wrongs, in some situations SOX may make criminals out of those who would otherwise be innocent. For example,

section 302 requires officers to certify that they have disclosed to auditors "any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls." Suppose, for example, the officer took office supplies, or knows of an officer or accountant who did, in violation of company rules (perhaps imposed because of SOX). By not disclosing and certifying, the officer has committed a criminal offense, punishable under section 906 by up to ten years in jail. Given these provisions, in future cases executives might find themselves exposed to criminal and civil liability at the time of approving defective procedures, before they knew or could have known that the procedures were being used to perpetrate fraud. When they do find out about the fraud, their existing exposure may induce them to participate in a cover-up.

Perverse Incentives and Undoing Efficient Risk-Bearing

An important effect of SOX is to put an increased burden of the risk of corporate fraud on monitors and gatekeepers such as auditors, lawyers, outside directors, and senior executives. This is true not only of the liability provisions discussed above, but also of provisions like section 304, which requires reimbursement of compensation and stock profits following accounting misstatements, regardless of whether the executive knew of the fraud and even if he exercised all reasonable care in monitoring and instituting controls.

This is questionable policy. As discussed at the beginning of chapter 2, a significant function of the modern corporation is to reduce the costs of risk-bearing by enabling investors to own diversified portfolios of shares. For diversified shareholders, if one company goes down because of fraud, the portfolio is still largely intact. But SOX undoes this advantage by shifting enormous risk back to individuals. Under SOX, an executive who does not take every conceivable precaution against fraud exposes himself to the risk of a personal catastrophe. Even if the executive is protected from personal liability through indemnification or insurance, he

may behave more cautiously than the shareholders would want to avoid the risk litigation poses to his reputation, which he cannot reduce by diversifying.[60]

Nor can the significant risk-shifting in SOX be justified on the ground that the defendants are better able to monitor or take precautions against fraud. In many situations there may be little an auditor or a lawyer effectively can do to prevent or spot fraud. Instead, they might order excessive precaution—more than the shareholders would want if they could make the decision—in order to protect themselves from the risk of ruinous liability. In other words, the same separation of ownership and control that leads to agent fraud also leads to excessive precautions against it. Instead of reducing agency costs, SOX may actually increase them.

Consider the ways that risk-averse executives may respond to the extra risk SOX imposes. They may avoid types of business or transactions that are particularly likely to trigger suspicion and liability in the event of fraud, even if these transactions maximize the value of the firm. These would include, for example, the derivatives and special-purpose entities that attracted so much attention in Enron but might have been valuable if properly managed. Or risk-averse executives may adjust disclosure so as to minimize liability but not necessarily increase accuracy. For example, they may use overly conservative accounting methods, or hedge or qualify disclosures.[61] This may reduce errors like those common in the pre-SOX era, but at the cost of introducing a different type of error. It will not necessarily increase market efficiency because market prices reflect basic asset values and expectations of future cash flows rather than accounting methods.

These incentives to avoid risk excessively might be offset by compensating executives in ways that make them act more like shareholders, such as with options or restricted shares.[62] Yet SOX moves in the opposite direction by banning some types of loans to executives, including loans for buying the company's stock. In this way, it simultaneously creates a problem and limits private contractual solutions to the problem.

Criminalization of Corporate Agency Costs

SOX is one of many examples of the recent trend toward using criminal sanctions to deter and punish social and commercial conduct that traditionally has been subject only to civil sanctions.[63] Although criminalization of all antisocial activities may be politically popular or expedient, there are numerous reasons for questioning the propriety of using such sanctions against many individual and corporate actions. For example, many regulatory crimes are strict liability crimes that do not require the traditional proof of criminal intent, *mens rea.*

SOX's most important criminal provisions are section 807, which increases the criminal penalty for knowingly committing securities fraud, including imprisonment for up to twenty-five years, and section 903, which increases imprisonment for mail and wire fraud from five to twenty years. Apart from increasing the penalties, SOX exacerbates the "over-criminalization" problems discussed above by enabling criminal liability even for those who have not themselves engaged in self-aggrandizing conduct, but have certified reports where they had knowledge of internal controls lapses or failed to disclose information to auditors and the audit committee. In this regard, it is worth noting that the new crimes added by SOX are on top of numerous other criminal sanctions—including the common-law fraud and federal securities laws—that are being used to prosecute former Enron executives Kenneth Lay and Jeffrey Skilling and others. The following discussion covers some of the general problems of corporate criminal liability that SOX makes even worse.

The Folly of Criminalizing Corporate Agency Costs. The challenge of controlling corporate agency costs is at the heart of corporate law and the contractual theory of the corporation. Senior executives and board members are expected to act on behalf of their shareholders. In addition to fiduciary duties under state corporation law, there are strong market incentives for officers and directors to act in their shareholders' best interests. Of course, because monitoring of executive performance is costly, there is always some opportunity for

executives to behave in ways that do not maximize shareholder value. Such agency costs are a fact of corporate organization. Indeed, they are anticipated and reflected in market prices. The market rewards firms that do a better job of controlling agency costs.

If corporations do not control agency costs and maximize share value, several things that are not good for officers can happen. First, the corporation can become the target of a tender offer or proxy battle for control. Second, the corporation will not fare well in its product markets. It will lose market share and may ultimately go bankrupt. And, if agency costs are extraordinary, civil lawsuits may be brought against the board and officers.

Criminal sanctions for violating SOX may actually increase agency costs. A major concern of agency theory has been that corporate managers were not being diligent enough in pursuing their obligation to maximize the value of the firm. For example, managers could simply be lazy. Under SOX, laziness—failure to take the time to evaluate controls before attesting to their adequacy—can result in criminal liability. Although this threat should take care of the laziness part of agency costs, it might create a larger problem—instead of being lazy, managers might focus too many of the corporation's resources on ensuring the adequacy of corporate controls in order to avoid personal criminal liability. That is, in order to avoid criminal liability, the managers are likely to use corporate resources to their own benefit, even though they know it is not in the best interest of shareholders.

The analysis of criminal sanctions explains why corporate executives will tend to interpret section 404 compliance requirements strictly. As long as criminal liability is perceived as a consequence of failure to comply, overcompliance is going to be the norm.[64] The SEC's and PCAOB's suggestions in spring 2005 that auditors back off on their strict interpretations fell on deaf ears in part because criminal liability in a statute is much more powerful than a pep talk.[65]

Weakening the Moral Force of the Criminal Law. Criminal liability for internal controls lapses exacerbates an inherent problem with criminal liability in the corporate governance context: The criminal law loses both its moral force and moral legitimacy if it is

used to discipline behavior that is not clearly distinguishable from innocent behavior or is not regarded by most people as culpable. Thus, even if manipulating corporate transactions to give a misleading picture of the firm is inefficient or morally wrong, it should not necessarily be criminal because it is often difficult to distinguish such behavior from innocent aggressive accounting. It is an even more serious problem if the defendant simply certified the adequacy of internal controls falsely, even if the defendant arguably knew that the precautions were inadequate.

SOX in the Context of Current Prosecutor Practices. SOX's criminal provisions should be analyzed in the context of how federal prosecutors will use their expanded powers to enforce these provisions.

First, SOX helps prosecutors use their broad discretion to coerce guilty pleas by threatening long prison sentences—now increased by SOX section 906—and offering the option of shorter sentences or civil fines. Plea-bargaining defendants then are available to testify against others in their firms. In SOX "internal controls" trials, the plea-bargaining defendants might testify not only about what their codefendants knew about the fraud, but also about circumstances bearing on what they should have known about the inadequacy of controls.[66]

Second, prosecutors are increasingly using their power and discretion to compromise corporate agents' ability to defend themselves against criminal charges by threatening their employers. Although SOX did not create this problem, it exacerbates it by expanding the scope of corporate criminal liability with which corporations and their agents can be charged. Thus, in the wake of SOX, federal prosecutors have more opportunity and leeway to use failure to cooperate with an investigation as a lever to obtain information. Suppose, for example, that a U.S. attorney begins an investigation into the possibility of executive wrongdoing, such as faulty certification of internal controls, perhaps alerted by a SOX-protected whistleblower. Prosecutors may demand that the corporation agree to waive the attorney-client privilege, and object to advancement of attorneys' fees

to defendants. Under an explicit policy, the Justice Department may use the corporation's refusal to "cooperate" as a factor in deciding whether to charge the corporation with criminal violations that could threaten its ability to remain in business.[67] Indeed, KPMG succumbed to just such threats in order to avoid becoming the next Arthur Andersen.[68] Yet, without their employer's support, the employees may not be able to bear the huge costs of defending themselves against a taxpayer-supported government prosecution. At the American Bar Association's annual meeting in Chicago in August 2005, the ABA House of Delegates passed a resolution stating it "opposes the routine practice by government officials of seeking to obtain a waiver of attorney-client privilege or work product doctrine through the granting or denial of any benefit or advantage."[69]

Finally, information that has been pried from the company when either the company or its executives are under the threat of criminal prosecution, even if it does not lead to criminal convictions, may find its way into the hands of civil attorneys, who will then use it against the company.

Auditor Regulation

As detailed above, SOX imposes significant new regulation on auditing firms, including the creation of a new regulatory body with which auditors must register, the PCAOB, regulation of auditing standards, and restriction of ties with clients. This regulation may impose significant burdens on auditing firms. For example, auditors may need to protect themselves from liability or sanction by insisting on routinely checking every piece of information they receive from clients, even if the costs of this type of audit outweigh the benefits to investors in uncovering fraud. Remember that investors in publicly held corporations hold diversified portfolios, which makes it cheaper for them to bear risk than to put it on the auditing firms. Moreover, auditor checking may duplicate fraud protection from other sources, such as inside managers, lawyers, and outside directors.

Rules mandating auditors' financial independence by barring them from performing ancillary services for clients have been

particularly contentious. Because of the auditor independence rules, a firm cannot use its own auditor to advise it on appropriate compliance methods. Rather, it has to use a consultant, which could be another auditing firm, who must compile information about the business from scratch, in order to help set up the system that the firm's auditor will now review. This additional expense for the company does not produce profits for most firms, since it is necessitated solely by the suspicion, unsupported by data, that nonaudit work for clients reduces audit quality.[70] But it is good for accounting firms, since the inefficiency adds to their profits even as it reduces those of the clients. So auditing firms get rich from a law that was intended in part to address their own failures. This regulation was the product of "policy entrepreneurs," particularly including former SEC chairman Arthur Levitt Jr., who strongly advocated it in congressional testimony while disregarding studies that might have reduced the persuasiveness of the testimony.[71]

An additional problem inherent to auditor regulation is that, if auditors must bear some of the risk of fraud or reporting errors, it may be harder or more costly for riskier firms, such as startups or innovative firms, to obtain the auditing they need in order to access the public markets. There have been reports that, following SOX, auditors are dropping clients that are "considered too small to be worth the extra work now required, as well as those judged too risky to work with under the new accounting rules."[72] Thus, a law intended to improve auditing has reduced its availability.

Regulation of Analyst Conflicts

Securities analysts are a crucial source of market efficiency, which is, in turn, an important way to spot fraud and evaluate firms' monitoring and reporting mechanisms. Analysts' links with the investment banking departments of their firms arguably compromise their independence. Section 501 of SOX provides for the adoption of SEC rules intended to address these conflicts. However, ties between analysts and investment bankers may produce information that is otherwise too costly to communicate because of legal

restrictions on disclosure.[73] This regulation decreases information as it increases independence. Thus, the costs of this regulation are likely to exceed the benefits because, among other things, it reduces the effectiveness of market monitoring.

Crippling the "Genius" of American Corporate Law

As discussed in chapter 3, efficient corporate governance rules could evolve in response to Enron and other meltdowns in the absence of SOX through state competition to supply corporate law. Given the potential positive role of state competition in corporate governance reform, it is unfortunate that SOX moves in the opposite direction, toward an erosion of that role. There was once a fairly clear divide between federal law on disclosure and state law on substantive governance rules. The Supreme Court clearly endorsed this distinction in the *Santa Fe* case, which denied liability under the federal securities laws for conduct that was fully disclosed to shareholders.[74] However, since *Santa Fe*, Congress and the SEC have been moving toward greater federalization of corporate governance.

SOX represents a qualitative leap and a significant new threat to state corporate law. Specifically, the act makes numerous inroads into corporate governance issues formerly considered to be quintessentially subject to state control, unrelated to the kind of disclosure rules that were formerly the exclusive province of federal law. Among other things, SOX

- requires complete independence of audit committee directors, along the way providing a new federal definition of director independence;
- directly controls executive compensation by requiring some bonuses to be returned to the company and by prohibiting certain executive loans;
- determines the power of a board committee vis-à-vis the board as a whole, the shareholders, and the managers by requiring that the board's audit committee

control the hiring and firing of accountants and the nonaudit work accountants do for the corporation;

- provides for specific SEC rules on off-balance-sheet transactions and special-purpose vehicles.

The problem of federal interference in state competition is not simply a matter of the federal government ousting the states from particular issues where federal supervision is deemed necessary, such as takeovers in the Williams Act. Rather, the problem is that each federal intervention in corporate governance law increases the general federal presence, has spillover effects beyond the specific federal rules adopted, and increases the threat of future intervention. These effects incrementally reduce both the scope and incentives for state action. As pieces of exclusive state jurisdiction fall away, the states are increasingly constrained in applying a consistent policy framework to interrelated issues such as fiduciary duties and board powers. Moreover, state legislatures and courts have less incentive to undertake major policy initiatives in areas that Congress and the SEC are occupying or seem likely to occupy soon. In other words, entire areas of state lawmaking become "vestigialized," as David Skeel showed has happened for governance of insolvent firms in the wake of federal bankruptcy law.[75] Thus, even if the federal government were able to legislate more efficiently on a particular issue—and there is little reason to think it can after SOX—the federal legislation may be inefficient, given its overall effect on state policymaking in corporate governance.

The executive loans prohibition is especially problematic because it departs so strikingly, not only from the disclosure orientation of federal law, but also from the state law approach of leaving these issues to shareholder and manager voting. It also replaces an active state evolution in this area that has produced several distinct approaches from which firms can choose.[76] As Delaware Chancellor William B. Chandler III and vice chancellor Leo E. Strine Jr. have written,

> By this method, Congress took upon itself responsibility for delimiting the range of permissible transactions that

> corporations chartered by state law could consummate. In itself, the mandate is relatively trivial, but its precedential significance may not be. What's next? A ban on going private transactions? Or on options-based compensation of executives? Or on interested transactions?[77]

Moreover, apart from the areas of specific invasion of substantive rules, the internal controls reports under SOX section 404 invade a developing area of state law on directors' duties to ensure that

> information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[78]

Although most Delaware corporations have taken advantage of a Delaware statutory provision to waive the duty of care, which would implicate this duty, Delaware courts have been developing a "good faith" duty that theoretically could embrace a duty to develop information and reporting systems. Alternatively, the Delaware legislature could decide explicitly to adopt a nonwaivable duty in the wake of Enron. But SOX effectively precludes these state law alternatives.

The costs of the creeping federalization of corporate governance include the ousting of the expert Delaware courts from the ability to develop detailed policy on a case-by-case basis, and the loss of the opportunity states offer for proposing a variety of approaches to difficult governance issues. Chandler and Strine note that SOX and other reforms adopted in 2002 following Enron substituted a rigid, one-size-fits-all federal approach for Delaware's "principles-based" approach:

> The Delaware approach has tended to create incentives for particular good governance practices, yet also recognizes

> that what generally works for most boards may not be the best method for some others. The fiduciary duty form of accountability is well-suited to this sort of flexibility because it is context-specific in application. But because the 2002 Reforms naturally take a more rule-based form, they come with the risk of codifying (by statute or contract) an array of procedures that, when implemented in their totality, might be less than optimal.[79]

The different approaches of federal and state law sometimes may force a collision. For example, in *Newcastle Partners L. P. v. Vesta Insurance Group Inc.*, the Delaware Court of Chancery refused to allow the company to delay its annual meeting to give its accounting firm time to supply audited statements required by the SEC. The court said,

> There are, of course, some circumstances in which a state's governance of internal corporate affairs is preempted by federal law, but those instances are rare, and occur only when the law of the state of incorporation is "inconsistent with a national policy on foreign or interstate commerce."[80]

As federal law makes further inroads into state governance law, these confrontations are likely to become more frequent.

The conflicts threaten to impose a federal perspective on corporate governance, in sharp contrast to the perspective that has emerged from decades of lawmaking in Delaware and other states. Thus, in contrasting the emphasis of Congress and the SEC on the "ordinary investor" with Delaware's more realistic understanding of the important role of institutional shareholders, Delaware chief justice Myron Steele has said that

> increasingly institutional shareholders dominate the market. Do they need an advocate in DC wedded to prescriptive regulation or can their complaints, if any,

> be as readily and more equitably addressed by private ordering in State civil law litigation on a case by case contextual environment? Moving corporate governance to DC means increased costs with little effort to determine benefit, an arena for dispute resolution decisionmaking that is not unbiased and portends no guarantee that the guidelines, regs or pronouncements from the banks of the Potomac will enhance long term shareholder value. Those who advocate a drift from the common law resolution of disputes by a highly trained and experienced cadre of jurists to the bureaucracy in DC should be careful what they wish for.[81]

More often than direct confrontation, federal law will cause subtle changes in state law, or make this law more indeterminate. For example, the SOX approach, particularly including its rules on director independence, apparently has had the effect of destabilizing Delaware law. Vice Chancellor Strine predicted immediately after SOX was passed that federal law would pressure state courts to consider personal, social, and professional relationships in assessing director independence.[82] One writer documented state decisions citing SOX, noting that during 2003, the Delaware Supreme Court sharply increased both the number of reversals of chancery court rulings and results favoring plaintiff shareholders.[83] Another discussed how the chancery court, apparently responding to SOX, expanded the state definition of director interest to move closer to the federal standard, though the supreme court apparently limited this to the sensitive context of special litigation committees.[84]

Of particular interest in this respect is SOX's apparent effect on the shifting results in the Disney litigation involving Michael Ovitz's employment contract and termination. Prior to SOX, the Delaware courts had dismissed a shareholder complaint against the Disney board.[85] On remand, following SOX, Chancellor Chandler refused to dismiss the amended complaint.[86] But then, two years later, after a lengthy trial, Chandler denied all relief.[87] To be sure, the shifts were not clearly attributable to SOX.[88] However, it is reasonable to

infer that these shifting outcomes in the same highly publicized case were at least partly attributable to the Delaware courts' concerns about further corporate law in the wake of SOX.

To the extent that federal law is causing a shift in the Delaware law on director independence, and even apart from the problems inherent in decreeing a single norm from Washington, this shift is likely in the wrong direction. Chandler and Strine note that SOX forbids a director affiliated with a substantial shareholder to serve on the audit committee. They point out that this restriction may apply to the representatives of venture capital or leveraged buyout firms:

> This incentive system is contrary to much good thinking in academia and in Delaware decisional law, both of which have taken the view that independent directors who have a substantial stake as common stockholders in the company's success are better motivated to diligently and faithfully oversee management.[89]

The judges are also concerned that, as the federal prohibition on ties with officers creeps into state law, it

> could have an unfair effect if extended into the litigation context without appropriate sensitivity. There may well be situations in which the CEO of a company is entirely capable of acting "independently" on an issue because his management status (and presumed desire to keep it) has no bearing at all on his incentives. . . . Well-qualified people may be dissuaded from serving on boards, to the resulting detriment of stockholders.[90]

In short, SOX could have significant negative effects in eroding the competition among the states to supply corporation law—what Roberta Romano has called the "genius" of our corporate law system.[91] The effect cannot be blinked away by arguing that SOX's interference with state law is only on specific issues. This federal intrusion, when coupled with the federalization that had preceded

SOX and the threat SOX poses for the future, could seriously weaken the viability of state corporation law. SOX harms a major institutional framework that has generated effective corporate governance for over one hundred years. Combined with the discussion of its manifest defects, there is strong reason to believe that the costs of SOX's adverse effect on the development of state law outweigh any benefits of an increased federal presence in this area.

Chasing Away Foreign Firms

The effect of SOX on issuers not based in the United States is a classic example of the nonobvious, and even unintended, consequences of the act. Its application to non-U.S. firms was not debated and scarcely mentioned during Congress's brief deliberations. Yet SOX's new substantive governance standards and liabilities impose especially high costs on foreign firms trading in the United States.

The most attention has been given to the SOX requirements for independent audit committees. The SEC rules interpreting this provision exclude from the audit committee any "affiliated person," defined as one who "controls, or is controlled by, or is under common control with, such issuer."[92] This is a problem for the vast majority of non-U.S. firms that are controlled by one or a few large shareholders.[93] The act is particularly problematic for firms subject to the laws of Germany and other countries that require two-level boards consisting of a managerial unit and a supervisory unit. German companies with two-level boards appoint the auditor at the shareholders' annual general meeting, upon nomination and determination of the auditor's independence by the supervisory board.[94] Thus, complying with SOX may conflict with the shareholders' appointment power under German law. SOX's excludes anyone who receives a "consulting, advisory or other compensatory fee from the issuer" or is "an affiliated person" of the issuer,[95] which may include most labor members of the German supervisory board. And SOX may exclude others who have relationships with the company, including representatives of

banks and other large shareholders who have significant monitoring functions in German firms.

Other SOX provisions may conflict with foreign firms' home-country law. Just as its executive loan prohibition goes further than many state laws, it also conflicts with foreign laws, such as German law, which permits loans approved by the supervisory board. Also, SOX requirements for executive certification of reports and supervision of internal controls, as well as other rules imposing liability on executives and requiring return of executive compensation paid during restatements, may conflict with laws in other countries, such as Japan, that provide for hierarchies different from the simple triangle in U.S. firms. Not only might it be difficult to identify which people the act covers, but SOX provisions may be inappropriate in these countries because executives are less powerful and less in need of policing.[96] Also, SOX provisions requiring monitoring by and independence of lawyers and other professionals may not make sense in countries where the professionals lack independence from clients. Indeed, SOX's entire scheme for regulating the internal governance of firms may make little sense in firms that rely on monitoring by large shareholders rather than fiduciary duties and other regulation.

The differences between SOX and foreign law may arise unexpectedly. For example, the SOX whistleblowing provisions, which provide for anonymous tips, may conflict with European privacy laws.[97] U.S. companies operating in Europe may be forced either to comply with SOX or to comply with local law. Even worse, European Union data-protection laws are applied differently in each of the EU's twenty-five countries, making it even harder for U.S. companies to comply with SOX.

SOX, therefore, imposes significant costs on the non-U.S. firms to which it applies.[98] This includes not only firms that have elected to trade in the United States, but subsidiaries of U.S. firms.

The anecdotal evidence shows that SOX is taking a toll on the trading of foreign securities here. For example, John Thain, CEO of the New York Stock Exchange, reported that for two years after SOX was passed, new cross-listings fell to half the annual totals prior to

the act. New York's share of new stock offerings of foreign companies dropped from 90 percent in 2000 to 10 percent in 2005, in large part because of the high costs SOX imposes on foreign firms.[99] Meanwhile, London is pressing its regulatory advantage by offering a special low-cost market (AIM) for smaller companies just as the United States, through SOX, is raising costs for these firms.[100]

The reduced presence of foreign firms in the United States causes significant problems in the U.S. market. These include both reduced income to the U.S. securities industry and reduced access of U.S. investors to foreign firms, because of the higher costs of trading foreign firms on foreign markets. This phenomenon is hurting the "ordinary investors" about whom Congress and the SEC always purport to worry, since professionals can always buy shares in London.

SOX's defenders initially relied on the idea that there were no hard data on the effects of SOX on foreign firms and cross-listings,[101] and the inconclusive fact that firms were continuing to cross-list in the United States. However, harder evidence of SOX's effect on foreign firms has now become available. Kate Litvak has shown that stock prices of foreign companies cross-listed in the United States declined during key announcements indicating the act's application to foreign issuers, and increased in reaction to announcements qualifying application of the act. These reactions were strongest for European companies and companies from high-GDP countries—that is, firms from a relatively high-quality institutional environment.[102] Litvak controls for economic and political factors by, among other things, comparing companies within a given country that are, and are not, cross-listed.

Not surprisingly in light of these facts, non-U.S. firms complained loudly soon after SOX was passed. From the beginning there has been some concern that SOX would threaten cross-listings.[103] Foreign firms have continued to react, particularly to the SOX internal controls certification. Some firms, spurred by the approaching application of this rule, want an exemption for foreign firms that have less than five percent of their share volume trading in the United States, rather than the three-hundred-shareholder rule that now applies.[104]

The effect of SOX on non-U.S. firms has triggered a political dynamic that may have far-reaching consequences. This began when the United States responded to criticisms from German and other companies by issuing a rule that partially exempts foreign firms from some SOX requirements.[105] The rule, among other things, permits nonexecutive employees in foreign-based issuers to serve as audit committee members, large shareholders to send observer representatives, and foreign firms to substitute for the audit committee a board of auditors or similar body whose independence and responsibility for appointing and overseeing the firm's auditor is provided for in home-country legal or listing provisions.[106] Also, the SEC has clarified that the SOX prohibition on trading during pension blackouts applies only to foreign firms' principal executive, financial, and accounting officers;[107] that lawyers' duties under SOX do not apply to foreign attorneys who are not admitted in the United States and do not advise clients regarding U.S. law;[108] and that the SEC has delayed until 2006 the application of internal controls reporting to foreign firms.[109]

These rules raise the question of how far the SEC can go in exempting foreign firms before triggering significant complaints from their U.S. competitors in the U.S. capital markets. The exemptions undoubtedly are attributable to some extent to the fact that foreign firms are much better able to exit the U.S. market than U.S.-based firms. The latter may be subject to U.S. laws even if they trade overseas, and they have other business reasons for needing to trade in the United States. To the extent the exemptions are, or should be, based on the costs of compliance, they arguably should apply to any firm that is incorporated under and must comply with the corporate law of another country, regardless of where the corporation's operations are based. But any such exemption would invite U.S. firms to avoid U.S. law by incorporating elsewhere. To the extent that such competition forces U.S. regulators and legislators to reassess the damage they have done to American securities markets, such exits by U.S. firms could ultimately help correct the SOX mistake.

5

The Litigation Time Bomb

SOX's defenders say that the main problem with SOX is the cost of filling out forms, that for big firms this is mainly a startup cost that will be fixed as firms adjust, that the SEC can fix the bigger problem for small firms by exemptions or modifications of the rules, and that the remaining costs are outweighed by the benefits. As discussed in the preceding chapter, this is unduly sanguine. Even from a paperwork perspective, SOX threatens to cause a major restructuring in how firms do business. The problems become even more serious if one considers SOX from the perspective of the litigation it will trigger a few years out.

This chapter explains that a SOX litigation "time bomb" will explode with the next major stock market adjustment because SOX not only provides new causes of action; it also appears to make proving liability relatively easy by tracing the decline in market price to some inadequacy in internal controls. Similarly, SOX litigation "time bomblets" will be triggered whenever a specific industry or sector suffers a downturn. Shareholder litigation on this scale should not be confused with investor protection.

A Review of Liability Threats under SOX

The biggest liability threats under SOX arise under sections 302 and 906. As detailed above, section 302 requires officers to certify not only the accuracy of the financial statement, as they were required to do even before SOX, but also that they have

- designed "internal controls" that ensure material information is "made known" to the officers;

- evaluated and presented their conclusions as to the effectiveness of these controls as of at least ninety days prior to the report;
- disclosed to the firm's auditors and board audit committee "significant deficiencies" in the design of the controls that could affect processing and reporting of financial data;
- identified for the auditors "material weaknesses in internal controls" and "any fraud, whether or not material" involving employees "who have a significant role in the issuer's internal controls";
- indicated "significant changes in internal controls or in other factors that could significantly affect internal controls" since the last evaluation.

The SEC has further articulated executives' internal controls reporting obligations. According to the SEC

> The assessment of a company's internal controls over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include, but are not limited to controls . . . related to the prevention, identification, and detection of fraud. The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, inquiry alone generally will not provide an adequate basis for management's assessment.[1]

As discussed above, the assessment "must be supported by . . . documentation, regarding both the design of internal controls and the testing processes."

Violation of these provisions is treated the same as violations of other securities law provisions.[2] That would include private

class-action suits under the general antifraud provisions of the securities laws, including section 10(b) of the Securities and Exchange Act of 1934 and rule 10b-5, for false certifications. The SEC has already indicated the potential for personal liability for false certifications in an administrative proceeding against Richard Scrushy, former CEO of HealthSouth, and the firm he founded, for false certifications under the requirements of pre-SOX law.[3] This case illustrates that the concept of executive certification of reports is not new to SOX. What SOX added is the potential for liability, not only for knowing of untruths as to the actual numbers, which is what the SEC claimed against Scrushy, but also for knowing about bad processes that ended up producing bad numbers. SOX section 906 includes the bracing addition of criminal penalties of up to a fine of a million dollars and ten years in prison for one who certifies under this section "knowing" that the periodic report does not comply with the section's requirement, or five million dollars and twenty years for "willfully" certifying with this knowledge.[4]

Using 20/20 Hindsight to Assess Risk

SOX cases will turn on whether a problem (almost certainly a precipitous drop in share price) occurred because of a "significant" deficiency or "material weakness" in controls that the executives should have reported to the auditors, or because of a gap in an internal controls system that the executives had assessed in the certified report as adequate. SOX takes care of the case in which senior executives arguably build a wall between themselves and the fraudsters deliberately. But there are serious problems with applying these standards where the executives have not been deliberately fraudulent. To begin with, as Harvey Pitt has pointed out, even a tiny possibility that a flaw in the system could permit a very serious event such as destruction of the company could be "material," taking into account the magnitude of the potential problem.[5] There is also a question of which "controls . . . related to the prevention, identification, and detection of fraud" will be deemed to have been necessary to prevent the new kinds of fraud

arising in future cases, particularly if the fraud originates deep in the organization.[6]

Even if courts and the SEC are ultimately reasonable in applying these provisions, their reasonableness might come only after considerable litigation expense. As Pitt observes:

> In a litigation following the discovery of an error and using 100 percent hindsight, the plaintiff's attorney isn't going to draw any distinction between probability and fact. As a result, a one-in-one-thousand event and incidents of higher probability are treated the same. Management must deal with both with the same degree of response. This creates considerable uncertainty for accountants during an audit and leads them to stress caution at the expense of cost.[7]

One might argue that SOX prevents excessive liability by requiring only that the certifiers know of weaknesses or deficiencies in internal controls. This "scienter" requirement might work, at least to some extent, if the question were whether the managers knew of the fraud. But, as emphasized above, SOX moves the culpability back a step, to whether the executives knew of deficiencies in the procedures for spotting fraud. The managers may well have known at the relevant time about a particular characteristic of the internal controls system that they assessed as adequate, and even that this characteristic might fail to spot fraud under some circumstances, but not that this gap was a sufficient problem that it needed to be rectified, or that it was a "significant" deficiency that needed to be identified for the auditors.

SOX is likely also to lead to litigation under state fiduciary law, either on the basis that federal law affects the application of state duties, as by defining director independence, or through a claim that violation of the act injured the firm.[8] Moreover, as violations of law, these claims arguably would be nonwaivable under Delaware law.[9]

Litigators' Incentives

Since, as we have seen, these new provisions eliminate the troublesome need to prove knowledge of actual fraud, civil trial lawyers and government attorneys have strong incentives to bring cases under them. The trial lawyers do not necessarily have the interests of shareholders or investors in mind, since risk-averse defendants (officers and directors) face incentives to settle even dubious cases, particularly if their indemnification or insurance depends on an unfavorable outcome.

One can hope that courts will filter out the worst cases, particularly by dismissing them on the pleadings or other preliminary stage. But courts face the perennial problem of the hindsight bias. To be sure, courts appear to be dealing with this problem by expressing a reluctance to find what they have called "fraud by hindsight." But, as Gulati, Rachlinski, and Langevoort have shown, the cases applying this approach actually are using the rationale to justify management of what they subjectively conclude are weak cases, without dealing realistically with the underlying bias problem.[10] Thus, there is no reason to believe that this doctrine, developed for the specific context of determining the existence of fraud, will be adequate to deal with the new issue under SOX of whether senior executives wrongfully certified the processes for preventing fraud. Even courts that are supposedly wary of fraud by hindsight may well impose liability for precaution by hindsight—that is, the failure to protect *ex ante* against frauds that have become obvious only later.

It may be that courts will impose civil and criminal liability for SOX violations only against corporate thieves and defrauders, as in past cases. If so, these problems may not be serious. But that is to say that SOX is not pernicious only if it is ineffective.

The Potential for Blackmail

SOX creates an ideal scenario for "litigation blackmail," in the sense of inducing settlements for more than the value of the claim, because individual officers and directors face the threat of heavy

discovery costs and potentially ruinous liability. This is particularly serious in light of the fact that, even before detonation of the SOX time bomb, securities class action settlements rose on an inflation-adjusted basis from $150 million in 1997 to $9.6 billion in 2005, with the average settlement size increasing sevenfold during this period, despite the enactment in 1995 of the Private Securities Litigation Reform Act intended to rein in securities class actions.[11]

The increased likelihood of blackmail is evident from several characteristics of post-SOX litigation. First, the event triggering litigation is likely to be a large and public loss of shareholder wealth, providing an opportunity for exaggerated damage claims. Plaintiffs may be able to bring "fraud-on-the-market" claims, in which all investors who traded during the period in which facts were not disclosed can recover the difference between the price at which they traded and the value as measured by the price adjustment when the facts were disclosed.[12] The damages are highly likely to exceed any realistic estimate of the loss by shareholders as a whole because, among other things, it is rarely clear how much of the price adjustment on disclosure can be attributed to the misrepresentation, and the damages are not offset by the gains of the investors with whom the plaintiffs traded.[13] Moreover, damages based on the price decline following disclosure might be significantly increased by a sort of feedback loop—the risk of litigation over the disclosure itself increases the price decline.[14]

Second, liability may turn not only on outright theft or lying about basic facts, but on whether executives certifying the firm's disclosures should have known about certain risks and the need for controls to deal with them.

Third, to the extent that plaintiffs sue both managers and the corporation itself, the actions may harm even some of the investors on whose behalf the action is brought, to the extent they are shareholders in the defendant corporation. The significant risk of liability and the potential for extravagant damages may induce managers to enter into settlements on behalf of the corporation that are not in the shareholders' interests. Since plaintiffs have little information about the facts when the complaint is filed, defendants can be

expected to win most cases. Diversified shareholders therefore would prefer to settle very few cases; they are willing to take the risk of the occasional loss. particularly since the corporations in their portfolios will be plaintiffs about as often as they will be defendants. Individual defendants, on the other hand, stand a chance of losing everything in every case, and therefore have a strong incentive to settle, particularly if settlements (but not adjudications of liability) are covered by indemnification or insurance.

Fourth, litigation may cause significant distraction, as executives and staff must prepare for trial and comply with burdensome discovery requests. These costs are part of the calculus executives must take into account when deciding whether settling even a weak lawsuit is in the company's interest. Moreover, executives have an extra incentive to settle lawsuits to avoid the personal stress and embarrassment of litigation.

What Can Shareholders Do about the Time Bomb?

Although the litigation time bomb is ticking loudly enough for anybody to hear, there is not much shareholders can do to avoid it. Although shareholders can minimize the risk of managerial malfeasance, they cannot diversify away firms' compliance costs. Although firms have varying risks of fraud, the risk of SOX litigation forces all firms—good and bad—to incur excessive compliance costs. For this reason, rational shareholders would probably rather take their chances with good old-fashioned fraud and theft than the litigation lottery created by SOX.

6

The Bottom Line: Has SOX Been Worth It?

SOX's defenders claim that, despite all of the havoc the act has wrought, it has been worth the cost for curtailing the terrible frauds that led to it. We have shown that much of this could have been accomplished without federal intervention, and that SOX's costs have been more subtle and extensive than its defenders have suggested. This chapter discusses what we know so far about whether SOX's supposed benefits outweigh its costs.

Since SOX, several studies have shown its overall effects. The most direct evidence is the effect of its enactment on firms' market value. These studies, several of which were analyzed by Romano, generally indicate that the market has reacted negatively to the adoption and implementation of SOX, though the results are inconclusive because it is difficult to infer causation when the law affects every stock in the market.[1]

The most extensive and persuasive study of SOX's costs estimated the loss in total market value of firms around legislative events leading to the passage of SOX at $1.4 trillion.[2] The study specifically found that the market reacted negatively to the restriction of the provision of nonaudit services, provisions relating to corporate governance, and the internal controls provision. Firms with "weak" governance declined as the likelihood of passing tough SOX rules increased, indicating that investors thought the costs of such rules to poorly governed firms would exceed the benefits. In other words, if SOX were effective in protecting shareholders, then the market prices of firms with weak governance would have increased with its passage. Instead, the prices declined, suggesting that SOX does not protect even the investors in poorly governed corporations.

An earlier study showed that enactment of SOX was associated with positive stock returns.[3] Also, the study found no significant differences between SOX's effects on firms that had been managing earnings or had fully independent audit committees, and those on firms that had not. This indicates that the market did not expect SOX reforms in these areas to be meaningful.

Another study found that the SOX governance rules had a positive effect on the value of large firms, but no significant effect on small firms.[4] A third found that events "favorable" to SOX's enactment were associated with positive stock returns, but that firms that were better governed before the act did better after SOX.[5] This is generally consistent with the distinction between well and poorly governed firms in the first study discussed above. It is not clear what it means, however, since the better-governed firms arguably had both lower compliance costs and lower benefits from the SOX reforms. So the numbers could just mean that the firms that were already paying a lot for governance did better after SOX than their previously more efficiently managed rivals, who were now forced to incur higher costs.

All of these studies are highly sensitive to the events selected for measuring stock price effects. The studies that find positive returns associated with events favorable to SOX enactment include a period of rising stock prices that occurred after the market passage of SOX had been assured, and therefore probably after the market had registered the act's effects. By contrast, the study that finds significant negative stock price effects more realistically focuses on an earlier period of sharp market declines around the time when events such as President Bush's July 9 call for strong legislation made it evident that strong legislation would pass.

There is also evidence of positive market-price reaction to the SOX executive certification requirement.[6] Another study shows that firms' share prices did not react to certification, suggesting that the market could separate good from bad firms without certification.[7] Romano analyzes two of the studies in detail and concludes it is difficult to draw "any definitive conclusion" from them.[8]

There are several reasons to have serious doubts about whether SOX can be worth these high costs. First, there is evidence that the

market simply does not care that much about the information SOX is extracting at such high costs. A study has found that firms disclosing internal controls weaknesses have a slightly higher cost of equity, but that this difference is mainly associated with general economic characteristics of the disclosing firms, except for a few that delayed their SOX 404 disclosures.[9] Further studies of this sort may provide additional information about the impact of the disclosures.

Second, there is the serious question whether the disclosures will have their intended effect of preventing fraud. For example, the recent Refco bankruptcy unfolded after disclosure that its CEO owed the firm $430 million. Neither SOX nor the intensive disclosure required in an initial public offering could protect investors. The prospectus did not disclose that the company's "receivables" were owed by its CEO or other "related party," since the identity of the debtor was disguised by cycling the loan through a customer.[10] The lesson is that all the disclosure in the world, including the detailed disclosures SOX requires of internal controls, cannot prevent fraud, even in a relatively small organization. And if businesspeople were not deterred from willful fraud prior to SOX by the risk of long jail sentences or fines under prior law, increasing the terms, raising the penalties, and extending the scope of liability to include failure to prevent fraud will not accomplish this, either. These changes are more likely to deter honest people from engaging in risky but productive businesses than they are to prevent dishonest people from circumventing the law.

Third, even if SOX elicits information that is valuable to rational and informed investors, it is unrealistic to expect that this will prevent another Enron-type bubble. During the boom that led to SOX, even sophisticated investors ignored ample warnings, such as the fact that WorldCom was repeatedly meeting its projections to the penny. They also ignored the warning of a hedge-fund manager that Enron had become a derivatives speculator with unhedged investments.[11] They bid Enron up to fantastic price-earnings multiples despite the obvious risk that its business, even if legitimate, was very vulnerable to competition. Investors were susceptible to confirmation and conservatism biases that led them to discount evidence inconsistent with

the sky-high expectations engendered by the long-running bubble market.[12] More information alone cannot prevent these judgment errors. Even if it were possible to pound investors until they understood the risk, this might just drive them in the opposite, equally unrealistic, direction, particularly in bear markets.

In short, all of the mountains of information and inconvenience produced by SOX cannot prevent another Enron. The only thing that might have some effect is for investors to be more knowledgeable, careful, and skeptical, and to learn from their mistakes. As will be discussed in chapter 8, investor education holds out some hope. But SOX moves in the opposite direction, towards miseducation, by offering the false hope that Congress and the SEC have found the magic bullet that prevents fraud.

7

Immediate Policy Implications

The preceding analysis supports the overwhelming conclusion that SOX was a colossal mistake. By any reasonable standards of public policy analysis, the act should be repealed. In a recent survey, 58 percent of corporate directors in the United States favored repealing or overhauling SOX.[1] However, despite the mounting evidence and criticism, repeal is highly unlikely. Even if society is losing, the act retains the support of influential interest groups and the press. The big losers, such as entrepreneurs, are less organized and therefore less influential.

There is, however, a possible avenue to change. A favorable court decision in a recently filed lawsuit could provide the leverage to enact some major changes in SOX. On February 8, 2006, the Free Enterprise Fund filed a lawsuit alleging that the PCAOB violates the appointments clause of the Constitution because its members need to be appointed by the president or heads of executive branch departments rather than the SEC.[2] This suit has the potential to overturn all of SOX, which lacks a severability clause. If the plaintiff prevails, however, the courts are likely to give Congress a window of opportunity to fix the act. Although political reality makes it unlikely Congress will repeal SOX, lawmakers may be able to seize the opportunity to fix the act's worst flaws.

It is, therefore, worth discussing the changes Congress should consider if it has the opportunity or inclination. These changes might turn SOX from a debacle into a model for future federal regulation, along the lines of suggestions we will offer in chapter 8. Although some changes could be adopted by the SEC[3]—and, indeed, Congress could be expected to delegate significant authority

to the SEC—the SEC needs Congress to authorize and guide significant revisions. Indeed, it is not even clear that the SEC has the authority under current law to adopt the changes it is considering.[4]

Defuse the Litigation Time Bomb

As detailed in chapter 5, SOX created a litigation time bomb that will explode with the next major market downturn. All of the perverse incentives of SOX are exacerbated by this threat. Congress can prevent this by amending the act to provide that violations of SOX cannot be redressed by private lawsuits.

Congress has acted before to curb excessive litigation against corporations. For example, in 1995, Congress passed the Private Securities Litigation Reform Act, which attempted to curb abuses in securities class action litigation by eliminating so-called "professional plaintiffs" and instituting pleading standards that were more stringent. In 2005, Congress passed the Class Action Fairness Act, which attempted to control forum-shopping in favorable "magnet" state courts by permitting removal of many class actions to federal courts.[5]

In support of an amendment addressing the litigation risk from SOX, Congress can cite language in the Supreme Court's recent *Dura* opinion.[6] The Court noted:

> Allowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about harm of the very sort the statutes seek to avoid. . . . It would permit a plaintiff "with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence." *Blue Chip Stamps*, 421 U.S., at 741, 95 S.Ct. 1917. Such a rule would tend to transform a private securities action into a partial downside insurance policy.[7]

Thus, removing the litigation time bomb—a modest, but very important, reform of SOX—may have significant political and legal traction.

Allow Opt-Outs or Opt-Ins

Congress demonstrated in SOX that it simply could not foresee the full effects of sweeping corporate reforms. This is an important reason corporate governance has generally been controlled by state, rather than federal, law. If a state makes a mistake, firms can, in effect, opt out by reincorporating in another state. If Congress makes a mistake, firms can avoid it only by the far more costly route of moving their activities and capital-raising offshore. This suggests that Congress might minimize the risk of imposing unanticipated costs—that is, the costs of miscalculating the impact of its regulation—by permitting firms to opt into or opt out of at least some of SOX's provisions. Leading candidates for opt-out would be the section 404 internal controls provision and the section 402 prohibition on executive loans.

The argument against opt-out is that this is contrary to the rationale for regulating disclosure through mandatory federal laws. Investors arguably need a certain minimum amount of information to make investment choices, including choices based on applicable governance rules. So, the argument goes, shareholder choice does not work for the very rules that make this choice effective. A problem with this argument, however, is that investors would not be making this choice about disclosure in the dark; they would know, at least, that they would be making a riskier investment because of what the firm may choose not to tell them. Indeed, risk-averse investors might tend to place an unrealistically high weight on this consideration, thereby giving firms an incentive to opt for disclosure. There are more sophisticated arguments for mandatory disclosure, but they do not tell us precisely what disclosures should be required.[8]

Two considerations support making some provisions of SOX, including those noted above, optional. First, as emphasized throughout this monograph, the optimal amount of fraud is not zero. At some point, regulation of fraud and disclosure is so costly

that it is inefficient. The question is, who should decide when that is the case? Even if some mandatory disclosure is efficient, there may be significant debate at the margins. In these situations, it makes sense to let the shareholders decide. The debate raging over the internal controls disclosures indicates that this should be one of the marginal provisions for which opt-out is appropriate. Moreover, this public debate highlights for the shareholders both the costs and benefits of opting out of this particular disclosure provision.

Second, it is important to keep in mind that what is most significant about SOX is the way it veers off from the federal government's traditional concern with disclosure and into the sort of substantive governance provisions that traditionally have been the province of state corporate law. This is certainly true of the executive loan provision. It is also arguably true of some ostensibly disclosure-oriented provisions, like the internal controls provision, that effectively regulate governance. While the provision says only that the firm must disclose internal controls problems, in substance it not only strongly encourages firms to have controls, but effectively requires them to set up an internal framework that enables them to make the disclosure. This is regulation of governance and not merely of disclosure. In at least these cases, and probably others, shareholders should have the same opportunity they have under state law to decide the terms of their investments.

The specific mechanism for opt-out or opt-in could be the very proxy framework that Congress has approved as the basis for enabling shareholder choice. Thus, directors could propose the option in the proxy materials, and would be required by the proxy rules to give full disclosure of the reasons for and consequences of the proposal. Alternatively, shareholders could make an opt-in or opt-out proposal either by sending out their own proxy materials, or by taking advantage of the shareholder proposal rule.[9]

There are additional questions whether any options should be provisions that apply by default unless the firm opts out or that apply only if the firm opts in; the specific procedural requirements for opt-out or opt-in; which provisions would be subject to opt-out or opt-in; and which companies would have the options. Congress

might delegate some of these questions to the SEC, to be determined through rulemaking after notice and comment.[10]

Foreign Firms

Prior to the Enron and WorldCom imbroglios, American capital markets were widely considered the strongest in the world. As discussed in chapter 4, SOX has made American markets less attractive to foreign companies, in part by imposing substantive governance provisions that conflict with these firms' home-country laws. This has provided a significant competitive opening for other securities markets, particularly London.

Congress can address this problem by exempting foreign firms either from SOX generally or from specific provisions, such as the audit committee and internal controls provisions that are so troublesome for many foreign firms. Alternatively, assuming Congress does not make these provisions or the act itself optional for all firms, it can make them optional for foreign firms. This might be the best approach, since some cross-listing foreign firms might actually prefer to "bond" their disclosures by subjecting themselves to the highest level of U.S. regulation.[11]

A potential problem with SOX exemptions and opt-outs for foreign firms is that they might give a significant advantage to the foreign firms over their U.S. competitors, particularly given the high costs of SOX discussed throughout this monograph. One response is that the different treatment is justified on the ground that foreign firms are subject to regulation in their home countries. But U.S. firms might protest that this regulation is weaker—at least it does not include SOX.

This problem might be dealt with by extending the exemption or the opt-out to any firm that is subject to the governance law of another country, irrespective of where it is physically based. Under current rules, whether a firm is subject to U.S. regulation depends on both where the firm is incorporated and organized and where its business, shareholders, and management are located.[12] This would appropriately reflect the key reason for exempting foreign firms. In

other words, this change to SOX, while specifically responding to the need to treat U.S. and foreign firms comparably, might be a modest beginning toward recognizing a true regime of jurisdictional choice.[13]

Exempt Small Corporations

As discussed in chapter 4, SOX presents significant problems for small firms, since their compliance cost per dollar of capitalization is much higher than for larger firms. Moreover, SOX's disproportionate impact on these firms is entirely unwarranted, since the corporate meltdowns that led to it were a phenomenon of large corporations. To the extent that SOX addresses the problems in the latter, its provisions are not necessarily appropriate for small firms. In particular, small firms may have far less need for extensive internal controls provisions throughout the organization. Of course there will be a question as to what the dividing line should be for any "small firm" exemption. As with the provision suggested earlier in this chapter, this might be left to SEC rule.

As with foreign firms, Congress might give small firms the ability to opt into or out of SOX provisions. Small firms might be given this option only for certain provisions that are much more costly or less appropriate for them, such as the internal controls provision. Congress might also provide for a sliding scale in which the act or some of its provisions do not apply at all to the smallest firms, and allow opt-ins and opt-outs for medium-sized firms. This discussion indicates only some of the many alternatives to one-size-fits-all mandatory regulation Congress can pursue.

There is, of course, a question concerning the appropriate cutoff for smaller firms. The SEC's Advisory Committee on Smaller Public Companies has already done significant work on this issue. It has in process a general opt-in proposal that would specifically include the internal controls provision permitting opt-in for the smallest firms, defined as the smallest 1 percent by total capitalization and less than $125 million in annual revenue, and the next smallest 5 percent by total capitalization with less than $10 million in

revenue. The committee's careful proposals reflect consideration of not only the differential reporting burdens and benefits of smaller firms, but also the need for standards that are transparent and relatively easy to apply.

It is important, however, to keep in mind that the Advisory Committee was constrained to operate within the existing statutory framework. Congress's mandate in revising the act, and the scope of any SEC rulemaking power under a revised act, might be significantly broader than what is permitted under current law. Moreover, any proposal to exempt small firms inherently creates a risk of giving firms perverse incentives to limit growth in order to avoid SOX's onerous requirements. Accordingly, the Advisory Committee's proposals cannot solve the problems SOX creates.

Remove Criminal Penalties

As discussed in chapter 4, SOX exacerbates the increasing overcriminalization of corporate law not only by increasing criminal penalties for violation of the securities laws, but by providing new crimes, particularly including those based on certification of inadequate internal controls. The dramatic post-Enron trials and plea bargains demonstrate not only the many powerful pre-SOX criminal sanctions that prosecutors have at their disposal, but also the potential for prosecutorial abuse of these sanctions. These sanctions make the corporate suite a very dangerous place even for law-abiding executives. They may react by avoiding public firms that are subject to SOX, or engaging in conduct that is far more conservative than diversified shareholders would prefer—including excessive attention to internal controls disclosures.

Criminal liability under SOX was one of the clearest examples of Congress's attempting to appease popular sentiment and engaging in symbolic politics rather than careful lawmaking.[14] But the firms and executives who must live under this regime, and the corporate criminal defendants, are not mere "symbols." If Congress has an opportunity to revisit SOX in a calmer atmosphere, one of its first responses should be to eliminate criminal liability under its provi-

sions. To be sure, this would be only a partial response to the general problem of over-criminalization. But it could be an important first step.

Limit Internal Controls Reporting

SOX section 404 goes much too far in penalizing and even criminalizing executives' failure to spot not just problems, but even risks that later happen to turn into problems. If Congress concludes that it must retain section 404, it can at least revise the provision so that it does not impose the huge costs discussed in chapters 4–6. The revised law should clarify that managers can exercise reasonable business judgment about risks to report, and that these risks will be assessed as of the time the report is completed rather than in light of subsequent events.

Leave Internal Governance to State Law

Several SOX provisions amount to a federal takeover of the internal governance of corporations, which has traditionally, and rightly, been the province of state law. These include rules mandating audit committee independence, prohibiting certain executive loans, mandating forfeiture of executive compensation when earnings are later restated, and requiring lawyer reporting of corporate wrongdoing. Congress should consider repealing these provisions and returning these matters to state law, where they belong.

8

The Future: Regulatory Hubris or Greater Humility?

So far, we have shown the high costs and dubious benefits of SOX, as well as the powerful political forces that push for SOX and other corporate reforms. These problems do not represent a one-time regulatory quirk, but rather are inherent in corporate governance regulation. The forces that produced SOX have converged before and can be expected to converge again. The lesson from this discussion is that policy analysts and corporate law scholars need to be prepared for them.

Failure to be prepared can result in much more intrusive regulation with the next generation of "reform." As bad as SOX has been in many respects, it clearly could have gone further. SOX relies mostly on disclosure provisions that can have significant substantive governance implications. Its most invasive provisions, such as the executive loan prohibition, relate only to specific pockets of activities rather than spreading across the range of corporate decision-making.

What might be next? In a recent paper, James Fanto serves up a sobering vision of the future of the largest business firms being saddled with "monitors" employed by the SEC, who keep a close eye on the firm's management.[1] Fanto bases his suggestion on the regulations that already govern banks. This sort of invasive regulation is obviously inappropriate for entrepreneurial business corporations that are not subject to federal deposit insurance. The risk of failure and even fraud is built into any successful capitalist system, and can be shouldered by investors holding diversified portfolios of

shares priced by efficient markets to reflect risk. But while the proposal flops as normative prescription, it might be worth a look as prediction. As long as our political leaders accept the idea that the law should strive to eliminate all risk of fraud to the extent possible—even at excessive cost—we should brace for the next set of reforms when the current ones fail at their impossible task.

It is entirely possible that the next boom and bust will bring the next regulatory panic, and with it another demand that Congress "restore confidence" in the market. The reformers will again step up, forgetting that SOX was supposed to be the law that ends all laws, ignoring the futility of trying to regulate away fraud, and urging yet another try. This time they will have Fanto's, or some similar proposal, queued up and ready to go.

Will the business community put up a united front against further encroachment, as it did not do against SOX? Not necessarily, because, as Fanto points out, it may be better for executives to accept a monitor who tells them what to do every step of the way than to accept the risk of liability when they do not follow the increasingly extensive rules. Fanto says:

> The business community may even find that it is in its interest not to oppose the corporate monitor, if it only recognizes that the regulation of public firm management is already a long way down the paternalistic road, but, at least with regards to enforcement, in a way that is not favorable to this management. Executives and board members are now sanctioned harshly for their faults by the SEC and federal prosecutors without having the kind of relationship with a regulator that might make unnecessary the sting of enforcement.

So the business community may be willing, next time, to accept a long-term "relationship" with regulators, rather than just the casual dating that occurs now.

There is a possible alternative to this dismal scenario. We can try to understand the true costs and benefits of regulation, and regulate

in light of that understanding. This would involve regulators appreciating the significant limitations on government's ability both to eliminate fraud and to anticipate the full consequences of regulation. The following presents some suggestions of what regulating in light of this understanding might look like.

Periodic Review and Sunset Provisions

We have articulated the consequences and costs of SOX that Congress undoubtedly did not expect. These costs may become evident only after the effects of such an act are carefully tested. Important new legislation like SOX provides a sort of laboratory for financial economists. Although some of SOX's consequences and costs should have come as no surprise to dispassionate academic observers, chapter 1 demonstrates that Congress does not act in anything like the relaxed conditions of the ivory tower. Moreover, any legislation poses the risk of costs that no one can anticipate, including that business developments will render legal controls unnecessary.

For these reasons, significant new financial and governance regulation like SOX that displaces and supplements prior regulatory approaches should be subject to periodic review and sunset provisions. Although Congress, of course, can always undertake such reviews, prior experience indicates that it will not. Legislation is a one-way regulatory ratchet. It arises when the conditions for reform are ripe for a regulatory panic. The conditions for a "deregulatory panic" are less likely to develop. Firms learn to live with the extra costs and may not be willing or able to bear the costs of lobbying for repeal, at least in the absence of a regulatory cataclysm. Thus, it is not surprising that SOX sponsor Michael Oxley, despite recognizing that SOX was "excessive" in some respects, and admitting that it had been rushed through Congress, suggested that Congress would not be revisiting the issue, even as to the seriously affected small companies. He said, "If I had another crack at it I would have provided a bit more flexibility for small- and medium-sized companies."[2] In other words, Congress normally does not have "another crack" at regulation. A sunset or review mechanism would change that.

Perhaps Congress can learn some lessons from itself. The USA Patriot Act was passed less than one year before SOX and, like SOX, was passed by an overwhelming majority. Unlike SOX, the USA Patriot Act includes sunset provisions for some of its most controversial provisions.[3]

The Patriot Act's sunset provision forced Congress and the president to reevaluate and debate those provisions, in an atmosphere far removed from the immediate post-9/11 panic. American investors would benefit from a sober reevaluation of SOX. Perhaps the courts will provide that opportunity. For future regulatory panics, Congress would do well to remember the lessons of the Patriot Act.

Certification and Opt-Out Approaches

The law might regulate "humbly" by imposing optional rather than mandatory rules. For example, it could supplement market or private fraud-prevention mechanisms by prescribing a certification regime, and let firms decide whether they want to certify.[4] The government function here would be to provide an organization that could provide a signal of honesty that investors could rely on. But firms can decide for themselves whether the signal costs too much to send. Similarly, the government could prescribe a regulatory scheme but permit firms to opt out as long as they get the requisite approval from their owners and make the appropriate disclosures to investors.[5] For example, the law might, as in the United Kingdom, let firms "comply or explain"—that is, opt out of compliance as long as they explain that they are doing so and why.[6]

Nuanced Regulation

Regulation should take account of differences among firms and regulatory contexts. The best way to do that is to make the regulation optional. If mandatory rules are deemed necessary to fix significant market defects, Congress should focus them on the specific problems that cannot be dealt with by optional rules. It should also design the

rules taking into account differences among firms as to the need for regulation and the costs of compliance. For example, Congress clearly should have scaled costs by firm size, as well as take into account the different internal governance structure of foreign firms subject to SOX.[7]

Investor Education

The corporate frauds addressed by SOX happened in part because of investors' willingness to ignore indications of questionable accounting and to accept extravagant claims about unproven business plans. These problems might be mitigated more cost-effectively by providing some minimal training in the basics of finance.[8] This education might help offset some judgment biases of investors, teach the rudiments of efficient markets and how hard it is for ordinary investors to "outsmart" the market, and warn them of the folly of not investing in diversified portfolios or index funds. Even if investors continue to fall for scams, at least they could be persuaded not to bet their life savings and retirements. For example, instead of trying to rid the market of all potential conflicts, including those that have net benefits for investors and firms, investors might be alerted to the problems of conflicts and then allowed to make their own judgments.[9]

Congress and the SEC could start this education process by ensuring that their own regulatory efforts do not mislead investors into believing that markets are safer than they are.[10] For example, moves toward subsidizing securities research for ordinary investors imply that they should be researching and investing in individual stocks. Shareholders are better off diversified and rationally ignorant.

Deregulation

Some problems in the securities markets could be mitigated by reducing the amount of regulation that already exists. An example is the SEC's regulation of disclosure to securities analysts. Analysts have strong incentives to ferret out information about firms, including information about potential fraud. Congress recognized the

importance of their monitoring role by adding provisions to SOX concerning analyst conflicts.

Yet, prior to Enron, the SEC promulgated regulation FD, which had the effect of hobbling analysts' ability to get information. Regulation FD requires firms that disclose information privately to analysts also to make the information public.[11] This reduces analysts' incentives and ability to research by denying them the ability to have one-on-one conversations with corporate executives. It also reduces firms' incentives to disclose, since there is some information they need not make public, and they would rather not do so. For example, some pieces of information disclosed to trusted analysts might be subject to misinterpretation if released piecemeal to the market.[12] There is evidence that, in fact, some firms have chosen to stop disclosing information rather than disclose publicly.[13] Indeed, regulation FD may have given insiders an excuse to hide from inquiring analysts, where before they would trigger negative inferences by doing so. Thirty years ago, insurance industry analyst Ray Dirks broke the notorious Equity Funding scandal. Regulation FD may have inhibited him from performing a similar function today. Not surprisingly, there is evidence that analysts' forecasts have declined following regulation FD.[14]

Regulation FD is part of the SEC's and former chairman Arthur Levitt's quixotic quest to ensure "fairness" in information. This effort is doomed to failure because inequality of information is a basic fact of the securities markets. If one group is denied the information, another will get it.[15] The main effect of forced sharing of information is not to eliminate inequality but to weaken the incentives to gather and create information on which efficient securities markets rely. Although regulation FD may reduce firms' ability to "buy" analysts' support with exclusive information, it is far from clear that this is a serious problem, given the market's ability to punish biased analysts.

Conclusion

SOX was suspect from the beginning—enacted in haste in the middle of a regulatory panic with almost no deliberation on even its most important provisions, and little or no credible evidence supporting the need for new regulation of any kind.

Laws were already in place to deal with the fraudulent conduct that emerged with the bursting of the millennial bubble. It makes no sense to impose significant new regulation, even if this regulation might reduce fraud, if the costs of it exceed any possible benefit from fraud reduction. In fact, SOX has been horrendously costly, with the best evidence of its effect on market prices standing at almost a trillion and a half dollars.

Some of the costs of SOX are in the form of direct compliance, including the notorious internal controls provision and the burden of finding directors to comply with the new audit committee independence rules. SOX's defenders attempt to fall back on the argument that these direct costs (although much higher than even they expected them to be) will decline in time as firms put compliance systems in place. But even if this is the case, it is only a feeble response to SOX's problems, since we estimate that these direct compliance costs are only about a fifth of the total costs the act imposes.

SOX's indirect costs—both those that have already manifested, and those looming on the horizon—are legion. They include

- the costs of managing in the "climate of fear" created by SOX's myriad new liabilities and rules, particularly section 404, including constraints on managerial risk-taking;

- limits on executive compensation through the insider-loan prohibition;
- the opportunity costs of diverting executives' time from business management to paper management;
- the high costs imposed on small firms, effectively forcing many to forgo public ownership and reducing valuable entrepreneurial activity;
- the reduction in the flow of information and trust in firms by, among other things, turning employees and lawyers into hall monitors;
- the placing of the cost of business failure on corporate executives, thereby undoing the efficient diversification of risk enabled by public securities markets;
- a furthering of the trend toward criminalizing ordinary agency costs, with significant impact both on corporate management and the criminal justice system;
- the placing of significant new burdens and risks on auditors, thereby forcing additional inefficient risk-bearing that makes it even harder for smaller and riskier firms to enter the public markets;
- regulation of securities analysts that reduces their incentives to gather information important to market efficiency;
- interference with state regulation of corporate governance, which has been a significant reason for the success of our capital markets;
- the discouragement of foreign firms from trading in the United States, thereby eroding the U.S. dominance in world securities markets;
- the setting of a litigation time bomb that will explode in the next economic downturn, exposing firms to ruinous litigation from hindsight evaluation of their disclosures in response to SOX's new requirements.

SOX's defenders might persist even in the face of this litany of costs by saying that, despite the huge costs, our capital markets derive incalculable benefits from reducing the fraud that had eroded investor confidence prior to the passage of the act. However, even if we assume for the sake of argument that the risk of fraud is lower now than it was before SOX, it is not clear that this is a result of SOX's provisions or that the market or the states would not have responded on their own if SOX had not been adopted.

Congress should, and may have an opportunity and incentive to, reexamine SOX. Even if the result is not complete repeal, Congress should consider revisions that would reduce the horrendous costs SOX imposes. Possibilities include exempting foreign and small firms, eliminating criminal and civil penalties for violation of SOX, and permitting opt-in or opt-out of at least some of the act's provisions by at least some types of firms.

An understanding of these high costs and minimal benefits, and of the forces that produced this misguided legislation, may help to prevent a regulatory debacle in the future. We make specific recommendations for any future regulation of the capital markets that are suggested by the SOX experience, including optional provisions, periodic review and sunset provisions, and regulation whose scope is more carefully designed and focused. SOX should teach us to respond to fraud in a more measured way, with regulation that works with, rather than against, markets.

Notes

Introduction

1. Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

2. "Learning to Love Sarbanes-Oxley," *Business Week*, November 21, 2005, http://www.businessweek.com/magazine/content/05_47/b3960113.htm (accessed April 10, 2006); Joe Nocera, "For All Its Cost, Sarbanes Law is Working," *New York Times*, December 3, 2005, http://select.nytimes.com/search/restricted/article?res=F00A1EFA39550C708CDDAB0994DD404482 (accessed April 3, 2006); James Surowiecki, "SOXed-In?" *New Yorker*, December 12, 2005, http://www.newyorker.com/talk/content/articles/051212ta_talk_surowiecki (accessed April 3, 2006). For a response to all of these articles, see William Sjostrom, *Ideoblog*, http://busmovie.typepad.com/ideoblog/2005/12/another_prosox_.html (accessed April 3, 2006). For responses to the Nocera article, see Stephen Bainbridge, "Shedding Light on SOX," December 7, 2005, http://www.tcsdaily.com/article.aspx?id=120705G (accessed April 3, 2006). For responses to the *Business Week* article, see Dale Oesterle, "Business Law Professors Square Off over Sarbanes-Oxley," *Business Law Prof Blog*, December 3, 2005 http://lawprofessors.typepad.com/business_law/2005/12/business_law_pr.html (accessed April 3, 2006), and William Sjostrom, "A Silver Lining in Sarbanes-Oxley," *Business Law Prof Blog*, November 14, 2005, http://lawprofessors.typepad.com/business_law/2005/11/silver_lining_i.html (accessed April 3, 2006).

3. See Nocera, "For All Its Cost."

4. The assertion that Congress should be in the management consulting business is laughable and brings to mind President Ronald Reagan's famous quote: "The ten most feared words in the English language are 'Hi, I'm from the government and I'm here to help.'"

5. Michael G. Oxley, "In the Wake of the Sarbanes-Oxley Act," *Ohio Northern University Law Review* 31 no. 3 (2005): 319–24.

6. Arthur Levitt Jr., "A Misguided Exemption," *Wall Street Journal*, A8, January 27, 2006, http://online.wsj.com/article/SB113833559392957970.html? mod=todays_us_opinion%20 (accessed April 3, 2006). As to the role of Levitt and other "policy entrepreneurs" in obtaining passage of SOX, see chapter 1. Also, see pp. 91–92 for more on the proposed exemptions.

7. The different positions of the big and small business lobbies on SOX are discussed below in chapter 1.

8. See AMR Research, "SOX Spending for 2006 To Exceed $6B," November 29, 2005, http://www.amrresearch.com/Content/View.asp?pmillid=18967 (accessed April 3, 2006).

9. Assuming that the $6 billion will continue as an annual payment in perpetuity, and assuming an interest rate of 2 percent, the present discounted value of the direct costs is "only" $300 billion.

10. The complaint may be found at http://www.feinstitute.org/pdfs/FEF%20v%20%20PCAOB%20Complaint.pdf (accessed April 3, 2006). For a discussion of the suit, see "A Matter of Oversight," *Economist* (U.S.), February 18, 2006, 71. For analysis of this issue, see Donna M. Nagy, "Playing Peekaboo With Constitutional Law: The PCAOB and its Public/Private Status," *Notre Dame Law Review* 80, no. 3 (March 2005): 975–1072, available at http://ssrn.com/abstract=622964 (accessed April 3, 2006).

Chapter 1: From Enron to SOX

1. See Samuel E. Bodily and Robert F. Bruner, "Enron, 1986–2001," Social Science Research Network Case and Teaching Paper Series, Darden Case No. UVA-G-0563-M-SSRN, 2002, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=302155 (accessed March 21, 2006).

2. William C. Powers, Jr. et al., Report of Investigation By the Special Investigative Committee of The Board of Directors of Enron Corp., February 1, 2002, http://files.findlaw.com/news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf (accessed March 29, 2006).

3. See Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," *Yale Law Journal* 114, no. 7 (May 2005): 1521–1611. See also Jayne W. Barnard, "Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act," *Ohio Northern University Law Review* 31, no. 3 (2005): 325–58 (also presenting detailed legislative history and background, focusing on executive loan provisions).

4. *Wikipedia*, s.v. "Sarbanes-Oxley Act," http://en.wikipedia.org/wiki/Sarbanes-Oxley_Act (accessed March 29, 2006).

5. For a skeptical analysis of the alleged lack of "investor confidence" leading up to the enactment of SOX, see Peter J. Wallison, "Sarbanes-Oxley as an Inside-the-Beltway Phenomenon," AEI Online, June 1, 2004, http://www.aei.org/publications/filter.all.pubID.20582/pub_detail.asp (accessed April 3, 2006).

6. See chapter 6, below.

7. Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1559; Karlyn H. Bowman, "Sarbanes-Oxley and Public Opinion After Enron and WorldCom," paper presented at the American Enterprise Institute event, "Sarbanes-Oxley: A Review," May 5, 2004, http://www.aei.org/events/eventID.809,filter.all/event_detail.asp (accessed April 3, 2006). Follow "video" link, at 00:13:45, for discussion of data compiled by the Media Research Center.

8. David P. Baron, "Persistent Media Bias," Social Science Research Network Working Paper Series, Research Paper No. 1845, Stanford Graduate School of Business, 2004, http://ssrn.com/abstract=516006 (accessed March 21, 2006).

9. Michael C. Jensen, "Toward a Theory of the Press," in *Economics and Social Institutions*, ed. Karl Brunner (The Hague: Martinus Nijhoff Publishing Company, 1979).

10. John E. Core, Wayne R. Guay, and David F. Larcker, "The Power of the Pen and Executive Compensation," Social Science Research Network Working Paper Series, October 28, 2005, http://ssrn.com/abstract=838347 (accessed March 10, 2006).

11. See, generally, Mancur Olson, *The Logic of Collective Action* (Cambridge, Mass.: Harvard University Press, 1965); Robert E. McCormick and Robert D. Tollison, *Politicians, Legislation, and the Economy: An Inquiry into the Interest Group Theory of Government* (Boston: Kluwer, 1981); Robert Tollison, "Public Choice and Legislation," *Virginia Law Review* 74, no. 2 (March 1988): 339–72.

12. See Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance."

13. See Henry G. Manne, "Economic Aspects of Required Disclosure under Federal Securities Law," in *Wall Street in Transition: The Emerging System and its Impact on the Economy*, ed. Henry G. Manne and Ezra Solomon (New York: New York University Press, 1974), 33–36.

14. See Richard B. Schmitt, "Lawyers' Growth Industry: Corporate Probes," *Wall Street Journal*, June 28, 2002, B1 (discussing how lawyers specializing in internal corporate investigations are profiting by recent corporate fraud scandals).

15. Nocera, "For All Its Cost."

16. The accounting profession, in other words, was "born and bred in the briar patch." See Joel Chandler Harris, "Brer Rabbit and the Tar Baby," http://www otmfan.com/html/brertar.htm (accessed March 10, 2006).

17. Jonathan R. Macey, "The Politicalization of American Corporate Governance," Conference on Boundaries of SEC Regulation, Claremont McKenna Financial Economics Institute, February 3, 2006.

18. See Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1586–87.

19. Elisabeth Bumiller, "Bush Faces Scrutiny over Disclosing '90 Stock Sale Late," *New York Times*, July 4, 2002, A11. For a discussion of how Bush's political problems related specifically to the adoption of the executive loan provisions in SOX, see Barnard, "Historical Quirks."

20. See Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1562.

21. Joann S. Lublin, "Loans to Corporate Officers Unlikely to Cease Soon," *Wall Street Journal*, July 10, 2002, A8.

22. See Barnard, "Historical Quirks," 338.

23. Ibid., 340.

24. George Miller (U.S. Representative, R-Cal.), quoted in Carolyn Lochhead, "Bush to Sign Corporate Crackdown: GOP Drops Opposition, Backs Tougher Version," *San Francisco Chronicle*, July 25, 2002, A1.

25. See Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1568–85.

26. See ibid., 1534n35, and Zoe-Vonna Palmrose and Ralph S. Saul, "The Push for Auditor Independence," *Regulation*, Winter 2001, 20, http://www.cato.org/pubs/regulation/regv24n4/v24n4-3.pdf (accessed March 10, 2006).

27. Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1583.

28. See ibid., 1555–58.

29. See American Bar Association, "Report of the American Bar Association Task Force on Corporate Responsibility," March 31, 2003, http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf (accessed March 10, 2006).

30. Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1585–91.

31. See Barnard, "Historical Quirks," 338–39.

32. Joann S. Lublin, "Questioning the Books: The President Speaks: Loans to Corporate Officers Unlikely to Cease Soon," *Wall Street Journal*, July 10, 2002, A8.

33. Barnard, "Historical Quirks," 339n102.

34. Sarbanes-Oxley Act of 2002, S6690, 107th Cong., 2d sess. *Congressional Record* 148 (daily ed. July 12, 2002), quoted in Barnard, "Historical Quirks," 339.

35. Ibid.

36. See Larry E. Ribstein, "Sarbox: The Road to Nirvana," *Michigan State Law Review* 2004, no. 2 (2004): 279–98.

37. See Ribstein, "Bubble Laws," *Houston Law Review* 40 (Spring 2003), 77–97. See also Stuart Banner, "What Causes New Securities Regulation? 300 Years of Evidence," *Washington University Law Quarterly* 75, no. 2 (Summer 1997): 850 (showing that securities market regulation in the United Kingdom and the United States in the eighteenth and nineteenth centuries was adopted only after stock market declines); Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1591–94 (discussing regulation as a function of stock market declines).

38. Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1551–68.

Chapter 2: What Shareholders Want—The Optimal Amount of Fraud

1. Berle and Means, *Modern Corporation and Private Property.*

2. Market forces provide strong incentives for contracting parties to perform as promised. In this view, corporate law plays the important role of providing standard terms and gap-fillers that define the legal relationships among the parties. See Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991), 1–39, and Henry N. Butler, "The Contractual Theory of the Corporation," *George Mason Law Review* 11, no. 4 (Summer 1989): 99–124. The contractarian approach to corporate law suggests that corporations should be free to alter the default rules. See Henry N. Butler and Larry E. Ribstein, "Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians," *Washington Law Review* 65, no. 1 (January 1990): 71, and Frank H. Easterbrook and Daniel R. Fischel, "Contract and Fiduciary Duty," *Journal of Law and Economics* 36, no. 1–2 (1993): 425–51.

3. For an analysis of the rationales for and functions of the business judgment rule, see Larry E. Ribstein, "Accountability and Responsibility in Corporate Governance," *Notre Dame Law Review* 81, no. 4 (2006, forthcoming).

Chapter 3: Imagining a World Without SOX

1. See Nocera, "For All Its Cost, Sarbanes Law is Working."

2. See Oxley, "In the Wake of the Sarbanes-Oxley Act," 320–21.

3. For evidence that there was no lack of investor confidence, see Wallison, "Sarbanes-Oxley As An Inside-the-Beltway Phenomenon," 15.

4. See William H. Beaver, "What Have We Learned from the Recent Corporate Scandals that We Did Not Already Know?" *Stanford Journal of Law, Business and Finance* 8, no. 1 (Autumn 2002): 155–68.

5. See Richard M. Frankel, Marilyn F. Johnson, and Karen K. Nelson, "The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality," Social Science Research Network Working Paper Series, Working Paper No. 4330-02, MIT Sloan, January 2002; http://papers.ssrn.com/paper.taf?abstract_id=296557 (accessed March 21, 2006).

6. Jonathan Karpoff, D. Scott Lee, and Gerald S. Martin, "The Cost to Firms of Cooking the Books," Social Science Research Network Working Paper Series, July 25, 2005, http://papers.ssrn.com/paper.taf?abstract_id=652121 (accessed March 21, 2006).

7. Hemang Desai, Chris E. Hogan, and Michael Wilkins, "The Reputational Penalty for Aggressive Accounting: Earnings Restatements and Management Turnover," *Accounting Review* 81, no. 1 (January 2006): 83–112.

8. See Jonathan R. Laing, "The Bear that Roared: How Short-Seller Jim Chanos Helped Expose Enron," *Wall Street Journal Online*, January 28, 2002, http://online.wsj.com/barrons/article/0,4298,SB101191069416063240.djm,00.html (accessed March 10, 2006).

9. William W. Bratton, "Enron and the Dark Side of Shareholder Value," *Tulane Law Review* 76, no. 5–6 (June 2002): 1275–1362.

10. See George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84, no. 3 (1970): 488–500.

11. See, for example, A. Michael Spence, *Market Signaling Informational Transfer in Hiring and Related Processes* (Cambridge, Mass.: Harvard University Press, 1974).

12. Benjamin Klein and Keith B. Leffler, "The Role of Market Forces in Assuring Contractual Performance," *Journal of Political Economy* 89, no. 4 (1981): 615–41; Oliver Williamson, "Credible Commitments: Using Hostages to Support Exchange," *American Economic Review* 73, no. 4 (September 1983): 519–40.

13. See Stephen J. Choi and Marcel Kahan, "The Market Penalty for Mutual Fund Scandals," Social Science Research Network Working Paper Series, Law and Economics Research Paper No. 06-07, New York University, January 2006, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=877896 (accessed March 21, 2006).

14. See John E. Core, "The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance," *Journal of Law Economics, and Organization* 16, no. 2 (October 2000): 449–77 (showing a significant association between directors' and officers' premiums and proxies for the quality of firms' governance structures, which is confirmed by positive correlation between firms' insurance premiums and excessive CEO compensation).

15. See Joshua Ronen, "Post-Enron Reform: Financial Statement Insurance, and Gaap Re-Visited," *Stanford Journal of Law, Business and Finance* 8, no. 1 (Autumn 2002): 39–68.

16. See SEC Rule 14a-8.

17. See Roberta Romano, *The Genius of American Corporate Law* (Washington, D.C.: AEI Press, 1993).

18. William Cary, "Federalism and Corporate Law: Reflections Upon Delaware," *Yale Law Journal* 83, no. 4 (March 1974): 663–705; Ralph Winter, "State Law, Shareholder Protection, and the Theory of the Corporation," *Journal of Legal Studies* 6, no. 2 (June 1977): 251–92. For more recent versions of Cary's view, see Lucian Arye Bebchuk and Allen Ferrell, "Federalism and Takeover Law: The Race to Protect Managers from Takeovers," *Columbia Law Review* 99, no. 5 (June 1999): 1168–99, and Lucian Arye Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law," *Harvard Law Review* 105, no. 7 (May 1992): 1435–1510.

19. See Sanjai Bhagat and Roberta Romano, "Event Studies and the Law: Part II: Empirical Studies of Corporate Law," *American Law and Economics Review* 4, no. 2 (Fall 2002): 382–94 (reviewing studies relating to state competition debate); Peter Dodd and Richard Leftwich, "The Market for Corporate Charters: 'Unhealthy Competition' versus Federal Regulation," *Journal of Business* 53, no. 3 (1980): 259–83 (showing "management's decision to reincorporate in another state does not reduce stockholder wealth"); Roberta Romano, "The Need for Competition in International Securities Regulation," *Theoretical Inquiries in Law* 2, no. 2 (July 2001): 495–97 (reviewing eight studies finding positive abnormal stock returns from changing incorporation state).

20. See William B. Chandler III and Leo E. Strine Jr., "The New Federalism of the American Corporate Governance System: Preliminary Reflections of

Two Residents of One Small State," *University of Pennsylvania Law Review* 152, no. 2 (December 2003): 953–1006.

21. Enron reincorporated from Delaware to Oregon in 1997 in order to buy an Oregon electric utility, Portland General Electric, and be eligible for the intrastate exemption of the Public Utility Holding Company Act. See Senate Committee on Governmental Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, 107th Cong., 2d sess., 26, October 8, 2002, 2002 WL 31267528. Georgia led the country in adoption of a particularly effective "dead-hand" poison pill. See *Invacare Corp. v. Healthdyne Tech. Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997), a device Delaware invalidated in *Quickturn Design Sys. v. Mentor Graphics Corp.*, 721 A.2d 1281 (Del. 1998); *Carmody v. Toll Bros. Inc.*, 723 A.2d 1180 (Del. Ch. 1998).

22. Delaware courts are well-suited to responding quickly to the regulatory challenge presented by corporate fraud. See Jill E. Fisch, "The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters," *University of Cincinnati Law Review* 68, no. 4 (Summer 2000): 1061–1100.

23. Mark J. Roe, "Delaware's Competition," *Harvard Law Review* 117, no. 2 (December 2003): 588–646.

24. See Sanjai Bhagat and Bernard Black, "The Non-Correlation Between Board Independence and Long-Term Firm Performance," *Journal of Corporation Law* 27, no. 2 (Winter 2002): 231–74; Sanjai Bhagat and Bernard Black, "The Uncertain Relationship Between Board Composition and Firm Performance," *Business Lawyer* 54, no. 3 (May 1999): 921–64; Bhagat and Romano, "Event Studies and the Law," 402–3.

25. See Barnard, "Historical Quirks."

26. See Stephen J. Choi and Andrew T. Guzman, "Portable Reciprocity: Rethinking the International Reach of Securities Regulation," *Southern California Law Review* 71, no. 5 (July 1998): 903–52; Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation," *Yale Law Journal* 107, no. 8 (June 1998): 2359–2430. For criticisms of these proposals, see James D. Cox, "Regulatory Duopoly in U.S. Securities Markets," *Columbia Law Review* 99, no. 5 (June 1999): 1200–52; Merritt Fox, "Securities Disclosure in a Globalizing Market: Who Should Regulate Whom," *Michigan Law Review* 95, no. 8 (August 1997): 2498–2632.

27. See Larry E. Ribstein, "Cross-Listing and Regulatory Competition," *Review of Law and Economics* 1, no. 1, article 7 (2005), http://www.bepress.com/rle/vol1/iss1/art7 (accessed March 11, 2006).

28. See, generally, Paul G. Mahoney, "The Exchange as Regulator," *Virginia Law Review* 83, no. 7 (October 1997) 1453–1500.

29. See New York Stock Exchange, "Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors," August 16, 2002, http://www.nyse.com/pdfs/corp_gov_pro_b.pdf (accessed April 3, 2006). Rules would require a majority of the board to have no material relationships with the firm and lengthen to five years the "cooling-off" period for board service by former employees of the issuer or its auditor; require that directors meet without management; require wholly independent nominating and compensation committees in addition to the independent audit committee; require the chair of the audit committee to have accounting or financial management expertise; require the audit committee to have sole responsibility for hiring the auditing firm; and prohibit compensation of audit committee members apart from directors' fees.

30. There is some reason to believe that stock exchanges no longer can fulfill the function of regulating the governance of listed firms. Jonathan Macey and Maureen O'Hara argue persuasively that changing technology has lowered the cost of trading, which has facilitated the emergence of competing trading venues, in turn affecting the viability of exchanges as regulators. Jonathan R. Macey and Maureen O'Hara, "From Markets to Venues: Securities Regulation in an Evolving World," *Stanford Law Review* 58, no. 2 (November 2005): 563–99. Among other problems, exchanges cannot effectively discipline listed firms that have a variety of trading venues. Also, with so many available trading venues, an exchange does not internalize the benefits of its regulatory efforts, and therefore has an incentive to invest too little in regulation and enforcement. As a result, "self-regulation" by the exchanges is really regulation forced, or at least strongly urged, by the SEC.

31. See Gilles Hilary and Clive Lennox, "The Credibility of Self-Regulation: Evidence from the Accounting Profession's Peer Review Program," *Journal of Accounting and Economics* 40, no. 1–3 (2005): 211–29 (showing that opinions issued by peer reviewers have provided credible information, based on evidence that audit firms gained clients after receiving clean opinions from their reviewers and lost clients after receiving modified or adverse opinions). Also see Paul V. Dunmore and Haim Falk, "Economic Competition between Professional Bodies: The Case of Auditing," *American Law and Economics Review* 3, no. 2 (2001): 302–19 (showing that competition among professional

auditing associations can efficiently substitute for most government regulation).

Chapter 4: The Costs of SOX

1. See Ivy Xiying Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002," unpublished paper, 2005, http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf (accessed March 11, 2006).

2. See Securities and Exchange Commission, "Certification of Disclosure in Companies' Quarterly and Annual Reports," Release 33-8124, August 29, 2002, http://www.sec.gov/rules/final/33-8124.htm (accessed April 3, 2006); Securities and Exchange Commission, "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," Release 33-8238, June 5, 2003, http://www.sec.gov/rules/final/33-8238.htm (accessed April 3, 2006).

3. See SEC Rules 13a–15(f), 15(d)–15(f).

4. See SEC Release 33-8238.

5. See SEC Rules 13a–15(c), 15d–15(c); SEC Release 33-8238.

6. See §103(a)(2)(A)(iii).

7. Securities and Exchange Commission, "Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002," Release 33-8138, October 22, 2002, http://www.sec.gov/rules/proposed/33-8138.htm (accessed April 3, 2006).

8. See, e.g., Cary Klafter (director of corporate affairs, Legal Department, Intel Corporation), "Comment Letter," File No S7-40-02; Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, November 27, 2002 (stating that "based on our actual experience to date, we believe that the Commission has underestimated the time and effort involved in complying with these rules by at least a factor of 100, if not a greater order of magnitude") http://www.sec.gov/rules/proposed/s74002/cklafter1.txt (accessed April 3, 2006).

9. SEC Release 33-8238, n. 174.

10. Financial Executives International, "Sarbanes-Oxley Compliance Costs Exceed Estimates," http://www.fei.org/404_survey_3_21_05.cfm (accessed April 3, 2006); AMR Research, "SOX Spending for 2006 To Exceed $6B."

11. Securities and Exchange Commission, "Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers," Release 33-8545, March 2, 2005 (extending compliance

date for nonaccelerated filers and foreign private issuers to fiscal years ending after July 15, 2006), http://www.sec.gov/rules/final/33-8545.htm (accessed April 3, 2006); Securities and Exchange Commission, "Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies that are not Accelerated Filers," Release 33-8618, September 22, 2005 (extending compliance date for nonaccelerated filers to July 15, 2007), http://www.sec.gov/rules/final/33-8618.pdf (accessed April 7, 2006); SEC Advisory Committee on Smaller Public Companies, "Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission," April 23, 2006, http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf (accessed April 25, 2006); Securities and Exchange Commission, "Staff Statement on Management's Report on Internal Control Over Financial Reporting," May 16, 2005 (results of the roundtable and a "guidance" issued by the SEC), http://www.sec.gov/info/accountants/stafficreporting.htm (accessed April 3, 2006); Securities and Exchange Commission, "Roundtable Discussion on Implementation of Internal Control Reporting Provisions," April 13, 2005 (transcript of the roundtable), http://www.sec.gov/spotlight/soxcomp/soxcomp-trans.txt (accessed April 3, 2006).

12. The policy statements are at www.sec.gov/news/press/2005-74.htm (accessed April 3, 2006) and http://www.pcaobus.org/Rules/Docket_008/2005-05-16_Release_2005-009.pdf (accessed April 3, 2006), respectively.

13. Cynthia Glassman, Remarks before the Conference on Listed Companies and Legislators in Dialogue, Danish Ministry of Economic and Business Affairs, Copenhagen, Denmark, November 17, 2005, http://www.sec.gov/news/speech/spch111705cag.htm. (accessed April 3, 2006).

14. As the SEC Advisory Committee has noted ("Final Report," 29), Auditing Standard No. 2 was developed for external auditors and "does not provide management with guidance on how to document and test internal control or how to evaluate deficiencies identified," despite the fact that SOX section 404 clearly provides for different requirements for managers and for external auditors.

15. See, for example, survey data compiled by CRA International, "Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update," December 8, 2005, http://www.crai.com/pubs/pub_4896.pdf (accessed April 3, 2006).

16. See SEC Advisory Committee, "Final Report," 29–30, discussing this history.

17. This is summarized in Larry E. Ribstein, "Market v. Regulatory Responses to Corporate Fraud," *Journal of Corporation Law* 28, no. 1 (Fall 2002): 26–29.

18. Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1532.

19. See James S. Linck, Jeffry M. Netter, and Tina Yang, "Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards," Social Science Research Network Working Paper Series, March 2005, http://papers.ssrn.com/paper.taf?abstract_id=687496 (accessed March 21, 2006).

20. For a discussion of the business effects of SOX compliance, see Brian Doherty, "You Can Be Too Careful," *Reason*, January 2006, http://www.reason.com/0601/fe.bd.you.shtml (accessed April 3, 2006).

21. SEC Release 33-8238, n. 79.

22. Daniel A. Cohen, Aiyesha Day, and Thomas Lys, "The Sarbanes Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs," Social Science Research Network Working Paper Series, July 23, 2004, http://papers.ssrn.com/paper.taf?abstract_id=568483 (accessed March 21, 2006).

23. Peter J. Wallison, "Blame Sarbanes-Oxley," AEI Online, September 1, 2003, http://www.aei.org/publications/filter.all.pubID.19123/pub_detail.asp (accessed April 3, 2006).

24. See I.R.C. §162(m).

25. Financial Economists Roundtable, statement on "The Controversy Over Executive Compensation," November 24, 2003, http://www.luc.edu/orgs/finroundtable/statement03.pdf (accessed April 3, 2006).

26. See Robert F. Göx, "Tax Incentives for Inefficient Executive Pay and Reward for Luck," Social Science Research Network Working Paper Series, October 2005, http://ssrn.com/abstract=823884 (accessed March 21, 2006).

27. See Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Mass.: Harvard University Press, 2004); Securities Exchange Commission, "Proposed Rule Change: Executive Compensation and Related Party Disclosure," Release 33-8655, January 27, 2005, http://sec.gov/rules/proposed/33-8655.pdf (accessed April 3, 2006).

28. See Ribstein, "Sarbox: The Road to Nirvana"; Charles M. Elson, "The Duty of Care, Compensation, and Stock Ownership," *University of Cincinnati Law Review* 63, no. 2 (Winter 1995): 695.

29. See Khuldeep Shastri and Kathleen M. Kahle, "Executive Loans," Social Science Research Network Working Paper Series, EFA 2003 Annual

Conference Paper No. 184, AFA 2004 San Diego meetings, February 2003, p. 10 (showing that insider loans from 1996–2000 made to facilitate stock purchases were often diverted to other uses), http://ssrn.com/abstract=423447 (accessed March 22, 2006); Elizabeth A. Gordon, Elaine Henry, and Darius Palia, "Related Party Transactions: Associations with Corporate Governance and Firm Value," Social Science Research Network Working Paper Series, EFA 2004 Maastricht Meetings Paper No. 4377, p. 6, August 2004 (finding a negative relationship between industry-adjusted returns and insider loans), http://ssrn.com/abstract=558983 (accessed March 22, 2006).

30. See Barnard, "Historical Quirks," 349.

31. See chapter 1.

32. See Barnard, "Historical Quirks," 350–51.

33. Deborah Solomon, "Sarbanes and Oxley Agree to Disagree," *Wall Street Journal*, July 24, 2003, C1.

34. The SEC eventually provided limited guidance as to the legitimacy of foreign bank loans to bank executives; Securities and Exchange Commission, "SEC Adopts Fund Disclosure Rules and Foreign Bank Loan Exemption; Proposes Shell Company Rules," http://www.sec.gov/news/press/2004-50.htm (accessed April 3, 2006). The Department of Labor eventually clarified the application to ERISA plans; Field Assistance Bulletin 2003-1, April 15, 2003, http://www.dol.gov/ebsa/regs/fab_2003-1.html (accessed April 3, 2006). See also Mayer, Brown, Rowe, and Maw, "Sarbanes-Oxley Act: Interpretive Issues Under §402—Prohibition of Certain Insider Loans," www.mayerbrown.com/sarbanesoxley/interpretiveissuesundersec402.pdf (accessed March 12, 2006), and Mark R. Patterson, "Law-Fixing: Should Lawyers Agree How to Interpret Statutes?" Social Science Research Network Working Paper Series, PUB-LAW Research Papers No. 50, Fordham School of Law, p. 18-9, May 5, 2004, http://ssrn.com/abstract=555706 (accessed March 21, 2006). For a counterargument and other observations, see Larry E. Ribstein, "Should Lawyers Agree How to Interpret Statutes?" Ideoblog, January 11, 2005, http://busmovie.typepad.com/ideoblog/2005/01/should_lawyers_.html (accessed April 3, 2006).

35. See SEC Advisory Committee, "Final Report," 96–97.

36. Jill E. Fisch and Caroline M. Gentile, "The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors," *Duke Law Journal* 53, no. 2 (November 2003): 583.

37. Robert Eli Rosen, "Resistances to Reforming Corporate Governance: The Diffusion of QLCC's," *Fordham Law Review* 74, no. 3 (December 2005): 1251–1318,

available at http://papers.ssrn.com/paper.taf?abstract_id=830131 (accessed March 21, 2006).

38. See Larry E. Ribstein, "Limited Liability of Professional Firms after Enron," *Journal of Corporation Law* 29, no. 2 (Winter 2004): 427–48.

39. See Deborah Solomon, "For Financial Whistle-Blowers, New Shield is an Imperfect One," *Wall Street Journal*, October 4, 2004, A1.

40. See Milton Friedman, *There's No Such Thing as a Free Lunch* (LaSalle, Ill.: Open Court, 1975).

41. See Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top Management Incentives," in Michael C. Jensen, *Foundations of Organizational Strategy* (Cambridge, Mass.: Harvard University Press, 1998).

42. See *BusinessWeek Online*, "Going Private," February 27, 2006, http://www.businessweek.com/magazine/content/06_09/b3973001.htm (accessed April 3, 2006).

43. See William J. Carney, "The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private,'" Social Science Research Network Working Paper Series, Emory Law and Economics Research Paper No. 05-4, February 2005, http://papers.ssrn.com/paper.taf?abstract_id=672761 (accessed March 21, 2006).

44. See Jeffrey T. Doyle, Weili Ge, and Sarah E. McVay, "Determinants of Weaknesses in Internal Control Over Financial Reporting," Social Science Research Network Working Paper Series, July 2005, http://papers.ssrn.com/paper.taf?abstract_id=770465 (accessed March 21, 2006).

45. See Jason Scott Johnston, "Signaling Social Responsibility: On the Law and Economics of Market Incentives for Corporate Environmental Performance," Social Science Research Network Working Paper Series, University of Pennsylvania, Institute for Law and Economics Research Paper 05-16, May 11, 2005, http://papers.ssrn.com/paper.taf?abstract_id=725103 (accessed March 21, 2006); Michael P. Vandenbergh, "The Private Life of Public Law: Accounting for the Influence of Private Agreements on Public Regulation," *Columbia Law Review* 105, no. 7 (November 2005): 2029–96.

46. See Ellen Engel, Rachel M. Hayes, and Xue Wang, "The Sarbanes-Oxley Act and Firms' Going-Private Decisions," Social Science Research Network Working Paper Series, 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=546626 (accessed March 21, 2006).

47. See ARC Morgan, "Using Reported Weakness Disclosures to Benchmark Internal Controls" (showing that companies with sales of less than $250 million incurred $1.56 million in costs on internal controls, while firms with sales of $1 billion– $2 billion incurred $2.4 million in costs, including internal costs, opportunity costs, and intangibles); and SEC Advisory Committee,

"Final Report," 32–37 (including graphs showing post-SOX external audit fees as percentage of revenue much higher for smaller companies, and higher ratios of audit fees to capitalization and compliance costs to revenues).

48. SEC Advisory Committee, "Final Report," p. 5, table 1 (showing that such firms represent about 78.5 percent of total companies by number, but only about 6 percent by capitalization), and 35–36; Weili Ge and Sarah E. McVay, "On the Disclosure of Material Weaknesses in Internal Control after the Sarbanes-Oxley Act," *Accounting Horizons* 19, no. 3 (September 2005):123.

49. Securities and Exchange Act of 1934, s 12(g)(5).

50. See Engel et al., "The Sarbanes-Oxley Act and Firms' Going-Private Decisions" (also finding more favorable share price reaction to going private in firms with high inside ownership, which may have had relatively low benefits from being public, and therefore larger net gains from going private); Christian Leuz, Alexander J. Triantis, and Tracy Yue Wang, "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," Social Science Research Network Working Paper Series, AFA 2006 Boston Meetings Paper, 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=592421 (accessed March 21, 2006).

51. Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley, "Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis," November 2005, http://www.law.ucla.edu/docs/talley_012306.pdf (accessed April 3, 2006).

52. For a debate on this issue, see Victor Fleischer, "Is SOX Leading More Firms to Go Private?" January 24, 2006, *Conglomerate*, http://www.theconglomerate.org/2006/01/is_sox_leading_.html (accessed April 3, 2006), and Larry E. Ribstein, "Who Cares about the Disappearing Small Public Firms?" *Ideoblog*, January 24, 2006, http://busmovie.typepad.com/ideoblog/2006/ 01/who_cares_about.html (accessed April 3, 2006).

53. See Leuz et al., "Why Do Firms Go Dark?"; Engel et al., "The Sarbanes-Oxley Act and Firms' Going-Private Decisions"; Carney, "The Costs of Being Public"; Andras Marosi and Nadia Ziad Massoud, "Why Do Firms Go Dark?" Social Science Research Network Working Paper Series, November 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=570421 (accessed April 12, 2006).

54. See Leuz et al., "Why Do Firms Go Dark?"; Marosi and Massoud, "Why Do Firms Go Dark?"

55. Leuz et al., "Why Do Firms Go Dark?"

56. See Rick Antle, Elizabeth A. Gordon, Ganapathi Narayanamoorthy, and Ling Zhou, "The Joint Determination of Audit Fees, Non-Audit Fees,

and Abnormal Accruals," Social Science Research Network Working Paper Series, Working Paper No. AC-15, Yale School of Management, June 14, 2002 (showing that audit firms' provision of nonaudit services did not affect the incidence of abnormal accruals), http://papers.ssrn.com/paper.taf ?abstract_id=318943 (accessed March 21, 2006).

57. As to the interrelation between law and trust, see Larry E. Ribstein, "Law v. Trust," *Boston University Law Review* 81, no. 3 (June 2001): 553–90.

58. See, for example, Bruno S. Frey, *Not Just for the Money* (Cheltenham, U.K., and Brookfield, Vt.: Edward Elgar, 1997), 7–8.

59. Richard W. Painter, "Lawyers' Rules, Auditors' Rules and the Psychology of Concealment," *Minnesota Law Review* 84, no. 6 (June 2000): 1399–1438; Jeffrey J. Rachlinski, "Gains, Losses, and the Psychology of Litigation," *Southern California Law Review* 70, no. 1 (November 1996): 113–86.

60. As for insurance, the firm and the shareholders are probably in a better position to monitor executives than the insurer. This may explain why directors' and officers' liability insurance became costlier and scarcer after Enron and WorldCom increased the liability threat and, thus, the burden on insurers relative to shareholders. See Christopher Oster, "Directors' Insurance Fees Get Fatter," *Wall Street Journal*, July 12, 2002, C1 (discussing the large rise in premiums and deductibles); Christopher Oster, "Insurers Expected to Try to Deny WorldCom Officers' Coverage," *Wall Street Journal*, July 1, 2002, C14 (noting that "the recent rash of earnings restatements and accounting problems has driven up rates for D&O policies"). Indemnification just throws the risk back on the corporation and the shareholders, where it belonged in the first place.

61. See Gerald J. Lobo and Jian Zhou, "Did Conservatism in Financial Reporting Increase after the Sarbanes-Oxley Act? Initial Evidence," *Accounting Horizons* 20, no. 1 (March 2006): 57–73 (showing an increase in conservatism in financial reporting following SOX, including reporting lower discretionary accruals, incorporating losses more quickly than gains in reporting income).

62. Bhagat and Romano, "Event Studies and the Law," 409 (reviewing studies).

63. See Paul Rosenzweig, "The Over-Criminalization of Social and Economic Conduct," Heritage Foundation Legal Memorandum No. 7, http://www.heritage.org/Research/LegalIssues/lm7.cfm. (accessed April 3, 2006).

64. SEC commissioner Paul S. Atkins summarizes the problem:

> Before people will rationalize their approach to the internal control process, both the SEC and the PCAOB will have to give people comfort that we will actually allow people to use their professional judgment and that they will not be second-guessed. Both the SEC and the PCAOB recently issued guidance on these issues. Both sets of guidance acknowledged that more needs to be done in this area and that the current approach was too granular, was not risk-based and did not employ a top-down strategy.

Remarks before the SIA Leadership Luncheon, San Francisco, June 8, 2005, http://www.sec.gov/news/speech/spch060805psa.htm (accessed April 3, 2006).

65. See pp. 41–42

66. At least in jury trials, this dynamic is further affected by prosecutors' ability to take advantage of what has been called criminal defendants' "ambiguity aversion": While prosecutors are repeat players whose decision depends on the known overall conviction rate, defendants only care about their individual cases, where the prospects are ambiguous. See Alex Stein and Uzi Segal, "Ambiguity Aversion and the Criminal Process," *Notre Dame Law Review* 81, no. 4 (2006, forthcoming), available at http://papers.ssrn.com/paper.taf?abstract_id=846044 (accessed March 21, 2006).

67. U.S. Department of Justice, Office of the Deputy Attorney General, "Memorandum on Principles of Federal Prosecution of Business Organizations," January 20, 2003, http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm (accessed March 29, 2006).

68. See John Hasnas, "Department of Coercion."

69. See ABA Task Force on Attorney-Client Privilege, "Recommendation 111," Task Force Releases Report and Recommendation to the ABA House of Delegates, August 9, 2005, http://www.abanet.org/buslaw/attorneyclient/materials/hod/recommendation_adopted.pdf (accessed March 22, 2006).

70. See Antle et al., "The Joint Determination of Audit Fees."

71. The evidence on the value of this restriction is far from convincing. Romano showed that fifteen of twenty-five studies on the effect of nonaudit services on audit quality reports demonstrated no connection between the two, one found no connection for big-five accounting firms, and three found that nonaudit services improved audit quality. Testing of other relevant factors undercuts other surveys' findings that nonaudit services

affect quality. See Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1535–37. There is also evidence of negative market reaction to the restriction on provision of nonaudit services See Zabihollah Rezaee and Pankaj K. Jain, "The Sarbanes-Oxley Act of 2002 and Security Market Behavior: Early Evidence," Social Science Research Network Working Paper Series, March 22, 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=498083 (accessed March 21, 2006).

72. See Lynnley Browning, "Sorry, the Auditor Said, But We Want a Divorce," *New York Times*, February 6, 2005, sec. 3, p. 5, col. 1.

73. See James C. Spindler, "Conflict or Credibility: Analyst Conflicts of Interest and the Market for Underwriting Business," Social Science Research Network Working Paper Series, Olin Working Paper No. 215, University of Chicago Law School, John M. Olin Program in Law and Economics, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=564381 (accessed March 21, 2006).

74. *Santa Fe Industries Inc. v. Green*, 430 U.S. 462 (1977).

75. See David A. Skeel Jr., "Rethinking the Line Between Corporate Law and Corporate Bankruptcy," *Texas Law Review* 72, no. 3 (February 1994): 471–558 (arguing that the federal law of corporate bankruptcy discourages both state and federal resolution of issues that lie in the boundary between bankruptcy and state law).

76. See chapter 4, pp. 33–35.

77. Chandler and Strine, "The New Federalism."

78. *In re Caremark International Inc Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

79. Chandler and Strine, "The New Federalism," 979–80.

80. *Newcastle Partners L.P. v. Vesta Insurance Group Inc.*, 887 A.2d 957 (Del. Ch. 2005). See the discussion in Larry E. Ribstein, "A Chicken Game in Delaware," *Ideoblog*, November 19, 2005, http://busmovie.typepad.com/ ideoblog/2005/11/a_chicken_game_.html (accessed April 3, 2006).

81. Myron Steele, "Sarbox and De," NYU Journal of Law and Liberty Blog, October 27, 2005, http://www.nyujll.org/blog/index.php?paged=3 (accessed April 3, 2006).

82. Leo E. Strine Jr., "Derivative Impact? Some Early Reflections on Corporate Law Implications of the Enron Debacle," *Business Lawyer* 57, no. 4 (August 2002): 1372.

83. Renee M. Jones, "Rethinking Corporate Federalism in the Era of Corporate Reform," *Journal of Corporation Law* 29, no. 3 (Spring 2004): 625–64.

84. See Lisa M. Fairfax, "Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards," *Ohio Northern University Law Review* 31, no. 3 (2005): 381–416.

85. See *Brehm v Eisner*, 747 A. 2d 244 (Del. 2000).

86. *In re Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch., 2003).

87. *In re Walt Disney Company Derivative Litigation* (Del. Ch., August 9, 2005), 2005 WL 1875804.

88. See Roe, "Delaware's Competition," 643 (commenting after the chancellor's 2003 opinion that "the difficulty here is to sort out whether its abrupt shift was due primarily to the federal gravitational pull, to the dynamics of the litigation, or to the state's direct perception of the underlying corporate problems").

89. See Chandler and Strine, "The New Federalism," 992.

90. Ibid., 998.

91. Roberta Romano, *The Genius of American Corporate Law.*

92. 17 CFR §240.10A-3(e)(1)(i).

93. See Mara Faccio and Larry Lang, "The Ultimate Ownership of Western European Corporations," *Journal of Financial Economics* 65, no. 3 (September 2002): 365–95.

94. Aktiengesetz §119 I Nr. 5; HGB §318 I.

95. 17 CFR §78j-1(m)(3).

96. See Lawrence A. Cunningham, "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX," *International Journal of Disclosure and Governance* 1, no. 3 (June 2004): 269–98.

97. See David Reilly and Sarah Nassauer, "Street Sleuth, Tip-Line Bind: Follow the Law In U.S. or EU?" *Wall Street Journal*, September 6, 2005, C1, http://online.wsj.com/article/0,,SB112596782625632302,00.html?mod=todays_us_money_and_investing (accessed April 3, 2006).

98. See Erin Marks, "The Sarbanes-Oxley Act: Costs and Tradeoffs Relating to International Application and Convergence," *Research in Accounting Regulation* 17 (2004), Social Science Research Network Accepted Paper Series, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=499403 (accessed March 21, 2006); Ribstein, "Cross-Listing and Regulatory Competition."

99. See Craig Karmin and Aaron Lucchetti, "New York Loses Edge in Snagging Foreign Listings," *Wall Street Journal*, January 26, 2006, C1, http://online.wsj.com/article/SB113824819390656771.html?mod=todays_us_money_and_investing (accessed April 3, 2006).

100. See Craig Karmin, "London Calling," *Wall Street Journal*, December 23, 2005 C1, http://online.wsj.com/article/SB113530126767530086-search.html?KEYWORDS=london+calling&COLLECTION=wsjie/6month/ (accessed April 3, 2006).

101. See Michael A. Perino, "American Corporate Reform Abroad: Sarbanes-Oxley and the Foreign Private Issuer," *European Business Organization Law Review* 4, no. 3 (October 2003): 213–44.

102. Kate Litvak, "The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US," Social Science Research Network Working Paper Series, Law and Economics Research Paper No. 55, University of Texas Law School, December 22, 2005, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=876624 (accessed March 21, 2006).

103. For the initial outcry, see the comments by representatives of foreign firms in response to the SEC's rulemaking on the audit committee requirements. These comments are collected at http://www.sec.gov/rules/proposed/s70203.shtml, and summarized at http://www.sec.gov/rules/extra/s70203summary.htm#P1121_88452 (accessed April 3, 2006).

104. See Anna Snider, "Going SOX-less," *California Lawyer*, October 2004, 37; Floyd H. Norris, "European Companies Push for Relief from U.S. Security Laws," *International Herald Tribune*, February 12, 2004, http://www.iht.com/articles/2004/02/12/comply_ed3_.php (accessed April 3, 2006).

105. 17 CFR §240.10A-3.

106. 17 CFR §240.10A-3(c)(3).

107. See Securities and Exchange Commission, "Proposed Rules: Insider Trades During Pension Fund Blackout Periods," November 6, 2002, 17 CFR §§240, 245 and 249 [Release 34-46778; IC-25795; File No. S7-44-02], http://www.sec.gov/rules/proposed/34-46778.htm (accessed April 3, 2006).

108. See "Implementation of Standards of Professional Conduct for Attorneys," Release 33-8185, 17 CFR 205.2(j) (defining "non-appearing foreign attorney"), August 5, 2003, http://www.sec.gov/rules/final/33-8185.htm (accessed April 3, 2006).

109. SEC Release 33-8545.

Chapter 5: The Litigation Time Bomb

1. See SEC Release 33-8238.

2. See Sarbanes-Oxley Act §3(b)(1), 15 U.S.C. §7202.

3. SEC Litigation Release 18044 (March 20, 2003). The certification was pursuant to SEC Order 4-460, Order Requiring the Filing of Sworn

Statements Pursuant to §21(a)(1) of the Securities Exchange Act of 1934 (June 27, 2002). A court has already upheld the constitutionality of section 906 in connection with this case. *U.S. v. Scrushy*, 2004 WL 2713262 (N.D. Ala. 2004).

4. It is interesting to speculate how these provisions and rules might have been applied to the frauds at Enron and other companies that provided the impetus for SOX. Many of these cases involved bad accounting by underlings in the company for largely correct underlying data. For example, Xerox accelerated revenues from long-term equipment leases, Qwest and Global Crossing manipulated revenues and expenses on sales of fiber optic capacity, and, most notoriously, WorldCom blatantly misstated billions in current expenses the company incurred to use transmission networks as capital expenditures. Some cases, like Sunbeam, involved false data—in that case, phony sales and rebates. This is reminiscent of one of the biggest frauds of all, Equity Funding, in which managers and employees simply manufactured life insurance policies.

Consider also cases where the impropriety of the accounting depends on complex background facts. For example, some of Enron's off-balance-sheet, special-purpose entities should have been on the balance sheet under applicable accounting rules because they had outside (non-Enron) equity of less than three percent of total capital. Andrew Fastow, Enron's chief financial officer, told the Enron board that the entities did have the requisite outside equity, but this was not true. As it happened, he never gave the board the specifics. SOX will now clearly require senior executives to get the specifics—but what if the Fastow of the future Enron lies or fabricates documents? More problematically, what if there is no background documentation? In the notorious Nigerian Barge case, Merrill Lynch brokers face jail for assisting in a transaction that was purportedly a purchase of barges from Enron but was allegedly not a legitimate sale because of an informal promise by Enron to buy the barges back. The court had to rely on hearsay as to the side deal.

A similar case arose recently in which the inside counsel of a Siemens subsidiary was indicted for preparing a transaction for a minority-owned joint venture that was allegedly not really a joint venture. The indictment quotes an email that established the absence of the requisite profit-sharing arrangement. It says that the Siemens subsidiary "relied on Roth [the inside counsel] to ensure legal compliance with the applicable ordinances." *U.S. v. Faust Villazan*, Superseding Indictment, 05 CR 792 (N.D. Ill. 2006), para. 11.

5. Harvey L. Pitt, "Commentary, Trials and Tribulations of Enron and S-Ox," Forbes.com, January 23, 2006, http://www.forbes.com/columnists/2006/01/20/enron-sarbox-pitt-commentary-cx_hlp_0123harveypitt.html (accessed April 3, 2006).

6. For example, under what circumstances might the executives of Siemens be liable under SOX in the situation just discussed for failing to have internal controls that would have caught the fact that the enterprise might not have been a joint venture?

7. Pitt, "Commentary, Trials and Tribulations."

8. See Chandler and Strine, "The New Federalism," 987.

9. See ibid., 987n90 (noting the qualification in Del. Code. Ann. Tit. 8, §102(b)(7)(ii) for knowing violation of law). To the extent that federal law compels directors to do what Delaware law permits or requires, state courts might be forced to align state with federal standards. This was the issue that was narrowly avoided in the *Vesta* case, discussed on p. 68.

10. See Mitu Gulati, Jeffrey J. Rachlinski, and Donald C. Langevoort, "Fraud by Hindsight," *Northwestern University Law Review* 98, no. 3 (2004): 773–826.

11. See Kenneth M. Lehn, "Private Insecurities," *Wall Street Journal*, February 15, 2006, A16, http://online.wsj.com/article/SB113996764865374191.html?mod=todays_us_opinion (accessed April 3, 2006).

12. See *Dura Pharmaceuticals Inc. v. Broudo*, 125 S.Ct. 1627 (2005) (holding that allegations of price inflation at the time of purchase were insufficient and implying that plaintiff must also allege a market adjustment following a corrective disclosure).

13. See Larry E. Ribstein, "Fraud on a Noisy Market," *Lewis & Clark Law Review* 10, no. 1 (2006): 137–68.

14. See Richard A. Booth, "Who Should Recover What in a Securities Fraud Class Action?" Social Science Research Network Working Paper Series, University of Maryland Legal Studies Research Paper No. 2005-32, February 2005, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=683197 (accessed March 21, 2006).

Chapter 6: The Bottom Line—Has SOX Been Worth It?

1. See Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1541–43.

2. See Zhang, "Economic Consequences of the Sarbanes-Oxley Act."

3. Haidan Li, Morton Pincus, and Sonja O. Rego, "Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002," Social Science Research Network Working Paper Series, January 11, 2006, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=475163 (accessed March 21, 2006).

4. Vidhi Chhaochharia and Yaniv Grinstein, "Corporate Governance and Firm Value—The Impact of the 2002 Governance Rules," June 2004, Social

Science Research Network Working Paper Series, AFA 2006 Boston Meetings Paper, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556990 (accessed March 21, 2006).

5. See Rezaee and Jain, "Sarbanes-Oxley Act of 2002 and Security Market Behavior."

6. See Paul A. Griffin and David H. Lont, "Taking the Oath: Investor Response to SEC Certification," November 19, 2003, Social Science Research Network Working Paper Series (showing more positive reaction for firms with prior securities litigation), http://papers.ssrn.com/paper.taf?abstract_id=477586 (accessed March 21, 2006); Beverly Hirtle, "Stock Market Reaction to Financial Statement Certification by Bank Holding Company CEOs," Social Science Research Network Working Paper Series, FRB of New York Staff Report No. 170, July 2003 (for bank holding companies that certified prior to the rule's compliance deadline, showing that the effect on share prices was correlated with the opacity of the firm's earnings), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=425002 (accessed March 21, 2006).

7. Uptal Bhattacharya, Peter Groznik, and Bruce Haslem, "Is CEO Certification Credible?" *Regulation* 26, no. 3 (Fall 2003): 8–10, available at http://papers.ssrn.com/paper.taf?abstract_id=511122 (accessed April 3, 2006).

8. See Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1542.

9. See Maria Ogneva, Kannan Raghunandan, and K. R. Subramanyam, "Internal Control Weakness and Cost of Equity: Evidence from SOX Section 404 Certifications," Social Science Research Network Working Paper Series, AAA 2006 Financial Accounting and Reporting Section (FARS) Meeting Paper, October 2005, http://ssrn.com/abstract=766104 (accessed March 21, 2006).

10 See Editorial, "Overseeing Refco," *Wall Street Journal*, October 17, 2005, A18, http://online.wsj.com/article/SB112950980774970305.html?mod= todays_us_opinion (accessed April 3, 2006); Deborah Solomon and Michael Shroeder, "How Refco Fell Through Regulatory Cracks," *Wall Street Journal*, October 18, 2005, A18, http://online.wsj.com/article/SB112959 398166971354.html ?mod=todays_us_page_one (accessed April 3, 2006).

11. See Laing, "The Bear that Roared."

12. See generally, Ribstein, "Fraud on a Noisy Market."

Chapter 7: Immediate Policy Implications

1. See Chris Evans, "Directors Call for Sarbanes-Oxley Repeal," *Accountancy Age*, February 23, 2006, http://www.accountancyage.com/accountancyage/news/2150885/sarbanes-story (accessed April 3, 2006).

2. See introduction, p 6. For further analysis, see Nagy, "Playing Peekaboo With Constitutional Law."

3. The SEC is already considering some of these changes, particularly including the forthcoming recommendations of its Advisory Committee on Smaller Public Companies; see SEC Advisory Committee, "Final Report."

4. Ibid., 44n96, argues that the SEC has authority to adopt exemptions for small firms under the Securities and Exchange Act, section 36(a)(1) and SOX section 3(a). However, the former section does not even apply to SOX section 404, which is not part of the Exchange Act, while the latter provides only for rules "in furtherance of this Act," which, arguably, would not include a broad exemption. See William Sjostrom, "Can the SEC Exempt Small Companies from Sarbanes-Oxley 404?" (part 2), *Truth on the Market*, February 27, 2006, http://www.truthonthemarket.com/2006/02/27/can-the-sec-exempt-small-companies-from-sarbanes-oxley-404-part-2/.

5. 119 Stat. 4, http://files.findlaw.com/news.findlaw.com/hdocs/docs/clssactns/cafa05.pdf (accessed April 2, 2006).

6. See p. 80, n. 12.

7. 125 S.Ct., 1634.

8. See, generally, Easterbrook and Fischel, *Economic Structure of Corporate Law*, chapter 11.

9. See SEC rule 14a-8.

10. The SEC's Advisory Committee on Smaller Public Companies is considering a broad opt-in proposal for smaller firms; see SEC Advisory Committee, "Final Report," 40–42.

11. See chapter 3, p. 35.

12. See SEC rules 3b-4(b) and 3b-4(c).

13. See Ribstein, "Cross-Listing and Regulatory Competition."

14. See chapter 1, p. 14.

Chapter 8: The Future: Regulatory Hubris or Greater Humility?

1. James Fanto, "Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation," January 4, 2006, Social Science Research Network Working Paper Series, Brooklyn Law School Legal Studies Paper No. 49, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=873667 (accessed March 21, 2006). For a critique, see Larry E. Ribstein, "Business Corporations as Banks: The Next Step in Corporate Governance Reform?" *Ideoblog*, January 21, 2006, http://busmovie.typepad.com/ideoblog/2006/01/business_corpor.html (accessed April 3, 2006).

2. Ohio e-CPA Weekly, "Oxley Says Some SOX Reforms 'Excessive'" (quoting *Financial Times*), http://www.ohioscpa.com/publications/ohiocpa/default.asp?article=3505-1 (accessed April 3, 2006).

3. See Congressional Research Service, Library of Congress, "USA Patriot Act Sunset: Provisions that Expire on December 31, 2005," http://fpc.state.gov/documents/organization/34499.pdf (accessed April 3, 2006).

4. See Stephen Choi, "Market Lessons for Gatekeepers," *Northwestern University Law Review* 92, no. 3 (1998): 916–66.

5. Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 1595–97, also discusses the possibility of optional regulation.

6. It may be necessary to adjust disclosure requirements to be sure they produce meaningful information. See Sridhar Arcot and Valentina Giulia Bruno, "In Letter But Not in Spirit: An Analysis of Corporate Governance in the UK," Social Science Research Network Working Paper Series, May 26, 2005, http://papers.ssrn.com/paper.taf?abstract_id=819784 (accessed March 21, 2006) (showing that firms increasingly are complying with the "comply or explain" regulations in the United Kingdom, but often using standard explanations for noncompliance).

7. See chapter 3.

8. See Lawrence A. Cunningham, *Outsmarting the Smart Money* (New York: McGraw-Hill, 2002), 181–200; Lawrence A. Cunningham, "Behavioral Finance and Investor Governance," *Washington and Lee Law Review* 59, no. 3 (Summer 2003): 767–838.

9. The SEC has already moved in this direction. See Securities Exchange Commission, "Analyzing Analyst Recommendations" (suggesting that investors note potential conflicts inherent in analyst recommendations), http://www.sec.gov/investor/pubs/analysts.htm (accessed April 3, 2006).

10. See Donald C. Langevoort, "Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda," *Villanova Law Review* 48, no. 4 (2003): 1139–66 (arguing that the SEC must try "to persuade investors that the issuers are honest enough to justify broad and confident public participation without committing its own version of a fraud on the market"); see also Donald C. Langevoort, "Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation," *Northwestern University Law Review* 97, no. 1 (2002–3): 151 (discussing the "myth" of desirability of encouraging trading by the retail investor); Henry T. C. Hu, "Faith and Magic: Investor Beliefs and Government Neutrality," *Texas Law Review* 78, no. 4 (2000): 883 (noting that government intervention "has led many investors to believe that [the Federal Reserve] can and would prevent a stock market crash").

11. Securities and Exchange Commission, "Selective Disclosure and Insider Trading," Exchange Act Release 33-7881, August 15, 2000, http://www.sec.gov/rules/final/33-7881.htm (accessed April 7, 2006).

12. See Laura S. Unger (commissioner), "SEC Special Study: Regulation Fair Disclosure Revisited," December 2001, http://www.sec.gov/news/studies/ regfdstudy.htm (accessed April 3, 2006).

13. See Anwer S. Ahmed and Richard A. Schneible Jr., "Did Regulation Fair Disclosure Level the Playing Field? Evidence from an Analysis of Changes in Trading Volume and Stock Price Reactions to Earnings Announcements," Social Science Research Network Working Paper Series, January 22, 2004, http://papers.ssrn.com/paper.taf?abstract_id=498002 (accessed March 21, 2006).

14. Anup Agrawal, Sahiba Chadha, and Mark A. Chen, "Who is Afraid of Reg FD? The Behavior and Performance of Sell-Side Analysts Following the SEC's Fair Disclosure Rules," Social Science Research Network Working Paper Series, paper presented at AFA 2003 Washington, D.C., meetings, October 2002, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=738685 (March 21, 2006).

15. See David D. Haddock and Jonathan R. Macey, "A Coasian Model of Insider Trading," *Northwestern University Law Review* 80, no. 6 (1986): 1449–72.

About the Authors

Henry N. Butler is the James Farley Professor of Economics, Argyros School of Business and Economics, Chapman University. He earned his B.A. in economics from the University of Richmond, M.A. and Ph.D. in economics from Virginia Tech, and J.D. from the University of Miami. His research interests include corporate governance, federalism, and law and economics. He recently completed the second edition of his casebook, *Economics Analysis for Lawyers* (co-authored with Christopher Drahozal). He has devoted a substantial amount of his career to improving our nation's judiciary through various judicial education programs. He is currently Director of the Judicial Education Program offered by the AEI-Brookings Joint Center for Regulatory Studies.

Larry E. Ribstein is the Richard and Marie Corman Professor of Law, University of Illinois College of Law. He earned his J.D. at the University of Chicago Law School, and his A.B. at Johns Hopkins University. Ribstein is a scholar in the areas of unincorporated business entities, partnerships, and limited liability companies, corporate and securities law, bankruptcy, and choice of law. He is the author of two casebooks on business associations, the leading multivolume treatises on partnership law and on limited liability companies, and has served as an editor of the *Supreme Court Economic Review.*

HESTEC 2006
SCHEDULE

Monday, Sept. 25, 2006
EDUCATOR DAY
HESTEC Educator Day is a premier teacher training conference that focuses on improving science and math instruction skills. Attendees pick up valuable continuing education credits as they listen to top education experts and motivational speakers. Educator Day will offer tracks for elementary, middle school and high school teachers and administrators.

UTPA SCIENCE SYMPOSIUM
World class researchers will present their research and encourage students to pursue advanced degrees in the sciences, mathematics, engineering and other technological fields. UTPA students selected by faculty for their research excellence will present in a poster session.

CONGRESSIONAL ROUNDTABLE ON SCIENCE LITERACY
Congressman Rubén Hinojosa (TX-15) brings together members of Congress, corporate and government executives and college administrators to share successful strategies to reach Hispanic students. The proceedings will be recorded and available via webcast to state and federal policy makers, colleges and universities and industry representatives.

HISPANIC NATIONAL MEDAL OF SCIENCE- The Álvarez Prize
HESTEC will unveil the Hispanic National Medal of Science, the Álvarez Prize, in 2006. A prestigious group of scientists will select the top Hispanic scientist or engineer from the nominations and applications received.

Tuesday, Sept. 26, 2006
STUDENT LEADERSHIP DAY
More than 1,000 high school students will develop their leadership skills by attending leadership building workshops and motivational seminars. In addition, these students will participate in a science related, hands-on competition within their schools before the winning entry is showcased at UTPA. In previous years, HESTEC has featured solar panel car races, wind generation and robotics competitions.

Wednesday, Sept. 27, 2006
LATINAS IN SCIENCE, MATH, ENGINEERING AND TECHNOLOGY DAY
Female high school students with their mothers will hear from prominent women executives and inspirational speakers. The speakers will highlight the important roles women play in these fields, encourage female students' interest in these areas and help mothers to provide encouragement and support to their daughters who choose to pursue careers in science, math and engineering.

Thursday, Sept. 28, 2006
HESTEC GEOGRAPHY SUMMIT
Middle school students will participate in hands-on workshops, competitions and listen to inspirational speakers - all activities designed to enlighten students about exciting careers in geography, engineering, science and technology.

Friday, Sept. 29, 2006
COLLEGE STUDENTS CAREER EXPO
Corporate and government organizations are invited to reserve exhibit space and meet with students from throughout the state who are seeking internships and career opportunities. Recruiters can receive students resumes in advance and schedule personal meetings.

Saturday, Sept. 30, 2006
COMMUNITY DAY

More than 20,000 attend Community Day making this an ideal event for organizations that want to promote their companies to parents, families, teachers and community members. Interactive exhibits, presentations and tours emphasize the importance of science literacy.

Contact us at hestec@utpa.edu

HESTEC 2006
KEYNOTE SPEAKERS

Congressional Roundtable on Science Literacy
Congressman Rubén Hinojosa, Congressman for the 15th District
Congressman Solomon Ortiz, Congressman for the 27th District
Congressman Lloyd Doggett, Congressman for the 25th District
Congressman Henry Cuellar, Congressman for the 28th District
Congressman Gene Green, Congressman for the 29th District
Blandina Cárdenas, President, UTPA
John Hofmeister, President of Shell Oil Company
Gilbert M. Grosvenor, Chairman, National Geographic Society
Laura Sanford, President, SBC Foundation
Sandra E. Ulsh, President of Ford Motor Company Fund
Marillyn A. Hewson, President and General Manager, Kelly Aviation Center...
Jeffrey J. Owens, President, Delphi Electronics & Safety
Raúl Yzaguirre, Former CEO and President of the National Council of La Raza
Mr. Del Velasquez, Vice President for Federal Government Relations, Verizon

Educator Day
John Hofmeister, President of Shell Oil Company
Orlando Figueroa, Director, MARS Program, NASA
Dr. Gerhard L. Salinger, Lead Program Director, National Science Foundation...

Superintendents' Summit
Sandra E. Ulsh, President of Ford Motor Company Fund
Hector Garza, President, National Council for Community and Education Partnerships
John Katzman, President, CEO Princeton Review
Dr. Peter Faletra, Director of Work Force Development of Teachers and Scientists...

College of Education Student Symposium
Dr. J. Michael Ortiz, President, California State Polytechnic University

College of Engineering & Science - University Symposium
Dr. Ivar Giaever, Nobel Prize in Physics 1973
Dr. John Purcell, Monsanto's Global Lead of Scientific Affairs

Ford Student Leadership Day
Camilo Pardo, Chief Designer, Living Legends Studios, Ford Motor Company
Mike de Irala, Executive Director, Manufacturing, Powertrain Operations, Ford Motor
Aaron Acuña, Ford Motor Company
Frank Flores, Ford Motor Company
Raul Samardzich, Ford Motor Company
Danny Ramirez, Ford Motor Company

Latinas in Science, Math, Engineering and Technology Day
Diane Rath, Texas Workforce Commission
Magda Yrizarry is vice president- Workplace Culture, Diversity and Compliance...
Romeo Perez, Planning, Business Analysis Manager, ExxonMobil Exploration Company...
Irene Garcia, Environmental/Regulatory Advisor, ExxonMobil Development Company
Mayela Quezada, Design Engineer, ExxonMobil Pipeline Company
Monica Saenz, GIS Mapping & CADD Coordinator, ExxonMobil Pipeline Company
Captain Kathlene Contres, Commandant DEOMI, U.S. Navy (Moderator)
Lt. Alexis Miller, U.S. Naval Academy, Admissions
Danielle Matsumoto, U.S. Naval Academy, Admissions
Commander Nora Perez, Department Head of Imaging at the Naval School of Health...

Emily Reina, Ford Motor Company
Sonya Galan, Manager, Finance Leadership Development Texas Instruments (Moderator)
Alma Martinez Fallon, President, The Society of Women Engineers (SWE), Manager.
Lorna Muniz Farr, Manager of Hispanic Advertising and Marketing, H-E-B

HESTEC Geography Summit
Mark Olson, Plant Biologist
Sylvia A. Earle, Oceanographer
Sandra Diaz, Chief Meteorologist, El Paso/Las Cruces FOX affiliate

Community day
Cheech Marin, Actor Art Collector
Vikki Carr, International renowned singer
Marjorie Agosin, Guest author
Dr. Steven Schneider, Author

HESTEC 2005 | *Highlights*

Overview

The world is in a race for tomorrow, and many of our children are being left behind. Although America is the strongest nation on earth, we seem to lack the national commitment essential to ensuring our country's future as a world technology leader.

Such is dramatically demonstrated among Hispanics, the largest minority in the United States. Few Hispanic students go on to college, even fewer graduate, and only a tiny percentage receive degrees in math, science or engineering. Why? Because we failed to give them the tools or the inspiration to do the job.

The world is in a race for tomorrow

Forty years ago, American astronauts were first to walk to the moon. Today, we're in a new global race, and HESTEC, a year-round leadership program, pioneered by The University of Texas-Pan American and Congressman Rubén Hinojosa, encourages Hispanic students to help build a path to participation in a more technologically advanced future, by boosting college enrollment numbers, increasing graduation rates, and opening the doors for the scientists, engineers, and mathematicians of tomorrow.

The future begins at HESTEC!

HESTEC 2005 | *Overview*

JOIN US AT HESTEC 2005

Developed by Congressman Rubén Hinojosa and the University of Texas-Pan American, Hispanic Engineering, Science & Technology (HESTEC) Week is a year-round leadership program that emphasizes the importance of science literacy to thousands of pre-k to college students and teachers. Through professional development workshops, presentations by world class speakers, competitions and hands-on activities, participants are encouraged to prepare for studies in math, engineering, technology and science.

The importance of HESTEC has never been greater-statistics show that the United States is falling behind in the numbers of students excelling in the areas of science, math and engineering and these figures are even more alarming among Hispanics and other minority groups.

A high percentage of Hispanic school-age children come from low-income families, and statistics show students in low-income households are twice as likely as their high-income classmates to score below basic achievement levels. As a result, few Hispanic students go on to college, much less graduate, and only a tiny percentage end up with a degree in math, science or engineering. The numbers seem daunting, but partnerships like those forged at HESTEC between schools, government agencies and corporate America, are the key to a better future.

During HESTEC, we give children and teachers the necessary tools and encourage them to reach for new heights. Students and educators interact with some of our country's top CEO's, engineers, scientists, astronauts and designers. Events like Educator Day, the Hispanic Science Literary Roundtable, Latinas in Science, Engineering and Technology, Robotics Competitions and Community Day allow students and educators the opportunities to meet top role models and learn valuable leadership lessons. In addition, more than $1.4 million has been raised for student scholarships.

Join us at HESTEC 2005 and help our children and educators
Reach Heights Never Reached Before!

HESTEC 2005 | *Exhibits*

College Students Career Expo

Friday, September 30, 2005
10 a.m. to 3 p.m.
Students from UTPA and other universities throughout South Texas will have the opportunity to seek jobs and internships.

HESTEC 2005 EXHIBITOR SCHEDULE
Thursday, September 29, 2005
5 p.m. – 11 p.m. Exhibitor Set-up
6 p.m. – 8 p.m. Student/Employer Networking Social

Friday, September 30, 2005
7 a.m. – 9 a.m. Exhibitor Set-up continues
10 a.m. – 3 p.m. College Students Career Expo
11:30 – 1:30 p.m. Exhibitor Lunch

Exhibition Costs
Corporate
Early Registration Discount by July 31, 2005 $250
Single Booth Registration $750
- 10' X 10' carpeted exhibit space
- One 6 foot-draped table with two chairs
- Company Sign
- Campus wide advertising to students
- Continental Breakfast, lunch and bottled water for two recruiters

Double Booth Registration $1000
- 10' X 20' carpeted exhibit space
- Two 6 foot-draped table with four chairs
- Company Sign
- Campus wide advertising to students
- Continental Breakfast, lunch and bottled water for four recruiters

Government/Non-Profit Organization
Early Registration Discount by July 31, 2005 $150
Single Booth Registration $500
- 10' X 10' carpeted exhibit space
- One 6 foot-draped table with two chairs
- Company Sign
- Campus wide advertising to students
- Continental Breakfast, lunch and bottled water for two recruiters

All Participating Companies will have:

- A booth at Community Day
- Tickets to Student/Employer Networking Social
- VIP tickets for Latinas Day Luncheon
- Program advertisement as HESTEC Exhibitor
- Access to conference area for interviews

l booths will have a basic 10 amp/120 volt electrical outlet at the Career Expo a
›mmunity Day.

ıdditional Company recruiter will be charged $25.

)LLEGE STUDENTS CAREER EXPO CONTACT
elissa De la Garza and Susie Chapa
6-381-2243
reer_place@utpa.edu

'ommunity Day at UTPA

'turday, October 1, 2005
›.m. to 9 p.m.
ore than 20,000 students, families and community members are expected to
end Community Day. The fun, family event will feature tours, presentations
d entertainment.

ıhibitor Schedule
ı.m. – 2 p.m. Exhibitor Set-up (Community Day)
›.m. – 9 p.m. Community Day at UTPA
›.m. Exhibit Tear-down

ıhibitor Costs
›rporate $500
›vernment/Non-profit Organization $250

ıhibitor Packet
- One exterior 10'x10' pipe and draped exhibit space with one 6' table, two chairs and a basic
- 10 amp/120 volt electrical outlet
- Program Advertisement as HESTEC Exhibitor
- Exhibitors invited to display information that will contribute to the learning experiences of students, their families and the community. In addition to scien

math and technology, suggested areas include diet and health, financial wellbeing, literacy and educational resources.

Community Day Exhibitor Contact:
Jessica Salinas
956-292-7547