THE WALL STREET JOURNAL.

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit http://www.djreprints.com.

http://www.wsj.com/articles/SB116217329560707445

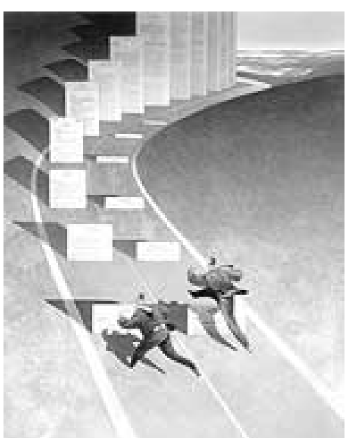
COMMENTARY

Is the U.S. Losing Ground?

By **R. GLENN HUBBARD** and **JOHN L. THORNTON**

Updated Oct. 30, 2006 12:01 a.m. ET

Corporate scandals over the past five years have fittingly brought the integrity of U.S. capital markets under scrutiny, provoking a significant legislative and regulatory response. The response was intended to strengthen protections for investors and to improve the traditional advantages of the U.S. market-transparency and accuracy in accounting and financial reporting, as well as laws and regulations that provide the proper incentives for good corporate governance. The events and the responses to them are as great as those underlying our bedrock securities laws of the 1930s.



Corbis

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

* * *

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

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

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

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

And questions remain as to whether the conflict-of-interest issues emphasized by Sarbanes-Oxley Section 404 got at the bigger problems from an economic perspective. There is a need to consider more seriously the role played by takeover mechanisms -- and the market -- in matters of corporate control and shareholder rights.

Since the new regulatory mechanisms have been put in place, developments in the U.S. capital market have not been positive. In 2000, 90% of the funds raised by foreign companies through new stock offerings were raised in the U.S. The "90% rule" held in 2005, too, but in reverse -- 90% of the funds raised by foreign firms through new listings occurred in Europe and other non-U.S. markets. Last year, only two of the world's 25 largest initial public offerings listed in the U.S.

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

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

In addition to regulation and accounting standards, the liability system can also affect the competitiveness of U.S. markets. Firms are sometimes confronted with circumstances in litigation, including securities class-action suits, where even a small probability of loss, given the size of claims, could result in bankruptcy. Consequently, companies often must agree to large settlements that result in reduced value for shareholders rather than pursuing a successful outcome on the merits of its case. Further, public companies are exposed to criminal prosecution which can lead to the collapse of the firm, as witnessed in the case of Arthur Andersen. Such a system rightly punishes the managers who have violated the rules. But it may also punish innocent parties -- employees, shareholders and the many firms who had conducted legitimate and profitable business relations with the now defunct enterprise. Do these dynamics have an effect on companies' willingness to issue securities in U.S. capital markets?

* * *

We announced on Sept. 12 the formation of a Committee on Capital Markets Regulation, an independent and nonpartisan group of academic, business, financial and corporate governance leaders. Our committee, working through task forces that will include additional academic and business leaders, is conducting a study of the competitiveness of U.S. public capital market, taking into account questions of investor confidence, liquidity, cost of capital and costs of regulation borne by shareholders directly or the economy as a whole. Our goal is to provide carefully considered recommendations for adjustments to the current regulatory and liability framework. On Nov. 30, we will issue our first report to policy makers.

The work of our committee is proceeding along three paths. First, the committee is synthesizing research by economists and legal scholars on a range of regulatory and liability issues affecting the competitiveness of U.S. capital markets. Second, the committee is integrating research on the measurement of benefits and costs of regulatory interventions. And third, the committee is evaluating alternative recommendations for applying cost-benefit analysis in assessing financial regulation and its benefits and costs for the competitiveness of U.S. capital markets. The committee will also evaluate principle- and risk-based alternatives to the present "rules-based" regulatory approach in order to understand how such mechanisms might affect the way managers incorporate the spirit and intent of financial regulations, as well as following the technical rules.

Rolling back the Sarbanes-Oxley law wholesale is not the answer. But subjecting regulation to rigorous cost-benefit analysis is surely right. Though much of the regulatory scrutiny will lie with the SEC and the PCAOB, we can also harness the expertise within other departments and agencies represented in the President's Working Group on Financial Markets, which includes the Department of Treasury, Federal Reserve and the Commodity Futures Trading Commission. Input from such institutions that have primary responsibility for investor protection will be necessary to prudently address broad tradeoffs between regulation and possible consequences of lost competitiveness.

America's capital markets have been an enviable model for job creation and increasing national wealth. But the efficiency and competitiveness of our markets cannot be taken for granted. Cost-benefit analysis of regulatory change may provide insights that could enhance the efficiency of our markets and strengthen investor protection at the same time. We should explore ideas that can help assure that new regulation does not inadvertently diminish the benefits of our markets by not accounting for regulatory costs.

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

Copyright 2014 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.