COMMITTEE ON CAPITAL MARKETS REGULATION

The Committee on Capital Markets Regulation is an independent and bipartisan group comprised of 22 leaders from the investor community, business, finance, law, accounting, and academia. It was assembled in 2005 and 2006 and is directed by Prof. Hal Scott, Nomura Professor and Director of Program on International Financial Systems at Harvard Law School. The Committee Co-Chairs are Glenn Hubbard, Dean of Columbia Business School, and John L. Thornton, Chairman of the Brookings Institution.

On November 30, 2006, the Committee issued its interim report, highlighting six areas of concern about the competitiveness of U.S. capital markets and outlining 32 recommendations in four key areas to enhance that competitiveness. These findings and recommendations are summarized in a separate posting on this web site, entitled "Interim Report Highlights".

In addition to research on the regulation of capital markets and shareholder rights, over the next two years the Committee also will study the competitiveness of mutual funds and derivatives markets. It will issue reports of its findings, along with policy recommendations, and will seek to stimulate and participate in public discussion on the issues it finds are influencing the competitiveness of U.S. capital markets.

Findings on U.S. Capital Markets Competitiveness

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

- 5% of the value of global initial public offerings was raised in the U.S. last year, compared to 50% in 2000.

- The U.S. share of total equity capital raised in the world's 10 top countries has declined to 27.9% so far this year from 41% in 1995.

- The decrease in U.S. listing premiums erodes the traditional edge maintained by the U.S. on cheaper cost of capital.

- Private equity firms, almost non-existent in 1980, sponsored more than $200 billion of capital commitments last year alone.

- Since 2003, private equity fundraising in the U.S. has even exceeded net cash flows into mutual funds and going private transactions have accounted for more than a quarter of publicly announced takeovers. The increased use of private markets disadvantages the average investor, who typically cannot participate in such markets.

- The dramatic increase in the use of private U.S. markets is important evidence that regulation and litigation are contributing to the flight of many companies from the public market.

Key Recommendations

The Committee's 32 recommendations follow from these findings and from its members' beliefs that enhancing shareholder rights while curbing excessive regulation and litigation will make the U.S. capital markets more competitive. To this end the Committee will explore and undertake research on issues affecting competitiveness and will develop and support recommendations for policy changes designed to strike a better balance between the benefits and costs of regulation and litigation. Investor protection and shareholder rights are bedrock principles underlying investor confidence in U.S. capital markets. Enhancing shareholder rights while simultaneously making regulation more cost effective will strengthen the competitiveness of U.S. capital markets and let market participants compete on the basis of creativity, service, technology and price.

U.S. capital markets historically have been the deepest, most liquid, and lowest cost alternative. Today, global competition is changing the landscape to the benefit of international businesses and the global economy. Now there are several viable markets for raising capital, and companies are using cost-benefit analysis- including the potential cost of litigation and the complexity of regulation to differentiate among these markets as well as among institutional providers. The stakes are high because of the pervasive impact of capital markets in ensuring economic growth, job creation, low cost of capital, innovation, service quality, entrepreneurship and a strong tax base in key areas of the country.

The Sarbanes-Oxley Act of 2002 helped restore market confidence after several high profile scandals. However, the cost of auditing internal controls has proven to be unnecessarily high and needs to be brought down. The major problem is the cost of litigation. The best opportunity to avoid or at least decrease this cost is to give shareholders the right to choose more efficient ways to resolve disputes with companies.

Following are highlights of the Committee's recommendations from each of the four areas of the report:

Shareholder Rights

- Classified boards should be required to obtain shareholder authorization to adopt a poison pill, and if this is not done within three months, the pill should automatically be redeemed.

- The Committee endorsed a cornerstone of shareholder rights – majority rather than plurality voting – and will devote further study to how best to apply this standard.

- Shareholders should be given the choice to decide how disputes with their companies should be resolved – through arbitration (with or without class actions) or non-jury trials.

- The SEC should resolve issues on ballot access caused by a recent court decision.

Regulatory Process

- The SEC and self-regulatory organizations should move to a more risk-based regulatory process, emphasizing the costs and benefits of new rules. In weighing the costs and benefits of new rules, regulators should rely on empirical evidence to the extent possible. Also to the extent possible, regulations should rely on principles-based rules and guidance.

- The SEC should periodically test existing rules to ensure they still meet reasonable cost/benefit standards.

- Public enforcement bodies like the SEC, Justice Department and state securities commissioners and attorneys general need to coordinate their activities, providing for federal precedence where enforcement implications are national in scope. There should be more effective communication and cooperation among federal regulators. The President's Working Group on Financial Markets is one natural venue for ensuring such cooperation.

Public and Private Enforcement

- Greater clarity for private litigation under SEC Rule 10b-5, and from the SEC on materiality, scienter (knowledge of wrongdoing) and reliance is needed. Criminal enforcement against companies should be a last resort, reserved for companies that have become criminal enterprises from top to bottom. Nor should outside directors be held responsible for corporate malfeasance that they cannot possibly detect.

- Public enforcement authorities should not be allowed to threaten corporate defendants with denial of their employees' right to due process.

- Outside board members who rely in good faith on the validity of audited financial statements should be shielded against liability by the SEC. Otherwise, it will be difficult to attract independent directors to boards.

- Congress should consider protecting audit firms against catastrophic loss by providing caps or safe harbors, as some European countries do now, and as the European Union is actively considering. The misuse of such protection must meet with stiff penalties for those responsible for misconduct.

Sarbanes-Oxley

- The SEC should adopt a more reasonable materiality standard both for evaluating the adequacy of internal controls and for financial statements.

- The SEC and the PCAOB should adopt enhanced guidance on auditors' roles and duties in testing for compliance with Section 404.

- If the SEC finds that, even after the general reforms outlined above are implemented, the revised Section 404 is still too burdensome for small companies (those with $75 million market cap or less), it should recommend that Congress exempt small companies from auditor attestation and instead subject them to a more reasonable standard for management certification.